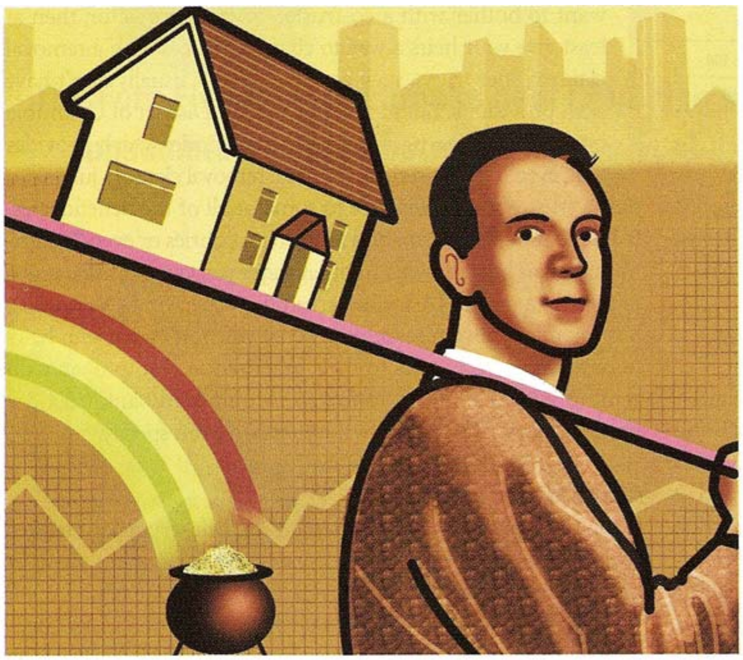
Hock Your House

Some advisers say to payoff your mortgage. We say leverage up and invest.

BY IRA CARNAHAN



SUZE ORMAN, THE UBIQUITOUS PERSONAL FINANCE guru, advises her followers to payoff their mortgages and live debt free. *"Please-become* mortgage free sooner rather than later," she implores readers in *The Laws of Money.* If you struggle to pay your bills, Suze's advice is sound. But if you are in a high tax bracket and your main concern is investing for the future, ignore her. So long as you have the self-discipline to invest the extra money you borrow rather than fritter it away, you're likely to come out ahead by carrying a bigger mortgage.

The reason is simple: the tax code. You can deduct interest on up to $1 million of mortgage debt (for the purchase of a principal and a second home) on your federal tax return. You can also get a deduction in 31 of the 41 states with income taxes, including such high-tax locales as New York and California, according to CCH Inc. For someone in the upper federal brackets living in a high-tax state, this can amount to a 40% or more government subsidy of borrowing costs. There are some restrictions and catches; for example, it's best to start out with a big mortgage rather than add on debt later. But more on the tax details later.

To see how this borrow-to-invest strategy works, consider a few numbers from E-Loan, the online mortgage lender. In November E-Loan was offering New York State residents a $1 million, five-year adjustable rate mortgage with no points and minimal costs at an interest rate of 4.9%. If you are a New Yorker who pays combined federal and state income taxes at a 40% rate, your after tax interest cost is just 2.9%. At the same time Vanguard's New York Long-Term Tax-Exempt Fund, with an average duration of 6.8 years, offered a yield to maturity of 3.8%. That's a 90-basis-point spread that the homeowner can scoop up. On $1 million of mortgage borrowing, you're ahead $9,000 a year, unless the bond issuers default (a low risk but not a negligible one).

You could, instead, get a 30-year fixed mortgage for 5.9% (reduced after tax to 3.5%) and buy a portfolio of 30-year munis yielding 4.7%, which would give you a spread of 120 basis points. What if interest rates fall and the bonds get called in early? No problem: You just cash out of the fund and call in the mortgage by prepaying it.

Using tax-subsidized borrowing to invest in tax-exempt bonds is a straight tax arbitrage. You may do better still if you're willing to invest mortgage borrowings in stocks; with this approach you are both tax arbitraging and shooting craps.

