PERSONAL FINANCE
– Beware of Wolves in Sheep's Clothing

by Ken Long

CHAPTER 1

FIRST THINGS FIRST

The phrase "Beware of Wolves in Sheep's Clothing" is centuries old and found in many ancient documents. The meaning of the phrase is, "Someone who hides malicious intent under the guise of kindliness." A well-known reference is from Aesop's Fables.

> *"Once upon a time, a Wolf resolved to disguise his appearance in order to secure food more easily. Encased in the skin of a sheep, he pastured with the flock deceiving the shepherd by his costume. In the evening he was shut up by the shepherd in the fold; the gate was closed, and the entrance made thoroughly secure. But the shepherd, returning to the fold during the night to obtain meat for the next day, mistakenly caught up the Wolf instead of a sheep, and killed him instantly."*

What did Bill do Wrong?

Bill had a full–time job and a morning paper route and his wife had a full–time job. They had two young children, a four–bedroom house in the suburbs, four computers, three televisions, two late model cars, and new furniture throughout the house. One day Bill came home from work, went up to his bedroom, laid down on the bed and died. Bill was thirty-six years old. The coroner could find nothing medically wrong and recorded worry as the cause of death. Bill was worried because he was two months behind on his mortgage payments; he was also buying most of the family's food on credit. What did Bill do wrong? His financial problem began when he learned to ask the question, "*What's the* *monthly payment*?" When you find yourself shopping for a new car or a house and you ask the salesperson how much the monthly payment would be, you are committing yourself to being broke. It is not so much the monthly payment that is at issue here, what is at issue is your attitude. Remember this: y*our attitude will determine your altitude in life.* Bill's attitude was limited to the here and now; he was more concerned with his monthly payments than he was how much something would cost him over the long run. He thought that if he could afford monthly payments, he could have anything he wanted. It was this attitude that drove him deep in debt and locked him into loan payments for an extended time. Before he knew it he had maxed out several credit cards while making the minimum payment on all of them. Eventually, most of the money he was paying out was going toward interest, with very little going toward principle.

What made matters worse is that he knew little about personal finances. For example, his banker convinced him that he could afford an expensive house with low monthly payments for the first five years of the loan. After five years, the payments would increase each year for five years. He did not realize that his payment in the early years of the loan was because the bank would be lending him money each month. For five years, he would pay nothing toward the principle and would increase his indebtedness to the bank each month. At the end of the five-year period, he would owe $25,000 more on the house than when he started making his loan payments. Regardless, he was only concerned with keeping his monthly payments as low as possible. Besides, his banker admonished him, housing prices always go up and this would add to his equity in the house. The idea of being able to buy the house of his dreams overrode his good judgment concerning the risk he was taking. What would happen if the market value of the house went down instead of up? This would make him upside down with the loan, which is what happened. Being upside down means that the borrower owes more on the house than what the house is worth on the market. In 2010, a third of all homeowners were upside down with their mortgages.

Another part of his problem is that he was too trusting of bankers. If the banker said that he could afford an expensive house based on his income, well, by gosh, he thought to himself, I guess I can afford this house. After all, he thought to himself, the bank would not lend me the money if I could not afford it.

However, the bank did lend him the money because the bank did not intend to keep his loan on their books. Before the ink was dry on the loan papers, the bank would sell his loan to Fannie Mae or Freddie Mac. Fannie Mae and Freddie Mac are two government owned agencies that buy mortgages from banks, bundle hundreds of them up into one collateralized debt obligation (CDO), carve the CDO up into several tranches and sell individual pieces to investors.

Eventually he could not make his loan payments, so the bank foreclosed on the loan. Banks can sometimes do this according to the fine print on the original loan contract. There is a tendency for banks to write into the loan contract provisions that will protect them to the detriment of the borrower. The United States is the only country that allows people to walk away from a mortgage without obligation by giving the house back to the lender. It is common for people to walk away from a house being $200,000 in the hole.

FISCAL WOES WILL DEEPEN

Today, about 17% of Americans are over the age of sixty; by the year 2020, 25% of the population will be over the age of sixty. The aging of our population means that the government will use ever more of the country's resources for health care. Eventually, public pension funds will not have enough money to maintain current benefit levels without tax increases. Some economists predict that eventually it will take all of the lifetime earnings of workers to support our social programs, as they exist today. The longer government takes to change the rules of the game, the more disruptive the changes will be.

In 1940, when the first Social Security pension checks went out, men had an average life expectancy of 61.4 years, and women 65.7 years. With a normal retirement age of sixty-five, making the system work was easy. On the average, men reaching retirement age collected Social Security for 11.9 years, and women for 15.2 years. Today men reaching the age of sixty-five can expect to live another 15.2 years and women another nineteen years as compared to 1940.

While we are living longer, we are also having fewer children. The average family size has dropped from 3.5 children in the 1950's to 1.1 children today. This means that as time goes on we have fewer wage earners paying into Social Security*.* Social Security Taxes (FICA) is the biggest tax in seven out of ten households. To keep the Social Security system alive, payroll taxes must increase. If we include Medicare, Social Security taxes will eventually have to be as much as 26 percent of your income.

Ever higher interest payments and taxes will mean that you will have to run faster and faster just to stand still. You stand less of a chance than your parents did of owning your own home and the majority of you will end up living with your parents upon graduation. Unlike with your parents' generation, your college degree is no longer a guarantee of a secure job, and if you do find a job, your benefits will be less than was the case with your parents. Unfortunately, your generation is the first generation where the likelihood of a part time job outweighs the likelihood of a full time job. In fact, one of the fastest growing industries place people in temporary jobs.

Suppose you are among the fortunate graduates who land a high paying job, let us say a job that pays you $60,000 per year. How much of this $60,000 will you keep? On the average, you will pay one third of this in taxes and a third will go toward interest payments, leaving you with only $20,000 for yourself. Another way to look at it is that you have to make three dollars in order have one dollar to spend. Under these circumstances, how are you going to save any money?

THE IMPORTANCE OF SAVING

Peter got his first paper route when he was eleven years old. When he was twelve, he had saved enough money to buy his dream, an expensive telescope. However, when it came time to make the purchase, he decided that he would rather have the money than the telescope. To spend all of his money on an expensive telescope went against the training he had received from his parents since he was a young boy.

Ever since he was five years old, his parents gave him chores to do around the house. These chores were beyond his everyday duties, like making his bed. If he did not do the chores satisfactorily, his parents did not pay him, but his parents did pay him for a job well done. His parents gave him four jars in which to put his money. He labeled the jars *Spending Money*, *Short Term Saving*, *Long Term Saving*, and *Charity.* His parents had him put one-fourth of every dollar he earned into each jar. For every dollar he put into the *Long Term Savings Jar,* his parents matched it dollar for dollar. As he saw his money grow, he was encouraged to save even more.

When Peter was eighteen years old, he went into the Marines for four years. The Marines gave him a perfect opportunity to continue his savings habit. Often, when it was his turn for shore leave, sailors would pay him to remain on the ship so they could take his leave. He then lent them money at interest so they could have a good time! Because of this savings habit, and because he learned how best to make his money grow, over time, he accumulated quite a bit of money. By his twenty-third birthday, he was making $30,000 a year return on his invested money. After he got married, he bought a $100,000 house with a $25,000 down payment. He then arranged to have his checking account automatically debited once a month to pay his mortgage, house insurance, and utilities. Meanwhile, the $600 a month interest he was earning went to pay all of his housing expenses.

The above story illustrates that Peter learned how to make money work for him instead of him working for the money. Peter learned and applied the principles of wealth building early in life. Peter's wealth building began when he learned to apply a principle illustrated in the following story that took place thousands of years ago in ancient Babylon, at a time when Babylon was the wealthiest place on earth.

THE RICHEST MAN IN BABYLON

George S. Clason wrote *The Richest Man in Babylon* in 1926. The following quotation is from the book published by Signet, a division of Penguin Books USA Inc., in 1988. In it, George Clason tells the story of how a poor scribe in Babylon learns the principle of wealth building. We will pick up the story on page 12 where a wealthy man, Algamish, comes to Arkad, the scribe. Algamish needs some clay tablets carved by the next day. Because this is a huge task, Arkad makes a deal with Algamish.

> "'*Algamish, you are a very rich man. Tell me how I may also become rich, and all night I will carve upon the clay, and when the sun rises it shall be completed*.'
>
> He smiled at me and replied, '*You are a forward knave, but we will call it a bargain.*'
>
> All that night I carved, though my back pained and the smell of the wick made my head ache until my eyes could hardly see. However, when he returned at sunup, the tablets were complete.
>
> '*Now*,' I said, '*tell me what you promised*.'
>
> '*You have fulfilled your part of our bargain, my son*,' he said to me kindly, '*and I am ready to fulfill mine . . .*

Mark you well my words, for if you do not you will fail to grasp the truth that I will tell you, and you will think that your night's work has been in vain.'

Then he looked at me shrewdly from under his shaggy brows and said in a low, forceful tone, '*I found the road to wealth when I decided that a part of all I earned was mine to keep. And so will you*.'

Then he continued to look at me with a glance that I could feel pierce me but said no more.

'*Is that all*?' I asked.

'*That was sufficient to change the heart of a sheep herder into the heart of a money lender*,' he replied. '*But all I earn is mine to keep, is it not*?' I demanded. '*Far from it*,' he replied. '*Do you not pay the garment-maker? Do you not pay for the things that you eat? Can you live in Babylon without spending? What have you to show for your earnings of the past month? What for the past year? Fool! You pay to everyone but yourself. Dullard, you labor for others. As well as be a slave and work for what your master gives you to eat and wear. If you did keep but one-tenth of all you earn, how much would you have in ten years? . . .*

Every gold piece you save is a slave to work for you. Every copper that it earns is a child that can also earn for you. If you would become wealthy, then what you save must earn, and its children must earn, that all may give you the abundance you crave . . . A part of all you earn is yours to keep. It should be not less than a tenth no matter how little you earn. It can be as much more as you can afford. Pay yourself first . . .

Wealth is like a tree, grows from a tiny seed. The first copper you save is the seed from which your tree of wealth shall grow. The sooner you plant that seed the sooner shall the tree grow. And the more faithfully you nourish and water that tree with consistent savings, the sooner may you bask in contentment beneath its shade.'"

The Richest Man in Bablyon, 1926

by George S. Clason

You can purchase the digital book from Amazon for $3.99. Click on the link above to go to the Amazon.com web site.

PROCRASTINATION

The most common cause of financial failure is procrastination. If you are waiting to pay off your bills or aim to save when you are better off financially, you are doing it wrong. Consider Joe and Stephanie. Joe got a job when he was eighteen years old and started contributing $2,000 to his IRA each year. After eight years, he stopped, having saved a total of $16,000. Stephanie went to college right out of high school and got a job after graduation. At the age of 26, she began contributing $2,000 a year to the same IRA as Joe. She continued this practice for the next 40 years. Her total savings over the 40 years was $80,000. Stephanie started saving the same year that Joe stopped saving. By the age of 65, whose IRA account do you think was worth more money? Assuming Joe and Stephanie each earned a 10% return (the average return in the stock market over the past 50 years), Stephanie accumulated $855,185, but Joe accumulated $1,035,160, $149,975 more than Stephanie did.

While Joe had invested only $16,000 to Stephanie's $80,000, his money earned interest for eight years longer than Stephanie's money. By investing sooner, Joe's account grew larger. Notice that even though Stephanie saved 32 years longer than Joe did, Joe ends up with a lot more money. The point to the above story is that there is never an ideal time for saving.

If you are 20 years old and want to raise $100,000 by age 65, you need to invest a total of only $1,132 today! A 50-year old would have to invest nearly $22,500 to obtain that same $100,000. This is the cost of procrastination. Time is your most valuable asset as a young person. A 20 year old would have to save $10 a month, but the 50 year old would need to save $239 a month to have the same $100,000 at the age of 65.

Consider this scenario:

- A 30 year old saves $100 a month until the age of 65, earning 10% per year; the resulting account would be worth $379,664.
- But, if this person waited just one year, beginning at 31 instead of 30, her account at age 65 would be worth only $342,539.
- Thus, the cost of not saving $100 a month for just one year is $37,125.

Can you really afford to give up $37,000 by procrastinating a year?

HOW TO SAVE

As it was thousands of years ago, regular saving is the key to financial success, and the key to saving is to make it automatic. The best way to make your savings automatic is for you to have a checking and savings account at the same bank. Instruct your bank to transfer a certain amount of money from your checking account to your savings account monthly. The amount you save can be less than 10 percent of your income, but you should start with something. Savings is the seed from which your wealth will grow. Positive effects of saving are slow at first, but just as an oak tree starts with a small acorn and grows slowly, your wealth will grow slowly.

Eventually, you should have three savings accounts. Your first savings account will help you meet unexpected expenses, such as car repairs and infrequent expenses, such as birthday and Christmas gifts. A savings account will enable you to pay cash for things you find on sale, thus saving you money without having to use your credit card. Have you ever run out of money before running out of month? You can borrow money from yourself and pay yourself back with your next paycheck. You should make a contract with yourself specifying the reasons for taking money out of your savings.

How much money should go into this first savings account? If you seldom have enough money in this account to meet your needs, you are not putting enough money in. However, if you frequently withdraw money for everyday living expenses, you are putting in too much money. It may take a while, but keep experimenting and you will find the right combination. This first savings account will also help protect your second savings account.

You can borrow money from yourself and pay less interest than you would pay if you borrow money from a bank. I can hear you asking me “but why borrow the money, why not pay for something with cash if I have the money?” You should not take money out of your second savings account because once you take money out you no longer have the savings. For example, suppose that you have $4,000 in savings and your roof needs replacing. Should you use the $4,000 to pay for the roof? The answer is no. Instead of using your savings, you should borrow against your savings if interest rates are high. In this case, you should borrow against your savings. Most banks will lend you money against your savings at a very low interest rate. Some banks will freeze the savings until you repay the entire amount and others will unfreeze the amount you pay back. For example, if you borrow $4,000 and pay back $500, only $3,500 remains frozen. If you keep the full $4,000 in savings, after you pay for the roof, you will still have your savings plus the interest your money has earned. The situation is different if interest rates are close to zero. However, if you are in the position where you need the money, you probably will not qualify for a low interest loan. An axiom in in the banking industry is that banks only lend money to persons who do not need to borrow money.

Your third savings account is for retirement. If you have a retirement plan with your employer, you do not have to open another one. However, if you do not have a retirement plan already, consider a tax deferred savings plan. Look for a detailed discussion of tax deferred savings plans and retirement planning later in this book.

Spending Habits

Always consider the little things. Tom and Susan are a two -income family. Both of them buy a newspaper when they get to work ($1.00), coffee ($2.50), and a doughnut ($2.00). To satisfy their hunger between lunch and dinner, they each buy a candy bar ($1.00), for a total of $13.00 a day. With twenty working days in a month, they are spending $260.00 per month, or $3,120 a year! But, wait, it gets worse! They have to earn over $6,000 in order to spend $3,000 because of taxes. In other words, this couple would have to earn about $6,000 a year in order to fritter away money on candy and soda.

Inflation

Inflation can erode even your best-laid plans. Consider Jim who is fifty years old and earns $50,000 a year. Assuming a 5.8% inflation rate, Jim must have a net worth of $2.2 million to retire at sixty-five with the same lifestyle. In other words, considering inflation, he will have to make $119,000 his first year of retirement to have the same real income.

Albert Einstein called the rule of 72 the eighth wonder of the world and the greatest mathematical discovery of all time. Here is how it works. If you take any incremental increase and divide it into 72, the result will be the length of time it will take the value to double. For example, if you have one thousand dollars and can earn a ten percent return, it will take about 7.2 years for the one thousand dollars to grow to two thousand dollars.

Taxes

It took a constitutional amendment to pass the federal income tax law in 1913. At first, there were no taxes on the first $20,000 of income and only a 1% tax on income between $20,000 and $50,000 — and $20,000 was a lot of money in 1913.

In the George W. Bush Administration, Congress passed two laws that lowered federal income taxes, the Economic and Tax Relief Reconciliation Act of 2001 and the Jobs and Growth Tax Relief Act of 2003. The Bush tax cuts had a sunset provision that made them expire in 2010. However, Congress passed a two-year extension by passing the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. But, unless Congress takes action, taxes will increase on almost everyone in 2013. Taxes will also increase because Congress passed the Patient Protection and Affordable Care Act (commonly called “Obamacare”) in 2011. For example, as part of this Affordable Care Act, the tax on dividends could go as high as 43.4% when the new Medicare tax goes into effect in 2013. Coupled with the scheduled expiration of President George W. Bush's tax cuts at the end of 2010, the Medicare tax would bring the top tax rate on capital gains to 23.8 percent in 2013. Under current law, the top rate on capital gains jumps to 20 percent from 15 percent in January. If Congress fails to act on Bush's expiring tax breaks, the government will tax dividends as ordinary income, with the top rate scheduled to rise to 39.6 percent from 35 percent. The increasing complexity of the income tax code will limit your income as time goes by. To make matters worse, the Social Security payroll tax rate and the amount subject to the tax has increased, making it more difficult for you to save. Is it no wonder that most people die with more debts than assets?

SHOULD I BORROW?

Borrow for things that you have to have, borrow for a business, and borrow for assets that will increase in value more than the inflation rate. When you do borrow money, never borrow from retailers. Retail companies are middle people between the bank and you. Therefore, the retailer will always get a kickback, which they pass on to you. You should borrow from a bank instead of a finance company. Finance companies are expensive because they specialize in lending to persons with bad credit histories; they lend money to people who do not qualify for bank loans.

When should you not borrow money? You should not borrow money to buy a depreciating asset. A depreciating asset is one that loses value over time. You should not borrow money for cars, vacations, televisions, and other luxury items, and never get overextended. As mentioned above, never consider the monthly payment, the only question you should ask yourself is “how much is this thing going to cost me after the final payment is made?”

BUILDING WEALTH

Building wealth is simple – the key is to spend less than you earn. Sometimes things can be simple - but not easy. Consider this, if you were to save $10,000 at 5% interest for 20 years, your profit from the savings would be $17,126 (ignoring taxes). However, if we double the rate of interest to 10%, you would earn $63,281. This illustrates the power of *compound interest.* Money does not grow linearly — it grows exponentially! Now consider this: if you earn 15% instead of 5%, your return would be $187,155. Thus, three times the rate produces 11 times the return.

When you save monthly, you will reap great rewards. If you save $100 a month over twenty years, you will have saved a total of $24,000. At 5%, your money would earn $17,103 in interest, but doubling the rate to 10% would again increase your return by 350% just as before. At 15%, you would earn $125,724, or the same 11-fold increase as when we invested $10,000, and at 20%, you would earn $286,965.

How do you invest your money to make 5%, 15%, or a 20% return? I cannot tell you — but this book will help. Remember, in life there are no guarantees — only opportunities and everything you do in life is simply a bet on some future event. If you do not save and grow your savings, you are betting that your current income will sustain you throughout your life.

CHAPTER TWO

PLUGGING the HOLES

John and Rosie Disney and their two children lived in a beautiful upper–middle class neighborhood in Connecticut. John made a good income as a car salesman and Rosie worked as a secretary for a construction company. The family spent much of their time together and took so many trips to Disneyland that friends knew John as Disneyland Dad. Their lifestyle began to unravel, however, when the automobile business went sour. John's sales plummeted almost overnight as the economy headed south in Connecticut. They immediately faced a crisis as they had no savings, and because they had no savings they quickly fell behind on their car payments. Two months later, due to a slowdown in the construction industry, Rosie lost her job. It was not long before they were unable to make the mortgage payments.

Their banker was sympathetic to their plight, but eventually they had to vacate the house. The bank had already repossessed the cars, and now put the house up at an auction. Within a year of their last trip to Disneyland, the whole family was living in a tent at the state park.

Unfortunately, John and Rosie saw their American dream evaporate. Like so many families in America today they lived their lives from payday to payday. Their lifestyle was possible only if they could continue making their minimum monthly payments. Typical of the average American family, they saved only 2 percent of their income while living ninety days from bankruptcy. Within ninety days of receiving no income, they would lose everything. If John and Rosie had lived below their means over the previous years and had saved more of their income, they could have made it through these difficult times. What could John and Rosie done differently? For one, they could have increased their savings by plugging up the holes in their financial pockets.

THE SECRET TO BUILDING WEALTH

Do not be like so many people who have their minds on making money—but spend very little time learning how to keep their money. It is a matter of attitude, remember, your attitude will determine your altitude in life. Instead of an attitude of making money, you attitude should be on keeping the money you already have. Then, as your money grows, you have to learn to make your money work for you instead of you working for the money. You will not build wealth by trading hours for dollars, like on a job; you will build wealth and find freedom through the process of duplication.

