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THE REAL ESTATE PAGE
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Should I Pay Off My Mortgage?

When there was easy money to be made in real estate and stocks, mortgage debt seemed like nothing to fear. Now an increasing number of homeowners are wondering if it makes sense to hasten the day they can say goodbye to a big monthly expense while earning the equivalent of a decent, guaranteed return.

"I'm hearing this question more now that clients aren't feeling as comfortable about the market," says Los Angeles area financial planner Eileen Freiburger.

Maybe you're part of a young family, and whittling down your loan balance seems like a sound strategy. Or maybe you're counting down to retirement (perhaps even already kicking back), have only a few years of payments left, and are wondering if you should just knock off the balance.

But if you're thinking of such a move, you're also well aware that mortgage interest is tax-deductible -- and if history is any guide, putting money into stocks will earn you a higher return over the long haul than putting it into real estate.

The answers to the questions below can help you determine your best course of action.

Do you have more pressing financial needs?

Anyone who has credit card debt or isn't maxing out her 401(k) should make those the priority. You should also have at least six months' worth of living expenses in cash.

A few years ago you would have been able to pull money out of your home quickly if, say, you lost your job. Now that lenders have tightened up, that's not so easy.

Retirees and near-retirees contemplating a lump-sum payoff need to ensure they have enough liquid savings to handle emergencies such as unexpected medical expenses, especially because it's hard to tap equity on homes without first mortgages.

The Considerations

- ⇒*Pressing Financial Needs*
- ⇒*How Long Are You Staying?*
- ⇒*The Tax Deduction*
- ⇒*Alternative Investments*

And you shouldn't pull money out of your IRA to pay off your home loan, since the IRA funds will be taxed at ordinary income rates.

How long do you plan to stay?

If you plan to trade up to a larger home or downsize to a smaller one within five years, it doesn't make sense to put extra money into your mortgage. The real estate market may be shaky for a while longer, and "you don't want to tie up your cash in your home and then not be able to sell," says La Jolla, Calif., financial planner Christopher Van Slyke.

What do you really gain from the interest tax deduction?

Assuming you itemize your deductions, you can find out what you save by multiplying the mortgage interest you paid last year by your tax rate (federal plus state). A couple in the 28% tax bracket, with a $200,000 loan at 5.0%, for example, will save $2,781 in taxes the first year of a loan. Your tax savings decline the further you get into the loan, as more money is applied toward principal.

For many retirees and near-retirees close to the end of the mortgage, the interest deduction is not a reason to avoid paying off the loan, especially since retirees often end up in a lower tax bracket, says planner Peter Canniff of Nashua, N.H.

How would you otherwise invest the money?

Put your money into stocks and bonds and you're likely to get a higher return over the long run than you would paying off your home loan, given today's low rates.

If you itemize, you can calculate your effective return by multiplying your mortgage rate and your tax rate, then subtracting the answer from your mortgage rate (you can do this with the mortgage tax-deduction calculator at bankrate.com/calculators.aspx).

So for someone in the 28.0% tax bracket with a 5.0% mortgage, the effective rate of return on paying off the mortgage is 3.6%. By comparison, a 50/50 stock/bond portfolio has historically earned 8.2% long term, though it's sensible to expect future returns to be a more modest 6.0%....

Source: Money Magazine

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