

A HOME FOR YOUR FAMILY 8

Financial Aspects of Home Ownership

While you may buy a home to shelter your family, your housing dollars buy more than just shelter. A home can be a good long-term investment if your equity increases. Home equity is the difference between a house's current value and any outstanding mortgages. Home ownership can reduce your income taxes. And, if the house is in good condition, home ownership can stabilize your housing costs.

Increasing Equity

The equity you have in your house will reflect any growth in the value of your home. The down payment you make may provide you with some initial equity. (Closing costs do not.) You can influence but you cannot control changes in equity.

Equity can increase in several ways:

- The value of a house may increase due to home improvements.
- Inflation and local supply and demand for homes may increase value. During times of inflation, the largest portion of Americans' net worth is their home equity.
- As you steadily repay your mortgage, you are building equity.

Improvements. Some improvements increase the value of the house while others do not. Improvements rarely increase the value of the house dollar for dollar. For example, don't expect a \$10,000 improvement to a \$60,000 house to make the house worth \$70,000. Improvements are most likely to increase a house's appraised value if neighboring houses are larger or in better condition. Conversely, if surrounding homes are smaller or have not been kept up, the cost of improvements to your home is less

likely to increase its value. It is important that you monitor the condition of the houses in your neighborhood.

Appreciation. Your house is said to "appreciate" when its value increases without any improvements being made. Factors that affect the rate of appreciation include interest rates, inflation rates, house prices, and the state of the local economy.

Principal Repayment. Part of your monthly mortgage payment will repay the borrowed money (the principal). During the early years of a loan, most of your monthly payment will be for interest on the loan. Slowly, over time, a higher percentage of each payment will go toward principal. Many loans have an option that allows you to make extra payments toward the principal in addition to the basic payment. Ask your mortgage company about its policy.

Tax Benefits

When you purchase a house, you are not just buying protection from the elements; you are also protecting some of your income from federal and state taxes. As a homeowner, you can deduct a portion of your total monthly housing cost from your federal income tax. Mortgage interest and property taxes are both deductible on your personal income tax return.

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During the early years of your mortgage, almost the entire payment will be tax deductible. However, the lower the interest rate, the more quickly the tax advantage will decrease.

To determine the impact home ownership will have on your income taxes, you need to know your marginal tax rate (and income tax bracket). To discover your marginal tax rate, find the amount of your “taxable income” on your most recent tax return. Then use the following federal and state income tax brackets to learn your current marginal tax rate.

FEDERAL INCOME TAX BRACKETS

for 1994 tax year

Joint Returns

| Taxable Income | Tax Rate |
|---------------------|----------|
| 0 - \$ 36,900 | 15% |
| \$ 36,901 - 89,150 | 28% |
| \$ 89,151 - 140,000 | 31% |
| \$140,001 - 250,000 | 36% |
| Over \$250,000 | 39.6% |

Single Returns

| Taxable Income | Tax Rate |
|---------------------|----------|
| 0 - \$ 22,100 | 15% |
| \$ 22,101 - 53,500 | 28% |
| \$ 53,501 - 115,000 | 31% |
| \$115,001 - 250,000 | 36% |
| Over \$250,000 | 39.6% |

STATE INCOME TAX BRACKETS

for 1994 tax year

Joint Returns

| Taxable Income | Tax Rate |
|---------------------|----------|
| 0 - \$ 21,250 | 6% |
| \$ 21,251 - 100,000 | 7% |
| over \$100,000 | 7.75% |

Single Returns

| Taxable Income | Tax Rate |
|-------------------|----------|
| 0 - \$ 12,750 | 6% |
| \$12,751 - 60,000 | 7% |
| Over \$60,000 | 7.75% |

To calculate the approximate benefit of your deductions for housing, follow these simplified steps. Add your federal income tax rate and your state income tax rate, for example, 15% + 7% = 22%. Multiply that combined tax rate by the amount of your deductions for housing to learn the dollar amount by which the taxes you owe (and thus your housing expenses) will be reduced. In the same example, a person with a combined tax rate of 22% who

claims \$8,780 in housing deductions (for interest payments and property taxes) will pay \$1,933.80 less in federal and state taxes. This is an actual dollar savings of \$161.15 each month.

In general, the tax benefits of home ownership increase with increases in the size of the household’s marginal tax rate, the size of the housing payment, the interest rate charged, and the length of the term of the mortgage.

