NATIONAL CENTER FOR POLICY ANALYSIS

Retiring Soon? Pay off the House First

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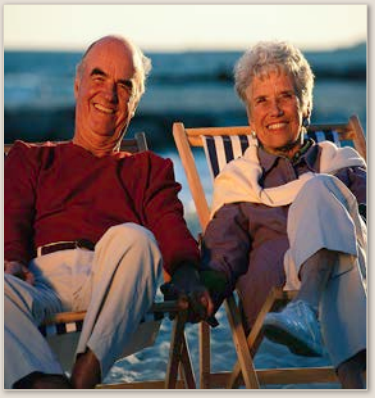
In 2011, the first of 78 million baby boomers turned 65. By 2031, the last year of the boomer generation will reach their full retirement age (67). Many will consider moving to a less costly, low-tax state to reduce their living expenses.



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However, more than half of those on the verge of retirement — 55 to 64 year olds — still carry mortgage debt, and some will carry it into retirement for many years. How will this affect their lifetime wealth?

The NCPA's State Tax Calculator (www.whynotmove.org) compares the tax burden from state to state as measured by the amount of lifetime spendable income after taxes and housing or rental expenses. The calculator accounts for federal and state income taxes, median property taxes, and state and local average sales taxes for each state. But regardless of where retirees spend their golden years, mortgage debt can significantly reduce their lifetime wealth.

Does Mortgage Debt in Retirement Really Matter?

Retirees have many reasons for carrying mortgage debt. If their mortgage payments are small, they may not consider it an issue to pay them in their retirement years. But it could have a substantial impact on their wealth. Consider a 64-year-old New Jersey resident who plans on moving to Texas (a state with one of the lowest tax burdens) and retiring at age 65. Assume he has $500,000 in tax-deferred retirement savings and $75,000 in regular savings. He currently earns $75,000 a year, and has a home in New Jersey valued at $300,000, with $50,000 left on his mortgage to be paid off in five years [see Figure I]:

- If he moves to Texas, purchases a house for the same amount ($300,000) and assumes a $50,000 mortgage for 10 years, his monthly payments will be low ($506 a month at a 4 percent fixed rate) but he will gain only $79 a year in discretionary income for the rest of his life. Assuming he lives to age 100, his lifetime gain will total $3,404.
- If he instead purchases a $250,000 home with cash, using the proceeds from his previous home, he will gain an additional $2,318 in annual discretionary income, resulting in an additional lifetime wealth accumulation of $99,334!

Two factors are at play. First, despite Texas' overall low tax burden, its median property tax rate is about the same as New Jersey's. Though property taxes and mortgage interest payments are both tax deductible, they are not enough to reduce his federal tax burden and increase his wealth. Thus, purchasing a less expensive home and paying it in full increases his wealth by reducing property taxes and interest payments.

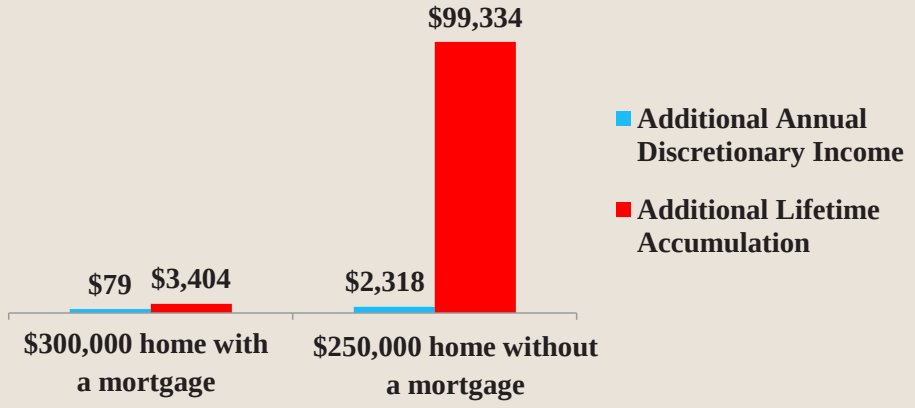
Because a home is often considered an investment, many

retirees may just assume that buying a bigger home is simply replacing a cash asset with housing wealth. While seniors could eventually tap into this equity through a home equity loan or a reverse mortgage, their homes do not always appreciate. Indeed, a home can be a poor investment if it is the only primary asset. The NCPA's State Tax Calculator takes into consideration the value of assets, including one's home, regular savings and retirement accounts, but only savings and retirement accounts are assumed to grow, at a conservative annual interest rate of 1 percent, adjusted for inflation.

Does more housing mean more wealth? Consider a couple earning $200,000 a year planning a move from New York to the lower tax state of Florida. Both spouses are 64 and will retire in a year. The couple has $1.5 million in retirement account savings and $200,000 in regular savings. They own a $400,000 home in New York with a $150,000 mortgage balance left to pay over 15 years. If they move to Florida, where tax rates are lower, and purchase a house for the same price as their New York home (with a $250,000 down payment and a 15-year mortgage), they will have an additional $3,651 to spend each year and an additional lifetime accumulation of $156,415. However, they more than double their additional discretionary income each year in Florida to $9,513 by "downsizing" to a $250,000 home and purchasing it outright. Their additional lifetime wealth would be more than $407,598. [See Figure II.]

Figure I

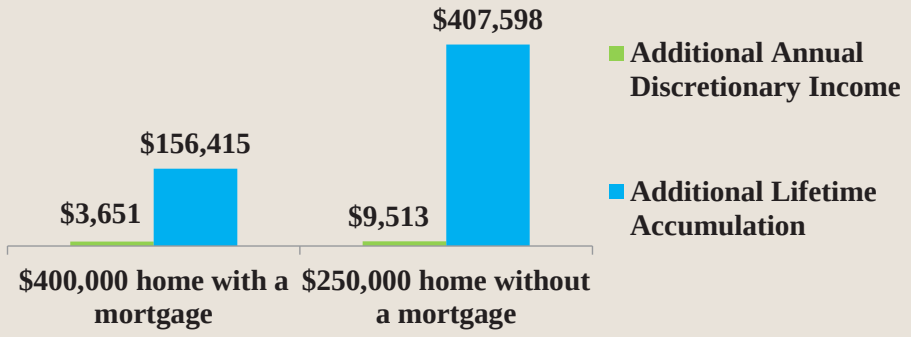
64-Year-Old Single Moving from New Jersey to Texas



Source: Author's calculations using the State Tax Calculator at www.whynotmove.org.

Figure II

64-Year-Old Couple Moving from New York to Florida



Source: Author's calculations using the State Tax Calculator at www.whynotmove.org.

Mortgage interest may not concern some retirees, as it is a tax deductible expense. But Social Security benefits and retirement account income will likely put them in a lower tax bracket than while they were working. Itemizing may not be the best way to reduce their tax liability. For tax year 2013, the standard deduction is $6,100 for singles or marrieds filing separate, and $12,200 for marrieds filing jointly, which could be more than if they itemized. So paying interest on a mortgage gives the homeowner no tax advantage.

Conclusion. When considering a move for their senior years, whether to another home or another state, pre-retirees should look at the pros and cons of carrying a mortgage. Paying down higher-interest debt, such as credit cards, should take first priority, but those who have only mortgage debt should think carefully before taking on another mortgage or extending their existing one.

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