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Debt Is No Longer "In"

Instead of saving, consumers have been refinancing or borrowing against their home equity and using credit cards as cash. But with home values decreasing and foreclosures increasing, debt no longer looks like the solution to consumers' money problems. Lenders are becoming more stringent in their lending criteria, while consumers are now faced with the reality that it is dangerous to live beyond your means. It's now time for everyone to return to the basics about debt:

Mortgages

Not so long ago, it was common to buy a home with no money down and an exotic mortgage that kept your initial mortgage payments to a minimum — perhaps the mortgage was amortized over a very long period, the first few years of the mortgage had a very low interest rate, or only interest payments were required. You often didn't even have to prove your income to qualify for the loan. What a difference a year makes. With home values declining and mortgage foreclosures on the rise, mortgage lenders are returning to the basics.

If you are looking for a mortgage now, expect to make a substantial down payment, prove your ability to pay the mortgage, and have a good credit rating for the best deals. And forget exotic mortgages.

Don't get complacent if you already have a mortgage. Work aggressively to reduce your debt so that when you do sell, you won't owe more than your home is worth. However, there are tax advantages to this type of debt, so you probably want to make sure your other debts are paid off before tackling your mortgage debt.

Interest rates on mortgages and home-equity loans are typically lower than other consumer loan options. Also, interest paid on up to $1,000,000 of mortgage debt and $100,000 of home-equity debt is deductible on your tax return. These two factors usually make the after-tax cost of a mortgage or home-equity loan much lower than consumer debt.

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Your 401(k) Contribution Amount

Before deciding how much to contribute to your 401(k) plan, find out three key figures:

What is the maximum percentage of your pay that can be contributed? The maximum legal limit that can be contributed in 2009 is $16,500 plus an additional $5,500 catch-up contribution for participants age 50 and over, if permitted by the plan. However, most employers set limits in terms of a percentage of your pay to comply with government regulations.

How much of your contribution is matched by your employer? A common match is 50 cents for every dollar contributed, but many other variations also exist.

Up to what percentage of your pay does your employer match? Most plans only match contributions up to a certain percentage of your pay. For instance, the plan may only match contributions up to a maximum of 6% of your pay.

Please call if you'd like help deciding how much you should contribute to your 401(k) plan. ❍❍❍

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The Tax Consequences of Debt Forgiveness

When the value of a home is less than the outstanding mortgage, the homeowner's options are dismal. Foreclosure, deeds in lieu of foreclosure, and short sales all result in the loss of the home with serious credit consequences for the homeowner. In addition, if the lender forgives part of the loan, the homeowner walks away with nothing, and there may still be tax consequences:

✔ The foreclosure is considered a disposition of the home for tax purposes, which results in capital gain or loss. If the homeowner lived in the home for at least two of the five years preceding the foreclosure, up to $500,000 of gain for married taxpayers filing jointly or up to $250,000 of gain for single taxpayers can be excluded from income. Losses cannot be deducted on the taxpayer's tax return.

✔ If there is a cancellation of debt (COD) by the lender, the amount of the COD is taxable as ordinary income.

There are a couple of situations where the taxpayer does not have to include COD in ordinary income:

✔ **The taxpayer is insolvent or in bankruptcy.** Insolvent means that the taxpayer's debts exceed the fair market value of his/her assets, both before and after the debt is forgiven.

✔ **The debt is nonrecourse debt.** This means that the homeowner is not personally responsible for the debt. The only recourse to the lender is to sell the home.

In December 2007, the Mortgage Forgiveness Debt Relief Act of 2007 was enacted, which provides temporary relief for many taxpayers. This law excludes up to $2 million of COD income resulting from debt cancellation of qualified principal residence indebtedness for foreclosures between January 1, 2007 and December 31, 2012. Some of the major provisions include:

✔ Qualified principal residence indebtedness is debt incurred to acquire, construct, or improve a taxpayer's principal residence, if the debt is secured by the residence.

✔ The amount of COD excluded from income reduces the taxpayer's basis in the home. Thus, it will increase the capital gain from the disposition. However, since those limits are so large, most taxpayers will probably not have a taxable capital gain.

✔ COD income from home-equity loan debt used for purposes other than to improve the principal residence is not excluded from income.

