Tax Savings for Home Ownership Are Very Overrated (Especially Under 2018 Tax Reform)

Do you believe that one of the primary benefits of owning a home in the USA is the tax savings from itemized deductions like mortgage interest, and property taxes? Weeeellll…I have some bad news for you. Despite the fact that this idea is so ingrained in most of us that we don't even question it, any of that savings is a lot less than you – and I – might have been led to believe. Personally, I have to be the first to admit that I have overvalued these primary residence "tax savings." And this was before the 2018 tax reform, which has only made things worse. For most of the homeowners in the USA this tax benefit has now been eliminated due to the increase in the standard deduction and to a lesser extent new limits imposed by SALT (state and local tax caps). Since our new reality is based on the 2018 tax reform, this post will be written with the new rules in place.

[If you are interested to see some analysis on this prior to the 2018 tax reform, please check out this post from The Money Commando. The big revelation I got from this post was that the "tax savings" from the ability to itemize should only be calculated on anything incremental to the standard deduction because everyone gets the standard deduction no matter what. It's obvious now and makes so much sense – I'm embarrassed I missed it for so long. The good news is that I never let that misunderstanding influence my decision to buy a house or pay it off early.]

Conventional Wisdom

Most people have been trained to believe that there is a huge tax savings that comes along with home ownership. However, there was always only a *potential* tax savings, and the hurdle to capture it has gotten much higher. Plus, accepted conventional wisdom says that you can estimate your tax savings by taking your marginal tax rate multiplied by the sum of the interest and property taxes you will pay, but that is an incorrect calculation and leads to an incorrect conclusion.

Let's look at an example, for a lovely couple we shall call Mr. and Mrs. GYFG:

Mr. and Mrs. GYFG buy a $500,000 home with 20% down and finance the remaining 80% ($400,000) with a 30-year 4.5% interest rate loan. California property taxes will be about 2%, or $10,000 (1% for normal property taxes and 1% due to Mello Roos). Their marginal tax rate is 30% and they have no other deductions outside of interest and property taxes (due to 2018 Tax Reform and the $10,000 Maximum SALT deduction).

Note: I have conveniently kept this example simple by ruling out any other itemized deductions and taking the max SALT deduction allowed in the 2018 tax reform.

In year one, the itemized deduction for the GYFG household would be calculated by adding interest of $17,868 (at 4.5%) and property taxes of $10,000 (at 2%), for a total itemized deduction of $27,868. Following conventional wisdom to estimate their tax savings, they multiply $27,868 by their marginal tax rate of 30%, which would indicate an annual tax savings of $8,360. The GYFGs do a little happy dance in their heads.

Then tax time comes…and they realize that their math was significantly off. They forgot to account for the fact that the standard deduction is now $24,000 for a married couple and that their tax savings is only the difference between their itemized deductions and the standard deduction (because they would have had a $24,000 deduction regardless of their itemized deductions).

They do the math and find that their tax savings from home ownership should actually be calculated off of $3,868 ($27,868 – $24,000 = $3,868). Multiplying *that* figure by their marginal rate of 30% they realize their tax savings is a paltry $1,160 (only 14% of their original assumption). Happy dance ends…

In hindsight, I realize that I should have based this example on the real position of the GYFG household, and not a fictional one that still resulted in a bit of tax savings, albeit tiny. In reality, for 2018 our itemized deductions will be approximately $22,000 ($12,000 mortgage interest, $7,500 property taxes, and $2,500 in state income taxes – far less than we will actually pay but all that is allowed under SALT), so we will be taking the standard deduction. The GYFG household gets **zero** tax benefits from home ownership, least of all for the debt interest we pay via our home mortgage. This is yet another motivating factor that convinced us to pay our house off even faster than we had originally planned.

What About the Average American?

The median home price (for a new home) in 2017 was $335,400. I don't think I even have to do the math for you to see that the value of being able to itemize mortgage interest and property taxes is worthless to most taxpayers in the USA. Nonetheless, for the sake of thoroughness, and because we all know that MATH IS KING, I will show you the math. We will use all the same assumptions except we will assume that the median home price is the mortgage amount (which is a generous assumption that tries to make this a more favorable outcome).

Say the average American pays interest of $14,982 (at 4.5%) and property taxes of $6,708 (at 2%), for a total deduction of $21,690. As you can see, this is less than the standard deduction, so there is therefore no tax benefit to the average taxpayer. (Even worse, the average property tax paid in this country is even less than California's 2% at 1.19%, further eroding the possibility of deduction benefit.)

Concluding Thoughts

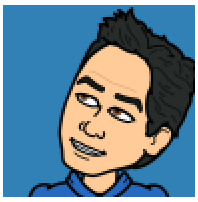
I think the most obvious takeaway is to operate on a policy of trust but verify. Yes, there is potential for some tax savings through home ownership but it's probably less than you think, and it might actually be zero. Don't forget that the 2018 tax reform also set another new limit and now says that only the interest on up to a $750,000 mortgage is deductible (inclusive of interest paid on a HELOC; previous limits were $1M for mortgage and $100K for HELOC).

This also points out how fast the rules can change. It's probably not a great idea to buy a house if your primary motivation is tax savings.

Also important to learn from this: debt is debt. With few exceptions – and getting fewer all the time – there is no “good debt.” Build your wealth-building structure on firm ground, without using debt of any kind as a long-term element of your foundation, and make sure that you aren’t spending a dollar to save 30 cents. Not only is that not smart, but even that savings can be taken away by forces beyond your control.

For the GYFG family, in particular, this is another incentive to pay the mortgage off early!

– Gen Y Finance Guy



Gen Y Finance Guy

Hey, I’m Dom - the man behind the cartoon. You’ll notice that I sign off as "Gen Y Finance Guy" on all my posts, due to the fact that I write this blog anonymously (at least for now). I like to think of myself as the *Chief Freedom Officer* here of my little corner of the internet. In the real world, I’m a 30-something former C-Suite executive turned entrepreneur turned capital allocator. I am trying to humanize finance by sharing my own journey to Financial Freedom. I believe in total *honesty* and *transparency*. That is why before I ever started blogging, I decided that I would share all of my own financial stats. I do this not to brag, but instead to inspire motivate, and also to hold myself accountable. My goal is to be a beacon of hope, motivation, and inspiration for *you*, the reader, by living life by example and sharing it **all** here on the blog. My sincere hope is that you will be able to learn from me - both from my successes and my failures! Read More