What’s the Smartest Way to Pay for Your Home Improvements?

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Looking to tap your home equity to fund a remodeling project? You’re not alone. U.S. residents have more than $500 billion in home equity debt according to the FDIC. During the second quarter of 2005 alone, 74% of mortgage refinancing activity was for more than the original mortgage balance as homeowners took cash out of their homes in record numbers.

If you’re planning a home improvement, you may believe that planning the project, selecting the contractor, and keeping him on time and on budget are the most difficult aspects of remodeling. However, while each of those tasks can be challenging, it is equally important to decide how to finance your project.

The first step is to determine the scope of your project. Exactly what work needs to be done? If you’re planning to remodel your kitchen, go down to the local home improvement store to see what materials are available. Another good idea is to go to a local home show where you can see a wide variety of products up close. You can also speak with contractors to get an idea of how much your project might cost. From your notes, you can develop a rough budget.

Pay Cash or Get a Loan?

Homeowners with cash may find it tempting to pay outright for their home improvements. While it may be cheaper in the short run to finance your project with cash, if you’re the type of person who would not be averse to putting that cash to work in a stock mutual fund, you might want to reconsider. That’s because, over time, compounding can make that $20,000 investment double or even triple, a sum many times more than the interest you will pay on the loan.

Remember, home mortgage interest is tax deductible and interest on the first $100,000 of a home equity loan or line is usually also tax deductible. What does this mean? Well you pay about one-third of your income in state and federal income taxes. So, for example, if you are considering a loan with a 6 percent interest rate, in effect you are only paying about 4 percent after taxes. Another reason to borrow the money and invest your cash is that, since 1929, the stock market has returned an average of 10 percent per year. This is much higher than the 6 percent interest you will pay on the loan.

Let’s say you decide it is finally time for the orange countertops and black kitchen cabinets to go. A $20,000 loan at 6 percent would cost you $6,645 in interest over 10 years. However, after taxes, that amount would be closer to just $4,430.

But if you invest that $10,000 at 10% per year, that same $20,000 becomes $54,141 in 10 years.

References: