Retirement Guide

Borrow and Build

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Two-thirds of homeowners 65 or older and one-half ages 55 to 64 own their homes free and clear. It's comforting to go into retirement with no mortgage. But if you are affluent, you might do better by borrowing against your home to pay for renovations than by drawing down your savings.

The reason is the tax code: Interest paid on up to $1 million of home mortgage debt is deductible in both the regular and the alternative minimum tax, provided the money is used to acquire or improve a primary or secondary residence. That's true regardless of whether you borrow through a first mortgage, a home equity line or a home equity loan.

The first question is where you'll get renovation cash if you don't borrow. Are your liquid assets mostly in pretax retirement accounts? Withdraw from an IRA and you'll owe federal tax at ordinary rates of up to 35% and sacrifice years of future tax deferral. That makes borrowing on your home attractive.

Even if you have money available in a taxable account, borrowing could make sense. The interest rate on new 15-year fixed-rate conforming mortgages (meaning those qualified for purchase by the federally chartered Fannie Mae and Freddie Mac) averages 5.4%. Say you live in California and your combined federal and state tax bracket is 40%. That mortgage would cost you only 3.2% aftertax. The Vanguard California Long-Term Tax-Exempt Fund (weighted average maturity: 10.5 years) yields 4.1%. So you could use a mortgage to pay for the renovation, while investing your savings in munis, to get a profitable little tax arbitrage. Caution: You can't pay cash for the new wing and then borrow against the house to invest in munis; that sequence of moves makes the mortgage interest nondeductible.

First mortgages are generally cheaper than home equity lines, which are usually second mortgages on a property. If you don't have a first mortgage, you can get one to finance renovations. If you do have a first, consider a "cash-out" refinancing--you replace your existing loan with a larger one and use the extra cash for remodeling.

One reason a cash-out might look good now is that for 2008 Congress has increased the size of loans Fannie and Freddie can underwrite from $417,000 to as much as $729,000 in high-cost areas. These typically carry lower interest rates than larger "jumbo" loans. You might have a jumbo now that can be refinanced as a conforming loan, even with the extra cash you're taking out.

A cash-out may not be the best choice if you already have a very low rate first mortgage or a first mortgage with a prepayment penalty. Jack M. Guttentag, a retired Wharton School finance prof, offers calculators that let you factor all this in, at mtgprofessor.com.

A home equity line can be attractive if you plan to do your renovations over time; the bank approves you for a certain amount, and you draw down cash as you need it. Lines typically carry an adjustable rate keyed to the prime rate. In early May the rate on new $100,000 equity lines averaged 5%, versus 6% to 7% for new fixed-rate home equity loans.

But there are two hazards with equity lines right now. Once the economy recovers and the Federal Reserve starts tightening again, adjustable rates will rise. So unless you're planning to pay off a line quickly, get one that allows you to convert to a fixed-rate home equity loan on favorable terms, advises Guttentag. Wells Fargo, for example, gives you nine opportunities over the life of the loan to convert your variable-rate balance into a fixed-rate loan.

The other hazard warning: As home prices drop, lenders are reducing the amount customers with existing untapped lines and modest equity can borrow. If you're in that situation and relying on a line to pay contractors, consider drawing down the money now, says William Jordan, a financial planner with Sentinel Group in Laguna Hills, Calif.

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