Options for Obtaining Cash from Your Homeõs Equity

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Summary

For most people, it is better not to tap your home equity unless you need to, but there are circumstances when it may be your best choice, even if you have other investments or savings available. If you decide that this move is right for you, there are several ways to do it. This paper outlines these methods, highlights when it is best to use each, and suggests how you can begin to move ahead with whichever choice you make.

Should you tap into the value of your home?

We are assuming that you own your own home, and that its ñequityò (the market value of the home minus any mortgages or other loans you have against it), is at least a moderately significant sum. Should you try to turn that equity into cash?

If you are running out of other investments and savings, and you have bills to pay, you may have little choice. There might be more ways you can economize, but you should not let your savings dwindle close to zero before you make a move.

But some people do it by choice. Why? Your other funds may be tied up in investments that are doing very well, that are hard to liquidate, or that have good tax benefits. Meanwhile, the economy may be such that you can get favorable interest rates on mortgages and home equity loans. In other words, the money to be made on your investments may be more than what it would cost you to borrow against your house.

If you can earn more money *safely* than you pay to borrow against your home, then the decision could make sense, but this situation is rare. More often, retirees are presented with the option of using their home equity to invest in higher yielding assets ï but ñhigher yieldingò means ñriskier.ò For most people, their home is their last defense against insolvency, and will be the ultimate source of funds if, near the end of their lives, they require long-term nursing or assisted living care, or if they have large medical expenses to deal with, or other emergencies. Putting this at risk unnecessarily is usually not a good plan.

So for most people: leave your home equity alone, unless you really need it.

Methods for tapping into the equity of your home

There are more possibilities than you may be aware of:

- Sell your house, and move someplace cheaper
- Take out (or refinance) a traditional mortgage or second mortgage
- Take out a home equity loan or line of credit
- Get a reverse mortgage
- Use a private annuity
- Rent out part of your home, or share it with others

Selling your home (or selling part of your property, if it is divisible)

Best if: You want to raise more cash and reduce future expenses at the same time

Selling your home and moving somewhere cheaper is a radical step, but it benefits you in two ways: it generates cash from the sale and also it reduces your ongoing expenses for real estate taxes, utilities, insurance, upkeep and, if applicable, payments on existing mortgages. You can sell your home and buy a smaller house or condominium, or you can sell and move into a rental (which may actually increase your monthly expenses, but could leave you with a large pile of cash whose earnings will help you pay for them). If you have the opportunity to move in with a child or a sibling or other relative of yours, or with one or more friends, your future expenses could be cut way back, and selling could easily be your best financial decision.

If you want to explore this possibility, most real estate brokers will be happy to give you a free estimate of what your home is worth (though these estimates can sometimes be a bit optimistic, so donôt bank on them). Take into account that you are likely to lose about 6%-to-8% of the value of your home in commissions and other transaction costs, and that you may also have to pay capital gains taxes on the profits you have made in your house (though the Federal government allows a generous $250,000 exclusion on gains on your home if you are single, or $500,000 if you are married, provided you have lived in your home two years or more). There will probably also be moving expenses. And of course you need to explore what it would cost to buy or rent a new place, including property taxes, condo fees, or other expenses that could actually be higher than what you pay now.

If you are lucky enough to have a sizeable plot of land that could be subdivided, or if you own a large home or apartment that could be split into two residences, you could sell part of your property without moving ï though you would be giving up some privacy. Most people donôt have such options, though. Selling property means moving, and many of us are attached to our homes and neighborhoods.

Moving can be hard, but if you just start looking around, without making any commitments to yourself or others, you might find something that looks surprisingly appealing: cheerier, easier to take care of, closer to family members or to friends or to places you like to go, maybe without troublesome stairs, or with other advantages. When you can actually picture where you would be moving *to*, not just what you would be *leaving*, the move could be easier.

Next steps if you think this option is for you: (1) have a local realtor assess the market value of your home; and (2) start scouting around for new places to live, so you can see if you are likely to find something reasonably affordable and appealing to you.

Taking out (or refinancing) a traditional mortgage or second mortgage

Best if: You need a lump of cash now, and can afford to make the monthly payments.

Taking out a mortgage, or a second mortgage if you already have one, is a big step. It commits you to paying back the loan, usually with monthly payments, starting immediately and lasting for a long time. Essentially, you increase your living expenses dramatically in exchange for a lump of cash up front. There are also some up-front costs (application fees, home appraisals, title searches, and the like). Refinancing an existing mortgage at a higher amount can be a bit easier and cheaper, but it has a similar impact on your finances.

You may, in fact, have trouble qualifying for a traditional mortgage if your expenses are already higher than your income. Most banks do not want to lend to you under these circumstances, and even if they would like to make an exception for you, they may not be able to. Most banks do not keep mortgages on their own books, but instead sell them to mortgage companies or other parties who have strict rules about the conditions under which mortgages are provided.