CAUTION: Many financial institutions today encourage homeowners to use the equity in their home as security for a loan or for a line of credit. The usual sales pitch is based on the fact that the interest payments on such loans will be tax deductible, while the interest on consumer credit loans is not. Homeowners should think long and hard about using this source of credit. If you were to lose your job or have a serious medical condition, would you be able to repay the loan or meet the credit payments? If not, you have placed your home at risk. Older people who want to stay in their homes, but have insufficient cash for living expenses, now have a way to tap into their home equity without risking the loss of their homes. This approach is referred to as a home equity conversion mortgage or HECM. (An increasingly common form of HECM is the Reverse Annuity Mortgage.) North Carolina law requires special counseling for older homeowners before they may enter into such an agreement.

Financial Planning Tips

Saving for a down payment and closing costs is well worth the effort and patience it takes. In addition to accumulating ready cash for a down payment and closing costs, you’ll need to plan and prepare for other important financial decisions—before purchase, at the time of purchase, and after you’re in your home.

Adjust Tax Withholding.

Many people have more taxes withheld than they need to. Although the money withheld will be returned to you after you file your income tax return, you will have lost the use of the money for part of the year. You may need this money for additional costs as you move into your new house, or you could be drawing interest on it from some sort of savings or investments. By completing a W-4 form correctly, you can avoid overwithholding. Ideally, you and “Uncle Sam” should come out about even each year. The beginning of a new tax year is the best time to check your

W-4, so that the amount withheld is more nearly accurate from the start.

A first or trade-up house generally brings with it higher tax deductions than you have taken previously, as interest on your new mortgage and property taxes are both deductible under current income tax law. When buying a house, a new W-4 work sheet should be completed as soon as you know the amount of mortgage interest and property tax you will be paying.

Select Appropriate Insurance.

Homeowners should plan for and be prepared to make decisions about three different kinds of insurance: homeowner's insurance, mortgage insurance, and perhaps mortgage life insurance.

Homeowners (HO) insurance protects against damage to your home and personal property. The amount of insurance carried on the dwelling is the most important figure because other property loss limits are usually stated as a percentage of this figure. Homeowners insurance also protects against liability for other persons' injuries or damage to their property. For example, if your dog bites a neighborhood jogger, or if a limb falls from one of your trees and damages a neighbor's car, the insurance company will generally pay for damages—up to the limits of the policy.

Four different standard HO policies are approved for sale to homeowners in North Carolina. (See Extension publication HE-443, *Homeowners and Renters Insurance*.) Most insurers require that a house be covered for at least 80 percent of its replacement cost. This is the amount you would need to spend today to rebuild the house, excluding the value of the land and the foundation. The 80 percent figure represents the minimum required to receive full payment for a partial loss. For example, suppose your house has a replacement cost of \$50,000 and you insure it for the required 80 percent, or \$40,000. If you incur a \$20,000 loss, you will receive full payment. To determine the replacement cost of your house, request a copy of your lender's appraisal or ask a licensed property and casualty insurance agent to calculate it for you. The standard method of determining replacement cost is to multiply local construction costs per square foot by the number of square feet in a house.

Mortgage Insurance will repay the lender in case you do not meet your mortgage payments. You, the borrower, must pay the premiums for this insurance, either "up front" at time of closing, or spread out over time.

Mortgage Life Insurance will probably be offered to you. It would pay the lender the balance due if you should die before the loan is paid off. If you already have enough life insurance to cover the gradually-decreasing size of your mortgage debt, you may not need or want this decreasing term life insurance.

Consider Prepaying Principal.

Prepayment of principal reduces the total interest costs of a home mortgage and pays the loan off months, even years, sooner than scheduled. With as little as an extra \$25 a month, homeowners can save thousands of dollars over time. (But consider whether a different after-tax investment return is available that would be greater than the benefit of prepaying your mortgage. For example, if you could earn a 20 percent return in the stock market and your mortgage interest rate is 7 percent, the better investment might be the stock market.)

Many homeowners, especially first-time buyers, are shocked to see the total amount of interest they pay on a mortgage. Although the interest is tax deductible, it is still money out of their pockets. For example, a \$40,000, 30-year conventional mortgage at 10 1/2 percent costs \$366 per month. After 360 payments you will have paid \$131,760, of which \$92,760 is interest. If you prepay an extra \$34 per month (\$400 per month total payment), the loan would be paid in 20 years instead of 30 years, and you would have paid \$96,000 instead of \$131,760—a reduction of \$35,760 in interest payments. (One reason for greater finance charges over a long period of time is that the value of money repaid to the lender will have declined near the end of the loan period due to the effects of inflation.)