If you have a job where you are simply trading hours for dollars, what is your limitation? Your limitation is that there are only 24 hours in a day. Now let us suppose that you own a business and have 100 people working for you. If each worker is working 8 hours in a day, let us suppose that all of the income they can generate in 7 hours goes to them in wages, taxes, retirement, insurance, etc. However, the income generated from the eighth hour goes to you. This is just as if you worked for an hour and made this income. With 100 employees, you are getting credit for 100 working hours in a day; thus, you are no longer limited to 24 hours. How much money could you make if you had 500 employees or 1,000 employees?

Not only can you potentially make more money this way, but also you have more flexible time. Let us suppose that you decide to take a week off; will your employees stop working? No, they will continue working and you will continue making money.

You will also have more security through the process of duplication than you would have with a job. You can make decent money with a job, but if you can no longer do your job, your income will stop because your security depends on your ability to perform. However, through the process of duplication you can continue to make money despite your physical capabilities.

You will learn in this book that the only difference between you and someone who has acquired wealth is your thinking. Perhaps the greatest author on the subject is Napoleon Hill (1883 – 1970). Napoleon Hill was born into poverty in Virginia. In 1908, Hill's career reached a turning point when he interviewed Andrew Carnegie, the richest man in the world at the time. Carnegie commissioned Hill to interview more than 500 of the most successful men and women to discover and publish a formula for success.

Here are some quotes by Napoleon Hill from his book Think and Grow Rich published in 1937:

> "Education comes from within; you get it by struggle and effort and thought."
>
> "The world has the habit of making room for the man whose actions show that he knows where he is going."
>
> "Our minds become magnetized with the dominating thoughts we hold in our minds and these magnets attract to us the forces, the people, the circumstances of life which harmonize with the nature of our dominating thoughts."
>
> "The majority of men meet with failure because of their lack of persistence in creating new plans to take the place of those which fail."
>
> "If you do not see great riches in your imagination, you will never see them in your bank balance."
>
> "Knowledge will not attract money, unless it is organized, and intelligently directed, through practical plans of action, to the definite end of accumulation of money."
>
> "Whatever your mind can conceive and believe, it can achieve."

In his famous book, Napoleon Hill gives six steps to financial wealth:

1. Fix in your mind the exact amount of money you desire.
2. Determine exactly what you intend to give in return for the money you desire.
3. Fix a definite date at which you intend to possess the desired amount of money.
4. Create a definite plan and put it into action at once.

5. Write out a clear, concise statement of the amount of money you intend to acquire. Name the precise time limit and what you intend to give in return for the money. Now describe clearly the plan through which you are going to accumulate it.

6. Read your statement twice daily. Once before you sleep at night, once after you wake up in the morning.

Watch this short video on YouTube by Napoleon Hill himself by clicking on the following link:

YOU TUBE VIDEO OF NAPOLEON HILL

You can also download a free version of Think and Grow Rich at the Success Manual.

Your job security depends on how important you are to your employer. The more important you are, the more difficult it would be to replace you, everything else being equal, the greater are your chances of staying employed. However, if you want personal freedom you must be unimportant while operating your own business, or at least being the recipient of money through the process of duplication, like earning dividends from stock you own. If you want to be able to do what you want to do, with whom, and when you want to do it, you have to hire talented people who are capable of running your business without you. If your business can run just as good without you as with you, you will have the freedom to do whatever you want and whenever you want.

You do not have to make a choice between having a job, owning a business or being a student. You can have a job and run a business simultaneously. For example, you can have a job and still own rental properties, own shares of stock, open a coffee shop, or you can simply earn interest on savings. More than anything else, entrepreneurship is an attitude, a way of thinking. Make a choice now by which money works for you instead of you working for money.

Is a college education necessary to be an entrepreneur? You will learn many useful things in college, but a college degree is hardly necessary to be a successful entrepreneur. The world is full of people who have learned to succeed and have never attended college. Following is the story of a billionaire who never graduated from high school.

Kirk Kerkorian dropped out of high school in the eighth grade to pursue a career in boxing. He was born in Fresno, California in 1917 of Armenian immigrant parents. After making money by transferring planes in World War II, he bought Cessna aircraft with his $5,000 in savings. In 1947, he bought Trans International Airlines. He then bought land in Las Vegas and rented it to Caesar's Palace. The rent and sale of the property netted him $9 million. After many other acquisitions, he has amassed a fortune of $3 billion. Can you succeed as Kirk Kerkorian succeeded? You may not become a billionaire, but you can achieve financial independence by mastering the principles in this book. So, let us begin our journey to personal freedom!

Plugging the Holes

Pam worked hard at her job as an accountant. She got to work early and stayed late. Once when the firm was having trouble with its computer network, Pam went into the president's office and said, "*If you give me the authority, I'll straighten up this computer mess.*" With the help of a friend, she worked weekends solving the problem. Consequently, her employer promoted her when other accountants were losing their jobs. Pam kept her job because she learned that to succeed she needed to do more than what people expected of her, she learned she had to go beyond a minimum effort. Pam also learned not to take credit for her actions.

Let us suppose that you were in Pam's position and you came up with new and better ways of doing something. These new and better ways of doing business led to higher profits and more praise for your accomplishments. How is this going to make your immediate supervisor look? Logic does not motivate people as much as emotion and ego motivates people. If the lime light is on you instead of your superiors, you will soon be looking for another job. Your job security, everything else being equal, is making the team look good; always give praise to people in authority over you.

Pam learned that making money is easier than keeping it. She did not want to be like some wealthy people she knew who always had financial problems. Pam realized that a high income alone is not sufficient to insure one's economic well-being. She found the secret to wealth building is control and time. It is not high earnings, inheritance, gifts, or luck. Knowing how much money is coming in and how much money is going out is critical.

Pam understood the importance of the little things. She learned to *dream big—but to think small*. She realized the importance of a good records management system. To help her keep track of bills and other important papers, she bought a good desk, a filing cabinet and an alphabetized index filer. All the insurance papers went under the letter I, all the employment records went under the letter E, all the tax papers went under T, and so on. Discarded were things like old checks, expired life insurance policies, expired car records and expired product warranties. She also took advantage of online banking and bill paying. She regularly went online to check her bank and credit card balances, while carefully scrutinizing her records for possible fraud.

Her desk became an important money management tool. Incoming mail went into one desk drawer and in another were three pouches, one for outstanding bills, one for paid bills, and a third for tax related documents. Thus, when she did her taxes, all the necessary receipts were in one place. She made a list of her credit cards, with account numbers and phone numbers should she need to report them missing or stolen. She also made a list of her insurance policies, including life, car, boat, and home. She put these lists into a file drawer with hanging files folders in alphabetical order. She also had a fireproof box for important papers such as birth and marriage certificates.

Pam got into the habit of going online every few days and reconciling her bank statement on a spreadsheet. She always balanced her checkbook to the penny, as even small errors have a way of compounding month to month. On a spreadsheet, she kept track of when each bill was due, how much she owed, and how much she paid out and when she paid it. She set aside every other Saturday morning for paying her bills online using her bank's bill paying service.

Organizing and setting goals was fun with a computerized money management program. Now she could keep track of inflows, outflows, and interest. She also used the program for tracking her investments by graphing her gains and losses. She learned to have fun playing *what if* games with the program. For example, if she saved X amount of money monthly, how much would she have in 2 years, 5 years, and so on. The two most popular financial management software programs are Intuit Incorporated Quicken and Microsoft Corporation's Microsoft Money.

QUICKEN – SIMPLIFY AND ORGANIZE YOUR MONEY

Click the link above if you want to purchase the $29.15 Quicken Starter Edition of 2012 from Amazon.com. The program gives you money management and budgeting tools to help you watch your spending and increase your savings, with step-by-step guidance along the way. Quicken Starter Edition 2012 organizes your finances by bringing your online accounts together--including checking, savings, and credit cards.

MONEY PLUS DELUXE

Click the link above for the Money Plus Deluxe – Old Version from Amazon for only $20.

YOU NEED A BUDGET

Click on the link above for the program You Need a Budget from Amazon for $60.95.

Budgeting

Budgeting is critical for proper money management. After several months of keeping track of where her money was going, Pam decided how much each family member should receive each month. Out of this allowance, they each were responsible for their wants.

Consider the following story of a family who never saved. While shopping together, the wife finds a dress that she likes; looking at her husband, she asks, “Can we afford this dress?” Now chances are there is going to be a problem no matter what the husband says. If he says no, she will feel neglected because there is no money to buy something she feels she needs. If they agree to buy the dress, they may be short at the end of the month to pay the bills. Because everyone needs to buy clothes anyway, why not accept this fact and allocate a certain amount every month for clothes.

Children can gain valuable insights by managing their monthly allowance. Out of their fund, they must pay for school lunches, haircuts, clothes, and if they can afford it, $100 tennis shoes. Now if the child spends too much on tennis shoes, there may not be enough money this month for school lunches -- sorry that is their problem. Budgeting in this fashion will eliminate unwelcome surprises and family strife while encouraging family harmony. A certain amount of money should be set aside for eating out, going to the movies, or just having fun.

Setting Goals

You cannot fail if you follow this simple rule “spend less than you make.” Financial success will eventually come to you when you learn to live below your means. To live below your means requires the proper attitude and the ability to set reasonable goals for yourself. Following are three components to a savings plan: the desired amount of savings, the length of time you have to save, and your return on the savings. With this information you can decide how much to save each month.

A simple way to figure how long it will take savings to double in value is to use the Rule of 72. The *Rule of 72* involves taking the rate of return and dividing that number into 72. For example, if the rate of return on $1,000 is 10%, it will take 7.2 years for the money to grow to $2,000. If you can make a 7.2% return on your savings, you would see your money double in ten years, etc. In reality, of course, the real return would be less than this because of inflation and taxes.

As you put more money into savings, you will notice a change in your attitude. Instead of focusing on the money, you will begin focusing on the return you are making on your money. As your savings grow, you will find more ways to use it as a tool. For example, you could borrow from yourself to pay for that car repair or that new roof instead of going into debt to someone else.

Making Larger than Required Payments

To avoid paying out high interest payments, you should pay your creditors more than the minimum payment. Let us use a typical mortgage as an example of how you can gain by making larger than required payments. Most mortgages are simple interest loans. With simple interest loans, lenders accept extra dollars paid as credit toward the principle. In the first year of the loan for each extra dollar you pay to your creditor, you will get credit for multiple dollars. With a 30-year $100,000 loan at 10 percent interest, for every extra dollar you pay beyond what the creditor requires you will get credit for $17. That is $17 saved in interest, which you do not have to pay. Each extra dollar paid beyond the minimum payment will earn you multiple dollars in return.

Prepayments can begin any time during the life of a loan, not just at the beginning or in the early years. For illustrative purposes, assume you are about to mail in mortgage payment number one. If you were to add $44.61 (principle payment #2) to the $877.57 payment, and mail in a single check for $922.18, the bank would give you credit for making the second payment. Therefore, you will never owe the bank the $832.96 of interest for the second month.

The next month when you mail in your check for $877.57 the bank will credit it as if it were payment number three. This is because the bank will have already credited the principle portion of payment number two. The interest payment that the bank's computer will now show as due is the interest amount for payment number three. Not only will the extra $44.61 payment save $832.96, but it will also reduce the term of the loan by one month. In other words, you gave away $44.61 but got back $832.96!

Instead of sending the bank an extra $44.61, let us suppose you send in an extra $134.94 with your first mortgage payment. Now you would get credit for $2,497.77. Wow, you give away $134.94

and get back $2,497.77, for a return of 54%! When you make the next payment, it is as if you paid the fifth payment instead of the second payment. Not only have you saved yourself $2,497.77, but also you will pay your loan off three months earlier than otherwise. Where else can you get such a safe, high, guaranteed return on such a small amount of money? In this example, for every extra dollar paid you got credit for $18.51 ($2,497.77 ÷ $134.94). Even if the bank automatically deducts your mortgage payments from your bank account once a month, there is a way to make extra payments.

Perhaps the best way to make generous payments is to decide how much extra you can pay a month, and then make that extra payment every month. Using the above example of a $100,000, 10%, thirty-year loan, consider these savings:

- An extra $25 paid a month, starting with the first payment, will save $36,379 and forty-two months
- An extra $50 a month will save $64,848 and seventy-two months;
- An extra $100 a month will save $90,496 and 113 months;
- And an extra $200 a month will save $123,176, and you will pay the loan off fifteen years (181 months) earlier than if you made the required monthly payments.

Banks compound mortgage payments monthly, but credit card companies compound their interest daily! Suppose you owe $500 on a credit card and never use the card again, but continue to make minimum monthly payments. Let us suppose that the interest rate is 18%, and the minimum payment each month is 5% of the balance owed. How long will it take to reach a zero balance and how much will you ultimately pay? It will take 8½ years and will cost you a total of $2,070. How long would it take to pay off a $1,000 debt at 18% while making only the minimum payment? It will take you fourteen years to clear the debt at a cost of $2,333. If you owe $2,000, it will take thirty-three years and will cost $9,125! Using a credit card to pay for a $20 meal and continuing to make minimum payments, the meal will cost $91.25!

Now let us see what would happen if you were to make extra payments on this credit card debt. Owing $2,000 at 18% interest, how much money will you save if you add an additional $3 a month toward the minimum payment? You will save $2,800. What would happen if you paid an additional $10 a month beyond the minimum? You would save $4,800!

Should You Always Make Larger Payments?

Remember, your attitude in life will determine your altitude in life. If your attitude is simply to make the minimum payments on your debts, you will never leave the ground, you will never have altitude, you will be digging yourself into a hole instead of soaring above the clouds. What kind of return can you expect to make by making larger than required payments? The higher the interest rate you are paying the more you will gain by making larger than required payments. Suppose you have two loans, on the first loan, you are paying 12 percent interest and on the second loan, you are paying 7 percent interest, what should be your game plan? You should pay as much as you can on the 12 percent loan while making minimum payments on the 7 percent loan because you can get a bigger bang for your buck with the higher interest loan.

Depending on interest rates and possible returns on investments, there are alternatives to making larger than required payments on your mortgage. Granted, there is a personal satisfaction in seeing your indebtedness dwindle, but if your situation fits any of the following cases, making larger than required payments on your mortgage may not always be the best thing to do.

- If you are living from paycheck to paycheck and do not have financial cushion, building up a fund of ready cash is far more important than extra payments on your house.
- If you are nearing retirement and have not saved as much as you would like, prepaying your mortgage ties up your cash. Before retirement, you need to add to your savings so that you have cash to meet all of your financial obligations.
- Can you gain by investments instead of making extra payments on your mortgage? If your mortgage interest rate is 7 percent but you can make a 10 percent return in a stock mutual fund, you will gain more by putting your money into a mutual fund. This is especially true if you can save your money tax deferred.
- If you have a 401(K) plan at your place of work and your employer is supplementing your contributions, that is, putting in $1 for every $2 you invest, it makes more sense to put as much money into this plan as you possibly can.
- Credit card debts have a higher priority than mortgage debt.

- If you anticipate large outlays in the future, like paying for college expenses, it makes more sense to put your money into savings than it does to make extra payments on your mortgage. Here, U.S. Savings Bonds would be an excellent choice

WHERE TO BORROW MONEY

Imagine yourself shopping at the supermarket. Have you ever compared prices as you walk down the aisles? Should you not have the same attitude when you owe money on loans? You should always be shopping around for the lowest interest rates. For example, most banks will extend loans against certificates of deposit, stocks, or bonds. You can usually get a one–year renewable credit up to 75% of the value of the collateral pledged. This type of loan is best when you borrow the money for a year or less. With this type of loan, the bank adjusts the interest rate to market rates. If interest rates go up very much, you would be better off with a fixed interest rate loan. Of course, if interest rates go down, you will end up paying a lower interest rate. A downside to this is that you lose control over your assets.

Brokerage houses lend money to qualified people against their stocks and bonds. Sometimes, if you own stocks or bonds you can open a margin account and borrow up to 50% of the value of your stocks or bonds. You can borrow money at a low interest rate because you are using your stocks as collateral. The disadvantage of borrowing against stocks is the possibility that the value of the stocks will decline below a certain level. If this happens, you could be subject to a margin call. A margin call occurs when the stockbroker demands payment.

A tax deferred saving plan is another good place to borrow if you have one and if the bank allows you to borrow from it. Tax deferred savings plans are financial plans approved by the IRS that allows you to defer paying taxes on the income you receive from the plans. This enables your savings within the plan to compound tax-free. Examples of tax-deferred plans are IRA's, 401–Ks, and 403–Bs.

Borrowing from your tax deferred savings has advantages and disadvantages. Two advantages are you are paying interest to yourself and you will pay a low interest rate. The bank will charge you a spread between the interest you are earning and the interest you are paying. For example, if you are earning three percent interest you may be able to borrow money at five percent. Suppose your taxable income before contributing to one of these tax-deferred savings plans is $70,000 per year. When you contribute $5,000, your taxable income goes down to $65,000. However, because you did not pay taxes on the money you put into the plan, you normally have to pay taxes on the money when you take it out of the plan. Nevertheless, when you borrow the money consider the following:

- You must repay the loan within five years and the loan must be less than 50% of your vested balance or less than $50,000.
- The bank can extend the five-year rule, however, if you use the money to buy a house for yourself.
- You must pay off the loan or the amount borrowed will be subject to income taxes and a 10 percent penalty if you are under the age of 59½.
- You must make loan payments through payroll deduction.
- Any money you owe to the plan you must pay back at the time you leave the company. Otherwise, the company treats the loan as a distribution from the plan, triggering taxes and penalties.

Consider a home equity loan when borrowing money. A home equity loan is a loan that uses the equity in your house as collateral. Equity is the residual value of a business or property beyond any mortgage thereon and liability therein. Most lending institutions will lend you money against your house up to 75% of the appraised value above what you owe on your first mortgage. For example, if you bought your house five years ago for $100,000 and have a $75,000 mortgage on it and the appraised value today is $125,000, you can get an equity loan up to $37,500 (75% of the $50,000 equity).

Banks have different loan requirements, but the following is generally true. You can qualify for a home equity loan if your first mortgage plus the home equity loan does not exceed 80% of the present market value of the house. Consider these two types of home equity loans — a second mortgage and a line of credit. A second mortgage is a fixed–rate loan and a line of credit is a variable–rate loan. If you take out a credit–line type of home equity loan, you will pay interest on any outstanding debt to the plan.

Home equity loans have advantages and disadvantages. Let us first consider the advantages. A home equity loan may offer the lowest interest rate compared with other types of loans. If rates remain stable or decline, these loans are less costly than most other alternatives. If rates rise, you can always refinance. Another advantage is that the interest paid is a tax deduction. Since interest paid toward a house is the only type of interest that is still a tax deduction for most people, this tax deductibility is a big advantage. Convenience is an advantage of a home equity loan. With some home equity loans, you can simply write checks against the money in the account. This convenience is useful when buying a car. Another advantage of buying a car with a home equity loan is that you will get the title up front. Being the title owner gives, you more options than would be the case if the bank owned the car.

Consider these disadvantages before taking out a home equity loan, however. If you are struggling financially, a home equity loan is not for you because the bank uses the house as collateral. If you cannot make the loan payments, even if you are current with the mortgage payments, the bank can repossess the house. In addition, you must pay off a home equity loan when you move, thus giving you less equity toward the purchase of another house. Another potential trap of some home equity loans is that the bank could deem you not credit worthy and rescind your line of credit. Here, the entire balance of the loan would be due immediately. A bank can consider a credit risk if your income declines or you have too much outstanding credit. To protect them, your bank may periodically review your credit report. If your report has changed for the worse, the bank has the right to demand payment and rescind the original agreement.

Some home equity loans charge origination fees that run $100 to $500. An origination fee is a fee charged by banks to begin the loan process. The smaller the loan, say less than $25,000, the more the origination fee is a burden. The loan can also include appraisal fees, legal costs, and insurance. Banks can charge nuisance fees. For example, with a line of credit, the bank can charge an annual fee whether you use the account or not. Some banks may charge a point for the loan. A point is pre–paid interest equal to one percent of the loan amount.

Another option to you is to borrow against a life insurance policy if you have one. You should never buy a life insurance policy for the sake of the policy's loan provision. However, if you already have a life insurance policy, you should consider borrowing from it. You can borrow from older policies at low interest rates. If this is the case, you should make sure to use a part of the borrowed money to buy inexpensive term insurance.

Join a credit union if you can. Credit unions are nonprofit cooperative ventures developed to pool the deposits of members to invest or lend to member-owners. Members usually have some common bond, such as the same employer, church, union, or fraternal association. You may qualify for membership through any of these organizations or possibly through a relative who has access to a credit union. Most credit unions charge favorable interest rates. Repayment is convenient because the bank can handle it through payroll deduction. In addition, credit unions may be more willing to work with you if you experience an interruption in your income.