Mortgages are most suitable, therefore, when there is a need for a large infusion of cash at once ï say, to help take care of a sick spouse ï rather than the ongoing drip-drip-drip of normal bills.

If you do qualify and decide to take out a traditional mortgage, make sure you are smart about what you do with the cash you receive. This is not a good time to increase your expenses, just because you have money in your pocket. That money has to cover your future mortgage payments, as well as your other expenses. If you are not sure you have the discipline to manage your money sensibly, enlist the aid of a trusted family member or a financial advisor to help keep you to a budget.

Next step if you think this option is for you: talk with one or two of your local bankers and see whether they think you will qualify. Even if they can't help you directly, they may have suggestions for alternatives available in your area.

Taking out (or refinancing) a home equity line of credit

Best if: You mainly need to cover bills or special expenses, but do not expect to ever use up your entire home equity

A home equity loan really is just a kind of mortgage. But loans made under this name tend to be more flexible. In particular, they can be issued as lines of credit rather than lump sum loans, which makes them more suitable for paying ongoing bills ï especially if you expect your needs to be fairly modest or temporary. Home equity loans can also be used to pay off credit card balances and other high-interest debts, because the home equity loan will typically have a lower interest rate and the interest is often tax-deductible.

With a home equity line of credit, you are authorized to write checks (to yourself or to others) up to a certain amount that has been pre-approved. This amount can sometimes equal the total equity in your home, and sometimes even more than that. However, the higher the percentage of your home equity you have access to, the higher the rate of interest you will pay (there really is no free lunch, especially at the bank!).

The main benefit of a home equity line of credit is its flexibility. Unlike a traditional mortgage, which gives you a give lump of cash that you immediately have to start paying interest on, a line of credit just sits there, at little or no cost to you, until you start using it. When do you use it, you pay interest only on the amounts you actually take out, not on the total that you *could* take out.

Home equity loans and lines of credit can be made with many different kinds of arrangements, but typically the interest rate you pay is adjustable on a monthly basis, as the economy changes. This means that your monthly interest payments can be a bit unpredictable, and could increase in the future, maybe a lot.

On the other hand, unlike with a traditional mortgage, you may be required to pay nothing but the interest. You often donõt have to pay off the amounts you are borrowing as long as the line of credit is there ï which in practice means until you voluntarily pay it off, until you default on your interest payments, or until you sell the house or die.

Interest payments on home equity loans are usually tax-deductible up to a point, but the rules are mildly complicated, and if your balance gets big enough, or if you already have other large mortgages, some of your interest may not be deductible. Fees to start up a home equity loan are usually smaller than with a traditional mortgage, or even zero ï but make sure you understand up front what your costs will be.

Next step if you think this option is for you: talk with one or two local bankers and see what options they have available.

Getting a reverse mortgage

Best if: You are likely to use most or all of the equity in your home over the remainder of your lifetime, and you strongly wish to stay in your current home

A ñreverse mortgageò sounds tricky ï and in some respects, it is. But the basic concept is simple enough. A financial institution gives you money (a lump sum, monthly payments, or a line of credit), and you get to stay in your house for as long as you live, without paying any of the money back. But when you do die (or voluntarily leave the house), the financial institution gets the house in repayment of the reverse mortgage.

Reverse mortgages are federally backed, so they may be limited in availability, and they come with rules. You arenõt eligible unless you are age 62 or older. Your house has to be in reasonably good condition. There will be limits placed on the amount of money you can get, depending on your age and the amount of equity you own in your home. There are also closing costs that are similar to selling a house. On the plus side, proceeds are considered loaned money, not income, and so are not taxable.

You do retain ownership of the home while you continue to live there ï and you also, therefore, remain responsible for its upkeep. But ownership will pass to the lender when you leave your home, so if you have children or other relatives who would be dismayed by having the house pass out of the family, this may not be the right plan for you. (However, family members can pay off the reverse mortgage later, if they wish to, and thereby keep the home.) If the home ends up being worth more than the amount you have borrowed, you will receive the extra amount if you are still alive, otherwise your heirs will.

When the home is eventually sold, you may owe capital gains taxes on it. If the entire proceeds of the house have been used to pay off the mortgage and interest, there could be trouble paying the taxes. The IRS will not waive the tax bill, so you have to be careful not to borrow up to the last dime, if capital gains taxes will be due. But they may not be due, and you should be able to figure this out reasonably well at the time you take out a reverse mortgage ï donõt forget about state taxes, though, while doing so, if they apply.

Next step if you think this option is for you: see the other paper in this series, called "Should You Use a 'Reverse Mortgage' to Raise Cash from the Value of Your Home?"

