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MORRISSEY MONEY MATTERS
The Property Management Firm
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WE HELP PEOPLE BUY AND SELL HOUSES TOO AND HAVE FOR DECADES.

MORRISSEY MONEY MATTERS RENTAL HOUSE NEWSLETTER

Las Vegas Rental Newsletter –Since 1981 - APRIL 2017 ISSUE, copyrighted George Morrissey/PSI *written by George Morrissey, Real Estate Broker, Investor, Tennis Player, Property Manager,* GRI, E-Pro Certified, Bachelor of Science in Finance, NARPM, UNLV Alumni, Alpha Kappa Psi

SUBJECT: IDEAS ABOUT PAYING EXTRA ON YOUR "MORTGAGE"

I have wanted to write this for a long time – as I continue to either be surprised and "told" "Hey George" I just paid off my rental house mortgage! Or find out when we ask an owner for more money for a big surprise repair, they don't have it – because they have been paying "extra" on their mortgage for years and are low on funds. Don't let this be you so read up!!!

Here are some real stories…

I was managing a house for a long time for a client who lived on the same street as his rental. His rent was about $1200 and his payment was about $850. Normally with this kind of positive (about $350 less fees) cashflow this would be a "keeper" for a long-term owner (like my family).

It should be noted he was taking all his cash flow and adding about $300 on top of that to pay off his mortgage faster and sooner. Just by adding up his extra $300 for 12 months we can see he was coming out of pocket $3600 each year he kept doing this. 12 x $300 = $3600. Now I did not know he was doing this. This was an older house on a cul de sac near Tropicana and Rollingwood area. Finally – as all older houses do – it had a big (not scheduled) repair needed. That repair was that it was time for a new roof. The cost for the new roof was going to be about $8,000 as he also needed some extra work over his garage, the patio, and the underlying wood that had rotted away over time.

Guess what? He did not have the $8,000! And since he ran a pizza restaurant business – and was struggling – had no extra funds from his business to help, and his credit cards were maxed out! When I found out he had been paying off his mortgage each month "early" and with "extra money" I had to tell him to stop! As each owner needs, at least six months (if not twelve months) of CASH RESERVES available for any future – and it always does happen – expenses, repairs, maintenance, turnover costs, vacancy, services and repairs. He eventually worked out a personal loan from his family but he got so "tight" with his money that he had to sell the house as he could not afford another vacancy or turnover or any substantial expense. I ended up selling it to the tenant – which is always a good first choice for an owner – so he got a substantial discount on my sales commissions as only one brokerage was involved – not two – so that went well.

When you sell to a tenant, the seller gets:

No Vacancy – because the tenant Is already in the house and will pay rent until the close of escrow!

Less "Negotiated Expenses" – where a buyer may only buy if the seller does "fill in the blank____" in his offer. However, the current tenant – who already has accepted the house and lives in it usually has LESS to ask for as a "Negotiated Expense" because the tenant/occupant already knows the property.

Less repairs are needed by selling to a tenant. A repair may have been caused by a tenant, so they don't ask for it to be fixed – where a new buyer might ask. Also, the tenant has again "accepted" the current condition way more than a "new buyer" so asks for less.

The tenant does not have to move so that saves the tenant money and gives him more motivation to buy the property.

The tenant is guaranteed to get his full security deposit back – and why not? If he is staying and buying the property.

The tenant will get some prorated rent back. So, if he pays rent for a full month, but closes escrow in the middle of the month, then the tenant would get back two weeks rent he paid in advance.

The tenant, if he gets a new loan to buy – and most buyers do – won't have a mortgage payment until 30 days after he closes escrow. Rent is paid in advance, but mortgage payments are paid in arrears (after the period is over) so this is almost like getting a free month to live in with no payment! Thus, the tenant does get to skip one payment. If he closes escrow on April 1st for example, he would not owe rent that day, and his first mortgage payment would be due May 1st! He still pays interest for April, but it is due in the May 1st payment. ALL THESE REASONS ARE WHY TRYING TO SELL TO A TENANT IS A GOOD FIRST TRY WHEN SELLING A PROPERTY. The tenant has many reasons as you can see now to consider very seriously buying the property. Thus, he is “motivated” to make a deal which may mean more flexibility which is good for the owner.