A consolidation loan is a loan used to pay off other loans. Instead of owing money to several creditors, you will owe money to only one creditor. The purpose of a consolidation loan is to replace several monthly payments with one monthly payment, hopefully at a lower interest rate. By having one small monthly payment rather than several payments, you can get a better handle on your finances. However, you should be careful not to borrow more money than you can comfortably afford to pay back. If you are not careful, you could end up a year or so down the road with a large consolidation loan and several smaller loans as well.

WHO ARE THE WEALTHY?

For two decades, Thomas J. Stanley and William D. Danko researched wealthy people in America. They wrote about their findings in The Millionaire Next Door, Longstreet Press, 1996. So what did they find?

> *"Twenty years ago we began studying how people become wealthy. Initially, we did it just as you might imagine, by surveying people in so called upscale neighborhoods across the country. In time, we discovered something odd. Many people who live in expensive homes and drive luxury cars do not actually have much wealth. Then, we discovered something even odder: Many people who have a great deal of wealth do not even live in upscale neighborhoods."*
>
> *"How do you become wealthy? It is seldom luck or inheritance or advanced degrees or even intelligence that enables people to amass fortunes. Wealth is more often the result of a lifestyle of hard work, perseverance, planning, and, most of all, self discipline."*
>
> *"The millionaires we discuss in this book are financially independent. They could maintain their current lifestyle for years and years without earning even one month's pay. The large majority of these millionaires are not the descendants of the Rockefellers or Vanderbilts. More than 80 percent are ordinary people who have accumulated their wealth in one generation. They did it slowly, steadily,*

without signing a multimillion dollar contract with the Yankees, without winning the lottery, without becoming the next Mick Jagger."

Who becomes wealthy? Usually the wealthy individual is a businessperson who has lived in the same town for all of his adult life. This person owns a small factory, a chain of stores, or a service company. He has married once and remains married. He lives next door to people with a fraction of his wealth and is a compulsive saver and investor. In addition, he has made his money on his own. Eighty percent of America's millionaires did not inherit their wealth.

Affluent people typically follow a lifestyle conducive to accumulating money. In the course of their investigations, they discovered seven common denominators among those who successfully build wealth.

1. They live well below their means.
2. They allocate their time, energy, and money efficiently, in ways conducive to building wealth.
3. They believe that financial independence is more important than displaying high social status
4. Their parents did not provide economic outpatient care.
5. Their adult children are economically self-sufficient.
6. They are proficient in targeting market opportunities.
7. They chose the right occupation.

According to Stanley and Danko, what is a typical portrait of a millionaire? What would he tell you about himself?

- I am fifty-seven-year-old male, married with three children. About 70 percent of us earn 80 percent or more of our household's income.
- About two-thirds of us who are working are self-employed. ... In addition, three out of four of us who are self-employed consider ourselves entrepreneurs. Most of the others are self-employed professionals, such as doctors and accountants.

- You would classify many of our businesses as dull and boring. We are welding contractors, auctioneers, and rice farmers, owners of mobile-home parks, pest controllers, coin and stamp dealers, and paving contractors.
- About half of our wives do not work outside the home. The number-one occupation for those wives who do work is teacher.
- On average, our total annual realized income is less than 7 percent of our wealth. In other words, we live on less than 7 percent of our wealth.
- About half of us have occupied the same home for more than twenty years. Thus, we have enjoyed significant increases in the value of our homes.
- Most of us have never felt at a disadvantage because we did not receive any inheritance. About 80 percent of us are first-generation affluent.
- We live well below our means. We wear inexpensive suits and drive American-made cars. Only a minority of us drives the current-model-year automobile. Only a minority of us ever leases a car.
- Most of our wives are planners and meticulous budgeters.
- We save at least 15% of our earned income.
- As a group, we are fairly well educated. Only about one in five is not a college graduate.
- As a group, we believe that education is extremely important for our children, our grandchildren, and ourselves. We spend heavily for the educations of our offspring.
- About two-thirds of us work between forty-five and fifty-five hours per week.
- We are fastidious investors. On average, we invest nearly 20 percent of our household realized income each year. Most of us invest at least 15 percent. Seventy-nine percent of us have at least one account with a brokerage company. But, we make our own investment decisions.
- As a group, we feel that our daughters are financially handicapped in comparison to our sons. Men seem to make much more money even within the same occupational categories. That is why most of us would not hesitate to share some of our wealth with our daughters. Our sons and men in general, have the deck of economic cards stacked in their favor. They should not need subsidies from their parents.

- What would be the ideal occupations for our sons and daughters? Our kids should consider providing affluent people with some valuable service.

I am a tightwad. That is one or the main reasons I completed a long questionnaire for a crispy $1 bill. Why else would I spend two or three hours with these authors? Oh, they made me another offer — to donate in my name the money I earned for my interview to my favorite charity. But I told them, "I am my favorite charity."

Here are some other traits Stanley and Danko found about the typical millionaire:

- More than half of all millionaires never received as much as $1 in inheritance.
- Fewer than 25 percent never received "an act of kindness" of $10,000 or more from their parents, grandparents, or other relatives.
- Ninety-one percent never received, as a gift, as much as $1 of the ownership of a family business.
- Nearly half never received any college tuition from their parents or other relatives.
- Fewer than 10 percent believe they will ever receive an inheritance in the future.

According to The Millionaire Next Door, who are the wealthiest ancestry groups? The Russian ancestry group ranks first, the Scottish ranks second, and the Hungarian ranks third. How can one explain the economic productivity of Russian Americans? In general, most American millionaires are manager-owners of businesses. Russians in disproportionate numbers are manager-owners of businesses. Further, this entrepreneurial spirit seems to translate from one generation to another.

Why do the Scots rank second? First, Scottish Americans are frugal. Their frugality allows them to save more and invest more than others in similar income groups. Scottish families who earn $100,000 a year saves at a level comparable to the typical American household that annually earns $150,000. The highest prices the Scots paid for suits, shoes, watches, and motor vehicles were far less than what was the norm for all millionaires surveyed. Research reveals that Scottish offspring are economically and emotionally independent even as young adults. Thus, they tend not to drain their parents' wealth. Members of the Scottish-ancestry group have instilled their values of thrift, discipline, economic achievement, and financial independence in successive generations. These values are also typical traits among most self-made millionaires.

Of all the professions one can go into, which would give you the greatest chance of becoming a millionaire? Would you believe the auctioneering profession? More than 35 percent of all auctioneers are millionaires! Auctioneers are more frugal than their high-income-producing counterparts are; they have lower overhead both for household and business expenditures. Consider the following:

- On average, millionaire auctioneers are about fifty years of age, six to eight years younger than their urban/suburban counterparts are.
- Urban/suburban millionaires are more than three times more likely than millionaire auctioneers to own luxury vehicles.
- Auctioneers hold most of their wealth in appreciating assets than do other high-income producers, and they invest in categories in which they have expertise.
- Auctioneers have experience with bankruptcy. They are aware that consumer goods often generate few cents on the dollar.

THE MILLIONAIRE NEXT DOOR

You can purchase The Millionaire Next Door from Amazon for $7.84.

WHAT'S COMING UP?

Baby boomers, people born from about 1946 to 1964, are beginning to retire. How does this relate to personal finance? Just about everything. The retirement of the baby boomers will profoundly alter the way we spend and the way we should invest. It will upend traditional notions of work and retirement. It bodes well for certain types of investments while raising red flags about others. In addition, while specific predictions vary, one thing is clear: The demographic shift happening now will prove crucial to understanding America's economy in the years ahead.

Start with the numbers. After the baby boom's huge bulge in births, from 1946 to 1964, the numbers fell off sharply in the mid-1960s and did not rebound until the baby boom began in the late 1970s. This boom-and-bust pattern has affected everything from schools and jobs to housing. Clearly, this population pattern will create new imbalances as it moves forward in time. However, with life spans getting longer, the time in question is itself changing.

This increasing longevity will have a major impact on families, giving people heading into their retirement years more responsibilities than in the past. In addition, it will bend the well-documented cycles of wealth accumulation and wealth depletion into a new shape.

Debt and the Paradox of Thrift

You will build wealth through the process of duplication. The key is to have money work for you instead of you working for the money. You can duplicate yourself in many ways, such as earning interest, having employees by owning a business, owning stock and bonds, receiving rent, etc. The least profitable way of making money is to trade hours for dollars, you work so many hours and get back so many dollars. However, most people are not into making money as their only priority. They see other priorities as more important, such as convenience, satisfaction, doing things that are familiar, or simply working at jobs to meet immediate needs.

In contrast, other people are simply into leveraging money. When you borrow money to buy rental property for example, it is called leveraging money. Another example of leveraging is the practice of buying stock on the margin. Let us suppose that a share of stock sells for $100. Instead of paying $100 now, you can give your stockbroker, let us say $25, and agree to pay the rest on a certain date in the future. If you can sell the stock for, let us say, $200 before the due date, you can pay the stockbroker back his $75 and you make a gain of $100. Leveraging comes from the fact that you used $75 of someone else’s money and only $25 on your own money to make this $100 profit. Now multiply this transaction by several thousand, or even millions, and you are talking about making a great deal of money.

This process of leveraging money was a major factor in the economy’s tremendous growth from 1999 to 2007. However, by the fall of 2008, things began to unravel and we entered a deleveraging period. Let us suppose that you bought the stock mentioned above for $25, but instead of the price going up, the price of the stock went down in the market. Even before the agreed upon due date of the loan, your stockbroker makes a margin call on you. This means is that you have to pay the $75 per share back immediately. If you bought, let us say, 100,000 shares of stock, you now owe $750,000. However, you do not have $750,000 in cash. Even if you sell all of your stock, it is not worth $750,000.

So what can you do? You will have to sell any asset you can to make good on the loan. This is where deleveraging comes into play. This is what happened to investors who bought heavily into the real-estate market, who speculated on house prices going up. When the price of houses declined, the situation forced them to sell everything to make good on the debts they owed.

In the later part of 2008 and into 2009, we witnessed the disappearance of trillions of dollars all over the world. How can money just disappear? If your stock was valued at $100 but it is now worth only $30, $70 has simply disappeared. This is the ugly side of too much debt. When people push the envelope and take on too much debt, when the downward cycle does come, it overwhelms them.

So what is the paradox of thrift? With so much money disappearing and so many businesses failing, fear sets in. Consumers are afraid to spend, and they start paying off their debt. Now if you save more you will have more in the future, but if everyone saves more, then everyone ends up with less as the economy shrinks. This is where the paradox comes into play. Paradox means a contradiction. By saving more, instead of having more in the future, most everyone has less. Once the downward spiral intensifies, unemployment begins to feed upon itself, leading to ever more unemployment.

CHAPTER THREE

CREDIT

Imagine standing in line at the store and handing your credit card to the store clerk who slides your card through an electronic device and waits for the signal that authorizes your purchase. In about twenty seconds, an incredible information journey takes place. If you are one of the 300 million *Visa* credit card holders, the journey will probably include a momentary stop in McLean Virginia, a Northern Virginia suburb. McLean is the home of Visa International Operations Center East, which is one of two hubs for the credit card association's vast information network. Its sister "super center" is in Basingstoke, England. *Visa* operates a computer system known as *Visa*Net that functions as a middleman among merchants, the merchants' bank and the bank that issues a customer's credit card. The 300 million dollar network encompasses nine million miles of fiber–optic cables that link about 20,000 financial institutions and ten million merchants in 247 countries and territories worldwide. VISA is the leader in the plastic-card world. In the United States alone, VISA has about half the market share, compared with 27 percent held by MasterCard and 20 percent by American Express

As the salesclerk slips your card through an electronic device that reads your account number, purchase amount and expiration date, the *Visa* network receives this information. The *Visa* network asks the bank that issued your card to authorize the sale. If the store lacks a card reader, the sales clerk telephones the information to a bank operator, who in turn will question the *Visa* system. Once the account information makes it to your bank, the computers ask the following questions: Has someone stolen your card? Does the purchase exceed your limit? Is the purchase unusual and beyond your normal buying habits? If the answers to these questions satisfy the computer, your bank will authorize the sale. This process usually takes between six and twenty seconds. It normally takes about three days to clear the transaction.

FINANCE CHARGE CALCULATION

Drew got excited when he got an offer in the mail for a new credit card. The new card offered him a low interest rate and money back based on his purchases. Because he had a large balance, which he carried over from month to month, he expected the lower interest rate would give him some reprieve from paying high interest charges. Consequently, he accepted the new card and transferred the balance from his old card to the new one. Much to his surprise, after several months of making payments he noticed he was paying a lot more in interest on the new card as compared to what he was paying on his old card. Why do you think he was paying more in interest charges despite the lower interest rate? The difference between his old card and the new one was the interest calculation.

Because he knew the card company was taking advantage of his lack of knowledge, he decided to learn more about credit cards. This is what he found. He found that his old card used the *average daily balance method* to calculate the interest owed, and the new card used the *two–cycle method.*

Let us suppose that you have two credit cards that offer the same interest rate. Now suppose that you carry over a balance from month to month. If one card uses the two–cycle method and the other uses the average daily balance method to determine how much interest you owe, everything else being equal, you will pay almost twice as much in interest with the two–cycle card as you will with the average daily balance card. Why?

The answer lies in the difference between these two interest rate calculations. Very simply put, here is the difference. Suppose that you have owed approximately $1,000 on your credit card for several months. Let us also suppose that your card uses the average daily balance method to determine your interest charge. At this point, you make a $900 payment. How much do you owe interest on the next month? You owe interest on $100 because that is your balance in the second month. However, with the two–cycle method, you would still owe interest on the full $1,000 the second month. Why? Because when you use a card using the two–cycle method the two stands for two months. So looking at it over a two-month cycle rather than a monthly cycle, your balance is still $1,000 in the second month. It is not until the third month that your balance goes down. In other words, with the two–cycle method of calculating finance charges, card companies divide the year into six equal parts instead of twelve, despite monthly billing. Of course, the interest calculation does not affect you if you pay your bill in full every month because most credit cards have a grace period.

A grace period is usually 20 to 25 days, during which you can pay your credit card bill in full and incur no interest charges. Typically, a card's grace period applies only when you start the month with a zero balance. If you start the month with a balance, interest charges begin to accrue on the day you make a purchase. This is why it is a good idea to pay your credit card bill as soon as possible after receiving the statement.

If you have three credit cards and carry a balance on each, put all the charges on two of them. Then when you make purchases that you expect to pay off in full, put them on the card with a zero balance. By so doing, you will pay less in interest charges than you would pay on three cards.

MINIMUM PAYMENTS

If you make minimum credit card payments, be cautious of companies who charge a low minimum payment. The most common minimum payment is only 2 percent of the outstanding balance. Suppose you have an unpaid balance of $2,000 and are paying 18 percent interest. The table below shows the results over time if you paid $40.59 a month without incurring any additional charges on the credit card.

If you kept a balance of $2,000 by charging the same amount you pay back and continued making the minimum payment every month, you would be paying an actual interest rate of about 250 %! Even if you did not make additional charges on the card and continued to make a payment of $40.59 a month, you would pay $1.18 in interest for every dollar borrowed. To calculate the exact length of time, use one of Nolo’s calculators at http://www.nolo.com/calculator.cfm.

COMPARING CREDIT CARDS

Credit card companies make money four ways: charging interest, accessing annual fees, charging penalty fees, and charging retail stores 3 percent or so of each sale made with their card. The

American Express Charge Card primarily makes money by charging an annual fee and by charging retail stores about 4 percent of every American Express purchase.

If you can get a credit card that has no annual fee, why even consider a card that charges you an annual fee? An annual fee card may be better if you carry over a monthly balance because the interest rate will probably be lower than with a no annual fee card. The higher your monthly balance, the more you can save with a lower interest rate, despite the annual fee. However, if you pay your balance in full each month, then a no annual fee card is probably better. If you have an excellent credit rating, you may qualify for a card with both a low interest rate and no annual fee.

Should you choose a card with a fixed or a variable interest rate? That depends on your expectations of the future. Cards with a variable interest rate will initially have lower rates than fixed rate cards, but the rate will go up quickly as market rates increase. If you have a variable rate credit card, your annual percentage rate for purchases may vary monthly in accordance to the prime interest rate plus 10% or so. The prime interest rate is the rate that banks charge their largest and best customers. Interest rates on fixed rate cards will change more slowly than on variable rate cards.

An *American Express Charge Card* has advantages and disadvantages. One advantage is that there is no limit, within reason and with some exceptions, to the amount you can charge on the card. You must pay off the balance each month; therefore, there are no interest charges. If you do carry over a balance from one month to the next, American Express will demand you use a different type of American Express Card, one that works more like a credit card. The *American Express Card* has two disadvantages. The card is not as widely accepted as credit cards and it has a higher annual fee than many credit cards.

Fees to Watch Out for in Credit Card Offers

- Late fees. Some card companies charge as much as $25 if you are just one day late making a payment.

- When late fees are charged. In times past you had 30 days to make a payment before being assessed a late fee. Today the average time you have to make a payment is a lot less than 30 days.

- Penalty interest rates. If you pay late, exceed your credit limit, or have a deteriorating credit report, the card issuer may raise your interest rate. You could pay as much as 10 percent more for a year. This is sometimes true if you are late on any payment, not just your credit card.
- Cash advance fees. Most card issuers charge you interest as soon as you make a cash advance, in other words, there is usually no grace period with cash advances, even if you start the month with a zero balance. Additionally, some card issuers charge a higher interest rate than on other unpaid balances. Also there is usually a one–time cash–advance fee of 2 percent to 5 percent.
- Balance transfers. When you transfer unpaid balances from an old card to a new one, the new one usually treats the transfer as a purchase. However, watch out for issuers that treat the transfer as a more expensive cash advance.
- Teaser pricing. A new credit card may bring you in by offering a very low interest rate. However, when you actually apply, you are told that your credit history is not good enough for the lower rate, so your card comes with a higher rate than that advertised.
- Billing method. Pay attention to the billing method in any credit card offer. Remember, if you carry over a balance from month to month, the two-cycle method will cost you more in interest charges, everything else being equal, than will the average daily balance method.
- Slamming. Slamming is the practice of charging you for extras without your approval. Some card companies will charge you monthly for credit life, disability, and unemployment insurance without notifying you.
- Low introductory rates. If you are carrying over a large balance from month to month, a low introductory rate for a year or so will make switching to the new card beneficial. However, for a shorter time, it may not be worth switching. Also, how high will the rate go after the trial period? Consider also the impact that another credit card will have on your credit report.

Perks

Following is an explanation of common benefits with credit and debit cards.

- Some card companies will assist you in making your flight and hotel reservations before leaving for a trip. In addition, you can secure a hotel room with your card number. Occasionally, you can get rental car and hotel discounts through the card company at the same time.
- Once you leave your hometown, using a card is easier than personal checks, and safer than carrying cash. You can also get cash at any ATM machine wherever you go. If you lose a card, or someone steals it, once you report a card missing, you are not liable for any unauthorized charges.
- Cards are good for record keeping, especially for tax information. At an audit, the IRS does not normally accept canceled checks as proof of a tax deduction, but they do accept card receipts.
- Some card companies also will guarantee customer satisfaction on purchases made with their card. For instance, when you have a dispute with a store manager, the card company will settle the dispute for you. During the time your card company is settling the dispute, you do not have to make payments for the purchase or pay any interest charges.
- Whenever you charge a rental car to your card, you may receive free accident insurance. Coverage normally includes loss due to collision, damage, fire, theft or vandalism.
- Some cards also offer free legal and medical referrals to you while traveling.
- Most card companies offer automatic travel and accident insurance, covering you and your dependents.
- With certain restrictions, some cards offer extended warranty coverage when you use the card to make a purchase.
- A few airline companies sponsor their own cards. These cards give you frequent flier miles credit on their airline with every dollar usage. For an extra charge, *American*

Express allows you to apply your dollar usage to one of several frequent flier programs of your choice.

WHICH IS THE RIGHT CARD FOR YOU?

Different credit cards will suit different people. The best credit card for you will depend upon how you intend to use it. Before you chose a credit card, you should decide why you want it and how you intend to use it. For example, do you want to

- pay off your bill in full every month?
- spread spending over several months?
- take advantage of special offers?
- have easy access to credit if and when you need it?
- support a charity or other organization?

You should look for the following features:

- the interest rates for purchases, balance transfers, cash advances.
- the length of the interest-free period.
- incentives and benefits, such as cash back, rewards or loyalty points.
- being able to manage your account online.
- using your credit card when you are out of the country.
- the availability of credit card checks.

Shopping Around

A great web site to help you compare cards is http://creditcards.com. At this web site, you can search for credit cards depending on your needs. Here is a list of the categories:

- low interest rate cards
- balance transfer cards
- rewards credit cards
- cash back credit cards

- airline credit cards
- instant approval cards
- prepaid credit cards
- credit cards for bad credit
- student credit cards
- business credit cards

This web site will also give you the latest news concerning credit cards, the latest rates, and a question and answer feature. The site offers several tools, such as news about credit cards, related blogs, RSS news feeds and a credit card newsletter.

