SERVICE IN ACTION

COLORADO STATE UNIVERSITY EXTENSION SERVICE

Home remodeling—financial and business considerations

Alice Mills Morrow[1/]

no. 9.924

Quick Facts

The financial and business considerations in remodeling, while less visible, are no less important than carpet and paint.

The family that decides to finance the remodeling job needs to shop for a loan, comparing credit costs and credit terms from various sources.

The credit contract is important because it outlines rights and responsibilities of the lender and of the borrower.

Colorado law provides that persons who furnish labor or materials for the improvement of real property of another have the right to a lien upon that property in order to secure payment for their services and materials; this is called a mechanic's lien and can cause an unsuspecting owner of real property to bear considerable expense.

Records of all remodeling expenditures should be kept in a safe place.

Insurance coverage may need to be reevaluated following remodeling.

The financial and business considerations in remodeling—while less visible—are no less important than carpet and paint. If a person does not have sufficient cash or does not want to withdraw money from savings to pay for home improvements, then the alternatives are to wait until sufficient cash has been saved or to borrow the money.

Postponing home improvements until there is enough savings to pay cash has disadvantages. Among these are:

—The repair or remodeling job may not be postponed easily. When a roof blows off, it needs to be replaced. If a leaking roof is not repaired, it may damage other parts of the house.

—Waiting to save the money to pay for the job may result in considerably higher prices. The cost of building materials has been increased considerably over the past few years.

—Saving money takes discipline. If some people waited to do remodeling until they had money accumulated, they would never get the remodeling done.

On the other hand, postponing the home improvements until there is enough savings to pay cash has advantages. Among these are:

—The family is not committed to regular installment payments.

—The family has not increased the remodeling costs by borrowing the money. The interest paid on borrowed money may increase the cost of the remodeling by as much as 12 to 20 per cent.

The decision about financing the remodeling project needs to be made carefully. Among the factors to be considered are:

—How much cash is available to meet emergencies? Money that is in savings accounts, in government savings bonds and the usual balance in the checking account should be added together. This total represents money that is available to meet emergencies.

—How much of the monthly income is currently being spent on expenses the family thinks of as necessary? Will these expenses increase or decrease during the period of the anticipated loan?

—How much of the monthly income currently is being used to pay on existing debts? When will this debt be paid off?

—How much is family income (after taxes) and what will happen to the family income over the period of the anticipated loan? Is income likely to increase more than expenses will increase? Is income like to increase less than expenses will increase? Is income likely to decrease?

—Are all family members willing to adjust spending patterns in order to pay for the remodeling project?

Shopping for Credit

The family that decides to finance the remodeling job needs to shop for a loan, comparing credit costs and credit terms from various sources. The plans and estimates should be shown to the prospective lender.

Possible sources of credit for home improvements are:

Bank home improvement loans—Some banks offer their own home improvement loans. The homeowner should check several banks and see what kind of plans they have. The bank may require an appraisal of the existing home and proposed improvement to set the amount of the loan.

HUD/Federal Housing Administration—insured loans—Banks and lending institutions may offer HUD/FHA-insured loans. The homeowner may check with the bank to see if they offer HUD/FHA home improvement loans and, if so, find out the restrictions.

Open/end mortgage loan—Some home mortgages contain an "open-end" provision. This means that money borrowed for home improvements is added to the original mortgage. The homeowner should check the mortgage agreement to see if the interest rate will change.

Refinancing present mortgage—If the morgage has no open-end clause, it may be possible to refinance the existing mortgage. This means that a new mortgage is taken out which includes money to pay off the old mortgage and money for improvements. The homeowner needs to read his or her mortgage agreement to see if there are any penalties for refinancing.

Personal loan—A loan which may be obtained from a lending institution such as a bank, credit union or finance company.

Dealer-installment loan—Some sellers of supplies and equipment will finance purchases.

The cost for borrowing money will vary at different institutions and with different terms. It is important to compare the annual percentage rate and the finance charge of various lenders.

A lender is required to tell the borrower the annual percentage rate (A.P.R.) and the finnce charge. The finance charge is the total amount repaid (the monthly payment times the number of months) less the amount borrowed.

To compare the cost of credit, a potential borrower should estimate how much money will be borrowed, check with

[1/] *Alice Mills Morrow, former CSU associate professor, home management (revised 3/1/79)*

Issued in furtherance of Cooperative Extension Work in Agriculture and Home Economics, Acts of May 8 and June 30, 1914, in cooperation with the United States Department of Agriculture. Lowell Watts, Director of Extension Service, Colorado State University, Fort Collins, Colorado 80523. By law and purpose, the CSU Cooperative Extension Service is dedicated to serve all people on an equal and nondiscriminatory basis.

various lending institutions to see what the annual percentage rate would be and what the finance charge would be and compare the loan for different time periods. (See Table 1. The example shows the cost of borrowing the same amount of money from the same bank but for different time periods.)

vast majority of business people and contractors are reputable and honest. The fact that in most instances there are no problems makes it easier for the financially unstable or disreputable home improvement contractor to cause serious problems for the unsuspecting homeowner.

Table 1: Chart to aid in the comparison of credit costs.