Since 1926 the S&P 500 has returned an average 10.4% a year. As a harbinger of the future this number must be taken with a certain caution: Much of the post -1926 return was from high dividends (averaging 4%), while today's yield is only 1.7%, and some of the past return was from expansion in price/earnings multiples, an expansion that cannot be counted on to continue. Still, it is not unreasonable to expect an 8% annual return from stocks over the next 30 years, or perhaps 7% after taxes. You must be prepared to accept lots of uncertainty in your annual returns and some uncertainty in the long-term return. It is quite conceivable that stocks, while you hold them, will return less than your mortgage costs.

When you borrow to invest, you must choose between an adjustable or a fixed-rate mortgage. You pay a significant premium to lock in a set rate for 30 years rather than the shorter lock you get with an adjustable.

If you're borrowing to invest in muni bonds, just match the mortgage to the maturity of the bonds you are buying. If you're investing in stocks, it probably makes sense to pay a premium to lock in a long-term rate and protect yourself against getting whipsawed. What if you get an adjustable and at the end of 5 years mortgage rates are up to 12% while your stock portfolio is down 20%? It could happen.

Now for the tax details. That $1 million limit on deductible borrowing is for what's known as "acquisition indebtedness." (The $1 million applies to single and joint filers. Married couples who file separately are limited to $500,000 each.) If you're refinancing, your "acquisition indebtedness" is limited to the loan balance from the mortgage you used to buy the house plus any amount you are now borrowing, or have borrowed, to improve or expand your house.

The interest on housing debt used for any other purpose is "home equity" interest. And here's the catch: Single and joint filers can deduct interest on just $100,000 of such borrowing; separate filers are limited to $50,000. Worse, home equity loan interest is not allowed in the alternative minimum tax. For 2004, 3 million taxpayers, including half of those earning $200,000 to $500,000, will pay AMT. And unless Congress changes the law, 19 million taxpayers will owe it in 2006.

Now here's another catch. The law says you can't deduct interest on a mortgage whose proceeds are used to buy or hold muni bonds. The first half of this rule is straightforward: If you take out a $100,000 home equity loan and the next day plop the sum into a Vanguard tax-exempt fund, the interest you pay is not deductible. But what about the "hold" part? Say you have $1 million in the fund, and then you buy a $1 million house, withdrawing only $200,000 from the fund and borrowing the other $800,000 instead of paying all cash. Was your purpose in taking out the mortgage to enable you to maintain $800,000 in the fund? Or to buy a house? It's murky, but you would probably win the right to deduct the mortgage interest even if you were audited.

So when you buy a new house, take out the biggest mortgage you can without incurring higher interest costs, even if you have spare cash. Invest the cash instead. And if you're at all restless in your current home (and don't hate moving), consider flipping your house to capture both the mortgage/investing arbitrage and another tax goody-the exemption from gains tax on up to $500,000 of profit on the sale of your principal residence.

The tax code may change, but the $1 million mortgage deduction isn't an easy target.

Say you're sitting in a house worth $1 million that you bought for $500,000 and on which you have a $300,000 mortgage. Sell the house and buy a new $1 million home with an $800,000 mortgage. You'll have $440,000 left to invest (after paying off the agent and your old mortgage), with all of the interest tax-deductible. Meanwhile, you've harvested a tax-free gain and eliminated the risk that Congress will take away the generous $500,000 gains exemption before you sell.

That raises the last risk in our borrow-to-invest strategy: Might Congress, in the name of tax reform or deficit reduction, further limits the home mortgage interest deduction? It's possible. While President Bush has suggested, any tax reform he proposes will retain the mortgage interest deduction, he hasn't said how big a deduction he aims to protect. Still, given the power of the National Association of Realtors, to say nothing of the builders' and bankers' lobbies, the $1 million mortgage deduction is hardly an easy target.