NEI's Real Estate Report

Published Monthly By Anthony Newman of NEI Realty

MARCH 2007

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How to Sell Your Highly-Appreciated Home Tax-Free (or Almost)

by Diane Kennedy

It's been 10 years since Congress brought us the homeowner gain exclusion deduction ~ one of the most powerful and useful tax-saving tools ever given to homeowners.

The deduction itself is simple: If you have lived in your home for two out of the previous five years, you get a tax break when you sell it. If you're married and you file a joint tax return the first $500,000 of gain (the difference between what you paid to buy the property and what you sold it for) you make on the sale is tax-free. If you're single, you get a tax break on the first $250,000 of gain. What constitutes "living in" is pretty flexible, too. Those two years don't have to be consecutive, nor do you have to physically live in your home every day. The IRS allows you to have temporary absences from your home each year that can be up to 11.5 months! You can literally buy a home, live in it for 2-3 weeks per year for two years and take the entire tax-free gain exclusion.

In most cases, this is a great strategy ~ buy, hold for 2 years and sell, tax-free. But what happens when the tax-free gain exclusion amount is less than the profit you make on your home sale?

Sometimes the path of least resistance is the best path of all. Simply by taking the gain exclusion deduction you're saving $75,000 on the first $500,000 in profit. Because you've owned the property for more than one year, the remaining profit will only be taxed at the capital gains rate of 15 percent.

Another option would be to convert the home into a rental property by selling it at fair market value (FMV) into a business structure you own. A limited liability company (LLC) is a good choice in most states.

The advantages to this option are huge. First, you still get the tax-free gain exclusion deduction when you sell. Second, your home becomes a source of monthly income. You can refinance to pull some equity out if you need it for the purchase of another home, and, depending on how much equity you pull out, you should still be able to keep your "new" rental property cash-flowing, meaning the price you rent it out for will still be more than the costs to maintain it (mortgage, insurance, utilities, etc.). You'll still get the benefit of appreciation, even though the market isn't appreciating as fast anymore.

Third, because your LLC paid FMV, it gets the benefit of the "step-up" in basis, meaning that the sales price is the new basis. This is important, because an investment property can do something your personal residence can't: Depreciate.

Depreciation is perhaps the number one (or maybe number two) reason to get into real estate. The government looks at real estate (the buildings, not the land) as something that goes down in value. So every year the building is worth a little less than the year before. After a certain period of time (27 years for commercial, 39 years for residential) the building has depreciated to zero.

In practical terms, this means your LLC can take a yearly depreciation deduction against the basis. That's why being able to step-up the basis to current FMV is such a good thing ~ your LLC has a much bigger basis to depreciate against. Depreciation doesn't cost you a dime, either ~ it's what we call a "phantom" expense ~ which means it is created without you having to spend any money, first.

Depreciation is just one of the deductions you are now able to claim through your LLC. There are hundreds of others. But because depreciation is a phantom expense, it can have a huge impact on your tax bill at the end of the day. Depreciation often contributes to the LLC reporting a paper loss at the end of the year, which can be used to offset your personal W-2 income, meaning your personal tax bill will go down, too. Yet even though the LLC shows a paper loss, it's actually making money for you each and every month.

So you get a huge tax break up front with the gain exclusion, a continuing source of passive income (from the rent) that is taxed at a lower rate than earned W-2 income, a giant source of deductions, a potential paper loss that will further reduce your W-2 income (and taxes), and you get to keep control of the property and benefit from its continued appreciation. What's not to love?

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How Low Can Your Monthly Payments Go?

by David Reed

For the past several years, buyers have used a common loan program called an 80-10-10. An 80-10-10 is two mortgages; a first mortgage at 80 percent of the sales price and a second at 10 percent of the sales price. The final 10 percent is down payment from the buyer. There is also an 80-15-5 program that is structured the same way, only the buyer puts 5 percent down and not 10 percent.

Since interest rates have been as low as they have for as long as they have, this combination of loans has been the product of choice for those who want to avoid private mortgage insurance, or PMI, which is typically required on all loans when the first mortgage exceeds 80 percent of the sales price.

The math works out because the total monthly payments between an 80-10-10 and a regular 10 percent down loan with PMI are lower with the 80-10-10.

For instance, on a $300,000 sales price, 30 year, 6.25 percent first and an 8.00 percent second, the monthly payments are $1,470 for the first on a loan amount $240,000 while the second note comes out to $218 and a $30,000 loan.

Add those together and the monthly payment is $1,688.

If you put 10 percent down and used that same 6.25 percent rate on 90 percent of the sales price, or $270,000, the payment is $1,610. Now add the PMI payment of $117 per month and the total payment is $1,770. Certainly a difference you can feel in your wallet each month.

However the second note stays with you for a long, long time. In this case at least 15 years. With PMI removed, the payment stays at $1,610. For a long, long time.

PMI is not a lifetime thing, and can be removed typically after 24 months have passed and the home has appreciated to provide a 20 percent equity position by appreciation, principal paydown or a combination of both.

That's a strong consideration for avoiding 80-10-10 loan for the sake of avoiding PMI. Especially since PMI is now tax-deductible in most cases.

The second mortgage will stay there for a long, long time while the PMI policy is only short term. It's been pretty much of a mortgage mantra to avoid the "dreaded PMI" by constructing an 80-10-10 loan. In fact, lenders and loan officers can make themselves appear to be financial wizards by "saving their borrowers" from the throes of PMI.

I suggest that idea may not hold as much water any longer, especially with new mortgage insurance rules. I say that it might be better to go ahead and put 10 percent down, let the property appreciate then get rid of PMI a couple of years down the road and enjoy lower monthly payments for the rest of the loan term.

Much longer than an 80-10-10 structure.

When pressed with 5 percent or 10 percent down don't automatically think 80-15-5 or 80-10-10, but also look at current PMI offerings. Your lender or mortgage broker can have both, but don't fall for the notion that PMI is a bad thing. It's not.

In fact, it could very well be the better thing.

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