How to Get a Low-Interest Rate Credit Card

- Only apply for two credit cards within a six-month period. Too many applications mean too many inquiries and instant denial.
- Unless the card advertises loan consolidation, do not mention it. Some banks do not want their cards used for that purpose.
- If you have high balances and are close to your credit limits on your other credit cards, pay them down before you apply for a new one.
- If you have several revolving accounts, close any you do not absolutely need. Some issuers total up all credit limits on the credit cards a consumer holds and considers the total potential liability.
- Make sure your debt–to–income ratio is under 30 percent. High debt–to–income ratios are another major fed flag to low–interest rate credit card issuers who cannot afford to take any risks.

TIPS FOR CREDIT CARD USERS

- Learn to use your credit card company's money to defer payments on major purchases. For example, suppose you start the month with a zero balance. Now suppose that your billing date is the first of the month, and you charge $1,000 on the second of the month. It will take thirty days or so before you receive a bill, then you have another twenty–five days before you owe interest on the $1,000. By so doing, you have used the credit card's money for almost two months without paying interest. Economists call this practice of using someone else's money float.

- When you compare credit cards, do not concentrate on the monthly payment. The only true cost of the card is the interest rate and the interest rate calculation method, that is the average daily balance method compared to the two-cycle method.
- You can have a pristine credit report, but if the report gives the impression of over extension, it could jeopardize a job opportunity.
- If you think there is an error on your bill, do not withhold payment. If a mistake is found, the company will credit your account.
- If you carry a monthly balance, you should mail your payment the day you receive the bill if you can. This is because card companies' compound interest daily, and therefore, interest charges accrue with each passing day you fail to make a payment.
- If you pay your balance in full each month, you pay no interest if the company receives the payment before the due date. The exception to this is when you take out a cash advance because there is normally no grace period on cash advances.
- Keep track of how much you spend on your credit card by making a note of any purchases as you make them.
- Use your short-term savings account to pay off your credit card bill.
- Avoid impulse buying. If you struggle with impulse buying, consider keeping your credit cards in a small safe deposit box at your bank until you gain mastery over your habit. Sometimes banks are receptive to bargaining. For example, if you have a credit card that has an annual fee and you are considering getting another card with no annual fee, first call and request that your card company drops the annual fee. If the bank knows that you are about to drop their card because of the annual fee, they may consider waiving this provision in your case.
- Always be on the lookout for ways to exchange high interest for a lower interest. For instance, if a credit card offers a very low interest rate on balances switched to their card, you could benefit if you have high balances on your present credit cards. Even if the low interest rate is for only a year, it still may be a good deal for you to make the

switch. However, keep these things in mind. First, what is going to happen after the introductory period is up on the new card? This is especially true since most cards that offer a special introductory rate are variable rate cards. Second, will an additional credit card look bad on your credit report? Third, do you have the self-discipline not to fall more into debt because you have another credit card?

- Sometimes banks will offer you a good deal on a credit card if you do all your banking with them.
- Beware of mail solicitations offering pre-approved gold credit cards promising high credit limits. The offer may not be for a *MasterCard* or a *Visa card.* You may be one of the thousands of consumers targeted for a gold credit card promising guaranteed approval and the chance to build and improve your credit rating. All that you can buy with these cards is the ability to purchase products out of a catalog that the company itself provides. To some, buying from a catalog sounds inviting, but beware; you may not get what you pay for.
- Avoid credit cards that offer c*redit life insurance.* Credit life is a decreasing term life insurance policy that will pay off the balance of a loan should you die. This type of insurance is very popular with creditors because it is so profitable for them, but very expensive for you. However, this may be a good insurance if you are otherwise uninsurable.
- Avoid cards that offer credit disability insurance. With *Credit disability insurance* if you become disabled the card company will make payments. However, strict guidelines govern disability. Usually you have to be completely bedridden and have a doctor's authorization to be eligible for benefits. Even if you are eligible, the insurance company will not pay for the first thirty days you are out of work. After thirty days, the company only pays your minimum monthly payments until you get back to work.
- Take advantage of credit cards that give you airline miles credit if you are on sound financial footing and know you are going to travel often. However, this is only a good deal if you pay off the card balance on time each month.

YOU CAN CHALLENGE A RATE INCREASE

Sam was surprised when he checked his credit card bill one month. He had been paying 13.90 percent on unpaid balances—but his rate increased to 24.96 percent. Why the jump? Because his card issuer decided that he had become a higher credit risk. Therefore, the bank exercised its contractual right to charge him more. It has been common practice for card issuers to raise rates for late payment or exceeding credit limits. Banks have even raised rates for no reason. Some companies run their customer's credit history through a scoring system. Your rate can increase if the bank concludes that your credit profile is not as strong as it was previously. What can cause a rate increase? The most common would be adding another credit card or increasing your debt load on your existing cards.

How do you avoid a penalty rate increase?

- Do not sign up for a card with a penalty rate. The card issuer lists penalties in the fine print on the application.
- Hold down your debt and always pay on time, if not early.
- Cancel any unused cards, including department store cards. The system will penalize you for having too many credit lines.
- Read your mail from the bank. You will get a small print disclosure, in advance, that your rate is going up. This will give you time to switch your debt to a lower rate card.
- In some states, you can keep the card and pay off your debt at the old interest rate—but only if you notify the bank in writing and quit using the card.

The rules of the game have changed since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of July 2010. The stated aim of the legislation is:

> "To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

Title X establishes the Bureau of Consumer Financial Protection, within the Federal Reserve. The new Bureau regulates consumer financial products and services in compliance with federal law. Even though the government placed the Bureau within the Fed, it operates independently. The bill prohibits the Fed from interfering with matters before the Director, directing any employee of the Bureau, modifying the functions and responsibilities of the Bureau or impeding an order of the Bureau

One group affected by this bill is college students, like yourself, and parents, your parents. With the Consumer Protection Act in place, your parents have to think about your credit. Unless you have the ability to obtain a credit card on your own, parents, or someone else over 21, must cosign credit card applications. This makes your parents responsible for any credit card problems you might incur.

JOINTLY HELD ACCOUNTS

Divorced persons beware. Do not be caught paying off your ex–spouse's credit card debts. As long as your name is on a credit card jointly with your previous spouse, you are liable for all charges on that card. Consider this situation. Ten years after their divorce, June's former husband reactivated a jointly held charge card without her knowledge. After incurring a $4,000 debt, he defaulted on the payments. Neither *Visa* nor *MasterCard* requires credit card issuers to notify the cosigner/joint owner of any default. If the borrower declares bankruptcy, the cosigner is liable for all debts incurred. At this time, only the states of Maine and Illinois have passed laws to protect cosigners.

June never knew of the default or of her obligation to pay. The Federal Trade Commission's Credit Practice Rule does require a lender to notify the cosigner in writing of his responsibility to pay the debt prior to loan approval; in the past banks normally have not notified cosigners of negative changes in debt transactions. The FTC's rule even allows the creditor to collect the debt from the cosigner without first trying to collect from the borrower. Consequently, the credit card company continued to make negative reports to her credit bureau. She did not know about the situation until she tried to rent an apartment.

During a divorce, it is essential that you open new credit card accounts in your name only and close all joint accounts. Call your credit card companies, banks, and other financial institutions and cancel all lines of credit when possible. Follow up the phone call with a certified letter with a return receipt requested. Make sure that you state that you will not be liable for any future transactions on the account as of the date of the letter. You may also want to request information on how you can establish your own account. Even if your lenders keep the accounts open, you have legally protected yourself from any liability after the date of the letter. Always keep a copy of pertinent letters for your records.

IMPULSE BUYING

Patricia was a frugal person who kept a budget. Then she began to have trouble with her marriage. She began to binge on food and on shopping and eventually her condition required a trip to the hospital. “Spending money gave me a lift, but then I would crash and feel guilty,” she says.

She had hidden the habit from her husband by waiting until he was away from home to bring her purchases inside. “I’d put them in my closet and bring the items out one at a time,” she says. I did not need most of the items; even so, she racked up several thousand dollars in credit-card debt just to support her shopping desire. She would hide the bills in a desk before her husband saw them. Because she had a job, she was able to make the payments without his knowledge.

Finally, her husband learned what was happening when she went into the hospital and he began opening the mail. After contemplating divorce, he decided that they both needed counseling. Eventually she learned to control her spending and they were able to salvage their marriage.

Many people have credit problems because they do not keep track of purchases made with credit cards and are shocked at the amounts they owe when the bills arrive. Here is a way to keep track of your credit card charges. At the beginning of each month, set the total amount you can afford for credit card charges. You may want to use the amount you can pay in full when the bills are due. However, if you carry over your balance, a rule of thumb is to set your total at what you can comfortably repay in three months or less. If current balances require six months or more to repay, you should consider curtailing your credit card use.

CAN YOUR PAY BE GARNISHED?

Garnishment means that a creditor can withdraw money directly from your paycheck or bank account. Consider the following story. When the bank sued Leann Weaver for not paying her credit card balance, her reaction was typical for someone in that situation. Personal and financial setbacks weighed her down, and she knew she owed the $2,470. Therefore, she never went to court to defend herself. She soon regretted her attitude by what happened next. When she swiped her debit card at the grocery store, her card company declined the charge. It turned out Capital One Bank had taken $224.25 from her paycheck, a quarter of her wages for two weeks of work at a retail chain, and her bank account was overdrawn. Because she never offered a defense, Capital One won a lawsuit without having to offer proof of her debts and therefore never had to justify to a judge the huge interest charges and penalties they tacked onto her bill. Ms. Weaver said she repeatedly asked Capital One for more time to pay her $2,470 debt, but last year the bank filed suit. She failed to show up in court, and the court entered a judgment against her. She now owed $1,800 in interest and lawyers' fees. Then the garnishment began, almost $500 a month, or a quarter of her pay.

Statistics have shown that if she had decided to fight back, she may have won the case. In the rare event that a consumer battles back, creditors frequently lack the documentation to prove their claim and they drop the case. That is because debt collectors often own the past-due debts for cents on the dollar.

Consider the case of Jim Jones. Mr. Jones, who resides in Virginia, took out a $4,097 personal loan from his local bank. He fell behind on his payments and the bank sued him. Mr. Jones did not appear in court. By default, his bank won a judgment of $4,750, and $900 in lawyers' fees, with the debt accruing interest at 27.55 percent until paid in full. The bank started garnishing his wages in March 2003. Over the next six years, the bank deducted more than $10,000 from Mr. Jones's paychecks, but he made little headway on his debt. According to a court order secured by his bank's lawyers last spring, he still owed the company $3,965, a sum nearly equal to the original loan amount. Mr. Jones, who did not graduate from high school, was baffled. "Where did all this money go that I paid them?" he said. A consumer law lawyer in Petersburg, Va., took Mr. Jones's case without charge, and found that all but $134 of his payments had gone toward interest, fees and court costs. "It's a perfectly legal result under Virginia law," the lawyer said.

Also, consider the case of Ruth Owens, a disabled woman. The Discover Bank sued her in 2004 for an unpaid credit card. Ms. Owens offered a defense, sending a handwritten note to the court. "After paying my monthly utilities, there is no money left except a little food money and sometimes it isn't enough," she wrote. The judge found that over a period of several years, Ms. Owens had paid nearly $3,500 on an original balance of $1,900. However, Discover was suing her for $5,564, mostly for late fees, compound interest, penalties and other charges. He called Discover's actions "unconscionable" and threw the case out.

SIMPLE INTEREST VERSUS INSTALLMENT LOANS

When you use a credit card the bank will calculate your outstanding balance each day (sometimes each minute), then it will multiply this balance times your interest rate and divide that number by the number of days (or minutes) in a year, let's say 365. This is how much interest you own that day. If you have not made a payment that day, then the next day the principle you owe has increased because of the interest charges. This occurs each day of the month. So, let's suppose that the accrued interest charges over the month is $100 and at the end of the month you make a payment of $100, now your indebtedness is the same as it was the month before. This is why you should make your payment as soon as possible; the longer you wait the more interest you will owe.

The above scenario is still better than when you borrow money as an installment loan. The most common type of loan offered to individual bank customers is the installment loan. An installment loan is a loan whereby you, the customer, pay a portion of the value of the loan each month until the amount owed is paid. Consider the difference between a simple interest loan and an installment loan that is front-end loaded, such as a loan based on the rule of 78's.

Simple interest loan

With this type of loan, you pay interest only on the remaining outstanding or existing balance on the loan. As you make each payment, you are consistently paying down principle and reducing the outstanding balance on your loan.

Always get simple interest loans. This is how a simple interest loan works. Suppose you borrow $1200 at 10% interest for one year. With the interest compounded monthly, your monthly payment would be $105.49. What is your interest payment the first month? The answer is $9.86. Here is how it works:

10% × $1,200 = $120

10%/365 days = .02739%

$1,200 × .02739% × 30 days = $9.86

What is your interest payment the second month?

$1,089.86 × .02739% × 30 days = $8.96

A Mortgage loan is a good example of a simple interest loan. For example, what would your interest payment be on the first month of a ten percent 30-year $100,000 mortgage? Your total payment would be $877.57. How do I know this? All lending institutions use the same payment formula when applied to mortgage loans.

What would your monthly interest payment be for this loan in the first month? Your interest payment would be $833.33. I know this because of the formula $100,000 times .10 equals $10,000 and $10,000 divided by 12 (for 12 months) equals $833.33. What percent interest are you paying the first month? The answer is $833.33 divided by $877.57 equals 95%!

How do you calculate how much interest you owe the second month? Now let' see, the original loan was for $100,000, but you paid approximately $44 toward the principle the first month (877 minus 833 equals $44.) So the balance you owe after the first month is $99,956 (100,000 minus 44.) The interest owed the second month is $830 (99,956 times .10 equals 9,956 and 9,956 divided by 12 is $830.) Because your monthly payment is always $877.57, again approximately $44 is going toward the principle. Now your loan balance is approximately $99, 910 after the first two payments.

How much interest do you owe for the third month? The answer is about $833. In the third month, you will pay about $45 toward the principle. The same process repeats each month for the duration of the loan.

How much interest will you pay the first year? The answer is $9,975! How much will you pay toward the principle in the first year? The answer is $556. This means that only 5.3% of your payments have gone toward the principle and a whopping 94.7% have gone toward interest payments! Is it any wonder that so many people can never seem to get out of debt!

Front-end installment loan

With this type of loan, you pay interest on the original loan each month. When you borrow money to buy a car you may very well be paying on a front-end installment loan. Watch for an installment loan agreements based on the "Rule of 78s". This is a clear sign that the loan is front-end loaded. The rule of 78s means that the lender will apply early payments to the interest, not the principle. Even though this method of finance charge calculation is illegal in some states, finance companies still use it when they can get away with it. This is how a rule of 78's loan works. Suppose you borrow $1,200 at 10%

interest for one year with the interest compounded monthly. Your monthly payment would be $105.49. What would your interest payment be the first month?

The answer is $18.46. Here is how you derive this answer.

$10\% \times \$1200 = \$120$

Add the sum of the digits $(1+2+3+ \ldots 12) = 78$

$(12/78) \times \$120 = .1538 \times \$120 = \$18.46$

What is your interest payment the second month?

$(11/78) \times \$120 = .1410 \times \$120 = \$16.92$

Consider the following story. You can find the entire report at
http://www.ripoffreport.com/reports/0/170/RipOff0170269.htm

“My name is Keara and I live in Middleville, MI. Recently, my husband and I purchased an automobile through Nationwide Auto in Hastings, MI through a gentleman by the name of Kevin.

During our negotiations, we had told Kevin that we only planned on spending $5000 and that we did not want to pay his asking price for the van, which was told to us as $6840.40 at 22% interest. We continued to tell him that our original plan was to finance a car for approx. $5000 and, upon receiving my husband's Christmas bonus from his job; we planned to pay off/down our loan with $4000. He said that we could still do that and that we should not be intimidated by the amount of the loan because, 'Michigan is a simple-interest state and, if we paid $4000 on the loan, we'd only be paying the interest toward the remaining 2840.40, which would take us less than a year to pay off.'

He continued to assure us that, because it was a 'simple-interest' loan, we would be benefitting by just getting the car now and we'd only have to worry about the remaining balance, which he assured us on our contract, was only $2840.40.

I then asked him why it stated on the contract that the AMOUNT FINANCED showed as $6840.4 but the TOTAL ('amount paid after all payments are made on schedule - 30mos.) showed as $8940.40. He assured me that, 'that's only the amount that we'd end up paying if we only made our regular payments over the entire loan period.' and he continued to say, 'If you're paying down the $4000, you won't owe that because you're cutting your loan term down and you're principle down because it's a simple-interest loan.' On that note, we agreed to finance the car.

On December 26, my husband received his bonus check and called Credit Acceptance Corp. to notify them that we would be sending them a check for $4000 and that we'd like that to go toward our principle of $6840.40. He continued by saying, 'Now we're clear that this money is to go toward the principle of $6840.40, leaving us to only pay the interest on the remaining $2840.40 and the representative assured him of that in return. We then wrote the check out, entered a statement on the MEMO section reading 'TO BE APPLIED TOWARD PRINCIPLE' along with a letter in the envelope which clearly stated our intentions for that money.

A couple of days later, our check cleared through our bank so my husband asked me to call Credit Acceptance to make sure that they applied it to the principle, as they had promised and as we had requested. When I called, the automated system stated that they received my $4000 and that my remaining balance was approx. $4953!

I then had my call forwarded to an operator and I expressed my concerns with her. I told her that there must be a mistake because my first payment for my car wasn't even due yet (not until Jan.2nd) and that my husband was assured by their institution and by Nationwide that my money would go toward the balance of $6840.40.

The representative told me that my balance was not $6840.40 but instead, $8953, which included finance charges. I told her that my loan is a simple-interest loan and that my contract even reads as such and nowhere in the contract does it imply otherwise. She then told me that my loan was NOT a simple-interest loan and that she doesn't understand why I was told that. I then told her that her own company even assured me that I'd only be paying the interest on the remaining $2840.40 if I sent them the $4000 and she said that she was 'sorry that we were misinformed but that there are no refunds and that the balance remains.'

I told her that I either want my $4000 back or I want it to be put toward the $6840.40, as promised to me by her company and by Nationwide. She said that she couldn't do either and that I should contact an attorney if I wanted to take it further. I told her that I researched her company on the internet through the Better Business Bureau and that it is reported that in the last 36 mos., over 100 complaints have been made and 45 of them were contract complaints. She laughed and told me to contact a lawyer."

Consolidation Loans and Overdraft Protection

A consolidation loan may be helpful but you must be cautious. The purpose of a consolidation loan is to replace several loan payments with one loan payment. This type of loan often relieves stress by allowing you to pay off several debts with one small monthly payment. However, there are some things to consider.

- Always exchange a higher interest loan for a lower interest loan if possible.
- If you are in the early months of a loan based on the rule of 78's, pay it off with a simple interest loan. Yet, keep a loan based on the rule of 78's when you are in the later months of the loan agreement because you have already paid most of the interest.
- Do not pay off a short-term loan with a long-term loan. For example, if you have a loan that you will pay off in three months; do not replace it with a consolidation loan that you may not pay off for several years.
- After consolidating your loans, you will feel that you have more money and therefore you might spend more. If you are not careful, you will end up with several debts besides the consolidation debt. Instead of spending the extra money, save it or put it toward making larger than required payments on your outstanding debts.

Take caution when considering overdraft protection on your checking account. This is how overdraft protection works. If you write a check and there is not enough money in your bank account to cover the amount of the check, your bank will make good the check. Either the bank will take money from your savings to make up the deficit, or they will lend you the money, sometimes in increments of $50 or $100.

Overdraft protection gives you protection from any charges made against your account due to insufficient funds. In this way, you will never have to pay for bounced checks. Is this a good idea? It depends on the method of protection. The best type of overdraft protection is where the bank takes money out of your savings account to cover the deficiency at no charge to you. Watch out for other arrangements though. When the overdraft protection comes with a line of credit from the bank, the bank will lend you as much as the deficiency and charge you interest until repayment. It would be better to use your savings as a backup. Your credit card company can also draft $100 increments from your card account to cover a deficiency. For example, if you need $250, the card company deposits $300 into your account. You must beware of any overdrafts on a regular basis whereby you spend the extra money and have trouble paying it back.

Home Equity Loans and Home Equity LOC

There are two types of home equity loans, a home equity loan (HEL) and a home equity line of credit (HELOC). Both of these loans are tax deductible the same as a mortgage payment. You need not spend the borrowed money on the house; you can spend it on anything of your choosing. A home-equity loan is essentially a second mortgage. You get a lump sum of money and pay it back in fixed monthly installments over a fixed period, typically 10 to 15 years. The most common HEL has a fixed interest rate. Not anyone who has a mortgage can get a HEL; you must have sufficient equity in your house to qualify. When you apply for the loan, the bank will do an appraisal of your house, the appraised value has to be considerably above the amount you owe on the house.