Using a private annuity

Best if: You have an affluent family member who wants to keep the property in the family, or you know someone else who wants to acquire it upon your death

A ñprivate annuityò is another potentially complicated arrangement that actually has a simple underlying concept: you get a lifetime income for yourself along with the right to stay in your home for the rest of your life, and in exchange a private individual will end up with ownership of your home.

This arrangement gives you the two things you probably care about a lot: the ability to keep living in your home, and a promise of income for as long as you live. Giving up your home after youôre gone may not seem like a big price to pay for those benefits.

The devil is in the details, though. First of all, you need someone who cares about you (or at least cares about your house) enough to make this arrangement with you, and who is affluent enough to pay you the monthly income in return for a property which he or she may not take possession of for many years.

Second, there will be legal and other advisory fees to set it up (which perhaps the other party will pay, or perhaps not), because all of the terms of the agreement have to be spelled out and have to be customized to your situation. In particular, the amount of monthly income you get should be based on your current life expectancy, taking into account your age, your sex, and your health, as well as on both the current and expected future value of your home. There will have to be clear provisions about who is responsible for upkeep of the house, and whether there is any payment to your heirs if, unfortunately, you die soon after the private annuity has been set up.

Third, you have to take into account the possibility that the other partyôs financial circumstances could change and he or she might have trouble paying you. In that case, perhaps that person is more at risk than you are, but if you have been counting on receiving a certain regular income and suddenly it dries up, it will be a problem for you, too.

(Note: private annuity arrangements are often used by wealthy people for tax reasons. In such cases, oneôs children receive title to the house and then they sell it immediately, using the proceeds to fund most or all of the regular payments. This arrangement does not allow you to keep living in the house, though, so it is not suitable when your purpose is just to extract equity from your home. ñCharitable remainder trustsò are used in a similar fashion, but again, while in theory such a trust could suit your needs, it is unlikely.)

Next step if you think this option is for you: talk with the person or persons you have in mind who might be able and willing to fund this arrangement, and see if they have any interest in the idea.

Renting or sharing living space

Best if: You have room to spare and are willing to trade some of your privacy for some extra income and companionship

This means becoming a landlord, which entails both extra responsibility and extra work. But you already own your home, which is the biggest requirement of all. If you have one or more bedrooms you are not using (and especially if you have or can easily create a separate entrance to part of your home, and include bathing and kitchen facilities there), you might well find someone compatible and responsible to live there.

There are plenty of other people who either cannot afford to be living on their own, or don't want to, or perhaps are getting a bit infirm and just shouldn't be alone. You can rent one of them a room, and share the kitchen and other public rooms of your house, and perhaps make enough extra money to cover your own bills. Perhaps you even have a family member or good friend who would like to do this with you. But if not, you can put the word out, or place an ad on a local bulletin board or in your local paper, and probably find someone compatible.

There are some duties and risks in becoming a landlord, especially if you are dealing with someone you don't already know well. So you should learn more about this subject before you commit yourself.

Next step if you think this option is for you: if already know someone who might be willing to share living expenses with you, then you can probably make relatively informal arrangements, and your next step would be to talk with that person about whether he or she is interested. If you would need to advertise for a renter or boarder, go to your local bookstore or library first and get a book about renting, which will alert you to your risks and responsibilities, and what to do about them.

Final thoughts

This paper introduces you to your main options, and maybe will help you focus on one or two of them as being more attractive to you than the others. But our best advice is to move slowly. Whichever path you take, make sure you understand it before you go in too far. The resources listed in the following section may help you get started.

In addition, if you use your home equity in any ways that rely on home prices continuing to rise, remember that this is not always the case. Real estate slumps do happen, and sometimes they are deep, and sometimes they are long. The housing market will not always bail you out of a mistake. Be especially cautious about any decisions that would turn out poorly if the market value of your home were to fall at the wrong time.

For More Information

- ***Papers available from this same source:***
  - “Should You Use a ‘Reverse Mortgage’ to Raise Cash from the Value of Your Home?”

- ñIf You Run Out of Moneyò ï helps you find ways to economize, or perhaps even find other assets or income, which might enable you to postpone the decision to tap into your homeôs equity

- ***Outside sources:***
    - Many consumer-oriented books on selling a home are available ï check out your favorite library or bookseller.
    - The AOL website has a good page on selling a home, which links to a variety of specific articles: http://realestate.aol.com/blog/guides/sell/.
    - Bankrate.com (http://www.bankrate.com/) has up-to-date general information on mortgages and home equity loans, as well as information on current rates.
    - The IRSôs proposed regulations on private annuities appeared in Internal Revenue Bulletin 2006-47, which you can find at the IRS website: http://www.irs.gov/pub/irs-irbs/irb06-47.pdf.