CONSIDERATIONS FOR PURCHASING A NEW HOME

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From the perspective of a financial planner, when buying a primary residence and borrowing money in the form of a mortgage to finance your home, you should buy with the expectation of living in the home for a 7-10 year period. Why 7-10 years, you may ask? At times there may be uncertainty around the current and future state of the economy. In the case that the economy falls into recession, you may find yourself with a home worth less than the current balance of your mortgage. In this case, should you need to sell your home you have not only lost the down payment and principal payments made in reducing the loan, you will also need to pay the bank to sell your home. Having a longer time horizon for your home allows for you to take your time and make a rational decision on when to sell your home, hopefully during a strong economic cycle.

New Home = New Expenses!

It is important to have a separate budget for the costs associated with purchasing and moving to a new home. Moving can be stressful and costs associated with moving add up quickly. A new and larger home might also mean new and more costly furniture. We always recommend that you take this into consideration. Planning and building a budget for the associated expenses and costs that come with purchasing and moving into a new home is an important component factoring into your total budget. Buying the house of your dreams is great, but if you blow your whole budget on the house you might struggle to furnish the home. Consider all of the variables to make an informed decision, stick within your budget, and be confident in your purchase!

Below, we've broken down a few other things to consider when buying a new home:

Borrowing Power: Prequalification vs. Preapproval

In most cases, you will likely need and want to finance the purchase of your new home. Thus, you will need to work with a bank or lender in order to understand what you can afford based on what a bank is willing to lend you. At this point a financial advisor or planner can help you understand what is affordable based on your financial picture. The planning that you do with an advisor can give you confidence in making this significant financial decision and should make it easier to work with the lender or bank.

There are two main methods for determining your potential borrowing power, prequalification and preapproval:

Prequalification is an early step in the homebuying journey. When you prequalify for a home loan, you are getting an estimate of what you might be able to borrow. The prequalification process is quick and easy as it does not require much in the sense of formal documentation of your finances.

Preapproval is a step above prequalification. Preapproval tells you what you can "actually" borrow. The preapproval process is a thorough analysis of your income, assets, credit history, and liabilities. The lender will request documentation and verify all your financial information. When you receive preapproval, the lender will likely approve you for much more money than you should consider spending on a home. Remember to stick to your budget as huge mortgage payments can become financially burdensome and that new home can quickly become your new nightmare.

Interest Rates and Their Impact on Homebuying:

Low interest rates in the current rate environment provide more buying power. Where as, higher interest rates provide less buying power. It is important to consider what potential higher interest rates in the future might mean for selling your home down the road to another buyer. Home values often move inversely to interest rates. For example, a $3,000 principal and interest payment on a 30-year 3% mortgage has a beginning loan balance of $711,568. If the interest rate increases to 4.5%, the amount of mortgage you can borrow on the same $3,000 payment will decrease by $119,485 to $592,083 representing a decrease of 16.79% in loan proceeds or the amount of the loan. Because the next buyer might be purchasing a home in a higher interest rate environment, homes values will often decrease to meet the new demand.

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Location, Location, Location:

Location is typically a key component in your search for a new home. Whether you are looking to be close to work or in a town with a reputable public school system, where you choose to live can have both pros and cons.

You will most likely pay more for the same type home in a more desirable area or neighborhood. Moving to another town may buy a bigger nicer home for the same price. However, consider why you might want or need the bigger home in the first place. With a bigger and often older home, you will be faced with higher maintenance and upkeep costs. A bigger home will most likely also cost more to furnish as well as have higher utilities costs associated with it.

While there is no perfect answer, do your research and stick to your budget!

Inspection and Third-Party Appraisal:

Before closing on a new home purchase, it is important to get a third-party inspection and appraisal performed. The main purpose of a home inspection is to give you the information needed to make an informed decision to go through with the purchase of a home. Most home inspections focus on the major defects that will cost the buyer a lot of money above the purchase price to repair. A home inspection can illuminate underlying costs of purchasing a home and in some cases, might cause you to rethink the purchase price or going through with the transaction all together. Lastly, an appraisal is used by the mortgage company to determine how much they are willing to let the homeowner borrow.

Owner's Title Insurance:

Owner's title insurance provides protection to the homeowner if someone sues and says they have a claim against the home before you purchased it.

When you purchase a home, you receive a document most often called a deed, which shows the sellers transferred their legal ownership, or "title" to their home, to you. Title insurance can protect you if someone later sues and says they have a claim against the home before you purchased it. Common claims come from a previous owners failing to pay taxes or from contractors who say they were not paid for work done on the home before you purchased it.

Most lenders require you to purchase a lender's title insurance policy, which protects the amount they lend you. Title insurance will pay you the purchase price of the house in the case of a serious legal title dispute.

Homeowners Insurance:

Homeowners insurance is made up of coverages that may help pay to repair or replace your home and belongings if they are damaged by certain perils, such as fire or theft. A homeowners policy may also help cover costs if you accidentally damage another person's property or if a visitor is injured at your home. When purchasing a home, it is important to make sure you have the correct homeowners insurance and are properly insured. Work with your insurance agent to ensure you are properly insured for other structures such as pools, sheds, detached garage, and/or any other valuable personal property such as art, jewelry and antique furniture, etc..

Consider an Umbrella Policy:

An umbrella policy is extra liability insurance that provides protection beyond existing limits and coverages to your homeowner's and auto policies. Umbrella polices can provide coverage for injuries, property damage, certain lawsuits, and personal liability situations. Essentially, an umbrella policy will cover most liability claims that exceed the underlying auto and homeowner's policy coverages. A few million dollars of additional coverage may only cost a few hundred dollars! For example, if someone trips on your stairs and seriously injures themselves, the fractional cost of adding an umbrella policy can save you from losing your home and more.

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Tax Treatment on Gain or Loss on the Sale of Your Principal Residence:

A principal residence is defined as the primary location that a person inhabits, also referred to as primary residence or main residence. It does not matter whether it is a house, apartment, trailer, or boat, as long as it is where an individual, couple, or family household lives most of the time.

What happens when you sell your principal residence for a gain?

In most cases, taxpayers must file taxes on capital gains from the sale of a property. However, when you sell your principal residence, you could potentially qualify for an exclusion of a $250,000 gain (individual) or $500,000 gain (married filing jointly) if you meet the following requirements according to the IRS:

1. You have owned the home and used it as your primary residence in at least two of the last five years preceding the sale of the property.
2. You did not acquire the home through a like-kind exchange in the past five years.
3. You did not exclude the gain from the sale of another home two years prior to the sale of this home.

For example, assume you and your spouse have lived in your principal residence for the past 10-years and sell your home for $800,000. If your cost basis is $425,000 (your original purchase price) your gain of $375,000 will not be taxed as it qualifies under the $500,000 married filing jointly exemption. This is a great benefit to owning a home.

What happens when you sell your principal residence for a loss?

Unfortunately, when you sell your principal residence for a loss (less then you bought it for), this loss is not tax deductible. Therefore, if you sell your home for $125,000 less than you bought it for, this loss is a personal non-deductible tax loss.

In conclusion, the purchase of a new home is most likely the largest financial decision people will make in their lifetime. Additionally, the cost to live in and maintain a home will also typically consume the largest portion of your annual cash flow. Thus, the decision to buy a home should not be taken lightly. Working with a financial planner to evaluate your budget and provide guidance in your home buying journey can give you confidence and peace of mind to ensure you are making an informed and smart financial decision.

Please feel free to contact us if you have any questions.

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This information is not intended to be a substitute for individualized tax advice. We suggest that you discuss your specific tax situation with a qualified tax advisor.

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