Should I Pay Off the Mortgage on my Investment Property?

This may sound like a strange idea, but it may be better to owe money on an investment property then to pay off the loan. This idea is currently popular with many of our investor/owners and you should consult with your tax advisor to see if it makes sense for you. Using the full spectrum of benefits available from current tax laws and professional management means it could make sense for individuals to make money buying and holding onto residential investment homes. This is not about scouting out foreclosures and rehabbing derelict properties, it is about a long term strategy of financial security by owning quality real estate.

Current U.S. tax laws have created unique benefits for owners of income generating real estate. This has caused the explosion of Real Estate Investment Trusts (REIT's) where many major corporations and pension funds invest. Large office buildings and commercial developments are always financed to some degree because of the combined benefits of leverage and tax deductions.

The same tax laws that benefit institutional investors can be used to benefit the owner of single family residential properties. Deductions are allowed for interest on the loan, deprecation on the physical asset, as well as other normal expenses like repairs, management fees and leasing fees. The advantages of these deductions, together with the benefits of leveraging, provide an expected annual after tax return greater than 10%-20%. This is based on a typical $30,000 investment used as down payment for a rental home in Texas. This is a common return for investors in the Dallas/Fort Worth (DFW) real estate market and assumes that real estate will do what it always has – appreciate over time. This strategy is not a way to make instant dollars over night; it is a way to accumulate personal wealth over a 15-30 year plan, using a conservative investment that has outperformed riskier and more volatile vehicles such as stocks and mutual funds.

Here is where your benefits occur:

1) Income you can use today:

We recommend a Loan to Value (LTV) ratio of 80% or less when purchasing a rental home. Based on our experience in the DFW market, if you choose the correct profile for a rental property and use a down payment of 20% of the value of the home, you should experience some positive cash flow. This may only be $100/month, but this is income you can use each and every month.

Positive cash flow is a benefit still available in the DFW market. Investing in rental properties in most major metropolitan areas is an exercise in negative cash flow with a goal to benefit from extraordinary appreciation. Other areas are definitely higher risk, betting on the greater than normal appreciation to generate value from the investment.

$100/month in income on a $30,000 investment is roughly equivalent to a 4% annual dividend, but because of current tax laws, it will probably be tax free (see "2" below). This is the smallest component of growth you will realize from your rental property, but it is better then the dividends of most Wall Street stocks.

2) Reduced Taxes/Increased Deductions

Because current tax laws allow deductions for interest on the loan, deprecation on the physical asset, as well as deductions on other normal expenses even if you experience positive cash flow, your deductions during depreciation should offset any income. You may even show a loss that can be used to offset future taxable income realized from your rental property. Individuals owning 7-10 properties or more may be eligible for the deductions to accrue against ordinary income if they become a registered real estate professional.

Once a property is fully depreciated you will no longer have this tax deduction, however, refinancing the home will allow receiving equity in cash and reinitiating another life cycle of deductions from the new interest expense.

3) Asset Appreciation

This is where the benefits of leverage provide the greatest return. Real Estate in the DFW area has a history of slow but consistent value appreciation. We avoid the wide swings in home valuations of other areas of the country, so what would seem to be a meager 5% appreciation growth actually provides a tremendous return on the actual cash invested.

If you invested $30,000 on a $150,000 home, a 5% increase in value is returning $7,500 each year on your $30,000 – a 25% annual return! You will end up with capital gains if you eventually sell your investment, reducing your after tax benefit to 21.25% at current tax rates. If you use a more conservative 3% appreciation, your estimated return is still 15% before taxes and 13% after taxes. This financial reward, when added to the benefits you have realized on an annual basis from income and reduced taxes provide an extraordinary return.

4) Retirement Annuity?

After having tenants pay your mortgage over thirty years, you have an asset that you can use in many different ways. You can a) refinance the home and start all over, spending the money you receive from an equity loan, avoiding taxes on capital gains, b) you can sell the home, pay the taxes and live off the equity, or c) sell and reinvest in a more rental properties or a conservative vehicle like a fixed rate, insured, Certificate of Deposit (Bank CD's). No matter what you choose, your initial $30,000 should be a more valuable asset then most other places you can store money.

What are the risks? There are risks in any investment, so you should assess the impact on your complete portfolio of assets. There is a common myth that rental properties are a high risk investment, but with the help of a professional management firm many of the risks are minimized. Choosing Texas as a location for this investment adds to the level of security because the laws in Texas recognize the Landlord rights of the investor/owner, including the right to have tenants who pay the rent on time and take care of the property. It is true that you have the occasional bad tenant that might create a need for an additional investment to rehab a property. The current worst scenario could require a reinvestment of $5,000 to $10,000, but this investment is for items that extend the useful life of the rental property and can actually improve the marketability and value of your investment property.

If your financial consultant does not have specific expertise with ownership of rental properties in Texas managed by a professional firm, please refer them to us so we can educate on the viability of this type of investment. Prime Properties currently represents over 300 clients, some of whom rely on these investments as their primary source of income and financial security and many others who use this as a way to diversify a larger portfolio.

Summary: The same benefits that attract major corporations and pension funds to invest in REIT's are available to an individual investor of more modest means. The single family residential market allows you to become a REIT of one! If you are interested in this long-term strategy for growth, with an understanding that there are short term ups and downs, you can take advantage of leverage just like an institutional investor. This is done with lowered risk because of the historical growth benefits of real estate. Remember what Mark Twain said about buying real estate, "Buy land, they're not making it anymore". If you would like more information, we are glad to refer you to well-researched books written by investors with direct experience in buying and owning quality real estate in the single family residential market.

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