Getting Ahead II: Home Ownership Better Than Renting?

Saturdays With Jim

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Dear Friends,

Today we introduce a new series called Getting Ahead.   Should everyone who can qualify own a home? Do the benefits of owning a home outweigh the benefits of alternative uses of the significant chunk of money that must be committed to owning a private residence? The bottom line – maybe, for some.

Reasons for Buying

- Security of eventual 100% ownership (after mortgage paid)
- Freedom to modify, with desire to improve
- Participate in price increases, should they materialize
- As equity builds, financial reserve and attractive loan possibilities (equity lines of credit)
- Perceived respect in society
- Tax benefits for itemized income tax filers: mortgage interest, real estate tax and possibly other deductions depending on type of ownership
- Possible income from renting rooms (though could possibly sublet rented space, too)
- Broad choice of housing type (single, multi-family, etc.)

Reasons for Renting

- Flexibility, can move after lease period as desired
- No large commitment to purchase, can use home purchase for other investment
- Simple lifestyle – others do maintenance, pay taxes, etc.
- Renting frees the schedule and the mind for serious work or leisure pursuits

Discussion

Home ownership represents a dream and status for many people, the foundation of a lifestyle they choose and potentially several financial benefits. Indeed, it's generally true that people who desire to "nest" and perhaps raise a family are inclined to buy while people who do not have a family and value mobility choose to rent. But to blindly say that you want a home for purely financial reasons overlooks the important alternatives to dropping a large amount of money into a purchase whose value is expected to rise while its physical condition is deteriorating due to age and weather. Buying a home purely to receive the mortgage interest deduction ignores the fact that income tax must be itemized to claim it. The standard deduction is often more than the amount of mortgage interest and real estate tax combined, especially for a couple (about $6,000 for a single and about $12,000 for a couple). Let's peer more deeply into the financial benefit derived from home ownership and the opportunity cost involved (opportunity cost is the price you pay when you forego other financial alternatives).

Home Ownership vs. Other Financial Alternatives

The money you put into a home could go elsewhere. For example, if you have a 401(k) plan, you can contribute up to $18,000 into your 401(k) accounts over a year, $24,000 if you are over 50. Furthermore, in addition to any gain on those 401(k) contributions you get a deduction from current income tax. Other retirement plans may have lower contribution maximums. IRAs are available for those who don't have retirement plans where they work. Let's look at the factors to consider when making a rent or buy decision. Note that the decision need not be permanent. You can buy now to sell and rent later and vice versa. Selling a home for a profit of up to $500,000 is tax-free provided it was your primary residence for at least 24 months.

From a purely financial perspective, according to a study done for Hello Wallet in 2014, annual rent totaling under about 5% of the cost of purchasing a comparable dwelling makes renting more attractive. For example, suppose you find a two bedroom home for $300,000. A comparable apartment costing under $15,000 per year (5% of $300,000) is a better deal provided that you can save a substantial amount in a retirement plan or an IRA. If you just spend without saving as you rent, the rent advantage is lost.

If you are not yet ready to buy a house, you can always accumulate your down payment or more in your retirement plan or IRA. First time home buyers may withdraw up to $50,000 from IRAs and most retirement plans penalty-free at any age for that first home. Alternatively, you can borrow money from your 401(k) plan balances up to a maximum of 50% or $50,000 (whichever is lower).

Of course, there are a lot of unpredictable variables, such as the rate of home price appreciation, the rate of rent increases, the availability of desirable purchase and rental stock, etc. But one thing is clear. Buying when prices and interest rates are low makes more sense than buying when prices and rates are high. Be careful not to get trapped in the thought that housing cannot drop in value – it can – or that prices will continue going up during the period of ownership. On average, home prices dropped 43% during the financial crisis.

Thank you for being with us today and for placing some of your wealth under our care.