A home equity line of credit, by contrast, functions more like a credit card. The bank assigns you a credit limit and you pay back only what you use plus interest. When you secure a HELOC, you typically receive a checkbook and a credit card against the account. Whenever you use some of the credit, you will owe a monthly minimum payment on your outstanding balance, but beyond that, you determine how much you pay back and when.

Banks peg the interest rate on a HELOC to the prime rate - the rate at which banks lend to their most creditworthy customers. The average HELOC rate is 1 percent over prime, although some banks offer HELOCs at the prime interest rate. These loans are a good deal in a low interest economy. A typical $25,000 loan will mean a monthly payment of only about $100 if interest rates are near the two percent range.

So, which type of loan is the best? When deciding whether to take out a home equity loan or line of credit, consider your goals, your payment schedule, your spending habits and your risk tolerance. A HELOC, by contrast, gives you more repayment flexibility and lets you borrow only the amount you need when you need it. That way you are only paying interest on the amount you have taken, whereas with a loan, you pay interest on the money whether you are using it or not. In addition, since banks tie variable-rate HELOCs to the prime rate they may be more risky in an increasing-rate environment.

Another big downside of a HEL is that you are putting your house at risk if you cannot make the monthly payments. Always consider whether there are less expensive ways to borrow money. For instance, it may make more sense to do a cash-out refinancing, which increases your mortgage, potentially lowers your rate and pays you the difference between your old and new mortgage in a lump sum. With a cash-out refinancing loan, you receive a new loan to replace your original mortgage. For example, say you owe $90,000 on a $180,000 house and you have a $30,000 second mortgage that has a variable interest rate, you may want to pay it off. You could refinance your mortgage for $120,000 with a lower fixed rate, and the bank will then hand over a check for $30,000, which you can now use to pay off your second mortgage. You can find a cash-out refinance versus a home equity loan calculator at http://www.lendingtree.com

CHAPTER FOUR

YOUR CREDIT REPORT

One day Sue received a letter from the Internal Revenue Service. During a routine audit, the IRS found that she owed taxes on income she made from her job at a garment factory. Yet Sue had never worked in a garment factory. Evidently, an immigrant had purchased her name and Social Security number from a fraud artist. Using this information, she simply reported her income to Sue's tax account. Although Sue is innocent, the IRS held her liable for taxes, interest, and penalty fees on $60,000 by deducting three–fourths of her paycheck. Even though it was obvious that she had never worked at the garment factory, the IRS still held her responsible. The IRS claimed that since the information was on her credit report, she should have known something was wrong.

WHY HAVE A GOOD CREDIT REPORT?

If an automobile insurance company has a choice of granting insurance to a person with a speeding record or a person who has a bad credit report—which person do you think will get the insurance? More and more auto insurance companies, including Allstate Corporation, are choosing the speeder. They contend that a person's credit history is the best predictor of future claims on auto policies. This practice of issuing insurance based on a person's credit report is spreading to homeowners and renters policies. Some insurance companies are simply denying coverage to people who have poor money management skills. These companies realize that persons who can manage their finances well also are more apt to be fastidious in other ways. Some insurance executives view people with flawed credit records as likelier to pad claims or commit fraud. Others judge your character, honesty, and dependability, as well to ascertain your credit worthiness, by viewing your credit report. Unbeknown to you, landlords can obtain your credit report to determine whether to rent to you. Your credit report may determine whether you get that job or not. Prospective employers have more restrictions as to what questions they can ask you during an interview. In addition, recommendations are of less importance than in former years. Previous employers are afraid to say anything that may leave them open to a lawsuit. Thus, your credit report has become more important as an indicator of your character. Credit bureaus house your credit report. These bureaus gather information on you from merchants, creditors, and court records. You can get a copy of your credit report at no charge, in some cases, or for a small fee.

The Internal Revenue Service (IRS) even checks into your credit report. The IRS may match your income as reported on your tax return with information on your credit report. By analyzing your credit report, they look for discrepancies between your reported income and your lifestyle. For example, if you declare an income of $25,000 a year, but have a $100,000 mortgage and three Visa Gold Cards with $15,000 limits each, they may get suspicious.

If a credit bureau computer detects that you are having financial difficulties, it assigns you a score that compares your record with others of similar demographics and lifestyles. Appending this score to your credit report, the credit bureau notifies all banks and retailers subscribing to the system. This can lead to a loss of credit privileges and harassment each time you are just a day or two late paying your bills.

You can have a pristine credit report, but if the report gives the impression of over– extension, it could jeopardize a job opportunity. Suppose that you apply for a job that requires handling large sums of money. A prospective employer notices that you have a large mortgage and several credit cards charged to the limit. He might think, "*If this guy can't manage his own financial affairs, can he handle mine?*

YOUR CREDIT REPORT

Judy got an awful shock when she checked her credit report. She was divorced eight years ago, but debts belonging to her ex–husband turned up on her credit report and she cannot get rid of them.

She discovered the problem when she and her new husband tried to refinance their mortgage. Her credit history was spotless except for a $2,000 credit card debt she apparently owed.

The debt, however, did not belong to her; it belonged entirely to her former husband. When they separated, she had called the bank and asked that the bank take her name off the credit card. The bank agreed and the statements quit coming to her address. Thinking she was in the clear she forgot about it. But she was not in the clear. The bank simply sent her ex–husband the statements and left the card in both of their names. Therefore, the bills remained on her account. The problems got worse when her ex–husband stopped paying entirely. At this point, the bank charged off the debt as uncollectible, damaging her credit report even more.

The moral to this story is that no one should walk away from a marriage with an open line of credit—be it a credit card, debit card, overdraft checking or a home–equity line of credit. If you applied jointly for a loan each of you remains liable, even for debts contracted after a divorce. When closing a credit line, never take the bank's word over the telephone that a joint account is closed. After you call the bank, follow up with a letter and ask the bank for written verification. Then, if the bank leaves your name on the credit card, you can prove the bank was wrong. When the error is clearly theirs, banks will clear a customer's credit report.

You should get a copy of your credit report at least once a year to ensure accuracy and to identify any negative information. Credit agencies can put negative information put on your report by mistake. People with similar names who live at the same address need to be especially on the lookout for mistakes.

Anyone can get a copy of your credit report. The Fair Credit Reporting Act (FCRA), the law, which oversees credit bureau activities, allows anyone "*with a permissible business purpose*" to purchase credit reports. The law does not require that a credit report buyer have proof of permissible purpose. You could become a victim of fraud if certain people invade your credit report.

Professional credit doctors scour the databases at credit bureaus for records they can use to doctor the credit reports of their own clients (people who have damaged credit reports). Supposing that your name and birth date are similar to that of a client and you have a pristine credit report, the credit doctor attaches your Social Security number to his client's name. Since the credit bureaus' computers generally ignore typos in names and birth dates, the companies ignore slight differences and the bureau establishes a clean credit report with your Social Security number. From now on, this person's credit report becomes your credit report. After charging large purchases, the client can default on the payments, leaving you holding the bag.

Credit Reports

Check your credit history every one to three years. If you apply and a company denies you credit, you have the right under federal law to a free copy of your credit report. You must request the report within 30 days of the denial. Some bureaus will provide the report free within 60 days of the denial. The three major U.S. credit bureaus are:

Equifax

http://www.equifax.com/home/en_us

Experian

http://www.experian.com/

TransUnion

http://www.transunion.com/

How Your Credit Score Affects You

A simple three-digit number has become critical to your financial life. Credit companies have designed this number, known as a credit score, to predict the possibility that you will not pay your bills. If your credit score is high enough, you will qualify for a lender's best rates and terms.

CREDIT REPORTING AGENCIES

Credit reporting agencies gather information from a combination of sources. Besides creditors reporting monthly to credit bureaus concerning their customer's status, credit bureaus also get information from public records, delinquencies on property tax payments, and sometimes by contracting out investigative reports.

Certain businesses submit information to credit bureaus regularly and order information from them every day. Some large banks can spend as much as $100,000 a month for this information. Those businesses who report and order are major credit card companies, major banks, major savings and loan associations, major department stores, collection agencies, and finance companies.

Businesses who order but may not report to a credit bureau are small banks, most oil companies, small credit unions, insurance companies, and some potential employers.

Some companies report to only one credit bureau. Therefore, if you do business with a company, in let us say another state, it may not report to the credit bureau that is in your area. Now if you get a copy of your credit report locally, it will be incomplete. Normally this does not present a problem; still, you may want to get a report from all three bureaus.

CREDIT FRAUD

If you have been the victim of credit card fraud, call the Consumer Assistance Service provided by the National Fraud Information Center at 800-876-7060 between 8:30 and 5:30 p.m., Eastern Time, Monday through Friday. The Service will provide information on how and where to report the fraud. The Consumer Assistance Service will send your complaint to the Federal Trade Commission.

OTHER DISPUTES

If you have a dispute regarding a credit card billing or credit history that you have not been able to resolve with the business to your satisfaction, contact your local consumer protection agency or state Attorney General's office. You may also The Federal Trade Commission at http://www.ftc.gov/. The FTC cannot resolve individual disputes, but the information you provide may indicate a pattern of violations requiring action.

WHAT IS ON A CREDIT REPORT?

The three types of entries on a credit report are neutral, positive, and negative. Personal statistics is neutral information and includes

- your name (including all previous names)
- your marital status
- past and present addresses and how long you lived at each address
- your Social Security number
- and your employment history.

Another type of neutral reporting is account information:

- the name and type of creditors with whom you have done business
- whether an account is individual or shared
- the account number
- whether the account is revolving (variable payments every month) or installment (equal payments every month)
- date opened
- your credit limit for each account
- the present balance
- and the highest amount charged.

An example of positive information is a record of timely payments to your creditors. Creditors examine your credit report looking for patterns. If you are in the habit of paying all your bills on time, this gives your credit report a good "feel." An occasional late payment may not harm your credit report—but a pattern of more than an occasional slip up may prove damaging. Creditors have the tendency to assume that good habits in the past will continue into the future. Conversely, credit problems in the past suggest that there will be credit problems in the future. Your credit report may have negative information despite your good intentions. This can happen because you do not understand all the rules of the game. Negative information can be such things as

- the number of late payments
- to whom
- and if they were 30, 60, 90, or 120 days past due. For example, suppose that your credit card closing date is the 15th of the month, but your card has a grace period until the 25th of the month. To calculate whether an account is thirty days past due, usually the 15th is used.

A credit report may include such things as

- tax liens
- foreclosures

- civil suits
- collection efforts (a collection entry indicates a delinquent loan)
- past credit difficulties
- criminal convictions
- charge–offs (a charge–off entry indicates an uncollectible loan)
- judgments (a judgment is a legal action)
- bankruptcy
- delinquent child support payments
- and even lost credit cards.

The credit bureau will record willing and unwilling repossessions. A willing repossession occurs when you voluntarily return a car because you cannot make the payments. When the bank comes after the car, it is an unwilling repossession. With cosigned loans, creditors report everything on both credit reports. Bankruptcy can stay on your report for ten years, inquiries for two years, and everything else for seven years.

When someone orders a copy of your credit report, the industry calls this an inquiry. Too many inquiries (more than six in any six-month period) reflect negatively on your report. Several inquiries could mean other creditors have decided that you are a bad credit risk, you are collecting credit cards for a shopping spree, or someone is fraudulently applying for credit in your name. Inquiries alone may not damage your credit report—but they are a part of the total picture. Getting a copy of your credit report does not count as an inquiry.

Investigative Report

Insurance companies and prospective employers may do an investigative report on you. This is an in–depth report on your lifestyle, character, and reputation based on the opinions of your neighbors, friends, and/or relatives. Included in this report is your sex, salary, race, religion, and checking and savings account information. The Fair Credit and Reporting Act give you some protection against the ill effects of an investigative report if an investigative agency does the report. According to the Act, the agency must notify you of a pending report. You have the right to know the name and address of the investigative agency. If you write to whoever ordered the report, they have to respond within five days with an explanation of the purpose of the investigation and a description of the questions. You have the right to voice your concern to the investigative party if you object to any of the questions. If you find any misinformation about yourself, you can request reinvestigation and correction. You can also request that the agency send a corrected report to any previous user of the report.

This protection does not apply to all investigative reports, however. For example, if you apply for a job and the company does an in-house investigative report on you, they do not have to notify you. Therefore, when applying for a job, you can ask if there will be an investigative report done on you.

ESTABLISHING GOOD CREDIT

A credit report with nothing on it is a bad credit report. Anyone looking at your credit report wants to see evidence of good credit. You should establish some credit in your own name if you are a married woman. If you do not, a divorce or the death of your husband can leave you with almost no credit history. This can happen even if your salary is a major part of the family's income. In this case, you should insure that all credit activities takes place in both names. It may also help to have a few charge accounts in just your name.

A secured credit card from a bank can be helpful in establishing good credit. Most people can qualify for a secured credit card because savings secures the card. Let us say you have $500 in a savings account. The bank then issues you a credit card that has a credit limit of $500. Meanwhile the bank is paying you interest on the $500. Eventually the bank may raise your card's limit without increasing the amount of the required savings, or it can lower the savings limit. After a year or so, when you prove yourself credit worthy, the bank could grant you a regular credit card. Meanwhile, by using the secured card you can establish good credit for yourself. The downside of secured credit cards is that they are more expensive than regular credit cards. Some retail stores can be helpful in establishing credit. Retail credit cards are among the easiest to get and the credit limits are low. Make sure that the retail store is one that reports monthly to credit bureaus. American Express has a special program for college students by offering them a card similar to their green card. By making regular payments on these credit cards, you will start to build a good credit history.

A debit card (also called a check card or access card) is another way of establishing good credit. Debit cards look like credit cards but purchases come from your checking account instead of from the issuing bank. Debit card applicants are subject to a simplified credit check before qualifying for a card. Even so, banks readily accept applicants even if they do not have a payment history, or have a bad payment history.

Some banks have two types of debit cards. With one type, a cash register will not accept the card unless there is enough money in your checking account to cover the purchase. With the other type, the bank will put money into your account to cover any deficiency. If this happens, the card becomes a regular credit card. Because banks withdraw the money at the time of purchase, keeping records of your transactions is important. With debit cards, you avoid paying interest charges. However, you will probably pay an annual or monthly fee, or per transaction charge, to your bank. The merchant may also charge you a transaction fee. Merchant fees range from ten cents to $1.50 per transaction. Your legal protection against fraud, billing errors, etc. with debit cards is not as extensive as with credit cards.

REPAIRING A BAD CREDIT REPORT

To repair a weak credit report, you must bury bad news with good news. A credit card with all payments current can be good news on your credit report— but be aware that potential creditors may consider four or more cards a negative because of your high debt potential. Avoid high limits on your cards and improve your report by keeping your charges well within the limits.

If you have too many credit cards, or if your limits are too high, decide which cards you want to get rid of, and the limits you want lowered. Call these companies and ask them how you can cancel your card, or have your limit lowered. They most likely will have you state your intentions in writing. To cancel a card you may have to have a zero balance on it for sixty days. Request that the card company report any changes to all necessary credit bureaus, get a written confirmation of these changes, and check your credit report.

Loans from a finance company are harmful to your credit report, even if you make all your payments on time! Why? Because finance companies specialize in lending money to high risk people, you could therefore be found guilty by association. Another reason for avoiding finance companies is the cost of administrative fees and insurance. Finance companies usually tack on insurances, such as credit life, credit disability, homeowner's insurance, and loss of income insurance. These insurances add to your total cost of borrowing. People sometimes pay back as much as $3,000 for a loan of less than $1,000! In states that have no regulations on interest rates, small–loan interest rates have reached as high as 94 percent.

Upon your request, the credit bureau will attempt to verify any entry on your credit. After receiving notice from the Credit Bureau, a creditor has thirty days to verify any information put on your credit report. Any information that they cannot substantiate they must be delete from your report. Even if your report has errors and the credit bureau fails to get verification from the creditor within 30 days, they must delete the entries from your credit report. This could happen because creditors simply do not respond to the request, or cannot respond because they are no longer in business. For these reasons, it is to your advantage to challenge negative information.

If you challenge specific entries on your report and the credit agency finds mistakes you can make a request of the credit bureau to send the corrected information to anyone who received your credit report during the past six months. If the purpose of your report is employment related, you have the right to have the report sent to anyone who had requested the report over the past two years.

If you disagree with anything in your credit file, or can give a good reason for the negative report, credit companies will accept a 100-word comment from you to put into your credit report. For a nominal fee, the credit bureau will send your version to those who recently requested your credit report. Often creditors will consider these explanatory remarks.

Rather than let past due debts plague your credit report, open up the communication between your creditors and yourself. Creditors will usually work with you to resolve problems. This gives you leverage because you have something they want. Therefore, you can negotiate to have negative entries removed or positive ones inserted in return for your cooperation in paying the debt. If the negotiations are successful, be sure to get the agreement in writing, and make sure you keep up your end of the deal—a creditor can always report a credit problem if you fail to follow up on the agreement.

Know what you can afford and manage to pay and do not go over that amount. Do not offer information about your intentions. Say something like, "*I feel terrible that I have not paid this account in full, but I would like to arrange to do so within my income*." Negotiation is the most ethical way to go about clearing your debts. Creditors will appreciate your willingness to work with them instead of forgetting or ignoring them. The very least you can accomplish is to have positive statements put on your credit report. There are professionals who will help you with your credit report on a fee basis. In fact, some charge as much as $100 for every negative entry removed.

HOW CREDITORS SCORE YOUR CREDIT PROFILE

When you apply for a loan, how does the banker decide whether to extend you credit or not? Most creditors follow a basic scoring system. A bank approves your loan if you receive enough points. Banks consider such things as:

- How many loans have you had in the past?
- Have you been consistent with making your payments on time, or do you have a history of late payments?
- Have you had any payments that are thirty days, sixty days or ninety days past due?

Creditors will also consider the number of credit cards you have and their limits. Too many credit cards and high credit limits count against you. They will assign you so many points considering your general credit history.

Another category is your marital status; marriage receives one point, being single zero points. Your age is also a factor. Being less than twenty–five or older than sixty–five earns you zero points; if you are between the ages of twenty–five and sixty–five you receive one point. If you have a monthly income up to $600, you can receive one point, from $600 to $800, you could receive two points, from $800 to $1,000, you could receive four points, and an income of more than $1,000 could earn you six points. A telephone in your name will earn you points, as will a checking or a savings account. If your monthly debt payments are above a certain amount, you get zero points in this category; if under a certain amount, you get one point.

Owning a house may be worth four points, a home with a mortgage may be worth three points, renting may be worth one point, and living at home with your parents will earn you no points. Living in the same geographic location for six or more years may get you a point, as will a job held for more than a year.

THE CONSUMER CREDIT COUNSELING SERVICE

If you are struggling financially and want to avoid major problems, answer the following questions:

- Do my monthly bills often exceed my monthly income?
- Am I unable to make minimum monthly payments?
- Do I have to borrow money to make minimum monthly payments?
- Would I like to have free advice on how to manage my personal finances?

You need to contact the *Consumer Credit Counseling Service* (800 769-3571) in your area if you answered *yes* to any of the above questions. Simply look under *credit* in the Yellow Pages of your telephone book, or call the 800 number above. The CCCS is a national nonprofit organization supported by the *United Way* and the business community. The web site is http://www.consumercredit.com

Besides debt counseling, the Consumer Credit Counseling Service (CCCS) can arrange a debt retirement program for you and may draft your bank account to make your payments. The CCCS may even arrange for reduced payments, although creditors eventually receive payment in full. Everyone is eligible for this service.

How will smaller payments affect your credit rating? Your creditors may report your accounts as paid slowly, but this is better than having late payments and much better than having a charge–off reported. A charge–off occurs when a company gives up trying to collect from you and reports this to the credit bureau. However, many creditors work with the Consumer Credit Counseling Service to help you.

DEBTORS ANONYMOUS

Debtors Anonymous (D.A.) is an organization, which consists of men and women who are hooked on debt. If you have fifteen to twenty credit cards and are prone to impulse buying, Debtors Anonymous may be able to help you. The founders patterned Debtors Anonymous after groups like Alcoholics Anonymous. People with debt problems meet regularly to share their experiences with one another. The goal of the group is to help individuals achieve financial solvency and stay that way. If you are interested in this group, check your local telephone directory for the chapter in your area. For more information go to http://www.debtorsanonymous.org/

FAIR DEBT COLLECTION PRACTICES ACT

According to the Fair Debt Collection Practices Act, the law does not allow creditors to harass anyone. If creditors hassle you and violate this act, you can file a complaint with the Federal Trade Commission. The FTC web address is http://www.ftc.gov/. Harassment includes the following.

- Contacting you before 8:00 a.m. or after 9:00 p.m.
- Contacting you at work after you have notified them not to.
- Threatening you with arrest or any other scare tactics.
- Contacting friends, relatives, neighbors, or coworkers about your debt.