Now from the Sellers perspective – the seller can be more flexible too because the seller avoids

Vacancy – if the tenant buys there is no vacant days!

Utility cost – if the tenant buys the home, then the utilities are never put in the owner’s name!

Close escrow sooner. If the tenant buys we assume there won’t be 3-5 months of marketing time and then waiting to close escrow. We should be able to close sooner! So, there won’t be 3-5 months of paying for the utilities, mowing the yard, and/or potential vandalism against the now vacancy!

The Seller can be more flexible too as he gets all these built-in advantages – that will save the Seller money - so why not be more flexible?

Part of the “process” that works the best is for the property manager to approach the tenant and help with this type of sale. Why? Because we have a relationship already built up with the tenant and help facilitate this sale much easier than another “stranger agent” who shows up to list the property. Also, since that other “agent” has no loyalty to the landlord tenant relationship, they many times do not even try to sell to the tenant and charge you full fees. It can be a real mess when you have two generals (the sales listing agent and the Manager listing agent) try to take care of the house and the tenant at the same time. Not recommended. What is, is to have ONE person in charge of the property who is helping you. And if the tenant does not buy, have them move out BEFORE you list it for sale.

More on paying off your mortgage. Here is a trick question. If you had a 4% interest rate on a $100,000 mortgage with an $850 payment what would be our “return” on your $1,000 if you paid “extra” this month over and above your regular mortgage payment? Answer: 4%. Why? Because if you pay EXTRA towards your mortgage – then you are NOT going to be charged interest on that $1,000 thus you are SAVING on the Interest charge – which in this case is 4%. So, you are saving 4% and not being charged anymore this 4% so you are making 4% on your EXTRA money you are investing by paying off your mortgage early.

A few more things to think about. This mortgage is giving you a TAX BREAK by you writing off any interest you pay on this mortgage. And if you pay it off (anytime) or early or extra – then as we all know you are SAVING INTEREST. This also means you are LOWERING YOUR TAX WRITEOFF which MAY raise you into the next higher tax bracket if you are close as you are LOWERING the amount you can write off the more you pay it off – either all at once or over time with normal payments or with extra payments.

Now BEFORE you start paying it off early and making extra payments LOOK AROUND at the rest of your financial life. Do you have an auto loan outstanding? Or a Credit Card Balance? I bet those interest rates are HIGHER than your home loan and probably not able to write off either! IF so your efforts should be to pay OFF the Auto Loan and/or Credit Card and/or any other debt that has a higher interest rate than your home loan! This one factor alone will save you more money than paying off your home loan.

The man above, who was cash poor, and who was paying off his rental home mortgage early with extra money each month – STILL had the same mortgage payment amount. Paying extra does NOT lower his mortgage payment. It just means you have LESS cash around for the future because you are spending it now – vs. having it later!

The simple formula is when paying off debt is this.

Don't pay the highest balance off first. PAY OFF THE AMOUNT THAT HAS THE HIGHEST INTEREST RATE THAT YOU ARE BEING CHARGED. This will save you the most money.

An example

$100,000 Mortgage at 4% with an $850 payment

$5000 Auto loan at 7% with a $300 payment

$1000 Credit Card at 12% with a $20 minimum payment. Which to pay off first if you had an extra $100?

YOU WOULD PAY OFF THE CREDIT CARD FIRST TO SAVE THE 12% AND pay the minimum to everyone else, then once the Credit Card Balance is ZERO you would then pay the Auto loan off. And then MAYBE see some more ideas below) you might consider paying off extra on your home loan.

My dad's example of paying off a 2nd mortgage (a true story).

