Equity Harvesting

Equity harvesting is a concept that has been around for many years but only recently is coming into the mainstream.

The concept behind equity harvesting is simple─borrow money and invest it in something tax favorable. So the questions for readers are as follows:

1) If you could borrow money with an interest rate of less than 7% to invest, would you?
2) Would it help if you could write off the interest on the loan?

3) Would it help if the place where you invested the borrowed money was a tax favorable environment where the money could grow tax free and potentially come out tax free in retirement?

If you just read the above and do not have an interest in this topics, we suggest you re-read the questions again.

From a financial standpoint, the concept of borrowing money when you can write off the interest and invest the money in something tax favorable is just about a no brainer when done right.

Where do you find a lender who will lend you money to invest and what asset(s) are used as collateral? If you own a home, then you know the answer.

For brevity's sake, we will discuss our favorite equity harvesting situation which revolves around a 1% cash flow mortgage program on the personal residence.

The 1% "Cash Flow" Option Arm Mortgage Program

The 1% cash flow mortgage program is designed for clients who would like to **minimize their current monthly home mortgage payments** while at the same time **invest** the saved money for future retirement savings.

This program is **not** designed for homeowners who are looking to reduce their monthly mortgage payments with an eye on paying off their home mortgage in the standard time frame 15-30 years.

The whole point of the 1% cash flow program is to minimize current costs, which frees up money for investing.

The 1% cash flow program has a 1% starting rate that stays low for five years. The **payments** (not the interest rate) of the arm increase at the rate of 7.5% a year (see the following chart for an example).

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At the end of the 5th year (or any time after the third year without a penalty), the client can re-finance the loan back into a 1% program (or the client can keep the going interest rate on the loan or completely re-finance with any other loan program).

The numbers speak for themselves.

For the following example, assume a client (male, age 42) has a $400,000 mortgage on a home with a fair market value (FMV) of $500,000. The first chart shows what will happen to the client's home mortgage payments with a 1% cash flow starting rate vs. a 6% 30-year conventional loan. The amortization with the 1% arm is 40 years.

Cash flow Cash Flow Analysis	30 Year @ 6.00%	1% Cash Flow Program	Savings
Year 1	$28,778	$12,137	$16,641
Year 2	$28,778	$13,047	$15,731
Year 3	$28,778	$14,026	$14,753
Year 4	$28,778	$15,078	$13,701
Year 5	$28,778	$16,209	$12,570
5 Year Totals	**$143,892**	**$70,497**	**$73,395**

Remember that the client who is a candidate for the 1% arm is looking to lower the mortgage payments to as low as possible so the saved money can be invested. With the 1% program, the client freed up **$73,395** of cash flow over the five-year window.

If the client invested the money saved from lowering the mortgage and had a return of 8%, the client would have $93,993 built up at the end of the fifth year (see the following chart).

Cash flow Investment Analysis	Equity Indexed Annuity @ 8.00%
Year 1	$17,972.64
Year 2	$36,399.99
Year 3	$55,244.69
Year 4	$74,460.87
Year 5	**$93,993.03**

In the example, we assumed a client used an indexed annuity as the investment which allows the money to grow tax deferred.

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If the client at age 63 started taking money out of the indexed annuity, he would be able to take out $28,000 each year for 20 years (the growth above basis would be income taxed, thereby netting $18,450 a year after tax).

If the client took the money saved from the first five years and invested it into an equity indexed life insurance policy earning 7.9% a year, the client could take out of his life insurance policy $22,000 a year income tax free from age 63-82 (plus the client has a sizable death benefit while the policy is in place).

Remember the numbers above are simply from the savings on payments from the first five years. Also remember that the client is writing off the interest on the loan.

Equity Harvesting

Would a client refinance a property if he could have payments on a 1% loan and invest the borrowed money in a tax favorable environment? Many would say YES.

Example: Assume a client has a $1,000,000 home with no debt or very little debt. Assume the client decides to sell the home and buy a new home. In that process, assume that he removed $600,000 of equity from the sale of the home and invested it for retirement income later. Assume the client used the 1% cash flow program and is in the 40% tax bracket.

