The Business Library — **Resource Report #35**

Your Assets: Financing and Refinancing Properties

Personal, Investment, and Business Properties

- **Basic Analysis of How and When**
- **Fixed vs. Variable Interest Rate**
- **Points vs. Interest Rate**
- **Mortgage Strategies**
- **Tax Deductions**
- **Home Equity Loans**
- **Refinancing Checklist**
- **Calculating the Interest Savings**

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Mortgages: Look Beyond the Interest Rate

Let's assume you financed your home or business properties 10 years ago and are now carrying a 25-year mortgage with a fixed interest rate of 8.5%, which means your annual mortgage payment is $9,663 for every $100,000 of mortgage debt.

Now, if you refinance the mortgage at 6.5% (two points lower), your mortgage payment drops to $8,103 a year, an annual savings of $1,560. If you spend $4,000 in upfront refinancing costs (points, legal fees, appraisal, etc.), it will take you a little more than 2.5 years to recoup those refinancing costs ($4,000 divided by $1,560 annual savings equals 2.56 years).

That's the kind of basic analysis you need to do before deciding to refinance any personal, investment, or business mortgages.

Looked at long-term, a savings of two percentage points in the stated interest rate on a $100,000, 25-year mortgage gives you about $39,000 more money in your pocket over the life of the loan. But the percentage points are not the full story. Is the interest rate locked in? Are there other loan terms which can negate these interest savings or restrict your ability to refinance?

* * *

When interest rates decline, as they have recently, property refinancings increase, as individuals and businesses rush to reduce the interest cost for existing mortgages. But don't be too quick to react to a decline in interest rates. The rate is only one of the factors you should consider when evaluating lenders who are willing to grant you a mortgage or other long-term loan.

Use this **Resource Report** to review all the factors before financing or refinancing a personal, business, or investment mortgage. Save it for future reference, particularly the Table on page 9, which will help you evaluate different financing offers and calculate the interest savings when refinancing any mortgage.

☐ **Refinancings.** As a general rule, the interest rate difference between your existing mortgage and a refinancing should be about two percentage points to recapture the upfront costs of a refinancing. *Those costs can include the* *following:* points, appraisal fee, origination or loan processing fee, transfer tax, recording fees, legal costs (including the lender's), mortgage tax, and new title insurance.

After these costs are identified and totaled, ask yourself:

- Do the points apply to the *total* refinanced amount or just the *new money* you receive? If the points apply to the *total* amount, your effective interest rate increases.

  Example: You increase your $200,000 current mortgage to $300,000 and pay three points ($9,000) on the total amount. In effect, you pay nine points on $100,000 of new money.

- Is all of the interest tax deductible? There are limits, particularly for home financings.

- Are you extending the mortgage beyond its original maturity date? The interest paid beyond that date may not be tax deductible.

- Are you likely to buy another home within the next five years? If so, you may not recapture your upfront refinancing costs.

  Example: If the refinancing costs you $4,000 and your monthly payment will be $80 less ($960 annually), you will need to be in your current premises for more than four years to recoup the full refinancing costs.

- Do you want to refinance for a higher amount and use the excess money to pay off higher-interest-rate debt you are carrying or provide cash for a special project or need (e.g., college tuition or home improvement)?

  Reasons: The interest is tax deductible; the rate probably is lower than you would get on other loans; and the administrative and legal costs are lower per dollar borrowed.

☐ **Fixed vs. variable interest rate.** Think twice before replacing a relatively low fixed-interest-rate loan with a new variable rate loan, even if the new variable rate is less than the fixed rate. *A low fixed interest rate is a very valuable asset:* It can't be changed by the lender and you have the comfort of knowing the *exact* amount of your monthly mortgage payment today and over the life of your mortgage. For example, if you currently have a 7% fixed interest rate, the loan with a two-percentage-point savings of a 5% variable rate could end up costing you more since interest rates fluctuate greatly and will go higher over the next 30 years, taking your variable rate with them. Recognize also that in some variable rate advertisements, the low interest rate applies only to the first year or two.

