Modern Real Estate Practice in Illinois, 6th Edition
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Chapter 3: Concepts of Home Ownership

Learning Objectives

After reading this chapter, students should be able to:

- Identify the various types of housing choices available to home buyers.
- Describe the issues involved in making a home ownership decision.
- Explain the tax benefits of home ownership and the provisions of recent changes to the Tax Code.
- Distinguish the various types of homeowner's insurance policy coverage.
- Define the following key terms: actual cost value policies; coinsurance clause; Comprehensive Loss Underwriting Exchange; equity; guaranteed replacement cost policies; homeowner's insurance policy; liability coverage; replacement cost.

Why Learn About Home Ownership Concepts?

In the past, homes tended to be single-family dwellings bought by married couples with small children. Today, social, demographic and economic changes have altered the residential real estate market considerably. Many real estate buyers today are single men and women, childless professional couples, unmarried couples and domestic partners. An aging Baby Boom generation has given rise to *empty nesters* — couples whose children have moved away from home. Still others may be friends or relatives who plan to co-own a home together, in the same way they might share an apartment lease. Today's homebuyers come from all economic classes, all ethnic backgrounds and from all over the world.

There are nearly as many different *kinds* of home ownership as there are people who own homes. As the real estate market changes and evolves over time, the successful real estate agent will understand the various (and sometimes conflicting) motivations that move people to buy property, and the options and opportunities that are broadening their range of choices.

As a nation we have chosen to give tax assistance to real estate. Knowing the various tax entitlements will assist you in informing your sellers and buyers of their existence and perhaps make a sale or purchase possible.

Suggested Items to Bring To Class

1. Photographs, slides, blueprints or models of various types of residential structures.
2. Subdivision maps indicating the types of amenities offered by various types of housing.
3. Sample insurance policy forms and brochures explaining the types of coverage each offers.
4. A condominium declaration and by-laws.

Lecture Notes

I. Home Ownership

People buy their own homes for psychological as well as financial reasons.

A. Types of Housing

1. **Apartment complexes:** groups of apartment buildings with any number of units in each building.
2. **Condominiums:** owners share ownership of common facilities. Management and maintenance of exteriors and common facilities are handled by the governing association and outside contractors, with expenses paid out of monthly assessments.
3. **Cooperatives:** units share common walls and facilities within a larger building. The owners buy shares of stock in the corporation that holds title to the building. Owners of the corporation that owns the building receive proprietary leases that entitle them to occupy particular units.
4. **Planned unit developments** (PUDs, or master-planned communities) merge residential, recreational and commercial uses in one self-contained development. PUDs are planned under special zoning ordinances. Owners do not have direct ownership interest in the common areas, which are maintained by a community association.
5. **Retirement communities** are often structured as PUDs and may provide shopping, recreational opportunities and health care facilities in addition to residential units.
6. **High-rise developments**, sometimes called mixed-use developments (MUDs), combine office space, stores, theaters and apartment units in a single vertical community.
7. **Converted-use properties:** factories, warehouses, office buildings, hotels, schools, churches and other structures that have been converted to residential or other uses.

8. **Manufactured housing,** once considered temporary residences, are often permanent residences or stationary vacation homes, situated in housing parks. Housing parks offer complete residential environments with permanent community facilities as well as semi permanent foundations and hookups for gas, water and electricity.

9. **Modular homes** are pre-assembled at a factory, driven to the building site on a truck, and then lowered onto a foundation by a crane. Later, workers finish the structure and connect plumbing and wiring.

10. **Time-shares:** multiple purchasers share ownership of a single property and are entitled to use the property for a certain period of time each year, usually a specific week.

II. Housing Affordability

Those who choose home ownership must evaluate many factors before they make a final decision to purchase a particular property. The purchasing decision must be weighed carefully in light of each individual's financial circumstances.

A. Mortgage Terms

An increasing number of creative mortgage loan programs are being offered by various government agencies and private lenders. Specific programs may offer lower closing costs or deferred interest or principal payments for purchasers in targeted neighborhoods or for first-time buyers.

