

More than three-fourths of Americans age 65 and older own their own home. However, for many people approaching retirement, a key decision on the path to financial security will be whether to pay off their current mortgage, to look for a mortgage with better financial terms, to get a new mortgage for their current home, or to buy a new home.

A mortgage is a long-term loan issued by a bank or another lender. Most lenders require you to pay a down payment of 20 percent of the loan. The remainder 80 percent is what you owe on the loan. When you make a payment, the money goes toward two basic expenses:

- The principal, which is the dollar amount you have borrowed; and
- The interest, which you pay at a specific rate, such as 6 percent per year.

Private Mortgage Insurance (PMI), another cost associated with a mortgage loan, is usually required if the down payment is less than 20 percent.

These tax tips may help you answer questions about your mortgage.

Tax Tips

- When you make mortgage payments, you get to deduct the mortgage interest from your income taxes.
- You do not get a deduction for paying the principal, so the closer you are to paying off the mortgage, the lower the deduction.
- If you stop working and your earnings go down, your income tax bill will probably also go down. So if you're still paying the mortgage, the deduction will save you less money.
- If you are paying a mortgage on the home where you live, you can deduct state and local real estate taxes on the property.
- You do not get a tax deduction for paying rent.

In addition to the principal and interest, you can usually also arrange to have real estate taxes and property insurance payments rolled into your mortgage payment, so you don't have to pay them separately. The lender holds these payments in an escrow account and then pays the bills when they come due.

In the first years of a mortgage, most of your payment is interest. The closer you get to paying it off, more of your payments go toward the principal.

Should You Have a Mortgage?

When deciding whether to have a mortgage as you approach retirement, consider these two key financial issues:

- Will you be able to afford the payments—as well as utilities, maintenance and insurance on your home—after you retire, when your income will probably go down?
- Will having a mortgage offer you a significant tax deduction?

Types of Mortgages

If you decide that getting a new mortgage or refinancing your current one makes sense for you, learn how the different types work. Before signing any papers, be sure you get the following information on the mortgage in writing before closing:

- Accurate estimates of the closing costs and fees;
- The exact amount you'll need to pay every month; and

- Whether the payment can go up, and if so, by how much.

In the past, a typical mortgage required a 20 percent down payment, lasted for about 30 years and had a “fixed” interest rate that never changed. But in recent years, many new complicated versions have come on the market. They are often tempting because the payments start out low. But they can be risky, because over time the payments can go up a lot. Here are some examples of other types of mortgages:

ARM: With an Adjustable-Rate Mortgage (ARM), you have a certain number of years to pay off the loan. But the interest rate can change, so you may end up paying more or less than you expected.

Take the case of a 20-year ARM with an interest rate of 6 percent for five years. After five years, the lender has the right to change the rate, using a formula that is based on financial factors, such as the interest rate on Treasury bills. Usually the rate cannot go up more than 2 percent a year, say from 6 percent to 8 percent. In this example, if you moved out of the property in five years, there would be no risk of higher payments. But if you planned to live in the property for 20 more years, your payment could go up quite a bit.

Interest-Only Mortgage: With an interest-only mortgage for the first few years of the loan you only pay the accrued interest. You put off reducing any of the principal amount you owe. Let’s say you take out a 20-year mortgage. For the first five years your payment is very low because it covers only the interest. After five years, you must start paying both interest and principal. So for the next 15 years your payment could increase dramatically to make up for not paying any principal for the first five years. If you are not certain what your future income will be, this type of mortgage could be very risky.

Balloon Mortgage: This type of mortgage offers lower payments for a certain number of years, for example seven years. After that, you must pay the entire balance of the loan in one lump sum. Don’t sign up for this type of mortgage unless you can count on having a big chunk of money on hand when it comes due.

Reverse Mortgage: If you are 62 or older, this may be a way to help with expenses. You get a new mortgage and instead of making monthly payments, the bank gives you money as a lump sum, monthly payment, or line of credit. The mortgage has to be paid when you move, sell, or die. This is a complicated financial transaction and can be expensive, so make sure you understand all the pros and cons before agreeing to it.

Sub-Prime Mortgage: People with serious credit problems may be unable to get a mortgage on typical market terms. Sub-prime mortgages carry much higher interest rates, penalties and other disadvantageous terms because the lender considered you a credit risk.

Mortgage Terms

One of the best ways to make sure you choose the best type of mortgage for your financial situation is to learn the lingo used in the field.

A good source of definitions of mortgage and real estate terms is the Federal Trade Commission’s “Real Estate Glossary,”
www.ftc.gov/bc/realestate/resources/realestateglossary.pdf.

Your To-Do List:

- ❑ **Use AARP's Retirement Planning Calculator** to estimate how much mortgage you can afford on your retirement income at www.aarp.org/money.
- ❑ **For tips on how to shop** for a mortgage and other practical advice, go to the Department of Housing and Urban Development website, www.hud.gov/buying/#afford.
- ❑ **Learn all about reverse mortgages** at www.aarp.org/money/revmort/ on AARP's website.
- ❑ **Order a free copy of AARP's "Borrowers Guide to Home Loans."** Just call 1-888-OUR-AARP (1-888-687-2277) and ask for D17381.

- ❑ **Your credit score**, based on your credit records, is a big factor in qualifying for a mortgage. To learn how it's calculated, and how to improve it, read "Credit Scoring" on the Federal Trade Commission's website, www.ftc.gov/bcp/edu/pubs/consumer/credit/cre24.htm.
- ❑ **Beware of predatory lending**—excessive interest rates and fees that may be charged to people with credit problems. Read "Don't Be a Victim of Loan Fraud" on the HUD website, www.hud.gov/offices/hsg/sfh/buying/loanfraud.cfm.
- ❑ **Learn about the tax consequences** when you sell your home by reading IRS Publication 523 at www.irs.gov/publications/p523/index.html. It explains how you can avoid having to pay capital gains taxes when you sell your home where you have lived for at least two of the five years before the sale.
- ❑ **If you are having a hard time** paying your current mortgage, read AARP's *Money Matters* Tip Sheet, "When You Are Struggling to Make Mortgage Payments," D18834.

This and other tip sheets provide general financial information; it is not meant to substitute for, or to supersede, professional or legal advice.