☐ **Term of mortgage.** If the interest rate is fixed and low, you want the longest time to repay the mortgage, i.e., 30 years rather than 10 or 15 years. That's because the fixed mortgage payment becomes less burdensome as time goes by because of inflation. In 15 to 20 years, your salary may be double what it is today, but your fixed mortgage payment will be the same. Be aware that there is usually a one-half point (0.50%) difference in the interest rate between a 15- and 30-year mortgage.

What to do: It's always a good idea to get four proposals from your lender: 15-year vs. 30-year mortgage and then a fixed vs. variable interest rate for each.

☐ **Points versus interest rate.** Points are simply extra fees charged on a loan by a lender to increase the rate of return on that loan and to recapture some of the costs of processing and administering the loan. For example, 2 points on a $100,000 loan represent $2,000. This extra cost is usually paid upfront when the loan is made.

The points charged by a lender on a mortgage or on other borrowed money can make a big difference in the effective annual interest rate, i.e., your real cost for borrowing the money (see Exhibit 3 on page 11).

☐ **Points versus mortgage term.** The impact of points is even greater if a mortgage is repaid (or prepaid) in the first three to five years after the loan is made. Then the cost of the points is, in effect, amortized (written off) over the shorter period the loan is outstanding, i.e., from the date of the original loan to the date of repayment or refinancing.

For example, if 4 points ($4,000) are charged on a 7%, $100,000, 25-year mortgage on your home, the effective interest rate is 7.46% over the full term of the mortgage. However, if that mortgage is repaid in three years (say you buy another house), the effective interest rate increases to about 8.5%. Basically, you take the $4,000 in points and divide by three years for an extra annual cost of $1,333. That's in contrast to a 25-year loan, where the points are spread over 25 years for an annual cost of $160 — $4,000 points divided by 25 years.

☐ **Tax treatment of interest.** Interest on an original mortgage, including home equity loans, is tax deductible in the year paid. Interest on refinancings is generally tax deductible but check with your accountant; there are restrictions and limits, particularly if you extend a personal mortgage beyond its original maturity date.

Limit on deductions: Interest is deductible only on the first $1 million of mortgage debt and the first $100,000 of a home equity loan, for a total of $1.1 million. The $1.1 million limit covers both your principal and second residences, i.e., you don't get a higher limit if you own a vacation home. *Note:* These limits do not apply to business mortgages.

☐ **Tax treatment of points.** For an original mortgage on your primary residence or a home equity loan, points are fully tax deductible in the year paid. For refinancings, the points are written off over the term of the mortgage.

If you own property for business or investment purposes (e.g., you rent property to another individual or family), you also must write off the points over the life of the mortgage. *Example:* Two points on a $100,000, 20-year mortgage are deductible at the rate of $100 per year ($2,000 divided by 20 years).

☐ **Prepayment penalties.** Check the lender's policy on *prepayment* penalties for paying off a loan early, particularly if you intend to sell the property in the next five to 10 years. The questions to answer:

- How many percentage points are charged for early payoff of the mortgage?
- Does the penalty decrease every year (e.g., 7 points in year one, 6 in year two, etc.)?
- At what point are there no penalties?

Note: If you already have a mortgage, you will find the prepayment penalty in the mortgage agreement or the deed of trust instrument that secures the loan. If a penalty has to be paid, it's fully deductible in the year paid.

☐ **Late mortgage payments.** You may be unavoidably late in making payment because of illness, poor cash flow, or even oversight. Find out how long the lender gives you after the due date to make payment and what the penalty is if payment is made after that time. Penalties can vary significantly among lenders. *Protect credibility:* Plan ahead with your lender if there's a probability you may be late with payments for a period of time (e.g., you're disabled). It may be better to refinance or negotiate an extension of the loan than to incur continuing late payment penalties and negatively affect your credit rating.

☐ **More questions to answer.** Review with your accountant and lawyer these special mortgage terms and requirements, which can differ greatly from lender to lender:

- Is the mortgage assignable to a buyer when you sell the property? If so, this provision will help you sell the property at some future time, particularly if the interest rate on the mortgage is low.