Consider this story of Bill and Betty Smith. After Betty's company laid her off from her job, the couple was only able to make partial payments on their credit card debt. Even though they agreed to pay $22 a month, calls from the bill collectors came day and night, even disrupting their sleep. One day Bill got as many as 26 calls in one hour at his place of employment. The callers used profanity and even threatened his life. All this over a $2,000 credit card debt! Things got even worse when Household Credit Services could not collect on the money and hired a collection agency, Allied Inc.

At this point, the Smith's sought help from a lawyer who took the matter to court. The jury found Household Credit Services responsible for harassment against the Smith family. The jury awarded the couple $11 million, ruling that the bill collectors went too far. Because Allied went out of business and even failed to show up for the trial, Household was made to pay the full amount.

BUYERS BEWARE

People can take advantage of you before you know it. For example, suppose that a store offers an appliance for sale with no interest and no payments for six months. How can the store offer such a good deal? A store can offer you a good deal because a finance company pays the store up front for the merchandise. So if you buy the appliance under this condition, you have to sign a loan agreement with the finance company. If you pay off the loan within six months, you avoid any charges. The agreement may specify, however, that after six months you owe a high interest charge on the unpaid balance retroactive to the date of purchase.

Unsolicited credit cards deserve your scrutiny. Ray and Linda received two credit cards in the mail. One card had Ray's name on it and the other Linda's. Each had its own account number. Because the company did not mention an annual fee, they kept the cards. The next month the bank charged them a $20 annual fee for each card.

Linda telephoned the company and stated they did not want the cards. The credit card company assured her that this was fine and the company would take care of the matter. The next month they received another bill for $40. Included in the bill was an interest charge for last month's unpaid balance and the $40 annual fee. Again, they called to complain, and again the company representative said she would take care of the matter. This time they cut the cards in half and sent them, along with a letter of explanation, to the card company. Despite this, they got a bill for $40 plus interest and a penalty fee in the third month. The company also made a negative report to all three credit bureaus.

Be Careful of These Loans

Avoid any loans using the rule of 78's. Even though this method of finance charge calculation is illegal in some states, finance companies still use it when they can get away with it. This is how a rule of 78's loan works. Suppose you borrow $1200 at 10% interest for one year with the interest compounded monthly. Your monthly payment would be $105.49. What would your interest payment be the first month? The answer is $18.46. Here is how it works:

10% × $1200 = $120

add the sum of the digits (1+2+3+ . . . 12)= 78

(12/78) × $120 = .1538 × $120 = $18.46

What is your interest payment the second month?

(11/78) × $120 = .1410 × $120 = $16.92

Always get simple interest loans. This is how a simple interest loan works. Suppose you borrow $1200 at 10% interest for one year. With the interest compounded monthly, your monthly payment would be $105.49. What is your interest payment the first month? The answer is $9.86. Here is how you derive it:

$10\% \times \$1{,}200 = \$120$

$10\%/365 \text{ days} = .02739\%$

$\$1{,}200 \times .02739\% \times 30 \text{ days} = \$9.86$

What is your interest payment the second month?

$\$1{,}089.86 \times .02739\% \times 30 \text{ days} = \$8.96$

SEEKING HELP

If you have a limited income, or have a damaged credit report, be wary of lenders of last resort. These companies often have high service fees and high interest charges hidden in complex loan arrangements. Despite a reasonable interest rate, you can still pay high penalty charges.

Consider this story of Mr. and Mrs. Scott, an elderly couple who took out a loan from Fleet Finance Company. After the finance company entangled them in a home–repair swindle, they took out a second loan from Landbank. When they began making monthly payments to Landbank that were much higher than expected, they went to Legal Aid. Legal Aid is a national organization, which provides free legal advice for people with low incomes. If you do not qualify for free legal advice, they will refer you to local lawyers who can give you brief counsel for no more than $30. The web site for Legal Aid is http://www.legal-aid.org.

Legal Aid found that Landbank was using a tangled financial arrangement to squeeze more interest from the couple. This is what happened. The couple had borrowed $18,000 from Fleet Finance Company to buy a house. The monthly payments were $132. While still owing $14,700 on the house, and being behind on several bills, they sought a $10,000 second mortgage to consolidate their indebtedness. In a typical second mortgage, the borrower takes out a second loan and makes two payments each month, one toward the first mortgage and one toward the second. Instead, Landbank offered the Scott's a wraparound second mortgage. This mortgage pays the lender monthly and the lender takes a part of the money to make payment on the first mortgage. Instead of making two payments, the couple would instead make one payment to Landbank for $376 a month. Landbank then deducted $132 from the couple's $376 and made payments on their first mortgage.

Under this arrangement, the face value of the Scott's second mortgage would include the new money they borrowed plus the $14,700 they still owed on the first mortgage. After paying $22,000 in the first five years of this loan arrangement, they would owe a lump sum balloon payment of $27,000, bringing the total to $47,000! A balloon payment is a lump sum owed to the creditor at some point in time. By writing the original $14,700 into the loan contract, Landbank was essentially collecting interest on money it never lent. Meanwhile, the Scott's were paying interest on this money twice, once to the original lender, and a second time to Landbank. Under the law at the time, the Scott’s were obligated to pay until they could make other arrangements. However, since their case, laws have declared this type of loan arrangement illegal in many states.

BANKRUPTCY

During a financial crisis, your first concern must be to talk with your creditors, the sooner the better. Some creditors may be willing to work out a suitable arrangement with you. The Consumer Credit Counseling Service can help you with this arrangement. Nevertheless, if you are considering personal bankruptcy, you should know some things.

Laws that govern bankruptcy differ from state to state, but generally fall into two categories. Under Chapter 7 of the Bankruptcy Code, straight bankruptcy, the court discharges most of a person's debts. The court does not discharge taxes, child support, and alimony. A person can voluntarily pay any of his debts. If a person wants to keep his car, for example, he must continue making payments. A person must pay any outstanding debt by selling his property. A limit is placed on what can be kept. This type of bankruptcy remains on a person's credit report for ten years from the date of filing.

Federal law allows a person to retain certain items after bankruptcy. In addition, some states allow a person to keep additional property. Generally exempted are

- A house
- A car with a fair market value of $1,200 or less
- Insurance cash values
- Tools of trade with a fair market value of less than $750
- Future income from Social Security, corporate retirement plans, annuities and other exempt sources

Under Chapter 13 of the Bankruptcy Code, the law allows a person to keep his assets while meeting his debt obligations. The court will arrange with creditors for reduced payments and will make sure that the person complies with the terms of the agreement. Meanwhile, individuals receive protection from creditors, collectors, and any legal action. A person has five years to pay off the debts. A Chapter 13 bankruptcy remains on a person's credit report for seven years.

A person must list all of his debts under both types of bankruptcy. Any debts not listed must be honored. Because of more bankruptcies in recent years, credit card companies contest bankruptcies that include recent large purchases, exceptionally high balances, or repeated filings by the same person over a period of several years. Most lawyers ask for payment in advance; payment can range from $650 to $1,000 plus court costs.

Even though there was a liberalization of bankruptcy laws during the 1980's, having either type of bankruptcy on your record is a serious matter. For a period of ten years or longer, your ability to borrow money, rent on apartment, buy a house, get a job, and qualify for a promotion is in danger.

CHAPTER FIVE

INSURANCE

Betty was a single parent with two young children. Unable to get financial support from her ex–husband, and having no training or education, she lived very poorly. With her children in mind, she bought a $10,000 whole life insurance policy with $5,000 coverage on each child for $27.50 monthly. Six months later, she died in an automobile accident, leaving each child $5,000 in insurance proceeds. The tragedy is that for the same $27.50 a month she could have bought a $300,000 term policy, which would have left each child with $150,000. Although hindsight is easier than foresight, this story illustrates the gravity in the decisions we make.

According to the National Insurance Consumer Organization, the average family spends about 11 percent of its disposable income on insurance each year. This translates into about $100 billion annually—or approximately $2,000 per household. Each family could save hundreds of dollars a year by simply learning the basics of insurance. So what is insurance?

Insurance provides coverage by a contract binding the insurance company to make payments for loss, injury, or damage to you in return for premiums paid. Insurance helps protect you and your family against financial hardship due to accident or death. By providing protection against the many risks of financial uncertainty and unexpected losses, insurance makes it possible for you to plan confidently. Yet buying insurance can be about as much fun as programming a VCR—and almost as complicated.

WHO NEEDS LIFE INSURANCE?

- If you have no dependents and no savings, you need a small term insurance policy to cover your burial expenses so these expenses do not burden someone else.
- If you live in a childless double–income family, you do not need life insurance unless you are financially dependent on your spouse.
- If you are a full time homemaker, you do not need life insurance unless you are a mother of young children who need childcare should you die.
- Life insurance on a child is unnecessary except a small term policy to cover burial expenses.
- If you are the sole breadwinner in a family with young children, you need life insurance.
- If your family has a history of certain diseases, you should buy insurance while you are still insurable.
- The more your assets and the less your debt load, the less life insurance you need.

HOW MUCH LIFE INSURANCE?

It is a simple question with a complicated answer. What is appropriate for your family may to too much or too little for another family. To determine how much you need, you will have to review your current financial situation and try to anticipate your family's future needs. The goal is to have enough insurance so that if you die, your beneficiaries could invest the benefit and maintain their current lifestyle. Make sure you are thinking return on principle over time. So how much life insurance should you buy? The answer to this question is not simple, but the following thoughts may help you.

1. How much money would your dependents need annually to maintain their standard of living if you were to die?
2. Calculate the amount of income your family can expect after you are gone, for example, your spouse's income, interest earned on CD's and other savings accounts,

retirement accounts, stocks, bonds, Social Security, trusts, rental property, and/or a business. The difference between the amount in number one and this amount is how much your family would need annually to replace your present income.

3. So how much money would you need invested in the markets to yield this income? The answer to this question depends on the return your money could make in the markets. This is impossible to calculate exactly, but let's say that your money could earn a real return of 5% in the markets, taking into consideration inflation and taxes.

4. Assuming a 5% real return, multiply the amount in number two by 20. If you had this much money in the markets, along with the other sources of income you listed in number two, your family could replace your present annual income.

5. Do you have enough in savings to pay for estate settlement costs such as taxes, probate and funeral expenses? If not, you will have to make allowances for these one-time expenses upon your death.

TERM LIFE INSURANCE

Term life insurance contains no cash build-up and is, therefore, pure insurance. The three types of term insurance are annual renewable, decreasing premium, and level premium. Whichever type of term insurance you buy, coverage will continue as long as you make the premium payments. However, depending on the insurance company, the insurance company will not extend your contract beyond the years of 65 or 70.

- With annual renewable term insurance, the face value stays the same from year to year, but the premium payments increase every year as you get older.
- With decreasing term insurance, your premiums do not change, but coverage decreases year by year. This type of insurance is popular to cover loans, such as mortgage insurance. With this type of insurance, when you pay off the loan, the insurance ends.
- With a level premium policy, you can choose five, ten, fifteen or twenty years of coverage. During this time, both your premium and the face value stay

the same. Afterward, the insurance company may or may not renew your policy. If the insurance company renews your contract, it will be at a higher premium than the previous one.

MORTGAGE LIFE INSURANCE

Mortgage life insurance is a form of decreasing term life insurance. It pays off your mortgage if you die. According to For Insurance, a site that connects consumers with insurance agents, mortgage life insurance policies are generally available to cover a range of mortgage repayment periods, e.g., 15, 20, 25 or 30 years, and the premium payment period may be shorter than the period of insurance coverage. Mortgage life insurance is often confused with Private Mortgage Insurance (PMI). You buy mortgage life voluntarily to protect your survivors from having to make the monthly payments. However, with Private Mortgage Insurance, lenders require you to buy a policy in order to protect them (the lenders) against the possibility that you will default on the debt. Banks require PMI if you cannot make a certain minimum down payment, usually 20 percent of the market value. Notice that the bank benefits, not you.

FINDING HELP

A few telephone calls will get you a batch of term–insurance proposals headed to your mailbox. Consider these sources:

- Quotesmith Corporation in Darien, Illinois, is a firm that maintains a database of companies offering term insurance. They will act as your agent at no cost to you. Not only will Quotesmith supply you with a price list but they will rank the policies for you. Quotesmith ranks policies by their guaranteed cost for one, five, 10, 15, or 20 years.
- To find a local agent, go to Quotesmith on the Internet or contact Insure at http://www.insure.com
- For a list of several insurers, you can also contact Wholesale Insurance at http://www.wholesaleinsurance.net.

WHOLE LIFE INSURANCE

Whole life insurance, sometimes called straight life insurance, ordinary life, or permanent life, has a cash–value provision built into it. Whole life insurance will give you protection for life, assuming you continue to make the payments. As long as you continue to make the payments, the insurance company cannot cancel your policy. The annual premiums usually stay the same over the life of the policy.

Whole life insurance has two parts - the face value (death benefit) and the cash value. The face value is the “insurance” aspect of the policy. When you die, your beneficiaries will receive the face value minus any outstanding loans against the policy. A beneficiary is the person you name in a policy that will receive the life insurance money when you die. The cash value is the “savings” aspect of the policy. How the insurance company treats this cash value determines what kind of policy you have. With a whole life policy the insurance company guarantees you a set return on your cash value.

A part of your monthly payment goes for insurance and a part goes to build up your cash value. As time goes on, although your payment stays the same, more of the payment goes toward insurance and less goes toward the policy’s cash value. Insurance companies design whole life policies so that the cash–value of a policy will equal the face value when you, the policyholder, would reach the age of 100. If you were to die at the age of 100, your beneficiaries would receive only the policy’s cash value.

Catch hold of what this means in terms of your cash value. Let us suppose you have a whole life policy with a face value of $100,000 and its cash value has built up to $30,000. Should you die, your beneficiaries would receive $100,000 and the insurance company would keep the $30,000 cash value. The insurance company will keep the cash value because they consider this cash build up and not savings. Cash build up is money that belongs to the insurance company as reserves to pay your death benefit. Even if the company will lend this money to you, it is still the company’s money earmarked to settle any claim against your policy. If you relieve the company of its liability to you by dropping the policy, it will return the cash build up, or reserve, to you.

Suppose you have a whole life policy that has a face value of $100,000 and a cash–value of $20,000. You borrow $10,000 from the policy and die shortly afterward. How much do your beneficiaries receive? They will receive a total of $90,000 minus any interest charges still owed from the $10,000 loan. Not only does the insurance company keep the $20,000 cash–value, but it also holds back $10,000 plus interest charges because that money is considered a loan to you.

Because your whole life policy includes a cash–value provision, you at least get full benefit from this cash–value if you drop your policy, right? If only horses could fly! Most of what you pay into the policy in the first three to five years goes toward commissions, fees, and surrender charges. You will pay high surrender charges if you drop the policy within the first three to five years. A surrender charge is a penalty for canceling the policy. Often, should you cash in your policy within the first three years, the insurance company will keep all the money you have paid into the policy. Usually it is not until after the third year of paying premiums that you begin to accumulate enough cash–value to receive anything back should you cancel your policy.

VANISHING PREMIUM AND DOUBLE INDEMNITY POLICIES

With a vanishing premium policy, the insurance company inflates your monthly premiums in the early years so you do not have to make payments in the later years. Some of this money goes into cash–value and the rest goes toward insurance. However, your premiums never really end because the company simply takes them out of your cash–value in the later years. You may not realize this until you cancel the policy and discover you have little cash–value left.

A policy with a double indemnity provision will pay your beneficiaries double the face value if you die accidentally. This sounds good, except for one thing. Suppose that you are involved in a serious automobile accident and die four days later. Will the insurance company pay your beneficiaries double the face value of the policy? Some insurance companies will not do so unless the insured dies instantly, proving that the accident caused the death.

Universal Life Insurance

With the introduction of universal life insurance in 1979, the insurance industry reached out to investment-minded persons. Universal life insurance combines term insurance, which provides the death benefit of the policy, with a tax-sheltered savings/investment account that pays interest at competitive money market rates. The special aspect of universal life insurance is that the insurance company identifies the term insurance and the savings portion of the policy separately in its price. When you make a premium payment, the insurance company uses a part of the premium to pay administrative fees and it puts the remainder into the savings portion of the policy. The return that you make on this savings varies according to market forces; however, the insurance company guarantees that you will make at least a minimum return. The insurance company withdraws money each month from your savings to cover the required death protection. This is what the insurance industry calls the mortality charge. This mortality charge per thousand dollars increases every year as you get older, the same as with an annual renewable term policy. You may not know this is happening because of your fixed payments every month. While there is enough money in the savings portion to pay the insurance premium the policy stays in force.

Besides this mortality charge, the insurance company charges you other expenses called loads. With a frontload policy, the company typically deducts five to 9 percent of your premium for its expenses before it credits the premium to your cash value. With a backload policy, the insurance company credits the entire premiums to your account. However, when you want to surrender your policy, or sometimes, when you make a partial withdrawal, they will assess a penalty. This penalty charge could be as high as 150 percent of the first–year premium. Surrender charges gradually diminish in most backload polices, disappearing between the tenth and the fifteenth year.

A popular aspect to this type of policy is that you have access to your money in the cash value account. The insurance company allows you to borrow against it, withdraw the entire amount (thereby losing your coverage), or withdraw only some of it (thereby reducing your death benefit).

With certain universal life policies, beneficiaries receive only the face value amount of the policy, just as they do with term or whole life policies. The insurance industry calls these “Option A” policies. “Option B” policies allow your survivors to collect the face amount and the accumulated cash value. Of course, Option B is more expensive for you to purchase.

Universal life policies offer a tax shelter, as does a whole life policy. The government taxes the cash value only when you withdraw it, not as it accumulates. When you do withdraw it, you pay taxes only on the portion of the cash value that exceeds the sum of the premiums already paid.

VARIABLE LIFE INSURANCE

Variable life insurance is similar to universal life except that you decide the investments made with your cash value accumulation. Once your money is in a mutual fund, you can move your money among stocks, bonds, and money market instruments. If the investments do well, your cash value grows accordingly, whereas poor performance could lead to an increase in your premiums to maintain your insurance coverage. All other aspects of variable life insurance are identical to universal life.

If you already have a whole life, universal life, or a variable life insurance policy, and you are no longer in good health, keep your present policy. If you continue to make your premium payments, the insurance company cannot cancel your policy within the term of the policy. However, after the agreed upon term is up, the insurance company can decide not to renew your policy.

CONVERTING FROM TERM TO CASH–VALUE INSURANCE

If your term policy has a convertibility clause, the insurance company allows you to convert it to a cash value policy, such as whole life or universal life. The conversion privilege is important in case you need life insurance after age 65 or so, since some insurance companies will not renew their term polices after a certain age. If you think you will need insurance in your later years, you may want to convert to a cash value policy. You can usually convert your term policy to a cash value policy without having to have a medical exam. Changes in your health or occupation will not prevent convertibility. Many term polices can only be converted to cash value policies with a death benefit of 75 to 80 percent of the original policy. In other words, the insurance company may only convert your $100,000 term policy to a $75,000 cash value policy. The company will base your annual premiums on your age at the time of conversion. You can convert and pay the same premiums as if you had originally bought the cash value policy, but you must pay for this privilege.

Insurance companies encourage convertible policies because they stand to make more profit from whole or universal policies than from term polices. Some companies even give you an initial price break if you convert your policy. Read your policy to make sure it is convertible or not. If it is convertible, it may have a deadline beyond which you may no longer convert. Many companies require you to decide by your sixtieth birthday; for others, the deadline may be earlier.

HOW TO COMPARE COSTS

Many people use the first year premiums of different policies to make a comparison between them. However, a far more telling figure to compare, but more difficult to obtain, is the interest–adjusted net cost index**.** This index is an industry-accepted method for determining the true cost of insurance over the long run. Included in this figure is the premium, interest earned, dividends paid (if any), and timing of your payments and receipts.

Ask your insurance agent to give you the cost index of a policy you are considering. In most states, the law requires that companies furnish the number if you request it. Companies express this index as a cost per $1,000 of insurance. A policy with a ten–year, interest–adjusted net cost index of 5.00, for example, will cost an average of $5.00 per $1,000 coverage per year, or about $500 annually for a $100,000 policy. When considering this cost index, the lower the index number, the better the buy.

BUYING THE RIGHT INSURANCE

Most insurance companies offer term life insurance, but most agents do not voluntarily encourage their clients to buy them. Why? Because insurance agents make more money selling a cash–value policy then they do a term policy. Insurance companies pay some agents as much as 100 percent of the first year premiums when they sell a whole life policy. However, they pay only 70 percent of a smaller premium if the agent sells a term insurance policy.

Once you decide how much life insurance you need, you must learn which kind of policy, term or a cash–value policy, best suits your needs. For most people, term insurance is the best buy, particularly if you are on a tight budget. To buy a $200,000 policy could cost a person $200 a year with a term policy, but as much as $2,000 a year for the same coverage cash–value policy.

