

November 2008 Issue

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Buying a Home in a Weak Market

The purchase of a home is a major financial commitment. While it is a decision that should always be made with care, the weak real estate market means you should exercise even more caution. Don't let the excitement of looking for your dream home prevent you from following these tips:

- **Set an upper limit for your home's purchase price and don't exceed it.** Before you start looking, carefully analyze your expenses and decide how much you can afford to pay for a home. An often-cited guideline indicates that your mortgage payment, insurance, and property taxes should not exceed 28% of your gross income. While lenders recently allowed up to 40% of gross income to be spent on housing costs, you will likely find more lenders are going back to traditional guidelines. However, make sure that you are comfortable with the mortgage payment. Don't raise the limit as you look at houses, thinking you can reduce your living expenses to cover the difference. It's very difficult to change your spending habits.
- **Consider how your down payment will impact your home's financing.** A lower down payment makes it easier to purchase a home, but also increases the size of your mortgage. While in the recent past you could get by with no down payment, more and more lenders are now requiring a sizable down payment. Expect to put down at least 10% to 20% of the purchase price. With a down payment of 20% or more, you don't have to obtain private mortgage insurance, which typically runs from .25% to 1.25% of your total mortgage amount.
- **Familiarize yourself with housing prices in the area.** No one likes to purchase a major asset like a home and then find it decreasing in value. However, it is difficult to predict market bottoms, and you may not be able to delay a home purchase until there is clear evidence that the market has bottomed. To protect yourself, get a comparative market analysis to see how much homes have sold for in the recent past. Base your offer to purchase a home on that analysis, even if your offer is substantially below the seller's asking price.
- **Choose a home you'll be comfortable living in for several years.** When home prices are rising rapidly, you can purchase a home, live in it for a couple of years, and then sell it at a profit. With modestly increasing or declining prices, it's difficult to sell at a profit after a couple of years, due to sales commissions and other costs

associated with buying and selling a home. Thus, you should purchase a home you'll want to live in for at least five or 10 years. If you know you'll need to move in less than five years, consider renting.

- **Sell your current home before buying another home.** It is taking longer to sell homes now. If you can't afford mortgage payments on two homes, make sure you sell your current home before purchasing another.
- **Consider resale value while you are purchasing.** While you may like unusual features, consider how likely other buyers are to want those features. Be cautious of purchasing a home with a much higher selling price than other homes in the area. Homeowners typically want to be surrounded by homes of similar size and value.
- **Get a professional inspection.** While the home may look like it is in great shape to you, an inspector will check things like the heating and air conditioning systems, plumbing and electrical, roofs, foundation, drainage, garage, and basement.
- **Review your options before selecting a mortgage.** Now is not the time to look at exotic mortgage options. Consider basic mortgages. Fixed-rate mortgages are typically a good option for homeowners who plan to stay in their home for many years. Adjustable-rate mortgages (ARMs) are popular with homeowners with rising incomes, those planning to move in a short time, and those who want the short-term cash flow benefits of lower interest rates. If you're not sure which is better, consider a convertible mortgage. These mortgages allow you to switch from an ARM to a fixed rate, from a fixed rate to an ARM, or from the original fixed rate to a lower rate if rates decline.

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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.

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 2008) 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 \$159,950 (\$79,975 for married taxpayers filing separately) in 2008, your itemized deductions are reduced by up to 80%. 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.

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The Tax Consequences of Debt Forgiveness

When the value of a home is less than the outstanding debt, 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 a capital gain or loss. If the homeowner lived in the home in 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, 2009. 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 or loss 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.

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Give Your Kids a Good Financial Start

It's a common enough goal - to live a better life than your parents. While you may be able to say you accomplished that goal, how likely is it that your children will be able to say the same thing? To help them with that pursuit, make sure to teach them these important financial lessons:

- **Graduate from college.** Even if your children are interested in pursuing careers that don't require a college education, encourage them to obtain a college degree first. It is much easier to go to college straight out of high school before

getting married or taking on other responsibilities. And financially, college graduates have higher earnings on average than nongraduates. For instance, the median earnings by level of education for 2005 were \$23,400 for someone who was not a high school graduate, \$31,500 for someone who was a high school graduate, \$37,100 for someone with some college education, \$40,600 for someone with an associate's degree, \$50,900 for someone with a bachelor's degree, \$61,300 for someone with a master's degree, \$79,400 for someone with a doctoral degree, and \$100,000 for someone with a professional degree (Source: *Education Pays*, 2007). Over a 40-year working career, a person with a bachelor's degree can expect to earn 61% more than a high school graduate.

- **Develop written financial goals.** Developing financial goals will help your children think about their future and how to pursue their goals. Get them into the habit of saving first, then worry about how to spend the rest of their money. Encourage them to set up a system to automatically divert some of their income to savings. As part of the process, encourage them to get a money management system in place to track expenditures and organize information about assets and investments.
- **Live well within their means.** As your children start lives of their own, help them make some fundamental decisions about how to live. They should realize that the only way to save for future goals is not to spend all their current income. So, before your children decide where to live or what kind of car to drive, help them prepare a budget to see how much they can really afford for those items and still have money for saving.
- **Utilize all retirement vehicles available.** As soon as they become eligible, your children should start contributing to a 401(k) plan at work. If their employer doesn't offer a 401(k) plan, teach your children the benefits of individual retirement accounts (IRAs), both traditional deductible and Roth. The importance of saving for retirement at a young age can't be stressed enough.
- **Use debt sparingly.** If your children take on too much debt early in life, they can spend the rest of their lives struggling to get out of debt. Stress to your children that it is best to use credit cards only if they can pay the balance in full every month. Other debt, like car loans and mortgages, should only be taken on after a careful analysis of whether your children can afford the payments and whether the purchase fits in with their financial goals.

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What Is a Short Sale?

Many homeowners are faced with the fact that their home's market value is less than the outstanding debt. Rather than going through a foreclosure or turning the home over to the lender, some homeowners are attempting a short sale, which is a home sale for less than the outstanding debt. According to the National Association of Realtors, short sales account for approximately 18% of home sales now.

If the lender agrees to the short sale, the seller eliminates the mortgage debt without foreclosure or personal bankruptcy. The lender agrees to the short sale if the loss would be less than going through a foreclosure. The Joint Economic Committee estimates that a foreclosure costs the lender up to \$50,000. A recent study found that a short sale resulted in an average loss of 19% of the loan amount, compared to 40% for foreclosures (Source: MSN, May 12, 2008).

However, short sales are not easy to complete. Typically, the seller puts the home up for sale and gets an offer on the property. The offer is then presented to the lender, who can take weeks or even months to make a decision. In most cases, the lender won't even consider the short sale unless the seller appears unable to make the mortgage payment. If the lender feels the seller can pay, there is no incentive to accept a loss on the property.

A short sale gets even more complicated when there is more than one loan against the home. In that situation, all lenders have to agree to the short sale. In many cases, the second lender will get an even smaller percentage of the loan, so that lender has even less incentive to accept the deal.