FINANCIAL ADVISORY

Why Interest Only Loans Can Make Sense for Investors

BY CHRISTOPHER MILLER, MBA
SPECIALIZED WEALTH MANAGEMENT

Happy New Year! As a real estate investor, you have probably heard of interest only loans. If you haven't, these loans are exactly what their name implies; a loan where the borrower makes payments of "interest only."

Most loans, like an auto loan or a traditional home mortgage, are "amortizing loans." This means that each payment you make will include both an amount that decreases your principal (the loan balance) and an amount that is simply an interest "fee." This interest charge is what you are paying to "rent" the money.

For example: if you buy an investment property with a $1,000,000 loan, fully amortizing over its 30 year term, at 4%: your monthly payment will be $4,774. During the first year of your mortgage, your payments will total $52,289. As I mentioned earlier; these payments have separate components that represent principal and interest. $17,610 will go to pay down the principal balance of the loan, and you will be charged $39,679 interest to "rent" the money. Change that loan to an interest-only one, and your monthly mortgage payment will drop to $3,333 or $40,000 annually. Could you use an extra $1,441 / mo. of cash flow?

AREN'T INTEREST-ONLY LOANS RISKIER?

Some in the real estate industry, (often those trying to sell conventional amortizing loans), will dismiss interest-only loans as "risky." I think a substantial case can be made to support a statement that "interest-only loans can offer less risk than an amortizing one." How could this be? Let's use the example above and compare an amortizing loan at $4,774 per month vs. an interest-only one at $3,333 monthly. Which payment will be easier to make every month? When taking out a mortgage, your primary risk is that you won't be able to make the monthly payment and will lose the property to foreclosure. With which of the above loans is that most likely to happen? The loan with the higher monthly payment is always the harder one to pay.

AMORTIZING LOANS ARE LESS TAX EFFICIENT

Most everyone knows that mortgage interest, just like insurance and property taxes, is tax deductible for your rental properties. Some don't realize that the portion of their payment that goes towards amortizing the loan is taxed as income by the IRS. Even though it is not spendable income, as you've already spent it on something else, you are still taxed on it. As I often say; a tax on money that is already

Please turn to page 72

Christopher Miller is a Managing Director with Specialized Wealth Management and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator and as an advisor helping clients through over four hundred and fifty 1031 Exchanges. Chris has been featured as an expert in several industry publications and on television and earned an undergraduate business degree and an MBA emphasizing Real Estate Finance from the University of Southern California. Chris began his real estate career in 1998. Call him toll-free at (877) 313 – 1868.

Continued from page 70

spent is the most expensive of taxes. For a high earner in the 45% (Federal + State) tax bracket, this leads to an additional annual expense of $7,925 when we use the $1,000,000 amortizing loan above. Note that, with an interest-only loan, you would still pay this $7,925: you would just have $9,686 left after taxes to show for it. With the amortizing loan you have already spent this money on amortization payments. By offering more spendable income, the interest-only loan is starting to look more attractive.

Additionally, due to the way an amortizing loan works, the taxable portion of your monthly payment will get larger every month. We'll explore that in the next paragraph.

HOW DOES AN AMORTIZING LOAN WORK?

As a loan amortizes (as the balance is paid down over time), the principal of your loan decreases. Therefore, your interest charge will decrease with the loan balance. (4% of a lower principal amount yields a lower interest charge.) Because your monthly payment remains the same; the amount of expenditure that goes towards the mortgage balance will decrease every single month. Your first monthly charge on the $1 million loan will include $3,333 interest + $1,441 principal = $4,774. Your last bill is $16 of interest and $4,758 principal = $4,774. Although your monthly expense has stayed the same, your principal payment, (and your tax bill), have both risen steadily over the loan term.

BUT I AM LOSING OUT ON PAYING THE LOAN DOWN – RIGHT?

Well, I would not call it "losing" anything. Rather than giving that income to the bank to pay down your balance, you are keeping that money for yourself. An amortization payment isn't really an "expense" like electricity, where the money is gone forever, but it does represent less money that you can spend today. Would you rather have a dollar today or a dollar in the future, when your loan is paid off? Myself, I think that I could make better use of a dollar today, and would rather have it than give it to the bank.

Note, too, that this "paying down" of your mortgage is not significant in the first 10 years of your mortgage. By again turning to the $1 million amortizing loan above, we can calculate our year-end loan balances by year. After 4 years, the loan balance is still $925,136, it is $882,973 in six years and only crosses the 20% paid threshold in year 10 when it ends the year at $787,840. Your year 10 loan balance with an interest-only loan would still be $1,000,000, but you haven't "lost out" on $212,160 by any stretch. In fact: that $212,160 went directly into your pocket rather than the bank's. This would produce almost a quarter million dollars more spending money over a decade. Now THAT is attention getting.

ARE INTEREST ONLY LOANS FOR YOU?

The point of my article this month isn't to convince my readers to run out and get interest only loans. I'm only seeking to educate investors about these financing vehicles. Too often I hear investors dismiss ideas offhand without learning more about them and thinking critically regarding their use. After all, informed landlords are smarter investors: and smarter property owners have the opportunity to be more successful. If you'd like to talk about this month's topic, my toll-free number is (877) 313-1868.

Securities offered through Emerson Equity LLC, member FINRA/SIPC. Emerson Equity LLC and Specialized Wealth Management are not affiliated. All investing involves risk. Always discuss potential investments with your tax and/or investment professional prior to investing. Hypothetical scenarios herein are provided to illustrate mathematical principals only, and they are not a promise of performance. There can be no assurance that any investment strategy will achieve its objectives.