For a complete analysis of any insurance policy, ask the insurer for a disclosure document called an in–force policy ledger**.** This ledger is a statement that strips a life insurance policy to its bones and can reveal just how secure your policy is. An in–force policy ledger shows a policy's current cash value. The statement also projects how much cash the policy should accumulate in the future. For example, for a universal life policy, the in–force ledger will forecast interest income the insurer expects you to earn on your cash value after subtracting administrative and other expenses. Conscientious life insurance agents provide this kind of in–force analysis for their clients annually.

ARE LIFE INSURANCE BENEFITS TAXABLE?

The "interest build-up" portion of the annual increase in the policy's cash value is not taxed. Dividends generally are considered to be a "return of premium" and are not taxable. Although life insurance death proceeds will not typically be subject to income taxation, they may be subject to federal estate taxation. If you own part or all of the policy when you die, those can be included in your gross estate for federal estate tax purposes. State inheritance taxes and federal gift taxes may also apply to life insurance policies/proceeds under specific circumstances. Contact your tax adviser regarding questions about possible income, estate and gift tax consequences surrounding any life insurance you own or are contemplating buying.

Death benefits are usually not subject to federal income tax. There are exceptions, though, if the IRS deems your insurance policy to be an investment in disguise. Your insurance agent should be able to tell you if your policy benefits will be taxable.

How do I collect on a Life Insurance Policy?

What if you know your deceased mother had an insurance policy, but you cannot find the policy. Of course, it is best to find out about life policies while the insured is still alive. Places to look: If she insured the house and a car, start with the local agents who sold those policies. Insurance companies usually keep track of customer names and Social Security numbers. If the policy was active, a premium notice eventually will come in the mail. Look for cancelled insurance checks. Private firms specialize in finding lost life insurance for a fee.

VIATICAL SETTLEMENTS

A viatical settlement takes place when a terminally ill person sells all or a part of his life insurance policy to a viatical company. In these cases, the viatical company becomes the beneficiary of the policy. The viatical company may buy the policy itself and pay the premiums. Alternatively, it may find an investor, or a group of investors, willing to purchase the policy. When the policyholder dies, the investors collect the proceeds. The return on investment depends on how long the sick person lives. Speedy deaths might produce an annualized yield of 80 percent—slower deaths have been delivering 15 percent or 20 percent payoffs.

AIDS and cancer patients can sell their insurance policies for 60 to 80 cents on the dollar. A $100,000 policy, for example, might garner a cancer patient $60,000. The shorter the life expectancy, the more money patients can expect to get. Investors prefer people who live less than a year, although some viatical companies take people with life expectancies up to five years.

If you can take advantage of a viatical agreement, you should consider the following.

Are you on Medicaid? Selling your policy can make you too “rich” to qualify. It may also reduce or eliminate any disability payment you are getting from Social Security.

- Is the price fair? Offer your policy to several companies to see which will pay the most.
- Do you want to use a viatical broker? If you do not want to shop the policy yourself, you might want to ask a broker to do it for you. Brokers earn high commissions from the companies, up to 6 percent of the policy’s face value, which reduces the payout you will get.
- Do you want to use a fee–only planner? These planners shop the policy but generally charge around $150 an hour instead of sales commissions. Because commissions do not motivate them, they might get you a better deal.
- Is your money safe? Be sure that your payment is safely in escrow before handing over your policy to a new owner.
- Do you have to sell all of your policy? You may want to sell just part of it, reserving the rest for your heirs.

To the sick, who have probably lost their jobs, their health insurance and their savings, a viatical payment can be an enormous relief. However, this is largely an unregulated industry, with an enormous potential for abuse. You can find a good resource for viatical settlements at http://www.national-viatical.com.

AUTOMOBILE INSURANCE

Linda's car broke down on a country road. While she sat there, another car came along and sideswiped her car, then sped away. Her insurance company paid for the damage, but raised her insurance rate by $1,000 a year for the following three years. After asking questions, she found that the company had categorized the accident under collision, when it belonged under the category of uninsured motorist. Within two minutes of asking the right question, the insurance company changed the category, saving her $3,000! As you can see, asking the right questions can save you money. Yet to ask the right questions—you have to have a working knowledge of automobile insurance.

If you are found at fault for an accident and don't have adequate insurance, you could pay a part of your income to cover the liability for the rest of your life. Following is a brief discussion of the various components of a typical automobile insurance policy.

- Bodily injury liability covers you when injury occurs to people in other cars during an accident in which you are at fault. It also insures you against injury to pedestrians. Bodily injury liability will also pay for injuries incurred by passengers in your car. Members of your family are insured while driving other cars, including rental cars.
- Property damage liability covers damage done by you to other people's property, whether the property is a car, a road sign, or anything else. The insurance company will pay for the damaged property within limits of the policy.
- Insurance company quotations are in two or three dollar amounts, for example, $300,000/$50,000 or $100,000/$300,000/$50,000. Always, the initial figure is for bodily injury liability. If it is a single number ($300,000), you have a single–limit policy; if it is a split number ($100,000/$300,000), you have a split–limit policy.
- Split–limit policies divide bodily injury into two parts. The first part is the maximum per injured person, and the second part is the maximum per accident. Property damage liability is always the third figure. A policy that has your liability coverage as $100,000/$300,000/$50,000 means that the maximum the company will pay for each person's injuries is $100,000, up to a total of $300,000 per accident. The maximum it will pay for property damage is $50,000 per accident.
- Single–limit policies are better than split–limit policies because of greater coverage potential. For example, let us compare a single–limit policy of $300,000/$50,000 with a split–limit policy of $100,000/$300,000/$50,000. If injury occurs to one person in an accident and the cost is more than $100,000, a split–limit policy will only cover the cost up to $100,000. You must pay the rest.

However, a single–limit policy will pay up to $300,000 before you have to pay anything. The insurance company will also pay your court costs for any accident for which you are at fault.

- The deductible is how much you pay yourself when you file a claim. The higher the deductible, the lower will be the cost of insurance.
- Comprehensive insurance covers the damage done to a parked car.
- Collision insurance covers the damage done to a moving car. Consider paying for minor accidents yourself because any reported accidents could lead to higher premiums and possibly a non-renewal of your policy. You are responsible for the deductible only if the accident is your fault, or if the insurance company is unable to collect from the other party. If you have an old car you might want to consider not paying for collision insurance. The amount you pay in premiums may be more than what the car is worth.
- If an accident totals a car, the repairs cost more than the car is worth. Insurance companies will reimburse you for the value of the car, not for repairs beyond that value.
- If you do not have major medical insurance, having medical coverage on your automobile policy is particularly important for you. Medical coverage covers you and any passengers.
- Towing and rental reimbursements are types of coverage. These types are usually inexpensive, especially with high deductibles, and are therefore good bargains.

WHAT DO I DO WHEN I HAVE AN ACCIDENT?

When you are involved in an accident, call the police or 911. Always get names and other pertinent information of everyone involved. Write down the specifics with a complete description; include weather and road conditions. If possible, get the names and telephone numbers of any witnesses. These things and the police report can help you later should there be any litigation. Next, call your insurance company; they will advise you what to do next.

Once the insurance company offers a satisfactory settlement, you have to sign a release. Upon signing the release, the settlement is final and you absolve the insurance company of any further liability. Therefore, be cautious not to sign too hastily.

HOMEOWNER'S INSURANCE

Homeowner's insurance protects your home and belongings from damage or destruction. This type of insurance is very broad and can cover a lot more than just your home. Some areas covered are boats, automobile break-ins, legal fees, and liability on your personal property. This goes beyond fires and takes in perils such as windstorms, vandalism and theft. Some policies cover events that the policy specifically names, while policies that are more expensive protect against all hazards except those that the policy specifically excludes. A typical homeowner's policy will cover incidents such as your child hurting a playmate, your dog biting a neighbor, you accidentally breaking another person's window or someone getting hurt on your premises.

However, homeowner policies do not protect you against every contingency. None, for instance, covers the impact of floods, war or simple neglect of maintenance. People whose property is in designated flood plains can buy separate flood insurance. Homeowner's insurance will not cover the intentional harm to another person, job related accidents, or accidents occurring while operating a motorized vehicle.

A regular homeowner's policy may not cover your valuables such as furs, jewelry, or even antiques. Depending on your needs, you should add a personal article's floater to your policy. When buying a personal article floater, you should take pictures of all your valuables and keep your receipts of purchase. The pictures and receipts will give the insurance company proof of your belongings and their value.

Buy replacement value and not present value coverage. If someone steals your computer, present value coverage will reimburse you only to the extent of its present market value. With replacement value, however, the insurance company will replace the stolen computer with a comparable new one. Replacement value coverage is only a little more expensive than present value coverage.

You should have umbrella liability coverage if your net worth is more than $50,000. Umbrella liability applies to bodily injury claims and legal costs resulting from any type of accident for which you are personally liable. For example, it protects you against the person who slips on your icy sidewalk and sues you for a million dollars. It also protects you away from home if your negligence causes harm to someone else. This coverage will cost you about $100 a year. Your automobile or homeowner's insurance company provides this type of policy as a supplement. You must have automobile and homeowner's insurance with the same company to qualify. Umbrella liability does not cover the assets of your business or profession. When you have your automobile and your homeowner's insurance with the same company, you may get a discount—so ask.

RENTER'S INSURANCE

If you live in an apartment, the landlord may fully insure the building, but your furnishings and other personal belongings are not covered. As a renter, you will need a special type of homeowner's insurance. For example, let us suppose that some water pipes burst and water ruins your furniture, rugs and other belongings. If the landlord is innocent, you are fully responsible for the damage.

Most renters' insurance is inexpensive and is a scaled–down version of a homeowner's policy. The insurance covers the contents of the house, apartment or cooperative unit, but not the structure and grounds. A standard renter's policy covers furniture, carpets, appliances, clothing and most other items for their cash–value at the time of the loss. Renter's insurance pays for losses caused by fire or lightning, windstorms, hail, theft, civil commotion, aircraft, smoke, vandalism, falling objects. The policy covers certain damages caused by water, steam, electricity, appliances, and frozen pipes as well.

For maximum protection, consider buying replacement cost insurance, though some policies limit the payout to four times the cash–value. Of course, replacement cost insurance is more expensive than cash–value policies.

HEALTH INSURANCE

- Group health insurance: Premiums for groups are lower than for individuals. This is why insurance companies commonly make up artificial groups for people to join. In this type of policy, usually your physical condition does not affect eligibility for coverage. The size of the group partly determines the exact coverage. If you leave the group, you can continue coverage for only 18 additional months. However, during this time you are obligated to pay higher premiums.

- Individual basic medical expense insurance usually pays some portion of hospital room, operating room, lab tests and X–rays. This type of insurance also covers in-hospital medical visits as well as inpatient and outpatient surgery. Most of these policies have time and dollar limits on the benefits. There may be a 31–day limit on hospital stays. Payments may be a fixed percentage, such as 80 percent of costs.
- Major medical insurance: This type of policy provides additional protection against the high costs of serious illness. Insurance companies pay benefits longer, and dollar limits are higher than with a basic policy. Benefits may also be broader such as inclusion of drugs and out-of-hospital costs. Some policies combine basic and major medical in a *comprehensive* policy.
- Hospital confinement indemnity insurance pays a fixed amount per day, week or month while you are in a hospital. The benefit bears no relation to actual expenses. You should purchase this insurance only as a supplement to other coverage, not as a primary health policy. You may want to buy this type of insurance to help defray your deductible expenses.
- Limited benefit insurance: This insurance covers only expenses arising out of a specifically designated illness such as cancer. A cancer policy pays nothing for such things as a heart attack, ulcer or other illness. Policies may pay benefits related to actual costs, while others pay daily or weekly benefits or, occasionally, a lump sum benefit. You should purchase this type policy only as a supplement to other coverage.
- Accident only insurance**:** These policies usually cover death, loss of a limb or sight, disability and medical care due to an accident.
- Intensive care insurance: These policies pay only if, and while you are in the intensive care unit of a hospital.

TIPS CONCERNING MEDICAL INSURANCE

Insurance companies are only obligated to pay amounts between the deductible and the limit—you pay anything below the deductible and over the limit. You can reduce the high cost of medical insurance with high deductibles. For example, you can save as much as 40 percent if you raise your deductible from $200 to $1,000. Usually having a high deductible and a high limit is better than having a low deductible and a low limit. With high limits you are protecting yourself from high medical bills. However, if your family has ongoing medical bills, you should keep the lower deductible and pay the higher premiums.

Additionally, your premiums can be lowered even more if you buy a co–insurance policy. With co–insurance, you share the cost of medical expenses with the insurance company. For example, when you incur medical expenses, you pay the deductible and 20 to 50 percent of the next $3,000 to $10,000. A co–insurance policy is good if you have excellent health and a low income. This is the best way to keep your premiums affordable, while still protecting yourself from catastrophic medical bills.

MEDICARE AND MEDICARE PART B

Medicare is health insurance for people age 65 or older, under the age of 65 with certain disabilities, and any age with End-Stage Renal Disease. Changes in these insurances can occur frequently, so call 1-800-633-4227 or go to http://www.medicare.gov for the latest updates. The federal government's Medicare program is divided into two parts—Part A and Part B

- Part A helps cover inpatient care in hospitals after deductions and coinsurance and payments under other companies' policies. It also covers skilled nursing facility, hospice, and home health care. This coverage is free to most people**.** You should apply for this coverage within three months of turning 65 regardless of whether you retire at this age or not
- Part B medical insurance helps pay for doctors' services both in and outside of the hospital. It also helps cover some preventative services to help maintain your health and to keep certain illnesses from getting worse.
- Part C is a health coverage choice run by private companies approved by Medicare. It includes Part A, Part B, and usually other coverage including prescription drugs.

- Part D is prescription drug coverage. It may help lower prescription drug costs and help protect against higher costs in the future.

With Medicare, you can choose how you get your health and prescription drug coverage. Below are brief descriptions of your coverage choices, Original Medicare is

- Run by the Federal government.
- Provides your Part A and Part B coverage.
- You can join a Medicare Prescription Drug Plan to add drug coverage.
- You can buy a Medigap (Medicare Supplement Insurance) policy (sold by private insurance companies) to help fill the gaps in Part A and Part B coverage.

Another choice is Medicare Advantage Plans. These plans are:

- Run by private companies approved by Medicare.
- Provides your Part A and Part B coverage but can charge different amounts for certain services. These plans may offer extra coverage and prescription drug coverage for an extra cost. Costs for items and services vary from plan to plan.
- If you want drug coverage, you must get it through your plan in most cases.
- You do not need a Medigap policy.

There are other Medicare health plans. These

- Plans that are not Medicare Advantage Plans, but still part of Medicare.
- Include Medicare Cost Plans, Demonstration/Pilot Programs, and Programs of All-Inclusive Care for the Elderly.
- Some plans provide Part A and Part B coverage, and some also provide prescription drug coverage (Part D).

You might also have health and/or prescription drug coverage from a former or current employer or union. To get free personalized health insurance counseling, including help making health care decisions, information on programs for people with limited income and resources, and help with claims, billing, and appeals.

With the passage of the Patient Protection and Affordable Care Act (PPACA) of March 23, 2010, many rules have changed and will change. Because the act is 2,300 pages long, it is too early to know all of the changes that will take place. Some changes have already taken place; others will not be in effect until 2014.

DISABILITY INSURANCE

Disability insurance covers you if you become disabled and are unable to work at your job or business. Statistically you stand more of a chance of this happening to you during your middle working years than of dying. Monthly benefits can be anywhere from 60 percent to 80 percent of your income at the time of purchase—although some companies offer cost-of-living adjustments. Some policies pay only for disability caused by accidents, other policies will cover both accidents and illness. Some insurance companies reserve the right to cancel your policy—other policies cannot be canceled. Some companies offer guaranteed annual premium payments that they cannot increase—others can increase your annual premium payments. Because companies base insurance premiums on your age when you apply, purchasing disability insurance at a younger age will provide you with a lower premium.

It is a trend for employers to invite insurance companies to sell policies to workers as a group instead of the employer providing the insurance. In order to qualify the group has to have a certain minimum amount of participants. As a marketing incentive, insurance companies often will waive the physical requirement if enough people sign up for the plan within a certain period.

Before you buy disability insurance, make sure you know what is involved. Pay attention to the company's definition of disability. Some company's definition of disability is so narrow that few people are eligible to collect anything. For example, suppose your doctor discovers you have multiple sclerosis, but you continue to work part-time on the advice of your benefit administrator. When you cannot work at all, you apply for disability benefits under your company's income protection plan. The insurance company may refuse you benefits. Why? According to their definition of disability they do not consider you disabled because you worked part-time after the discovery. In addition, many disability plans effectively exclude conditions with a progressive onset, such as multiple sclerosis, Lou Gehrig's disease, Huntington's disease, progressive diabetes, arthritis, and AIDS.

A policy with an own-occupation definition will provide payments to you if you cannot do your usual work, though you can do other types of work. For example, an own-occupation plan will pay a disabled schoolteacher if she cannot stand in the classroom all day but can do deskwork. When the insurance company defines the coverage as any-occupation, then you will be paid only if you cannot do any work.

Your insurance company can deny you benefits if you have a debilitating disease and fail to include a medical certificate from a doctor when you submit the claim. A denial is also possible if you do not answer every question in full on the original application. Additionally, the company can deny you benefits if it can show that you misrepresented yourself on the application. Therefore, improperly completed forms, or failure to follow a complex procedure for filing claims, can lead to denial of benefits.

Your present coverage is another consideration when buying disability insurance. For example, suppose you have been working at a job for twenty years and have used very few of your sick day benefits. Because sick day benefits often accumulate from year to year, you could be out of work for six months or more and receive full pay. In this case, you can keep premiums lower by electing a starting date six months or more.

Disability policy payments can extend from one year to a lifetime. Policies come in mostly two periods—short term (two years) and long term (five to sixty-five years). Except for a few professions, policies stop at the age of sixty-five. You may need coverage only until the age of sixty-five anyway because of other types of income that will kick in after this age.

EXTENDED WARRANTIES

An extended warranty, sometimes called a service agreement, a service contract, or a maintenance agreement, is a prolonged warranty offered to consumers. The warranty administrator, the retailer or the manufacturer may offer the extended warranty. These warranties extend the period of the manufacturer's standard warranty and are usually not "double coverage". For example, a refrigerator's extended warranty covers two years past the manufacturer's one-year warranty. Extended warranties cost extra and for a percentage of the item's retail price. In retail consumer electronics, extended warranties cost 20% to 30% of the price, and give sales associates up to 15% commission at some retailers. Occasionally, some extended warranties that you purchase for multiple years state in writing that during the first year, the consumer must still deal with the manufacturer in the occurrence of malfunction. Thus, a five-year extended guarantee is actually only a four-year guarantee.

Consumer advocate groups, such as the non-profit Consumers Union, advise against purchasing extended warranties. The extended warranty is usually in the best interest of the company, but isn't often in the best interest of the consumer. In many cases, if the item does need repairing, the costs of repairs are less than the cost of the extended warranty. Other advocates also advise against purchasing extended warranties, maintaining that they are a source of income for retailers, many of whom will refuse to repair items covered under such plans, if possible. Furthermore, consumer advocate groups point out that the only way the extended warranty could do any good is if the product breaks down after the standard warranty but before the extended warranty is up, which is unlikely. If you insist on buying an extended warranty, the best time to buy is just before the regular warranty expires.

CREDIT LIFE INSURANCE

Credit Life Insurance is a consumer purchase, often sold with a big-ticket purchase such as an automobile. The insurance will pay off the loan balance in the event of the death or the disability of the borrower. Although purchased by the consumer/borrower, the benefit payment goes to the company financing the purchase to satisfy a debt. Credit life insurance is a poor buy for the money. You would get a lot more for your money to buy more life insurance rather than buy insurance piece meal, such as credit life. The only time credit life insurance may be worth the money is if you are otherwise uninsurable and cannot purchase regular life insurance.

BUYER BEWARE

Following is a discussion of common abuses made by insurance companies. An insurance company may not scrutinize your application until after you file a claim. Then it will audit your medical records to search for information not included on your application. They will refuse your claim if they find any. For example, if you have cancer you may face a claims challenge if you did not report seeing a doctor several years before concerning a thyroid problem. In such instances, knowing your rights is important. If you had no knowledge of a medical problem at the time of you apply, or if you can show that you failed to appreciate the significance of an omission, or if the omission is immaterial or trivial, the company cannot rescind your coverage.

When applying for a new insurance policy, make sure that you answer all the questions yourself rather than letting an agent fill out the application. The reason for this is that an insurance agent may paraphrase questions that will elicit a questionable response from you.

For example, the agent may ask you if “you have any problems with your blood pressure?” when the question really read, “have you ever been treated for high blood pressure?” If you answer no because you do not currently have a blood pressure problem, but the insurance company can show that your doctor once treated you for high blood pressure, it can rescind your policy after making a claim.

