



Real Estate News & Information

Richland Properties

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Market Update - Inventory Levels

In the last several weeks, the Wall Street Journal, the San Francisco Chronicle and other local newspapers have written articles about the low levels of homes currently available for sale in California. This trend is also occurring in the Bay Area where the inventory levels of for sale homes have gone down from an average of around 6 to 8 month's worth of sales at the beginning of 2009 to around 2 to 3 month's worth of sales at the end of 2009 and to even lower levels in some neighborhoods. There are probably many reasons for the reduced inventory levels. However, there are several key ownership groups that affect the market more than others and these groups appear to have not been big sellers of homes at the end of 2009. These groups will be discussed below and are: (1) move-up buyers; (2) rental property owners; (3) owners of recently inherited properties, and (4) banks.

The first group of sellers is the move-up buyers. Move-up buyers traditionally sell homes at entry level price ranges and trade up into larger more established neighborhoods. Recently, these potential move-up buyers are staying in their current homes because their move is being affected by a bad job market, low levels of home equity, and a restrictive financing environment. Many move-up buyers who want to trade up into larger homes don't have confidence that their job is secure and don't want to take on higher levels of debt. Other potential move-up buyers have little or no equity in their homes which restricts their ability to sell their current home and transfer equity into a larger home. Still other move-up buyers who are secure in their jobs and want to sell and purchase a larger home are finding the difficult financing environment is not allowing them to buy their new home before selling their old one. These buyers as recently as 2 years ago would have taken out a home equity loan at a loan to value ratio as high as 95% allowing them to tap virtually all of their equity in their current home before selling it. Additionally, lenders were also allowing borrowers to obtain low-documentation loans at high loan to value ratios on second residences and investment properties. A common scenario had been for the move-up buyer to use a large home equity loan on their current home and then use a low-documentation purchase loan on the new larger second home. Now, move-up buyers are faced with the tough decision of trying to first sell their home before purchasing another. Many people are deciding to stay in their current homes for the immediate future. Going forward into 2010 and beyond, buyers may want to look for sellers who have little or no debt on their properties and who can provide temporary "seller financing" to the buyer. This temporary financing would allow the buyer to purchase the seller's property before having to market and sell their current home. We may also see buyers using more bridge loans from relatives and bridge loans from company sponsored employee assistance plans.

The second group of property owners, the rental property owner group, has been reluctant to sell their properties into a weak real estate market. These owners tend to affect inventory levels at various price ranges because they own properties in both the entry level markets as well as the move-up markets in the Bay Area. These owners tend to be older and are looking for stable investment income. With bank money rates at historically low rates and many dividend paying stocks suspending their payouts, it is easy to see why property owners are holding onto their properties until viable investment alternatives return. Many of these owners have significant levels of equity in their properties and have been able to refinance into historically low fixed interest rates. Consequently, they now have lower holding costs which allow them flexibility in renting their properties even as rental rates in the Bay Area have decreased. Even the small subset of rental property owners who bought properties at the market peak of a couple of years ago have not been willing to sell because they would be forced to sell at today's lower prices and recognize a loss. These owners will continue to hold their properties as rentals as long as the rental market allows them to rent their properties at levels which will cover their holding costs.

The third group of owners, the beneficiaries of inherited properties are also not moving fast to sell their properties. Many properties which have been inherited have little or no debt putting no forced pressure on heirs to sell. Additionally, some heirs appear to be in no hurry to sell into the current soft real estate market and are opting instead to rent out their properties. Additionally, with the low bank deposit rates and low yields from stocks currently, these owners are also not in any hurry to convert their real estate holdings to liquid investments. Over the last several years the federal estate tax exemption has continually gone up and as of 2009 was \$3,500,000 per estate which has allowed more families to keep their real estate assets instead of having to sell them to pay estate taxes. Again, going forward into 2010 and beyond, these owners may be more willing to part with their properties if one or more of the following occurs: (1) the rental markets continue to soften, (2) bank deposits and stocks begin to generate higher and more predictable streams of income, (3) the estate tax exemption gets dramatically reduced in 2010 and beyond or (4) rent control law changes keep occurring that make ownership of rental property in certain cities more problematic than other investment alternatives.

Lastly, the banks control a large level of inventory in the Bay Area. The banks control two groups of properties, the properties they own, or "REO" properties and the properties currently in the foreclosure or loan modification process. Regarding REO properties, banks appear to be selling them in a timely manner and not holding onto large amounts of these assets. The so called "shadow" inventory of properties owned by banks

and not currently on the market is probably not as large as people suspect in counties such as San Francisco, Marin and San Mateo. The interest level from investors for REO properties has been high and will continue to be high because investors in the Bay Area appear to be more comfortable with real estate than owning more stocks. Additionally, banks control properties as a result of their the negotiations with homeowners in the foreclosure process and who are "under water" with negative equity in their property. Banks have the ability to allow an underwater homeowner to sell their home via a "short sale". Short sales are now occurring with more regularity and certainty because congress recently put more pressure on banks to consider short sales as a viable alternative to foreclosure sales. However, at the end of 2009, there were fewer homes being marketed as short sales compared to the beginning of 2009. We should see the level of REO and short sale properties for sale increase in the first and second quarters of 2010 based on the current number of borrowers in the foreclosure process.

New Federal Income Tax Law Affects Conversions of Personal Residences to and from Rental Properties

Beginning in 2009, any gain from the sale or exchange of a principle residence that is allocated to periods of nonqualified use is not excluded from gross income. Nonqualified use generally means any period after January 1, 2009 during which the property is not used by the taxpayer as a principal residence. Renting a property or using it as a second home would be an example of nonqualified use. One exception to the new rule is when the nonqualified use (for example, renting out the property) occurs after the property has been used as the principal residence of the taxpayer during the 2 out of 5 year period for which the taxpayer is qualifying for the exclusion of gain on the sale of a principal residence.

This new rule is primarily aimed at taxing those individuals who have rental properties and who then decide to convert these rental properties into their principal residence for 2 years and then sell them. Prior to 2009, these taxpayers generally could have excluded up to \$250,000 (single taxpayers) or \$500,000 (married filing jointly taxpayers) from the sale of a principal residence. The new law will still allow taxpayers who have used their home as a principal residence for at least 2 consecutive years to then temporarily rent it out for a period of up to 3 years and still sell the home and utilize the \$250,000/\$500,000 gain exclusion. Before undertaking any sale of a residence that has previously been rented, you should discuss your plans with your tax or legal advisor to make sure this new law does not apply to you. Calculating gain under this new law will involve at least 2 calculations. First, any gain attributable to depreciation taken after May 6, 1997 on the property, is not eligible to be excluded from gross income. This is the current law and does not change. Second, the percentage of the gain allocated to periods of nonqualified use is calculated using a fraction based on the number of years of nonqualified use divided by the total number of years the taxpayer owned the home.

Conforming Loan Limits 1/1/2010

Currently in high-cost areas of the Bay Area such as San Francisco, Marin and San Mateo, the conforming loan limit for single family homes is \$729,750. This increased limit was enacted in 2008 and is currently still in effect. It should be noted however, that lenders still charge a slightly higher amount of loan points on loan amounts greater than \$417,000 but still under the conforming limit of \$729,750.

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New Tax Law for Converting Rental Properties to Personal Residences



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