What is the Tax Benefit of Purchasing a Primary Residence?

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Before 2018, the decision to buy versus renting a primary residence was quite easy to make from an after-tax cash flow perspective. Often after computing the numbers, many people would buy a home because of the tax advantages and possible appreciation in home value. However, buyer beware! The decision to buy a primary residence today is not as lucrative as it was for our parents, grandparents, or even someone your age who purchased a principal residence before 2018. The key takeaway is to consult your accountant and/or financial planner before making a decision. Consulting a professional can help you better understand the impact that buying a home versus renting can have on your financial situation. You don't want to be stuck with a highly leveraged asset that drops in value, creating an upside down mortgage that could take several years, if not a decade, to break even upon a sale. Do your due diligence!

The information below will help illustrate the detail tax rules used to determine if it makes sense from an after-tax perspective to buy versus rent. Although the information and examples are quite detailed, if you walk through these examples slowly, you will realize that the tax advantages that our parents received from owning a home has just been significantly reduced!

Starting in 2018, the Tax Cuts and Jobs Act (TCJA) has increased the standard deduction for a married couple from **$12,700 in 2017 to $24,400 in 2019,** and the personal exemption has been reduced from **$4,050 in 2017 to $0 in 2019.**

In addition, certain itemized deductions have been reduced and/or eliminated. For example, **the new law only allows for an itemized deduction of $10,000 as it relates to real estate taxes and state income taxes.**

The former tax law benefits of purchasing a primary residence or already owning one have now been significantly reduced. Under the new tax law, I will illustrate how the increased standard deduction and the loss of deducting real estate taxes have reduced the tax benefit of home ownership.

For example, let's assume the following facts:

- A married couple has combined W-2 earnings of **$190,000.**
- Their federal marginal tax rate is **22%** and the alternative minimum tax (AMT) does not apply.
- State income taxes are **$10,250.**
- Charitable deductions are **$2,450.**

For 2017, the total itemized deductions are $12,700 (state income taxes of $10,250 + charitable contributions of $2,450). Because the 2017 standard deduction is equal to the itemized deductions in this example, the return will report a $12,700 standard deduction.

For 2019, the standard deduction of $24,400 will be taken as the total itemized deductions are $12,450 (state income taxes of $10,000 + charitable contributions of $2,450). Notice that the state income taxes are only $10,000 as that is the maximum amount that can be deducted starting in 2018.

I will continue with the example by assuming the following facts for a home purchase:

- A married couple purchases a home for $750,000 on January 1st.
- They plan to finance $600,000 with a 30-year mortgage at 5% rate, which will result in a monthly mortgage payment of $3,220.93.
- The first 12 mortgage payments will consist of **$29,798.96 of interest** and **$8,852.19 of principal.**
- Real estate **taxes on the home are $12,500.**

For 2017, the total itemized deductions are $54,999 (calculated as state and local taxes of $22,750 + mortgage interest of $29,799 + charitable contributions of $2,450) as the $12,700 standard deduction is exceeded.

- State and local taxes of $22,750 (calculated as $10,250 state income taxes + $12,500 real estate taxes).
- Mortgage interest of $29,799.
- Charitable deductions of $2,450.

For 2019, the total itemized deductions are only $42,249 (calculated as state and local taxes of $10,000 + mortgage interest of $29,799 + charitable contributions of $2,450) as the $24,400 standard deduction is exceeded.

- State and local taxes of $10,000. (State and local taxes of $22,750 cannot exceed $10,000).
- Mortgage interest of $29,799.
- Charitable deductions of $2,450.

Next, here is the tax savings for purchasing the home:

- For 2017, the additional itemized deductions for owning a home are $42,299 (calculated as the itemized deductions when owning a home of $54,999 – the standard deduction when not owning a home of $12,700). The tax savings is $42,299 x 22% marginal bracket or $9,306.
- For 2019, the additional itemized deductions for owning a home are $17,849 (calculated as the itemized deductions when owning a home of $42,249 – the standard deduction when not owning a home of $24,400). The tax savings is $17,849 x 22% marginal bracket or $3,927.

The new tax law has reduced the tax benefit for home ownership by $5,379 (calculated as $9,306 tax savings for 2017 minus $3,927 tax savings for 2019). This reduction is due to the new tax law increasing the standard deduction and capping the state and local taxes amount at $10,000.

With these tax ramifications in mind, before you purchase a home, you may want to consider just renting.