B. Ownership Expenses and Ability To Pay

1. **"Rule of thumb" formula:** The monthly cost of buying and maintaining a home (mortgage payments — both principal and interest — plus taxes and insurance impounds) should not exceed 28 percent of gross (pretax) monthly income. The payments on all debts should not exceed 36 percent of monthly income. Expenses such as insurance premiums, utilities and routine medical care are not included in the 36 percent figure, but are considered to be covered by the remaining 64 percent.

C. Investment Considerations

- Gain
- Equity
- Tax deductions

1. **Equity** represents market value less indebtedness. Three ways to create equity are:

   a. to make payments on a mortgage loan

   b. to add improvements to the property

c. appreciation.

D. Tax Benefits

1. The federal tax code excludes $250,000 of property from capital gains tax on the sale of a principle residence. If the property is owned by a married couple who file jointly they would be eligible for a $500,000 exemption. This exemption may be used repeatedly, as long as the homeowners have occupied the property as their residence for an aggregate of two of the previous five years.
2. 1031 Exchange—capital gains tax is *not* avoided, but deferred until the property is later disposed of in a taxable situation.
3. Homeowners may deduct from their gross income
   - mortgage interest payments on most first and second homes
   - real estate taxes (but not interest paid on overdue taxes)
   - certain loan origination fees
   - loan discount points (whether paid by the buyer or the seller)
   - loan prepayment penalties
4. When a homeowner fixes up his or her property in preparation for its sale, the homeowner may deduct certain expenses in determining the adjusted sales price for capital gains purposes.
5. The cost of materials such as paint, carpeting and wallpaper and other repairs may be deducted from gain if the expense meets specific IRS requirements [IRS Regs 1.1034-1].

III. Homeowner's Insurance

Lenders usually require a homeowner to obtain insurance when the debt is secured by the property.

A. Coverage and Claims

1. **Basic form** provides property coverage against fire and lightning; glass breakage; windstorm and hail; explosion; riot and civil commotion; damage by aircraft; damage from vehicles; damage from smoke; vandalism and malicious mischief theft; and loss of property removed from the premises when it is endangered by fire or other perils.
2. **Broad-form** additionally covers falling objects; damage due to the weight of ice, snow or sleet; collapse of all or part of the building; bursting, cracking, burning or bulging of a steam or hot water heating system or of appliances used to heat water; accidental discharge, leakage or overflow of water or steam from within a

plumbing, a heating or an air-conditioning system; freezing of plumbing, heating and air-conditioning systems and domestic appliances; and injury to electrical appliances, devices, fixtures and wiring from short circuits or other accidentally generated currents.

3. **Special apartment and condominium policies** generally provide fire and windstorm, theft and public liability coverage for injuries or losses sustained within the unit. However, they do not usually cover losses or damages to the structure.

B. **Coinsurance clause** requires the owner to maintain insurance equal to at least 80 percent of the replacement cost of the dwelling (not including the price of the land).

IV. Federal Flood Insurance Program

A. The **National Flood Insurance Act of 1968** was enacted by Congress to help owners of property in flood-prone areas by subsidizing flood insurance and by taking land-use and land-control measures to improve future management for floodplain areas.

B. The **Federal Emergency Management Agency (FEMA)** administers the flood program.

C. Owners in flood-prone areas must obtain flood insurance to finance property with federal or federally related mortgage loans. In designated areas, flood insurance is required on all types of buildings—residential, commercial, industrial or agricultural. If a borrower can produce a survey showing that the lowest part of the building is located above the 100-year flood mark, the borrower may be exempted from the flood insurance requirement, even if the property is in a flood-prone area.

Classroom Exercises

1. Ask students in which types of housing they lived as a child, as a single adult, in marriage, after a divorce or in retirement. Often this will reveal a progression of different types of housing experienced as appropriate for various stages in life.
2. Divide the class into two groups: one will be homeowners, the other renters. Ask each group to list the advantages and disadvantages of both owning and renting, using specific examples. Compare the groups' lists.
3. Ask students to contrast the viability of investing in stock or other monetary investments as compared to buying real estate.
4. Have students attempt to qualify a fictitious buyer

