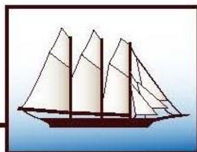

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Paying Off Your Mortgage Under the New Tax Act

Aug 23, 2018 / **By Debra Taylor, CPA/PFS, JD, CDFA and Cecilia Taylor**

Between rising interest rates and the passage of tax reform, many clients may be wondering if it is an opportune moment to pay off the mortgage. Here's what you need to know…

Homeowners young and old often face a strategic choice: Use investment monies to pay off the mortgage or keep their investments and continue to carry the mortgage debt? Unfortunately, there is no clear answer, as the right choice depends on a person's time horizon, risk tolerance, personal preferences, and many other factors. However, between interest rates increasing and the recent passage of the Tax Cuts and Jobs Act (TCJA), there are now many good reasons why you may be revisiting this age-old question with your clients.

Recent tax law changes and its effect on homeownership

Recent tax law changes are throwing traditional homeowner tax strategies into disarray. For starters, the standard deduction increased from $12,700 to $24,000 for married couples, and from $6,350 to $12,000 for individuals. In addition, for married couples, each spouse over age 65 gets an additional $1,300, meaning that a couple over the age of 65 would get a standard deduction of $26,600. As a result of the increase in the standard deduction, up to 90% of taxpayers may be claiming the standard deduction in future years. Therefore, your clients may not be getting the "homeowner's subsidy" as they had in the past, as many homeowners will no longer be itemizing.

The new tax law also included two significant limitations to the way that taxpayers pay real estate taxes and deduct mortgage (and home equity interest) on their home.

Aside from the $10,000 limitation on the deductibility of state and local taxes (SALT), interest on up to only $750,000 of new mortgage debt is deductible, while the prior law allowed an interest deduction on $1,000,000 of mortgage debt. However, this new limitation only applies to loans incurred *after December 14, 2017*, meaning that the interest paid on your existing mortgage is still deductible, unless you opt for the standard deduction, as many now will do.

The other drastic change is that the deduction for home equity interest has been completely eliminated. There is a small loophole however, because if the proceeds of the equity loan are used to "buy, build, or substantially improve" the home, the interest continues to qualify as deductible mortgage interest. The loan amount would be subject to the debt limit

(either $750,000 or $1,000,000 in total depending on when the loan was incurred, as discussed previously). But the interest would remain completely tax deductible.

However, if the loan proceeds were used to buy a car, pay for a child's college, or any other usage (as many home equity loans are), then the interest is no longer deductible, with no exceptions. This means that clients can no longer borrow against their homes for a variety of reasons and deduct the interest, a move that is frustrating to many.

As a result of the increased standard deduction and all of these limitations, many taxpayers are much more likely to switch to the standard deduction for 2018. By not itemizing, they will lose the tax benefit of a mortgage, as interest on the loan won't be able to be written off. And, for those retirees who are close to their mortgage payoff date, the loan may not generate enough tax-deductible interest to justify itemizing anyway.

Should I pay or should I go?

Overall, although more people are likely to take the standard deduction in the coming years (estimates say 90%), those nearing retirement age are more likely than most to fall within the standard deduction, and could benefit more from paying off their mortgage earlier, as they will no longer receive a significant tax benefit from holding it.

The conservative client

With the increased standard deduction, coupled with the mortgage and home equity interest limitations, paying off the mortgage can also make sense for a more conservative investor. Consider the alternative uses for the money, such as investing in CDs or high-quality bond funds. You will likely have limited returns in those more conservative investments and you will also pay taxes on any bond interest earned, thus potentially creating a negative real rate of return, while also being responsible for paying the mortgage without any tax subsidy.

Those who are invested more conservatively likely won't experience substantial returns and would therefore most likely benefit more by just paying off their mortgage. This is because the increase in the standard deduction means that they may not benefit from the deduction, meaning that the interest expenses incurred by keeping the mortgage would far outweigh the earnings on the investment of those monies.

Consider this analysis performed by the *Wall Street Journal*. The *Journal* looked at a high-earning couple in a high-tax state, who earn a combined $350,000 in 2018. However, suddenly, only $10,000 of their $40,000 in state and local taxes are deductible (due to new rules in the TCJA), *and* the standard deduction is increased to $24,000, meaning that they only receive a benefit for deductions over $24,000.

Let's say the couple has a $300,000 mortgage with a 4% interest rate. They have $10,000 in property taxes, $12,000 in interest expenses, and $5,000 worth of other deductions, creating a total of $27,000 worth of deductions.

They are in the 32% marginal tax bracket. The difference between the amount of deductions they have and the standard deduction is $3,000; 32% of $3,000 is $960, so they would only receive a $960 benefit from the mortgage deduction.

If the couple didn't pay off their mortgage, but instead decided to invest in a high-quality bond fund, earning 2.98% annually, they would be $5,000-$6,000 worse off than if they had paid off the mortgage, based on the profit gotten from a low-risk investment (which is also taxable). According to the *Journal*, they would have $5,301 more if they choose to pay off their mortgage: "It's a risk-free and now even more tax-advantaged free lunch."

This example shows that sometimes, the best financial move can be to just pay off the mortgage, especially if you are older or a cautious investor. In the end, though, it really comes down to the unique priorities of the homeowners in question. For instance, if this couple were to prioritize having a larger savings fund over having a paid-off house, they may choose not to pay off the mortgage, **despite the approximately $5,000 they would be saving.**

The aggressive client

Younger couples or aggressive investors might make a different choice. For those younger couples who will be able to invest for the long term (20-30 more years), and therefore expect an 8% return on investments per year, it would be worth not paying off the mortgage. Instead the couple should consider putting that money into the market since they would likely still be ahead of the game.

It's a personal choice

Overall, there are many reasons that a client, especially one nearing retirement age, might want to invest the money or just save it for a rainy day instead of fully paying off their mortgage. And for those who owe a small amount at a low interest rate, it might be worth it to build up savings and keep cash on hand for future expenses instead of making the decision to be mortgage-free. However, not fully paying off a mortgage might seem dangerous to clients who want to be debt-free once they enter retirement. Talk to your clients to figure out what the right move is for them, based on current tax laws and their unique wants and needs for the upcoming years.

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