Is it Actually a Good Idea To Pay Off a Low Interest Mortgage?

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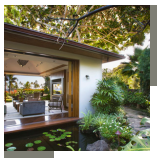

Home loans frequently make up significant amounts of household debt, and reducing as much debt as possible before entering retirement can seem like a good idea. A 2013 survey found that 40% of Americans ages 55 and older believe that paying off their mortgage was the smartest financial move they ever made.[1] There's also a certain peace of mind that can come from having one less bill to pay in your later years.

However, given today's low interest rates, your mortgage may be the cheapest form of debt to hold, and it may make sense to use the extra money in different ways. Given the choice, should you pay down your low-interest mortgage as soon as possible, or use the extra income to save more aggressively?

As with so many things, the answer is: it depends. Everyone's personal financial situation is different, and there are many factors to consider before making a decision about your mortgage.

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Things to Consider

Here are some questions to help guide your decision making.:

Are you maxed out on contributions to tax-advantaged accounts?

If you have crunched the numbers on your retirement assets with a financial representative and feel comfortable with your savings, you may be able to devote more income to extra mortgage payments. However, if you haven't maxed out your contributions or are concerned about your retirement preparation, you might be better off putting extra money into tax-advantaged saving accounts. The final

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years before retirement represent your last opportunity to add significantly to your nest egg, and it's important to make sure you have enough put away.

How would your taxes be affected by paying down the mortgage?

For many people, mortgage interest payments are deductible on federal taxes, which reduces the effective interest rate paid on the loan. Since contributions to retirement accounts, health savings accounts, and other qualified accounts are frequently tax deductible, making extra contributions (instead of extra mortgage payments), may add more to your bottom line.

However, if you are no longer able to deduct the interest on your mortgage, and are already maxed out on your tax-advantaged contributions to retirement accounts, paying down your mortgage could make financial sense. Keep in mind that taxes are just one part of the overall picture, and it's important to view your financial situation holistically.

Do you have adequate cash reserves?

Emergency savings are a critical part of your long-term financial plan. Unexpected life events like the loss of a job, a sudden illness, or expensive repairs can put a strain on your household finances. Having several months of income saved in cash can help you cover major expenses without being forced to liquidate investments or go into debt. If you don't already have an emergency reserve - or don't have enough money set aside - you should consider saving those extra mortgage payments for a rainy day.

Have you weighed risk against potential return?

Paying off high-interest credit card debt or personal loans is a no brainer. The average variable credit card APR was 15.61% at the end of April 2014.[2] This means you're essentially 'earning' that much back on every dollar you pay off. You're not likely to find investments paying that much consistently, so your priority should be to pay off that debt as quickly as possible.

However, given how low mortgage rates are - especially if you're getting a tax break on the interest - you'll want to carefully weigh the possibility of

Tax Implications

Home Mortgage Interest

According to the Internal Revenue Service[3], you can deduct the entire part of your mortgage payment that is for mortgage interest, if you itemize your deductions. However, your deduction may be limited if:

- Your total mortgage balance is more than $1 million ($500,000 if married filing separately), or
- You took out a mortgage for reasons other than to buy, build, or improve your home.

earning market returns higher than your interest rate. Market returns are not guaranteed, so it's a good idea to have a financial representative walk you through these calculations and help you understand your own attitude about risk and return.

How would paying off your mortgage affect your peace of mind?

Most financial decisions have emotional components, which is why it's so important to develop an understanding of your long-term goals. For many folks, knowing that they own their home free and clear outweighs most financial considerations. If being able to pay off your mortgage early helps you sleep better at night, it might be the best decision for you.

Conclusions

As you can see, there are many important variables that must be factored into a decision about paying off your mortgage. If you have any questions about the benefits and drawbacks of holding a mortgage or any other loan, please give us a call.We frequently help my clients evaluate their personal financial situations and help them determine the right strategy for their needs and goals.

Footnotes, disclosures, and sources:

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http://www.marketwatch.com/story/best-financial-decision-paying-off-mortgage-2013-04-24

2

http://www.bankrate.com/finance/credit-cards/rate-roundup.aspx

3

http://www.irs.gov/publications/p530/ar02.html#en_US_2013_publink100011857