

# THE PLAIN DEALER

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## ASK THE EXPERT

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**Credentials:** Certified Financial Planner, Certified Public Accountant, Certified Investment Management Analyst

**Experience:** 12 years

**Assets under management:** \$150 million

**Question:** *My brother and I always have the same argument. He says people are better off not paying off their mortgage so that they can always have the tax deduction. Is it true that people are better off always keeping a little bit of a mortgage for the write-off?*

**Advice:** No, people are not always better off holding on to a mortgage for the tax benefits. Each individual's circumstances should be reviewed to determine whether they should pay off a portion of their mortgage balance or use extra money for other needs. Start by asking yourself these questions:

- What is my true after-tax mortgage borrowing rate?
- Am I a disciplined saver?
- What after-tax rate of return can I earn on my investments?
- Do I have a cash reserve to cover three to six months of living expenses?
- Do I have job security?
- Do I have other debts that are costing me more than my mortgage on an after-tax basis (i.e. credit card, auto loan, etc.)?

Let's take a look at a case study to illustrate the decision-making process. We'll assume a \$100,000 mortgage balance at 6 percent interest; a \$10,000 auto loan balance at 6 percent interest; an expected investment rate of return of 8 percent; and \$30,000 cash on hand (\$20,000 of that is a six-month cash reserve). We'll also assume the person has a secure job, is a disciplined saver and falls into the 25 percent federal tax bracket and 5 percent Ohio tax bracket.

As you can see from the chart below, you should pay off your auto loan immediately because you are guaranteed a 6 percent after-tax savings on your money versus an expected 5.6 percent investment return. After your auto loan is paid off, you should invest excess cash over and above \$20,000 (your living

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expense reserve) because your after-tax investment return of 5.6 percent exceeds your after-tax mortgage rate by 1.1 percentage points (5.6 percent minus 4.5 percent).

If you are not a disciplined saver, you should use extra cash to pay down your mortgage. It wouldn't be beneficial to maintain the mortgage because the tax benefits would not exceed the investment rate of return on the bank account.

### COMPARING THE COSTS OF DEBT VS. INVESTMENT RETURN

	Mortgage	Auto Loan	Investment Return
Pre-tax rate	6%	6%	8%
Federal tax deduction	-1.5%	—	—
Federal and Ohio tax cost	—	—	-2.4%
After-tax rate	4.5%	6%	5.6%