Palo Alto online

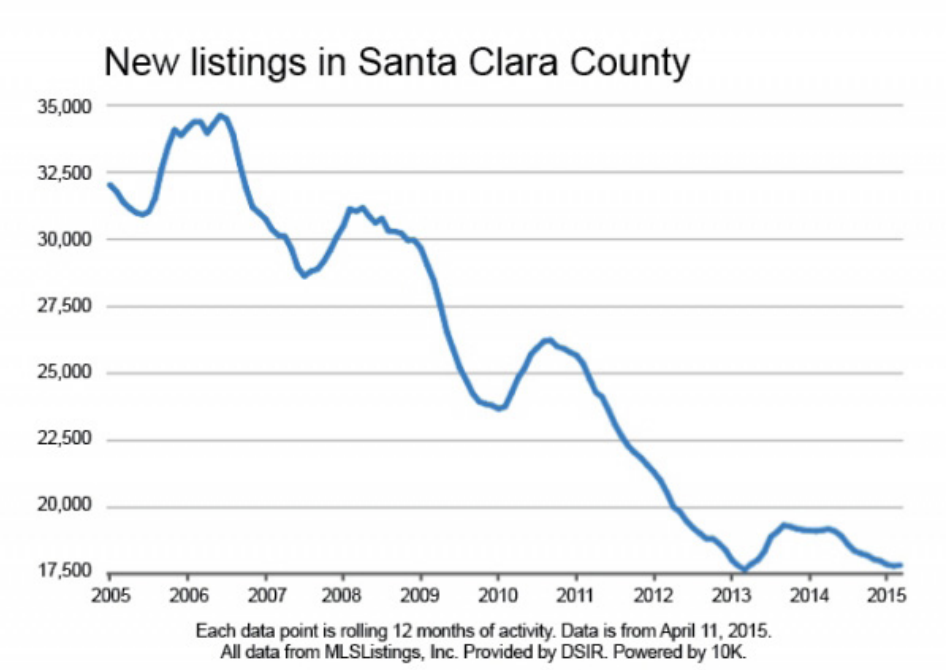
# Real Estate Matters

## Where have all the houses gone?

By Michael Dreyfus | July 31, 2015

At first realtors were whispering, "Wow, there is nothing for sale." Now they are yelling. Since 2008, the Peninsula and the greater Silicon Valley have been on a trend of ever-declining inventory. Don't mistake this for houses being snatched up by long lines of buyers. No, this is a story about supply.

In the past 12 months in Santa Clara County, almost half as many homes were listed for sale when compared to the same 12-month period in 2006. That's 17,813 homes versus 34,342. In San Mateo County, it went from 11,914 to 6,879. (See charts) This isn't merely a moment; it's a trend. Nobody is quite sure what's going on, but here's what we are hearing from our clients and seeing at Dreyfus Sotheby's International Realty.