Maximize Tax Deductions.

Mortgage interest and property taxes on a first and second home are fully tax deductible if you itemize deductions. Points paid to obtain a mortgage on a new primary residence are fully deductible by the buyer in the year of the purchase, regardless of whether the buyer or seller pays the points. Points are an advance interest charge imposed by lenders and can lower the mortgage interest rate. Each point equals 1 percent of the mortgage amount. Thus, if a lender charges three points on a \$60,000 loan, this would amount to a deduction of \$1,800 from the \$60,000. If, in the future, you refinance your home mortgage, the points must be amortized over the entire length of the loan, meaning the deductibility of the points must be spread out over the life of the loan.

Keep Good Records.

A house is considered a capital asset. Like any other investment, if it is sold for a profit, capital gains tax may be owed. Taxes can be deferred, however, if a house of greater or equal value to the one being sold is purchased within 2 years. Persons over 55 (or couples with at least one spouse over 55) who have lived in a home for at least 3 of the 5 years prior to its sale, are also eligible for a \$125,000 capital gains tax exclusion, which can be used only once in a lifetime.

It is important to save all records pertaining to capital improvements on your house from the moment you buy it. These records should be placed in a file separate from your annual tax records and maintained for as long as you own the house, plus 3 years. When you finally sell the house, you can reduce your capital gains taxes to their lowest legal limit by increasing your tax basis.

Your tax basis is the purchase price of your house, plus certain acquisition costs paid at closing, plus capital improvements made over the years of home ownership. The higher your basis, the lower your capital gain and potential tax will be. Examples of capital improvements are landscaping, wall-to-wall carpet, addition of a room, a new roof, a garage-door opener, vinyl or aluminum siding, a finished basement, and a new furnace, septic system or water heater. Note that capital improvements are not the same as repairs or maintenance, such as painting walls or fixing broken window panes. A capital improvement must add to a property's value, prolong its life, or adapt it to a new use. Repairs merely maintain a house in an acceptable condition.

Each time you sell a house, you must complete IRS form 2119, *Sale or Exchange of Principal Residence*. This form asks questions such as how much you paid for your house and how much you sold it for.

Always keep a copy of these forms because you will need to refer back to them for future house purchases and sales. One house sale affects the cost basis for the next house, and you need to keep track of how much profit you are deferring. You may wish to ask a professional tax preparer for help.

Monitor Escrow Accounts.

An escrow account is a fund established by your lender to pay for property taxes and homeowners insurance as they become due on your house during the year. The escrow account protects both the bank's and your investment in your house. For example, if you did not pay your homeowners and flood insurance premiums, a fire or flood that destroyed your house would also destroy the lender's collateral.

Most mortgage loans require an escrow account, but not all do. You may be able to negotiate with the lender for the right to pay your own taxes and insurance. By doing this,

you may avoid having your money tied up until it is needed. However, mortgages insured by the Federal Housing Administration (FHA) or Veterans Administration (VA) require escrow accounts. Mortgages insured by Farmers Home Administration (FmHA) may or may not require an escrow account, depending on your lender.

To have enough money to pay taxes and insurance when due, the lender adds 1/12 of the estimated annual amount due for taxes and insurance to your monthly mortgage payment. If the actual amounts due are greater than the amount in the escrow account, you will have to pay an additional lump sum. If the lender charges substantially more each month than is needed, that ties up your money unnecessarily. Most lenders send you an annual statement showing what has been paid from your escrow account and how much money (if any) remains. If there is a large amount of excess money you can ask for a refund and an adjustment of the amount you pay into the account in the future.

Be aware that changes in your property taxes or insurance premiums can cause your mortgage payments to change.

Summary

A house is probably the most expensive single purchase that most people ever make. A significant increase in value over time can provide funds for a child's education, for retirement, for investments such as additional real estate, or for long-term care costs in your later years. Be sure to review your financial situation regularly. Adequate insurance will increase your financial security, lower tax bills will improve your cash flow, and well-chosen home improvements and principal prepayment can increase your net worth.

Adapted from the following publications:

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