- What is the cost for the appraisal and the minimum appraised value to obtain the financing?

- Are there any restrictions on your ability to rent the property? The fewer the restrictions, the more marketable your property. In addition, if you can't sell the property at a good price, the interim rental of it may be a good alternative until real estate prices increase.

- Does the lender require mortgage life insurance? If so, it's usually cheaper and better in the long run to buy level term life insurance. That's because the face amount of term insurance *doesn't decrease* every month as mortgage life insurance does. *Result:* With level term, you are getting *additional* life insurance coverage in future years when the amount earmarked for the mortgage is lower. This can be particularly important if you are not adequately insured now.

Another Option: **Home Equity Loans**

If you want to borrow or cash in on some of the equity in your home without the hassle of negotiating a new mortgage or refinancing, consider a home equity loan. Your current mortgage holder probably can arrange one with little paperwork. But watch the ads; special deals are always being made on home equity loans. Time your loan application to obtain the lowest interest rate.

Added plus: The total administrative and legal costs on home equity loans are usually much less than with a regular mortgage.

Negative and plus: Most home equity loans have variable interest rates. However, the total interest paid each year can be substantially less than with a regular mortgage since you pay interest *only* on the monthly amount outstanding, whereas in a traditional mortgage you pay interest on the full amount borrowed.

Summary Checklist:
Before You Refinance, Ask Yourself...

It pays to be prudent when effecting a mortgage financing or refinancing. Remember, you will be living with its terms for many years. Use the checklist below before refinancing a mortgage. Many of the ideas also apply to all mortgage financings.

- Do the points apply to the *total* refinanced amount or just the *new money* received?
- Is all of the interest tax deductible? Have I extended the term of the mortgage beyond the maturity date of the original financing? If so, check with your accountant; your interest deductions may be restricted.
- How long will it take for me to recoup the upfront costs of refinancing? Two to four years is excellent.
- Will I be selling the property within the next five years? If so, I may not recapture my upfront refinancing costs.
- Is there a penalty for paying off the mortgage early? If so, how much is it and for how long is it applicable?
- If I'm electing a variable interest rate, am I willing to live with the possibility that the interest rate could increase substantially? (Remember, the prime rate went to 20.5% in August 1981.)
- Do I want or need more life insurance to cover the mortgage debt? If so, would I be better off with level term insurance rather than mortgage life insurance, which decreases as the mortgage principal decreases?
- Can I rent the property without the lender's consent? This is a valuable option if I can't sell the property at a good price.
- Should I consider a home equity loan? It may be less expensive and easier to effect than a traditional mortgage.

- Rather than just refinance the existing amount on my mortgage, should I use this opportunity to borrow more money at the lower interest rate to consolidate some debt and/or provide extra cash for other uses?

* * *

Lenders are very competitive in the interest rates they charge for mortgages and in the terms of their mortgage agreements. Use the factors discussed in this report to help you evaluate lenders and their mortgage packages. Remember, the interest rate, while very important, is only one of the components to analyze when financing or refinancing a personal or business property. ☐

References:

- *Exhibit 1:* Calculating the Interest Savings, see page 9.
- *Exhibit 2:* Tax Treatment of Points and Closing Costs, see page 10.
- *Exhibit 3:* How Points Affect Your Interest Rate, see page 11.

Exhibit 1

Calculating the Interest Savings

To show the impact of a change in interest rates on a mortgage or any personal or business loan financing, here are the numbers for a $100,000, 25-year mortgage.

Conversion to other loan amounts: We illustrate a $100,000 mortgage but you can easily convert the numbers to your mortgage amount. *Example:* For a $250,000 mortgage, multiply the numbers below by 2.5.