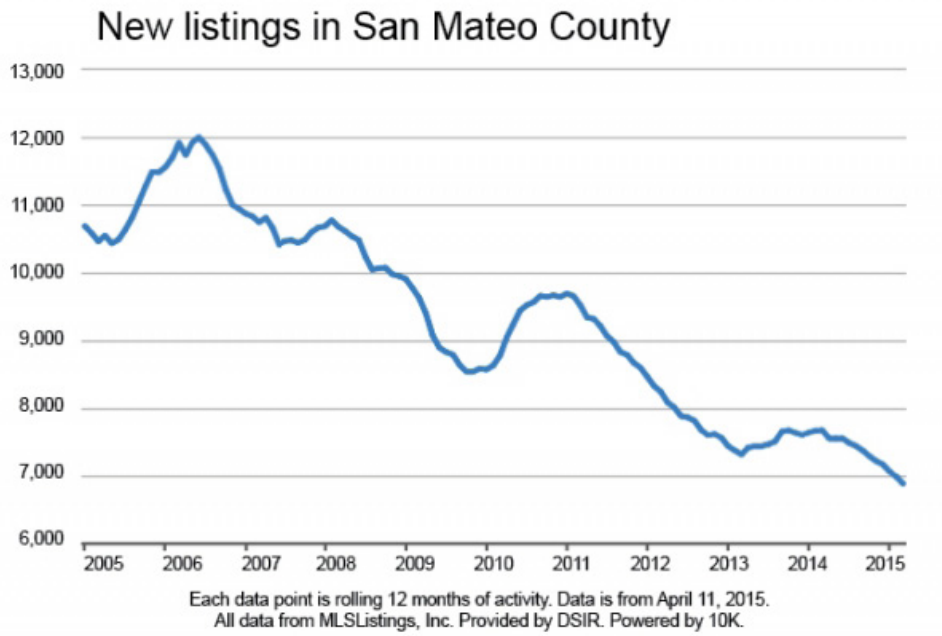

### Taxes, taxes and taxes

This seems like an obvious villain, yet it's a red herring. In fact, the 15 percent top long-term capital gains rate in place from 2003–2012 was historically low. When the rate was raised to 20 percent in 2013, our inventory slide was already in full swing. So what has changed? The timing of the gain pain.

In 1997, the tax rules were changed concerning the sale of a personal residence. Before 1997, the entire capital gain from a personal residence was deferred if the seller bought a more expensive house within a certain time period after they sold. After 1997, the rule changed to eliminate the deferral, but allowed $250,000 (or $500,000 for a married couple) of capital gain on a personal residence to be excluded from tax. This was great news in 1998, when $500,000 gains were extraordinary. Flash forward to today, people are looking at $1 million or even $2 million gains on homes. Bottom line, we're getting to $500,000 a lot faster.

This obliterates our move-up market. Equity that was previously available to leverage into a new, more

expensive home is eaten up by taxes. Add dramatically increased property tax to the mix, and more and more people stay put. Many opt to borrow against their equity and remodel their homes. This upsets the market's balance. Starter homes previously available are not listed. Not only that, they are being made into bigger, more expensive homes.




This is limiting the supply of cheaper homes in our area. Our older population moves down to these very homes. So now, retirees are faced with a similar issue. The tax on their home eats up the equity they need to buy the smaller home, which seems to be getting ever closer in value to their bigger home. In short, the buy down requires so much of their post-tax equity that they have little left to show for their trouble. They might as well stay in their current home and make the taxes go away by passing the house on to a surviving spouse or family members. A stepped-up basis on the death of an owner gives a current fair-market basis to a spouse or family member. Taxes gone. So, now the older population isn't selling, either.

### Fast and furious

Suppose you can get past the taxes thing. You'll move up and pay taxes, or move down and pay taxes. Now you're ready to get it done. You then discover that the market is crazy. There are multiple offers. Prices go up every day. Oh, and forget about an offer contingent on the sale of your home.

You need to sell your house first, close the deal and then find an interim rental while you fight the hordes for a new house. All the while, you're hoping the market doesn't go up. Unless you are willing to leave the Bay Area, the rational thought becomes, "No thanks, I'll stay right where I am."

### Market timing

After braving all the issues, those hardy few who are still interested often become paralyzed by the specter of missing out. "What if I sell too soon?" they ask. As long as the market keeps advancing, many wait so they don't leave money on the table.

### Asset hoarding

Some people want to move on, but don't need the money out of their home to do so. More and more are keeping their first house. Rents and appreciation make residential real estate an attractive asset class against low returns found elsewhere.

### Will it end?

These problems are supported by our rapidly appreciating residential market, a condition fed by the low inventory. It will take a market collapse to bring sellers back to the table, and they may be part of that collapse. The question remains: Are there enough buyers able to afford the now larger, high-end homes when everyone decides to sell? Confidence crisis in the market may see a swing from no houses to too many, when all the pent-up sellers come to market together.