Lending Source	Amount to be Borrowed	Monthly payment if financed for: 12 mo.	24 mo.	36 mo.	48 mo.	60 mo.	A.P.R.	Finance Charge	Comments
X Bank - 12 mo.	$2400.00	215.48					14%	$185.76	
X Bank - 24 mo.	$2400.00		115.23				14%	$365.52	
X Bank - 36 mo.	$2400.00			82.02			14%	$552.72	

Comparing the cost of credit takes time. Shopping for credit is as important as shopping for lumber or appliances. Shopping carefully for credit may mean spending less money.

The Credit Contract

The credit contract is important because it outlines rights and responsibilities of the lender and of the borrower. Before signing a credit contract, a person should know what he or she is signing. The entire contract should be read thoroughly. A contract with blank spaces never should be signed. If something is not understood, it should be cleared up before signing. After signing a credit contract, a borrower should always keep a copy of the signed contract (Sometimes a credit contract will be part of the work contract for the remodeling work.)

In certain situations, the consumer has the right to cancel a credit contract within three days of signing. Generally, the consumer has this right in a door-to-door sale when the sale takes place at a residence or away from the seller's place of business). The consumer also has the right to cancel a credit contract when the seller takes a security interest in the buyer's home or when the seller has a potential security interest (i.e., mechanic's lien) in the buyer's home.

A contract never should be signed just because the right to cancel is available. However, if a contract is signed and there are doubts about it, a quick check should be made to see if it can be canceled. If there is the right to cancel, it must be done within three days. A person needs to act quickly.

Remember, when a homeowner has three days in which to cancel a contract, a contractor will not start work until the three days have passed. In an emergency, the homeowner can waive the three-day cancellation period and the contractor may start work immediately.

Mechanic's Liens

Colorado law provides persons who furnish labor or materials for the improvement of the real property of another the right to a statutory lien upon that property in order to secure payment for their services and materials. This is a mechanic's lien.

Mechanics' liens can cause the unsuspecting owner of real property to bear considerable expense. For example: A homeowner hires a general contractor to build an addition to a home. The contractor hires a subcontractor to do the plumbing and a subcontractor to do the electrical wiring. The job is finished and the homeowner pays the contractor the contract price. Later the homeowner finds that several liens have been filed against the property because the contractor failed to pay the subcontractors and failed to pay suppliers of materials. The homeowners may end up paying the subcontractors and suppliers even though they have paid the contractor the full contract price.

The time to try to *prevent* mechanics' liens is *before* entering into a contract. Before entering into a contract, the homeowner should investigate the contractor's reputation, seek legal advice (money spent to prevent problems is money well spent) and require a performance bond on the contractor.

After entering into the contract for work, proper recording of the contract in the office of the county clerk and recorder in the county in which the property is located will protect the homeowner against certain liens and will limit liability somewhat.

Before paying the contractor, the homeowner should check to see if suppliers and subcontractors have been paid. This is effective in preventing mechanics' liens only to the extent that the subcontractors and suppliers are known. The

Record of Expenditures

Capital Improvements. Money spent remodeling and repairing a house may be what is called a capital improvement. If it is a capital improvement, it is important to have records of it when property is sold and taxes on the sale are paid.

Capital improvements are improvements or betterments having a life of more than one year. Such things as a new furnace, an additional bathroom and replacing the roof are capital improvements. (Items such as repainting and replacing broken windows are repairs and are not considered capital improvements.)

When a home is sold, a homeowner pays capital gains tax on the profit or gain made on the sale. The gain or amount realized on the sale of a home is the difference between the adjusted sales price and the adjusted basis. A capital improvement increases the basis. Increasing the basis (or cost) of property means that when it is sold there is less gain realized and less capital gains tax due.

When remodeling or adding on to a home, records of all expenditures should be kept, including sales receipts and cancelled checks. It may be 10 or 20 years before the house is sold. At that time, it will be important to have proof of money spent on capital improvements. It may be very difficult to reconstruct records. Records should be retained at the time improvements are made. If in doubt as to whether the improvement being made is a capital improvement, the records should be kept. It is better to keep them and later find they are not needed than to find out that they are needed and are not available.

Casualty Losses. If the repair or remodeling was necessary because of a casualty (fire or storm), the loss may be allowed as a casualty deduction on the homeowner's income tax.

If the homeowner has uninsured casualty losses, the records of the repair or remodeling needed because of the loss will help the taxpayer to verify the amount being deducted as an uninsured casualty loss.

Property Taxes

The county assessor's office appraises real estate and determines the actual value of the property for tax purposes. In determining actual value, the factors considered are location and desirability, functional use, current new replacement cost less depreciation, comparison with other properties of known or recognized value and market value in the ordinary course of trade. If the remodeling has increased the value of the house, reappraisal by the tax assessor may result in an increase in the property taxes.

Homeowner's Insurance

After remodeling plans have been carried out, the homeowner's insurance probably will need to be increased. In fact, unless the homeowner has a very recent policy, the amount of the insurance coverage may not have been adequate even before the remodeling.

Answers to the following questions will help in evaluating insurance coverage:

What type of loss does the insurance cover?

What would be the replacement cost of the house, fences, outbuildings and personal property?

What would the policy pay if part of the house or part of the personal furnishings was destroyed?

What would the policy pay if all the house and/or personal property was destroyed?