My Mortgage

An explanation:

Should I Pay it Off?

By

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Paying off Your Mortgage Early…
To do or not to do?

Q – Should I pay off my mortgage early or make more money by investing elsewhere and taking the tax deduction?

A - In Hamlet, Polonius counsels his son Laertes that:

Neither a borrower - nor a lender be[1]

In Shakespeare's day, days, lending was done by individuals more than banks, but I believe this advice makes sense 500 years later.

Twenty years ago when mortgage interest rates were 7% and anyone could throw a dart at the Wall Street Journal and make 20% on a stock pick, stockbrokers were spouting this advice – after all using other people's money to make a profit should be a no brainer. The clients made money and the stockbroker did too. Everyone was happy.

However, during the past 12 years, the stock market has not produced the lofty returns seen in the 80's and 90's. So let's look at the example of a stock currently paying a 6% dividend and mortgage interest of 4.5%.[2] The math seems simple - you make an extra 1.5% by using leverage. But to figure out the true impact, we need to dig deeper and ask some other questions:

What is your tax rate? If you are in the 25% bracket for Federal purposes and 5% for state, your combined tax bracket is 30%. By multiplying 6% by 30% (.06 X .3 = .018), you will be paying 1.8% tax on your 6% dividends. Therefore, your after tax rate of return is 4.2% (6% - 1.8%) - your interest rate is 4.5% so the math doesn't work in this instance.

So let's assume that in your particular case your tax rate is low and the dividend is high so your after tax rate of return is greater than or equal to the interest you are paying on the loan. Is it a good deal then? The next tax variable is seldom analyzed by most advisors, but it is vitally important. How much of the mortgage interest are you **actually** able to **deduct** on your return? For instance, if we assume you have a $200,000 mortgage with an interest rate of 4.5%, your interest deduction is 9,000 per year. Let's assume you are married and have other itemized deductions (charitable contributions, taxes, medical expenses, misc) of $5,000. Your total itemized deductions are 14,000. In 2013, the standard deduction is $14,600 for married couples over the age of 65. This is the amount that the government allows you to deduct if you don't itemize. Therefore, the actual real mortgage deduction benefit for federal taxes is $0.

If you are comparing dividend paying stocks to the totally safe investment of paying off your mortgage, you are really comparing apples to oranges. After all, if you find a 6% dividend paying stock, that may not be a company with the best long term prospects. The stock price may decrease. The dividends may decrease. The company may go bankrupt (Look at nice safe General Motors).

The only true apples to apples comparison would be comparing your mortgage interest rate to other risk free investments (such as CD's and treasury bills). Since I haven't seen a mortgage interest rate lower than the 1.71% yield[3] on the 10 year US Treasury, paying off the mortgage makes good financial sense – and I give this advice to my clients all day long.

The final part of this is the sleep factor. If you own your home you have a measure of financial security that most American's don't have. Being able to sleep at night knowing that you don't have that huge debt hanging over your head is a non-monetary benefit that – in my opinion – outweighs any small financial benefit of leverage.

If you have excess cash - in general - my advice is to pay off the house. However, there are a few exceptions to this general rule:

1. If your investment money is held in an IRA or other qualified plan. You would most likely be courting tax disaster if you withdrew funds - and had to pay tax on the withdrawal - from such a plan.

2. You should maintain an emergency fund of liquid investments. Don't spend every last dime you have to pay off debt.

3. If your mortgage is less than your home's value and you are considering walking away from your mortgage or doing a short sale.

Of course every one is unique and this important decision should not be made based upon a newspaper article written by a stranger. The reader should consult with his own tax, legal and financial advisor.

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Teresa Bear specializes in retirement planning and asset preservation for retirees and their loved ones. Teresa works primarily in the Phoenix Metro area and has offices in Mesa and Chandler.

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[1]Shakespeare, William, *Hamlet Act 1, scene 3, 75–77*

[2]This is a hypothetical illustration and not intended to project the performance of a specific investment. Actual investment experience will vary with stock selection and changing market conditions

[3]Yield on the 10 year US Treasury rate as of December 27, 2012 is 1.71%