The following would be the interest payments on the loan for the first five years:

Cash flow Cash Flow Analysis	Payments Starting @ 1.00%	Cost Out of Pocket After Tax
Year 1	$18,206	$10,923
Year 2	$19,571	$11,743
Year 3	$21,039	$12,623
Year 4	$22,617	$13,570
Year 5	$24,313	$14,588
5 Year Totals	**$105,745**	**$63,447**

If the client took the $600,000 and invested it returning 8% in an indexed annuity, the numbers would look as follows at the end of five years:

Year	Start of Year Balance	Contribution	8.00% Growth	Year End Balance
1	$600,000	$0	$48,000	$648,000
2	$648,000	$0	$51,840	$699,840
3	$699,840	$0	$55,987	$755,827
4	$755,827	$0	$60,466	$816,293
5	$816,293	$0	$65,303	$881,597

If the money continued to grow at 8% until the client reached age 63, he could take out $296,000 each year for 20 years. The client would pay income taxes on the amount above basis in each payment. After income taxes on the growth at 40%, the client would be left with $159,000 a year.

If the client invested the $600,000 into an equity indexed life insurance policy earning 7.9% a year, the client could take out of the life insurance policy **$191,000 income tax free** for 20 years starting at age 63 (plus the client would have a sizable death benefit to protect the family). The following is an example of what you would see from a life insurance illustration based the life of this particular example client. The illustration will obviously look better or worse depending on the investment returns. This particular illustration comes from using an indexed equity life insurance policy where the growth is pegged to the S&P 500 index (see page 125 in this book where we explain equity indexed life insurance).

Age	**Tax Free** Loans	Cash Surrender Value	Death Benefit
63	$193,000	$2,099,000	$2,639,000
64	$193,000	$2,068,000	$2,607,000
65	$193,000	$2,035,000	$2,552,000
66	$193,000	$1,999,000	$2,531,000
67	$193,000	$1,960,000	$2,506,000
68	$193,000	$1,918,000	$2,476,000
69	$193,000	$1,873,000	$2,441,000
70	$193,000	$1,824,000	$2,358,000
71	$193,000	$1,772,000	$2,263,000
72	$193,000	$1,717,000	$2,153,000
73	$193,000	$1,658,000	$2,027,000
74	$193,000	$1,597,000	$1,883,000
75	$193,000	$1,533,000	$1,844,000
76	$193,000	$1,464,000	$1,803,000
77	$193,000	$1,390,000	$1,758,000
78	$193,000	$1,310,000	$1,711,000
79	$193,000	$1,224,000	$1,659,000
80	$193,000	$1,130,000	$1,603,000
81	$193,000	$1,028,000	$1,542,000
82	$193,000	$917,000	$1,476,000
87		$1,314,000	$2,092,000
94		$1,550,000	$2,468,000

So again, the question is, would you like to use a 1% program to build wealth for retirement? Most clients with equity in their houses would say yes. Most clients will want to lower their current mortgage payments and invest the difference in order to build more wealth for retirement.

Side note: While clients might want to use the borrowed money to invest in stocks or mutual funds, not only is that not advisable, but it is not allowed under the law. Additionally, it makes little sense to put borrowed money in an environment where it can go backwards and where there are annual tax consequences with dividend income and/or capital gains taxes upon sale.

Real World Planning

In the real world when clients use this loan, they traditionally will refinance back into the 1% arm every 3-5 years. This keeps their payments to a minimum and allows the maximum amount of money to be used for investment purposes.

While a client could use the money saved and invested to pay any deferred interest, most clients, when they refinance, will refinance the deferred interest (if any) into the new 1% arm. This allows the invested money to grow and to be used for retirement when the time comes.

Remember that the client's home is appreciating at a minimum of 3.5%-10% a year and in many parts of the country at 10%+ a year. So while the client's debt could increase with the 1% program when refinancing the home, the increase in equity more than offsets this debt.

Summary

From a financial standpoint (without emotion), the 1% cash flow program is virtually a no lose proposition for clients. Payments on money borrowed starts at 1% and that money is invested where, even in the worst case scenario over the long haul, the money should grow at 5% and more likely will grow at 8%.

Clients who can take the emotion out of the idea of paying down the debt on their home because it is better long term financially will gravitate to the 1% cash flow program. Those clients will not only refinance current debt in order to free up investment dollars but will also take equity out of their homes in order to build that retirement nest egg quicker.

If clients cannot objectively look at the numbers and will sleep better at night because they are paying off the debt on their homes, then they are not candidates to build wealth in an accelerated manner through the 1% cash flow program.

The 1% cash flow program is not a program you will typically be able to find with your local bank or mortgage broker. If you would like information on using the equity in your home to build a tax favorable retirement nest egg, please feel free to contact info@thewpi.org.

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