✔ Vacation homes and other real estate investments do not qualify for the COD income exclusion. ❍❍❍

Staggered Retirements

The Center for Retirement Research indicates that only 20% of couples retire in the same year — 50% still have one spouse working two years after the other spouse has retired. Often, one spouse retires before the other due to health problems or a layoff, not necessarily because the spouse chooses to retire early. No matter what the reason, keep these points in mind if you are in that situation:

✔ **Try to minimize withdrawals from retirement accounts.** Although you will only have one salary instead of two, it's best to minimize withdrawals while one spouse is working. It's a good opportunity to test your retirement budget and try to reduce your expenses.

✔ **Utilize all available benefits from the working spouse's employer.** One of the most significant retirement expenses, especially if you don't qualify for Medicare, is health insurance. So, before one spouse retires, find out if that spouse is eligible for health insurance benefits through the working spouse's employer. If that spouse is not currently on that plan, find out how he/she can enroll. Does he/she have to wait for the annual open enrollment period or will retiring qualify him/her for coverage immediately?

✔ **Delay Social Security benefits.** Especially if you are retiring before full retirement age, it typically makes financial sense to delay Social Security benefits. For a significant number of married couples, the man is older, has higher earnings, and will not live as long as the woman. Because the surviving spouse can elect to receive 100% of the other spouse's benefits, it typically makes sense for the man to wait until age 70 to claim Social Security benefits, to provide his wife with the highest possible benefits after his death. On the other hand, there is usually no reason for the woman to wait beyond ages 62 to 66 to start Social Security benefits, provided she can claim benefits on her own earnings record. While the wife's benefits may be lower when her husband is alive, she will receive his higher benefits after his death.

✔ **Consider all defined-benefit-plan payment options.** If you are lucky enough to be covered by a traditional pension plan at work, make sure to consider all the payment options carefully before selecting one. Typically, you will have numerous options, but your choice will be irrevocable.

Please call if you'd like help planning for the retirement of one spouse. ❍❍❍

Debt

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Some strategies to consider for your mortgage debt include:

✔ **Evaluate refinancing options.** If interest rates have decreased since you obtained your mortgage, even by just 1/2%, take a look at refinancing options. If your credit score has improved dramatically since you obtained your mortgage, you may be able to negotiate a lower interest rate. Also, if your original loan was a jumbo loan (over $417,000 in 2009) and is now under that amount, you may qualify for a lower rate.

✔ **Eliminate private mortgage insurance (PMI).** If your down payment was less than 20% of your home's purchase price, you are probably paying PMI, which typically runs between .25% and 1.25% of your total mortgage amount. Once your home equity exceeds 20%, you don't have to purchase PMI. With housing values decreasing in much of the country, this may be harder to do. You will probably need an independent appraisal before your lender will cancel the PMI. While this may cost a few hundred dollars, you could eliminate several years of PMI costs, making it well worth the cost.

✔ **Determine whether to pay down your mortgage debt.** The after-tax cost of mortgage debt is typically fairly low. However, if your income exceeds $166,800 in 2009 or $159,950 in 2008 ($83,400 in 2009 or $79,975 in 2008 for married taxpayers filing separately), your itemized deductions are reduced by up to 80%. However, due to a tax law change, itemized deductions are reduced by only 1/3 of the amount required by this computation for 2008 and 2009. Thus, those with high incomes may find that mortgage interest does not provide much tax benefit. Individuals approaching retirement age may want to pay down their mortgage debt so they can enter retirement debt free. In all cases, however, you should compare your after-tax cost of mortgage debt to the after-tax return earned on investments before deciding whether to pay down your mortgage. If you decide to accelerate payments, make sure your lender allows additional principal payments without penalty.

Credit Card Debt

It's difficult to find anything good to say about credit card debt. Interest rates are typically high and not tax deductible. If you only make the minimum payments on the balance, it can take years to pay off the debt. Your goal should be to

pay off, as quickly as possible, all credit card debt. Some strategies to consider include:

✔ **Put your credit cards away until all your balances are paid in full.** If you are really committed to paying down those balances, you don't want to add to the problem by continuing to increase the balance. Pay cash or don't purchase the item.

✔ **Pay the balances in order of most expensive to least expensive.** Make a list of all your credit card balances and the interest rates charged on each. Add up your minimum payments and then determine how much more you can budget to help pay down those debts. Use these additional funds to pay off the debt with the highest nondeductible interest rate. Once that debt is paid in full, start paying the debt with the next highest interest rate, continuing until all the balances are paid.