My dad had a condo he rented out with a negative cash flow of about $180 a month. There were two mortgages on the property. While I was getting my finance degree in college and busy chasing down other money seminars to take – he announced one day that he had paid off his second mortgage and was super happy about it! I asked him how much the interest rate was on the 2nd mortgage and he said it was like 8%. Not bad. But how much did he pay off? He said $44,000. How much cash money did he have in his overall reserves? He said about $55,000. So now he was down to $11,000 in reserves. It should be noted that he had a few other rental property and business concerns. I noticed that now his cash flow had improved from a Negative $180 to a positive $140 a month or so. I commented and told him that with his lifestyle, he would probably not notice much that new $140 a month, but he may notice being $44,000 short for something "else" in the future. Well I never forgot that because of the following opportunity that my dad had the idea to follow…

My dad was presented the opportunity to buy a local McDonalds franchise here in Las Vegas about four months later. And it looked like after going over all his borrowing power, cash flows, personal investor loans, and is cash he was $45,000 short!!! No matter what he tried to work out it did not. So, he never bought that McDonalds Franchise, and the man who did now owns eleven (11) McDonalds franchises here in Las Vegas. I never forgot this. And I realized – which a principle I hold on to today – is this. Sometimes there is Debt that is GOOD debt. That would be debvt that is not too expensive (meaning it has a low interest rate) is easy to pay back (meaning it has a lot of years left to pay back) is tax deductible (mortgage debt usually is and credit card debt is not, and sometimes pay for itself (with a tenant paying some or all the debt back) by paying it off with rents collected. What IS Expensive, is not having to pay the interest, but NOT having the CASH for other opportunities like fixing your roof so you don't have to sell your house the man with the bad roof that had to sell it, just missed the BOOM in Las Vegas, and would have made $75,000 and more just by holding onto that property a few more years. My dad missed getting that McDonalds franchise which may have changed my family's life forever!

Moral of this story: Having Cash is better than paying off cheap debt. Cash is King, and lends itself (no pun intended) to other opportunities. I also asked my Dad if he got a discount by paying off that 2nd mortgage? I knew that 2nd mortgage was held by a private party and he may have received a 5-10% discount on the principle BY JUST ASKING! And if not, then don't pay it off!

By the way, a "Pro" may have taken my Dad's $44,000 and used that a as a down payment to buy another property – using leverage to get higher returns and more growth and cash flow and tax shelter in the future. Using a device – a rental house – that we are familiar with.

Two or three of my owners have announced – even after talking to me – that they are making plans to **pay off their mortgage on their rental in full** with a big chunk of cash – or selling it to pay off another mortgage for the house they live in.

Let's look at what a pro may do and what someone else may do.

The facts:

$100,000 mortgage balance at 4% Payments are about $750.

Taking $100,000 and paying this off. The owner will save 4%. Or about $4,000 in interest he would have paid this year.

A Pro, may take that same $100,000 and invest it in something that pays a HIGHER rate than 4%. Which is possible to do more than you think! Let's say I took that money and bought ATT stock which is paying about 4.5% a year right now in dividend yields.

Thus, I would make $4500 a year, pay the $4,000 in interest (by not paying off the mortgage) and pocketing the difference – in this case the $500.

Then next year, when the interest will still be the same, but the principal has gone down more, I would pay less in interest – say $3,900 and pocket the difference – in this case $600. This would continue for years and when I finally paid off the mortgage – I would (supposedly) still have my $100,000 in value of the ATT stock and still be getting dividends.

Note, this stock is kind of a boring stock and does not fluctuate widely (which is why I picked it for this example). It does have a great track record of paying dividends over and over and not missing payments, and does have some growth potential too. And ATT could and usually Does RAISE their dividends so often!

The example below makes some assumptions which could change.

I would think the ATT stock over 20 years could go UP in value and/or I could switch the stock to another with a better dividend yield, and or better growth potential. Also, ATT could raise their dividends as they have in the past, thus my savings would be greater than $500 a year.

My Client	Me with a different method
1st year $100,000 mortgage at 4%	1st year $100,000 mortgage at 4%
20 years left to pay	20 years left to pay
Rent of $1200 covers payment of $750	Rent of $1200 covers the payment of $750
Takes his extra cash and pays it off	Takes $100,000 and buys ATT stock
$0.00 mortgage balance	$100,000 mortgage balance

$0.00 Cash in bank	$100,000 in ATT stock
Year #2	Year #2
$4,000 interest saved, $4000 saved	$4500 in dividends earned, $500 saved, $4,000
	Paid in interest, thus I write off $4,000 (lower tax bracket too)
Year #3	
$4000 saved, $0.00 in bank	$500 saved, $100,000 in stock value
Year #20	Year #20
$4000 saved for 20 years is $80,000	$500 saved for 20 years is $10,000
$0.00 in bank	$100,000 in Stock Value.
What's left	

My Client over time sees this:

His $100,000 is gone. Thus, he has $0.00 in the bank. He did build up his cash savings at $4000 a year by not paying interest. However, he may be in a higher tax bracket now because he is not writing off that interest. Also, he sees no growth on his $100,00 as it was spent. He no longer has Cash for other opportunities for this time either (remember by dad's story). At the end of 20 years this house is still paid off, but my client spent his $100,000 20 years before that, so has no more cash left (unless from other sources).

What I see is This over time:

$100,000 in Stock savings still around. Sure, this could be LESS than the $100,000 I originally invested, but It could be more too. I now have $110,00 in cash and stock together at the end of 20 years. And the interest I paid over time was covered by my dividends and "then some" and helped keep me in a lower tax bracket. So, at the end of 20 years left on this mortgage which naturally (in this example) is now paid off, I have the best of both worlds by having a free and clear rental, and $110,000 in cash value too! During these 20 years, I could also take some of my stock and sell it and buy another rental house -using leverage and locking up a 30 year (the best) fixed rate mortgage at a low rate (we love those). And let inflation let my money grow in the house value going up over time and my tenants help paying it off too.

A summary:

If you have any other type of debt – be it a car loan, credit card balance, personal loan, boat loan, etc. Those should be paid off first. Pay off your house last -but before you do think about it. And think about if you want to "keep your cash around" instead of paying off a very inexpensive – as in "low interest" rate loan. You may be glad you have the cash.

Advantages and Disadvantages for Client

Less Debt. Easier for him to qualify for a loan later. Safer. Less Debt lowers the risk of him losing his rental house etc. His month to month cash flow will go UP by not having to make a mortgage payment.

He no longer has a large chunk of cash. This may make him miss other opportunities. He no longer has the interest write off, thus will pay "taxes" on his extra income – without that write-off. This alone could make him be in a higher tax bracket.

<u>Advantages and Disadvantages for Me (my method)</u>

I still have the mortgage Debt. It may be harder for me to qualify for other loans. However, I do have the rental income to offset that. I do keep my interest write off, thus I may stay in the lower tax bracket which could save me a lot (thousands) of money on taxes. I still have my $100,000 "base" of cash around – which is earning me MORE money that still pays off the debt and gives me "a bit of extra" money as in MORE than before. I am in good shape and STILL could take my cash and use it to pay off the mortgage in the future. But remember, If I wait just five years that $100,000 mortgage balance may only be $90,000 as it does go down each month when I make a payment – which could – again – allow me to retain more cash in my hands than what my client did.

<u>I feel I am much better off by using this method instead of my Clients method.</u>

Besides, the rule is if you can take your Cash and earn MORE somewhere else vs. the amount you are paying in interest – and in this example this is the case – than you should NOT pay off your mortgage early! Ever! And If you are cash poor and don't have six months of cash to pay your mortgage IN THE BANK THEN DO NOT PAY EXTRA ON YOUR MORTGAGE. You would be better off taking that $100 and putting it into the ATT stock (in this example) earning a higher yield than what you are paying.

<u>Another client lives in his own house – with a mortgage and has a rental in Las Vegas – also with a mortgage. His plan is to sell the rental house now and take the money and pay off his current home mortgage</u> – thus achieving a free and clear house where he lives. Certainly, a goal all investors and families should want. But there are different ways to go about it. A quick look…

<u>His idea:</u>

Sell house for $240,000 (all numbers are approximate but this is a real story). He will pay no taxes as he lived in the house 3 of the last 5 years before he rented it – and this is one good advantage! But not everything to consider! After paying off his fees, closing costs and mortgage on his rental house, he will net about $100,000 from his sale. The ONLY advantage I see is A) having less debt so is "safer" financially and B) not paying capital gains tax (which is low anyway) on the sale of this rental – since he lived in it 3 of the last 5 years. Those are the only advantages. He would have MORE advantages by using other methods to accomplish his objective – see below.