Interest Rate	Monthly Payment	Annual Payment	Total Payments
9.0%	$839.20	$10,070	$251,760
8.5%	805.23	9,663	241,569
8.0%	771.82	9,262	231,546
7.5%	738.99	8,868	221,697
7.0%	706.78	8,481	212,034
6.5%	675.21	8,103	202,563
6.0%	644.30	7,732	193,290
5.5%	614.09	7,369	184,227
5.0%	584.59	7,015	175,377

Savings per $100,000 mortgage debt. The interest difference between a 6.5% and 8.5% mortgage is $39,006 over the life of the loan. That represents a savings of $1,560 for each year of your 25-year mortgage. Compare those savings with upfront refinancing costs of $3,000 to $5,000 and **multiply** the $39,006 savings for each $100,000 mortgage debt, e.g., $300,000 mortgage saves you $117,018. □

A two-percentage-point interest savings on a $100,000, 25-year mortgage amounts to $39,006 over the life of the mortgage.

Exhibit 2

Tax Treatment of Points and Closing Costs

Points are charges paid by a borrower to a lender. They are considered interest if paid solely for the use of money, and not for the lender's services. Points are *fully* tax deductible in the year paid if:

- the payment of points is an established practice in the area where you received your loan,
- the points are for the purchase of your principal residence,
- the points are computed as a percentage of the principal amount of the debt, and
- your cash investment (e.g., downpayment on the home) is at least equal to the amount of the points.

You no longer have to pay the points with a separate check. If the points are added to the loan amount, you can still deduct them, but only if your downpayment and any other cash amounts paid at closing equal or exceed the amount of the points. Even if the seller has agreed to pay you the points as part of your negotiations on the purchase of the property, you are still entitled to deduct the points rather than add the amount to your cost basis.

Closing costs: Other expenses paid in connection with the purchase of a home, such as commissions, legal expenses, application fees, transfer taxes, appraisal costs, and recording fees, are *not* currently tax deductible and become part of the cost (tax) basis of the residence. If you *prepay* a mortgage, any prepayment penalties are fully tax deductible in the year paid.

What about refinancings? Points paid to refinance an existing mortgage are tax deductible over the life of the loan.

What about business, investment, and rental properties? Points paid on both *new* and *existing* mortgages are tax deductible over the life of the loan. ☐

Exhibit 3

How Points Affect Your Interest Rate

The Table below illustrates the impact of points on the actual interest rate you are paying on a fixed-rate, 25-year mortgage. It is designed to help mortgage borrowers who are wondering whether they should trade a lower number of points for a higher interest rate (or vice versa). The numbers reveal, for example, that a 7% mortgage with a payment of 4 points (effective interest rate of 7.46%) is comparable to a 7.25% mortgage with a payment of 2 points (effective interest rate of 7.48%). Both loans are virtually identical to lenders, but they have quite a different impact on borrowers.

Contract	Points at Closing			
Interest Rate	One	Two	Three	Four
5	5.10	5.20	5.30	5.40
5.25	5.35	5.45	5.55	5.65
5.50	5.60	5.70	5.81	5.91
5.75	5.85	5.96	6.06	6.16
6	6.11	6.21	6.32	6.43
6.25	6.36	6.47	6.58	6.69
6.50	6.61	6.72	6.83	6.95
6.75	6.86	6.97	7.09	7.20
7	7.11	7.23	7.34	7.46
7.25	7.36	7.48	7.59	7.71
7.50	7.61	7.73	7.85	7.97
7.75	7.87	7.98	8.10	8.23
8	8.12	8.24	8.36	8.48
9	9.12	9.25	9.38	9.51

Fractional points. If the points charged fall between whole numbers (say, between two and three points), you can still obtain the approximate effective cost from this Table. *Example:* If 2½ points are charged on a 7% loan, the effective interest rate is 7.29% (about halfway between the rates for two and three points, i.e., the difference between 7.23% and 7.34%).

Other mortgage maturities. You also can use this Table to evaluate 20-year and 30-year mortgages since the effective interest rates are *not* substantially different. For 20-year mortgages, multiply the effective interest rate in this Table by 101%; for 30-year mortgages, multiply the effective interest rate by 99%. ☐

Four points on a 7%, $100,000, 25-year mortgage increases the effective interest rate to 7.46%.

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This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

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