✔ **Look for a lower interest-rate credit card.** You may find an offer that contains a teaser rate that is only available for a limited time. You can transfer balances from your high interest-rate cards to the lower rate card and then pay off the balance as aggressively as possible. Before getting the new card, make sure to review all details. The low rate may only apply to new purchases or to transferred balances. You're looking for a card that will apply the low rate to transferred balances. Also check if there are any balance-transfer fees. Once the teaser rate is over, either find another low-rate card or call the company to request a lower rate on that card.

✔ **Consider using a home-equity loan to pay off your consumer debts.** Home-equity loans typically carry lower interest rates than other consumer debt, usually prime rate or 1% to 2% over prime rate; and as long as the balance does not exceed $100,000, interest paid on home-equity loans is deductible on your tax return as an itemized deduction. Keep in mind that you are taking equity out of your home when you do this. This may be a good tradeoff if you use the funds to reduce higher-cost debt. However, if you just run your credit card balances up again, you will still have the consumer debt plus less equity in your home. You may find it harder to get a home-equity loan than it was in the recent past. Now lenders are likely to require a loan-to-value ratio of at least 90%, a high credit score of at least 680, and a full appraisal of your home. Some homeowners with home-equity lines of credit are being notified by the lenders that the line has been reduced or frozen. ❍❍❍

Segregating Your Goals

Your willingness to assume risk with your investments is not necessarily a static concept. You may be less willing to take risk with investments designated for an essential financial goal, while you may be more willing to take risk for nonessential goals. However, those varying risk levels may be difficult to assess if all of your investments are commingled in one account.

For instance, assume you have three goals — to ensure you have enough funds to support yourself through retirement, to send your children to Ivy-league colleges, and to purchase a vacation home. The most crucial goal is to ensure you don't run out of money during retirement. Thus, you want a high level of assurance that you'll reach that goal, devoting a substantial portion of your resources to the pursuit of it. Your investments for that goal are likely to be somewhat conservative, especially as you approach retirement age. The next important goal is sending your children to Ivy-league colleges. You have more limited resources to devote to that goal, plus your children can still attend less expensive colleges or pay part of the cost themselves. For that goal, you may be willing to assume more risk with your investments to increase the likelihood of reaching that goal. Your goal for a vacation home is clearly last, so you may have few resources to devote to it. For that goal, you may be willing to use very aggressive investments, since that may be the only way you can achieve it.

The point is that your willingness to assume risk is not static. It will vary depending on how important each goal is to you and how much you can designate to that goal. Commingling all your investments for all goals in one account may make it difficult to analyze your investments in this manner. Thus, you might want to set up separate accounts for each goal, so you can more closely match the investments to your willingness to assume risk for that goal. Please call if you'd like to discuss this concept in more detail. ❍❍❍

Multinational versus International

With the U.S. market so mature in many industries, many of these companies have turned to overseas markets where demand for their products is higher. This helps keep their sales growth percentages higher, which often helps their stock price in the U.S. markets. Keep in mind that events in other parts of the world can affect the stock prices of these companies. But over the long term, a company's stock price is primarily determined by factors in its home country.

One of the primary benefits of international investing is to help reduce risk in your portfolio. When stocks in the U.S. are declining, it is hoped that stocks in other parts of the world will be either increasing or not declining as steeply. However, stocks of multinational companies are more likely to follow the trend of the U.S. stock market than that of foreign stock markets.

While multinational company stocks may be a good investment alternative for your portfolio, they probably should not be your only exposure to international investments. ❍❍❍

Financial Thoughts

On average, parents paid 32% of college costs from current income and savings and 16% from loans. Students typically covered one-third of their costs, mostly through loans and earnings. Scholarships and grants accounted for only 15% (Source: www.salliemae.com, August 2008).

According to a new study, an average 65-year-old man planning to retire this year with employer-sponsored health insurance will need to have saved at least an additional $122,000 to have a 90% chance of fully covering his future health costs. The number is $140,000 for a woman and $235,000 for couples. This figure does not include any long-term-care expenses (Source: Employee Benefit Research Institute, 2008).

Over the next five years, retirement account rollovers are expected to nearly double, from $260 billion recorded last year to nearly $500 billion in 2013. IRA assets are also expected to climb from $4.7 million in 2007 to $8.7 trillion in 2013 (Source: Financial Research Corporation, August 2008).

Approximately 23% of college students leave school with more than $5,000 in credit card debit, while 10% of students have more than $10,000 (Source: *Investment News*, August 2008). ❍❍❍