He plans to take this $100,000 and then pay off his home mortgage – also about $100,000 thus making it free and clear. His rental house has a mortgage of about $800 and his rent is about $1200 so he currently has positive cash flow and about 18 years left on his rental house mortgage (about 25 years left on his personal home mortgage). So, this example is simple. He loses one asset to transfer equity and profit from the one rental house to his personal house. So, he would then have 1) less leverage 2) less assets 3) but a free and clear home – which is safer to own as one cannot "lose" a home to foreclosure (except for property taxes and vendor/utility/hoa liens) with no mortgage!

Summary of my client's future position:

One House free and clear (that if it goes up 50%) would be worth $375,000

$0 in rent coming in. But no more mortgage payment mostly paid from other (not rent) owner funds.

Easier to qualify for a loan in the future because of less debt.

However, the cost of the sale does eat up part of your profit etc. (if no sale, then no closing costs).

My plan would be to keep both houses if I was in his position. What are the differences?

1) Houses are going up (at least) $500 a month right now. So, I would have 2 going up at the rate of $6,000 per year for each, thus $12,000 in appreciation for one year! And that $12,000 is NOT taxable until I sell (If I ever do). If I sell the rental I would lose this $6,000 (or more) annual appreciation.
2) The rental house pays for itself with positive cash flow. Some of this positive cash flow is "tax sheltered" by the depreciation from the rental house. And some of this cash flow (not all) helps pay the mortgage on my personal home.
3) Each month I continue to pay both mortgage – I also enjoy "paying down" those mortgages. I am probably at this point paying down – just using natural amortization by making the minimum payments - paying down about $150 (or more) monthly per each mortgage. This is a $300 benefit that will go away if I sell the rental house.
4) I continue to get other tax shelter by just owning the rental house from the depreciation the house creates (IRS rules) at the tune (normally) of about $3,000 a year or more. If I sell the rental, this goes away too.

Summary of my future position:

I would have TWO free and clear houses. This would give me 1) more cash flow 2) more leverage 3) more tax shelter. And I would have more equity. And if any inflation or appreciation takes place – and many feel Houses in Las Vegas will go up 50-65% in the next 5-10 years or so – then I enjoy that too and am on the RIGHT side of inflation/appreciation. So, if the cost of paint, eggs, movies, plumbing, electrical, roof tiles, carpet and everything else GOES UP! – So does rent (my rent) and the value of both of my houses. I then could sell the rental house in the future and make MORE money than by using a limited amount of money today and have less growth and opportunity.

Thus $375,000 in my personal house and $375,000 in my rental or $750,000 total

And $1200 (or more) in rental income monthly from the rental. So, I have a moving working asset base that has expanded more than by paying off a fixed debt lowering my opportunity.

$750,000 total in equity AND $14,000 in monthly rent coming in (from the rental).

No closing costs paid, because no sale took place. Note – I could sell my rental in the future and do a 1031 Tax Free Exchange (again, using the IRS rules that are in place) and pay NO TAX on my profits if done correctly. Part of the exchange rules are that you buy a property that costs one dollar or more than the property you sold, and you don't touch the money from the sale at any time, and you identify the property you are going to buy within a certain time frame. The IRS code says "IRC Section **1031** (a)(1) states: "No gain or loss shall be recognized on the **exchange** of property held for productive use in a trade or business or for investment, if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment." And From the time of closing on the sold property, the investor has **45 days** to identify another property(s) and has a total of **180 days** from closing to acquire the replacement property. I have done several exchanges for my family and clients.

So, next time you think about sending that extra $100 towards your mortgage, evaluate your position and if you are cash poor – don't – and have our savings grow for a rainy day. And if you are thinking of selling, make sure it is the right time, as you may be giving up 1) mortgage paydown, 2) appreciation, 3) tax shelter 4) cash flow and 5) leverage more than you realize!!!

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