Real Estate Tax Law's Effect on the Housing Market



Beverly Hills, California Jun 8, 2022 (Issuewire.com) - Syd Leibovitch Demystifies Real Estate Tax Law and its effects on inventories.

Syd Leibovitch is the owner of Rodeo Realty, a residential real estate brokerage in California. He's here to discuss Real Estate Tax Law implications and what it means for the current housing market. Syd founded Rodeo Realty in 1986, which has been ranked as the largest single-owner California real estate company for decades. He's a member of the LA 500 most influential leaders and impactful executives. Here are his thoughts on real estate tax law.

Why is the real estate market so dysfunctional? Until tax law changes this situation will get worse!

Why would someone sell if they must pay hundreds of thousands in taxes?

More buyers than sellers forces prices up - As any home buyer or seller knows home inventory levels are at a historic low level. More buyers than sellers have driven prices up with no end in sight. It is common to have a dozen or more offers on one house. Many buyers have lost out on so many properties that they have left the marketplace out of frustration. There are other reasons for low inventory besides the obvious reason that the building of new homes has not kept up with demand. Unfortunately, that's the only factor that's being discussed at a judicial level. I don't think our legislators realize the "domino effect" of housing. If they did, they would address how tax law has created this issue. Some of what they are proposing is counter-productive and will make the situation worse.

Tax law when selling your primary residence - Before 1995 a homeowner could sell their primary residence and buy another of equal or greater value and defer their gain. In 1995 the law was changed and a homeowner who lived in a home for two out of the last five years gets a tax exclusion on the first $250,000 as an individual and $500,000 as a married couple of their gain. In 1995 that limit was quite popular as it eliminated the need to defer the gain.

The exclusion has not been raised since 1995 - Unfortunately, home prices in most of the country are three to four times more than in 1995 yet the limit has never been increased to take appreciation and inflation into account. While the government has not adjusted for appreciation to the amount people can exclude from taxes when they sell their residence, they have raised the FNMA Conforming rate limit from $203,000 in 1995 to $647,200 today to adjust to inflation and appreciation.

The exclusion amount is the same if you lived in your home for two years or thirty years! -The $250,000 or $500,000 exclusion is the same if you lived in your home for two years or if you lived there for thirty years! Do we want to penalize people for being stable?

Why are people "trapped" in their homes? How is the tax liability on the gain calculated? - We see so many situations where our clients have been in their homes for so long that the home, they bought for $60,000 in the early 1970s is now worth $3 million. After they factor in their purchase and closing costs, improvements, and cost of sale they have a gain of about $2.7 million. Then they take their $500,000 exclusion and the gain would be $2.2 million. That would result in an $814,000 tax bill! If they live In California, the state and federal tax would be around 37%. That includes 20% federal capital gain, 3.8% health care tax, California income tax of 12.3%, and a 1% surcharge over $1million in California. When they are made aware of this they simply don't sell. Why should they? They can live in the home they no longer want for the rest of their life for less than the $814,000 in taxes.

Why should we care about someone that made over $2.2 million on their home? - The domino effect of real estate - When someone won't sell their $3 million houses because the tax liability of that home is not available for the person selling a $1.5 million house. If they feel they can't find a replacement house, they don't sell. Now the people that own a $700,000 house don't sell because they can't find a $1,500,000 home.

What is the profile of a typical home buyer and seller? – It is common for people to buy a "starter home." As their income increase, their family grows, and the equity in that home increases they can sell and purchase a larger home. Often their income grows further, and they can sell again and purchase an even larger more expensive home. Later their kids may have moved out or away and they may want to sell and move to a smaller home. Perhaps they want to retire and relocate. In most cases, buyers need to sell their current home to get the down payment and qualify for the new home they are purchasing. If they feel they cannot find a replacement home, they will stay put. The domino effect of the housing tax law has trickled down and caused a shortage of housing in every price range. Tax law is the number one reason for housing prices increasing at such an alarming rate!

How would the person above not be "trapped" in their home? – That is the unfortunate reality of this tax law. Had the example above sold their home every five years or so they would not have paid a dime in taxes because their gain would never have exceeded the married couple's $500,000 exclusion. This tax law penalizes a homeowner for being stable! Once a primary residence has appreciated above the exclusion about 37% of all future appreciation will be owed in taxes.

Even sellers of starter homes are beginning to be affected as home prices escalate - Just this week we had a seller of a home in Reseda decide they can't afford to sell. They bought it for $100,000 in 1984 and raised their kids there. Now their kids have kids and live in Westlake Village. They wanted to move closer to their children. They were excited that they could move their property tax payment to a

new home they would purchase. Unfortunately, they did not realize that the roughly $900,000 they made on their home would have a taxable gain of $400,000 after the $500,000 exclusion. If they sold, they would owe about $150,000 in federal and state taxes, so they were effectively netting $850,000 from a home selling for well over $1million. They chose to stay put. Another client had a condo in Pasadena that he paid about $120,000 ten years ago. He found a home in Granada Hills. It was $1,000,000. He made an offer. He hoped to sell his for $950,000 to get the money to buy the new one. He found out that after his $250,000 exclusion, he would have a taxable income of about $550,000 resulting in about $195,000 in federal and state taxes. He could no longer afford to sell and buy.

Why will the current situation continue to get worse with no end in sight if the tax law is not changed? – As homes continue to get more expensive, the tax liability of selling just gets larger. We already have such a large amount of the California population that would have such a high tax liability they feel “trapped” in their home. This is a problem that has developed over time. Had the exclusion kept up with appreciation or inflation it would be $2 million today not the $500,000 it was nearly thirty years ago. The higher the value of homes the higher the penalty to sell and the fewer homes will go up for sale. It’s only going to create a greater shortage of homes!

Why are home prices escalating while interest rates rise? Tax law! It looks like the number of sales will be down about 15% this year. It’s only going to get worse. The higher home prices get the larger the penalty for selling and the fewer homes will be available for sale.

What can we do today to make homeownership more affordable? - Fewer homes for sale drive prices up. Until tax law is changed prices will continue escalating in all price ranges. If you want homes more affordable the answer is to get more homes on the market. Changing tax law will do just that and it won’t have a lag time. More homes will go up for sale the day it becomes law!

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