Insurance companies may even deny preapproved claims. For example, suppose you call your insurer for preapproval of a medical procedure and receive approval. Later your claim is denied because the company deems the procedure either experimental, not medically necessary, or entailed excessive treatment. How can this happen? When you called the insurance company, you talked to a clerk who happened to answer the telephone. The clerk merely informed you that your policy generally covers the procedure, but did not verify that it specifically covers the procedure in your case.

Clerks are not claims adjusters and cannot pre-approve conditions. What should you do when you call your insurance company for preapproval? Be sure that you speak to a claims adjuster and not a clerk. Get preapproval in writing for a specific procedure and the amount that the insurer is willing to pay.

Another ploy by insurance companies is to engage in false or deceptive advertising. Some insurers train their agents to sell policies based on advertising or brochures that misrepresent the actual contents of a policy. The reading of a brochure may make a basic policy look like something more than it is. For example, in fine print the policy may state the insurance company will exclude any doctor’s visits after the first four weeks following surgery. The policy may also state that it covers less than 100% of a surgeon's fee. Make sure you read your policy carefully, including the fine print on the back. If you do get caught in a dispute, you must show the discrepancy between the actual coverage and the claims of the brochure. The courts will generally rule in your favor if you are specific and can verify your claim.

CHOOSING THE BEST INSURANCE COMPANY

Which is the best insurance company for you? Different companies have different offerings, and these offerings change from time to time. The best policy is out there waiting for you—but you must find it. You may find the following web sites helpful.

- *SelectQuote Insurance Services* (http://www.selectquote.com/home2/homepage.html

- *InsuranceQuote Services* http://www.insurancequote.com/health-insurance.php

- *Ameritas* http://ameritas.com/

By making the right choice, you will have adequate coverage while putting more of your money into savings. Pay attention to a company's rating. Five rating companies measure the soundness of insurance companies. They are A.M. Best, Standard & Poor's, Weiss Research Inc., Moody's, and Duff & Phelps. Each rating company has its own evaluation system. All but Weiss uses the letter A frequently, the designation often given to average companies. An insurance agent who fails to put a rating in context can mislead you concerning the rater's intent. For example, both Standard & Poor's and Duff & Phelps can give a company an A plus rating, which sounds terrific, but this is their fifth ranking from the top (the top rating is AAA). An A–plus rating is "good," but not excellent.

If you are interested in a single company's ratings, ask your insurance agent. The following web sites are helpful:

- *Standard & Poor's* http://www2.standardandpoors.com/
- *Moody's* http://v2.moodys.com/
- *Duff & Phelps* http://www.duffandphelps.com/
- *Weiss Research Inc.* http://www.weissgroupinc.com/research/index.html

- *A.M. Best* http://www.ambest.com/

Be sure to check out a company’s ratings and press any agent to give you a full list of rankings. Find out what the rankings mean and get the rater's own short, written summaries of the insurer's financial condition. The rating system is not uniform, so you should check with at least two sources. Do not rely on the insurance company's version of the rater's report.

CHAPTER SIX

BUYING, SELLING & LEASING A CAR

Ken learned how to get back on his feet fast -- he missed two car payments! However, let us go back a couple of years to when Ken lived in suburban Atlanta with his wife and his two young children. They had been driving the same car for five years, a car that was four years old when they bought it. The car was a small Chevrolet station wagon—with no air conditioning. Their problems began on a hot day in July when the family was getting ready for their trip to Disney World. Thinking how nice it would be to take their trip in a new car they went to a car dealer. They fell in love with a bright red van with air conditioning. So they decided to buy the van solely on emotion.

The interest on their car loan was 12% and the monthly payment was $445 for five years. After three years, however, Ken gave the car back to the bank because he could not afford the payments. The bank, in turn, reported repossession to the credit bureau. This hurt his credit report and damaged his credibility for seven years. The bank sold the vehicle at auction for $3,700 less than the outstanding balance on the loan. So after paying the bank $16,000 over three years, Ken no longer had a car, but still owed the bank $3,700. Because he could not pay the money, the bank filed a judgment against him, damaging his credit report even more.

SHOULD YOU BUY A USED CAR OR A NEW CAR?

It is not surprising that so many people buy new cars. Buying a new car is easy and convenient—buying through a dealer can be hassle free. Are you having trouble getting a bank loan? No problem, the dealer will find one for you. You say you cannot afford the monthly payments. No problem, the dealer will tailor payments to fit your budget. Are you concerned about the hassle of selling your old car? No problem, the dealer will take it as a trade–in. Additionally, interest rates are lowest on new cars.

Despite these advantages, the one major disadvantage is that new cars are expensive. According to the *Commerce Department's Bureau of Economic Analysis*, the average price of a new car in America today is about $25,000. As high as that sounds, it is probably on the low side as the government statistics do not include sport–utility vehicles, vans, and pick–up trucks which sell for thousands of dollars more than the average car. At $25,000, the average price of a new car is about the same as the average worker earns in a year. The bottom 20% of wage earners makes less than $20,000 per year. Considering interest payments, this $20,000 car will end up costing you about $27,000.

Let us compare the cost of a used car with a new car. Suppose you buy a new car for $16,000. How much will it be worth in two years? The answer depends on the car and the market, but a good guess is about $8,000. Instead, suppose that you buy a two–year old car for $8,000. How much will it be worth in two years? Again, it depends on the car and the market, but if it depreciates by 25%, the car will be worth $6,000. So in two years you have lost $2,000 with the used car as compared to $8,000 with the new car.

When purchasing a car, consider depreciation. After two years, the average new car will depreciate 50%. Now suppose you have an accident that totals your car that you paid $20,000 for when it was new two years ago. How much will you collect from your insurance company? You can only collect up to the car's market value, which in this case will be about $10,000. If the outstanding balance on your loan is $14,000, you still owe the bank $4,000. Now you have a $4,000 debt and no car.

When you buy a car, you also have to consider taxes. Many states charge a sales tax on cars. For example, a sales tax of 4% on a $2,500 car would be $100, and on a $20,000 car, it would be

$800. Some localities also access a personal property tax. The personal property tax paid on a new car will be more then on a used car.

Insurance is another consideration when buying a car. When purchasing an automobile the more expensive the car—the more expensive the insurance. Banks will require that you purchase enough insurance to meet their minimum standards. Additionally, creditors will encourage you to buy credit life, credit disability, and loss of income insurance. If you pay for these insurances with borrowed money, you will end up paying more interest.

Buying a New Car

Some dealerships are “no haggle.” These dealers appeal to customers who despise negotiations. They offer the same price to every customer who walks through the door. Even if you do not buy, the price that a “no haggle” dealer gives you serves as a good benchmark price when shopping around.

Here are some useful tips when buying a new car.

- Forget the sticker price. The only price you need to know is what the dealer paid for the car.
- When financing, shop around for the best interest rate. A previously approved loan can be a bargaining tool with the dealership. Also, you can usually get a better deal if you arrange the financing yourself.
- The best time to buy a car is at the end of the month because sometimes salespersons are eager to meet a sales goal then. Also, the end of a promotion might be a good time to strike a bargain. The dealer may have to unload some surplus cars he bought for the promotion.
- Take the car for a test drive without the salesperson.
- Do not drive while listening to the radio.
- Open the front left–hand door and check the doorjamb for the date of manufacture. If the car is several months old, the dealer may be eager to strike up a deal.

When you are ready to negotiate after doing all of the above—tell the salesperson the price you want to pay for the car. How do you calculate the best price? Adding 4% to the dealer's cost is a good beginning. During the negotiation, the salesperson will probably want to talk the deal over with the sales manager. The salesperson will then return with a note from the manager with his best offer. If this price is higher than your stated price, simply cross out the price and replace it with your own. Remember, you are in the driver's seat. You can always come back another day or go to another car dealer.

Are you ready to drive the car home after successfully negotiating a price? Not yet. You have to see the finance and insurance salesperson. Some dealerships profit more from the finance and insurance process than they do on the sale of the car, so be careful. The finance and insurance manager's job is to sell you high profit products and services. Some high profit products are insurance, dealer financing, extended warranties, rust proofing, undercoating, seat protection, and any other options.

EXTENDED WARRANTIES & AUTO SERVICE CONTRACTS

A warranty is an assurance by a seller that the seller will service a product. New cars come with warranties, but they also offer extended warranties**.** Similar to an extended warranty is something called an auto service contract**.** An auto service contract technically pays for repair or maintenance not covered by the manufacturer's regular warranty, or kicks in after the original warranty expires. These warranties do not come cheaply. For example, the GM Major Guard Protection Plan will cost about $1,000 over five years. If you lump this coverage in with a five–year loan at 15% interest, the insurance costs you $1,427. So, should you buy an extended warranty or an auto service contract?

An extended warranty is rarely a good bargain if you purchase it at the onset of the purchase. This is because you are paying for something you cannot benefit from until the regular warranty expires. Also, when you buy an extended warranty up–front, you end up paying interest on any amount borrowed until the loan is paid off. If you want an extended warranty, wait to buy it until just before the regular warranty expires. If you have already bought an extended warranty, you can usually get a refund by canceling the policy.

What about auto service contracts? Like with so many other things, you can win or lose. To increase your chances of winning, make sure that you adhere to the strict guidelines in the contract.

The contract on your new car is valid only if you get all of your servicing done by the dealership and abide by all of the stipulations of the contract.

WHY PEOPLE ARE BUYING FEWER NEW CARS

Americans are buying fewer new cars today than might be expected. It seems that America's love affair with the automobile is waning. Following are several reasons why people are buying fewer new cars today than yesterday.

- Among the big-ticket items on American consumers' wish lists, new cars have fallen to number 11 from number 3, according to CNW Marketing/Research in Bandon, Oregon. At the top of the list today are remodeling the kitchen, saving up to start a business and buying a computer.
- There are more and better-used cars to purchase. One factor is that leasing has become more popular in recent years. With two and three year leases being the industry norm, dealerships have more two and three year old previously leased cars for sale and these cars are usually in excellent shape. Why buy a new car when you can get a practically new car at used car prices?
- Cars last longer than they used to. America's automakers have closed the gap on the Japanese in terms of quality in recent years.
- Because people are generally keeping their cars longer, when they do decide to look for a new car, they are amazed at how much they have to pay for a new car.
- Cars are not the status symbols they used to be. Instead of being a prestige symbol, for many people the car has simply become another necessity of life. Other purchases hold appeal that is more emotional today, like owning a new computer. In fact, it is common today for people to brag how long they have had their car—it has become the in thing to show good stewardship.
- Women are making more car buying decisions. With the two-income family being the norm, women are having more of a say in the purchase of a new car. Generally, they are more conservative and less likely to splurge for

emotional reasons. Most women are looking for dependability and safety. Most women view the automobile as a tool rather than a toy.

BUYING A USED CAR

After considering the pros and cons of buying a new car, suppose that you decide to buy a good used car. So, how should you go about finding one? A good place to look is in the classified section of your local newspaper. Also, mention to friends that you are looking for a car. You might find that you have a friend who has a car for sale, or he might know someone who does. Banks sometimes sell repossessed cars at public auctions. Call some local banks and ask about their next car auction.

A good place to look for a used car online is at http://www.autoauctions.gsa.gov. GSA stands for General Service Administration. GSA Fleet offers you cars, trucks and other vehicles with low mileage and only one previous owner. Additionally, with no buyer's fees, pre-owned vehicles from GSA usually sell for substantially less than from other sources. You must register at the sponsoring auction facility on the day of inspection or auction to obtain a bidder's number. Any member of the public who is a licensed driver and at least 18 years of age is eligible to bid at our auctions. Registration to participate in any of our Vehicle Auctions is free. Each vehicle is sold to the highest responsive bidder. GSA Fleet reserves the right to reject any or all bids including bids under which a bidder would take unfair advantage of the Government or other bidders.

Always know the market value of a car before you buy it. How do you know the market value? A good source is the N.A.D.A. Official Used Car Guide put out by the National Automobile Dealers Used Car Guide Company. The web site is http://www.nadaguides.com.

A car in your area is worth what it sells for at a local automobile auction. These auction houses send information monthly to the National Automobile Used Car Guide Company, which puts out a monthly publication. Since the same automobile will sell for different prices depending on the geographic area, NADA publishes the guide in nine editions. The nine editions are New England, Eastern, Central, Southeastern, Southwestern, Midwest, Pacific, Northwest, Pacific Northwest and Mountain States.

If you want information on an American or a foreign car that is less than seven years old, ask your library or local bank for their latest NADA guide or go online. If you are looking for the value of a car that is more than seven years old, the best source is your city hall’s tax office. Cities that access personal property taxes need to know a car's value, thus, they have to subscribe to the NADA guide that includes cars older than seven years.

The NADA guide is very specific. For example, suppose you are looking for a Pontiac Sunbird. Is it an LE-4, an SE-4, or a GT-4 Turbo? Is it a coupe, sedan, or a convertible? Does it have two doors or four doors? It lists options that will add a specified value to the car are as follows: automatic transmission, power steering, air conditioning, sunroof, stereo tape, compact disc player, power door locks, power windows, tilt steering wheel, custom wheel covers and cruise control.

The NADA guide gives you three prices, the average trade–in, the average loan, and the average retail price. Average trade–in is the price the car sold for at auction and is the actual market price for the car then. The average loan is what the bank will lend someone to buy the car, and the average retail price is what a dealer would probably charge for the car. Of course, the average retail price is a lot more than the average trade–in price. You want to buy a car for the average trade–in price. All of the prices given assume that the car is in good condition.

Mileage is another factor. A low–mileage table and a high–mileage table can be found at the beginning of the guide. Each table gives normal mileage ranges for four classifications.

- The first classification is subcompact cars and compact cars and compact trucks.
- The second classification is intermediate and personal luxury cars and mid–sized trucks.
- The third classification is standard size cars and trucks.
- The fourth classification is luxury cars.

If a car has lower mileage than normal, the table will suggest how much money you should add to the value of the car. If the mileage is more than normal, the table will tell you how much to subtract from the value. By using all of the information in the NADA guide, you can come within $50 of a car's value.

How much money can you save when buying a used car from an individual rather than from a car dealership? To find out, compare the prices in the NADA guide to the prices advertised by car dealerships through your local newspaper. Remember, when you are comparing prices, use the average trade–in price in the far left column of the NADA guide. At times car dealers will advertise the fact that they use the NADA guide to set their prices. Most often, however, the prices they use are the retail prices as reported in the far right column. If the dealership is asking the average trade–in price, then it is a fair price.

You may want to take a car to a mechanic, who, for $50 or so, will give the car a going over. Suppose that he finds the car needs $200 of repairs. Now you can offer the owner $200 less for the car, or tell the seller that you will pay the asking price if the car is fixed.

FINANCING A CAR

The cheapest option is to pay cash—but if you are like 90% of all car buyers, you will have to borrow the money. When you buy a car on credit, finance it for three years or less. If you finance a car for more than three years, the car will be worth less than you owe on it for most of the loan period.

Remember, you can go broke by asking, "What's the monthly payment?" Your first concern should be the total price of the car, not the monthly payment. If you buy the car from a dealer, the dealership is interested in the highest return possible. The manager will manipulate the interest rate and the length of the loan payments so you will pay the most money possible.

A personal loan is an option. One advantage of a personal loan is that you will get the title to the car up–front. One possibility of a personal loan is a home–equity loan, if you qualify for one. With a home equity loan the interest rate will probably be lower than other types of loans, you will get the title up front, and the interest is tax deductible. If you do get a home–equity loan, repay it as quickly as possible. Because a car is a depreciating asset, you may have little equity while sacrificing $20,000 equity in your house.

Dealer financing is another option, and special promotions by manufacturers can make it well worth considering. First, negotiate the lowest possible price for the car. Dealer financing at 2.9% may sound like a good bargain, but if you are paying the sticker price, it's no deal at all.

Consider these sources when purchasing a car.

- *Edmunds New Car Prices* at http://www.edmunds.com
- MSN new and used car prices as http://www.autos.msn.com
- Car Price Secrets at http://www.carpricesecrets.com

- Consumer Reports at http://www.consumerreports.org/ and http://blogs.consumerreports.org/cars/2008/09/
- Cars Direct at http://www.carsdirect.com/

SELLING A CAR

Selling a car need not be a daunting experience; you just need to know the proper way to do it. Use the most recent NADA guide to learn the average trade–in price for your car. If you are in no hurry you can ask a higher price than the NADA wholesale price. But, if you want to sell the car quickly, ask the NADA price. If necessary, you can show prospective buyers the price in the NADA guide. You can also look for newspaper advertisements by car dealerships for cars similar to yours. Show prospective buyers how much they will save buying from you instead of from a dealership.

Looks are important. Make sure that you wash and wax the car and clean the inside. You may want to have the engine steam cleaned. Eliminate scratches with touch–up paint. Fix any rattles and clean the trunk. Spruce up worn carpets with inexpensive mats. If your car is very clean, in excellent condition, add to the NADA price; if it is in poor condition, lower the price. Also, don't forget about the high or low mileage table in the front of the book.

Now that you have done all of this preliminary work, it is time to advertise. Buy some space in the classified section of your local newspaper. Keep your ad brief. Following are some key words that attract buyers: low mileage, clean, like new, must sell.

After giving your telephone number, stipulate the times that people can call so that you're not receiving calls at all times of the day and night. To ensure that only serious people call, state your asking price. Remember you can always come down, but you can never go up in price.

Once you receive calls, arrange for a specific time to show the car. A good strategy is to show the car to as many people as you can at the same time. When you have several people at once looking at your car, you have a good chance of receiving a favorable price. Get the name, telephone number of the people calling you, and emphasize that they should call if they cannot make the appointment. If you put a value on your time, other people will also.

Never let a stranger take your car for a test drive alone. Why? Professional car thieves answer ads. They will ask to take the car for a test drive and just keep on driving. By the time you realize that they are not coming back, your car could be in the next state.

When you clinch the deal, tell the buyer that you will only accept cash, a money order, a convenience check from a credit card company, or a certified check. If there is still a bank lien on your car, you must clear the account in order to obtain the title to the car, which you need in order to sell it. Meanwhile, you should request a down payment of $200 to $1,000 to take the car off the market.

Contact your state's division of motor vehicles to find out what needs to be done to transfer ownership. Sign the title and registration and make out a bill of sale. After you sign the bill of sale, keep one copy for yourself and give one to the new owner. Once the car is legally sold, contact your insurance company and cancel the insurance. If you still owe money to the bank, pay off the loan before you cancel the insurance.

LEASING A CAR

According to *Automotive News*, many people do not even consider leasing as an option until they are at the dealership. Less than 6% of shoppers plan to lease when they enter a dealership; about 25% end up leasing. Currently, 50% of the more expensive model cars are leased. You can be “switched” from buying to leasing by slick salespeople before you have had an opportunity to do your homework.

Leasing typically offers the lowest monthly payments, but it is not cost effective. After making 24 monthly lease payments, you still don’t own anything. Of course, being able to walk away from a car you do not like at the end of the lease sometimes may outweigh purely financial considerations. Also, if you like driving an expensive new car every two or three years, leasing may be the way you can afford it.

So, what is leasing? In a way, leasing is like renting a car. However, leasing has one big difference from renting. When you rent a car, you are usually free to bring it back when you wish. Even if you had planned to rent a car for two weeks, you can bring it back in a week without penalty. A lease contract does not allow you that option. If you sign a three–year lease contract, you will probably pay a hefty penalty to return that car after one year. How hefty? The company can charge you a penalty equivalent to all the remaining monthly payments, an early termination fee, and a pro–rated excess mileage charge.

Leasing can be a complicated option. If you do it wrong you can throw away thousands of dollars, find yourself in a legal mess, and generally rue the day the idea of leasing entered your consciousness. For instance, dealers in most states do not have to tell you the actual price you are paying for the car. However, that should not stop you from asking. Indeed, it is smart to negotiate the price before even telling the dealer you want to lease a car.

Leasing generally does not require any down payment other than a security deposit and the same title and registration fees you would pay if you were buying. You can reduce your cost, however, with a down payment.

If you have cash available or access to a home–equity loan, some dealers offer the option of a single up–front lease payment, especially on luxury models, at a discount. Conversely, ask whether a balloon–payment loan is available. Instead of paying more up-front, with a balloon payment you pay more at the end of the term and monthly payments are lower than on a standard loan or lease.

Sometimes you can choose to purchase the car at the end of the term. In this case, you can pay the balance—which is equal to the residual value. The residual value is the difference between what you pay for the car and what the car is worth at the time. Read the fine print before you sign anything. Not all leases give you the option of buying the car at the end.

So now that you know a little about leasing, should you lease or buy your next car? To decide, answer the following questions.

- How much do I drive each year? Most leases permit 12,000 to 15,000 miles annually, with extra charges at the end if you exceed that amount. If you drive a lot less, or a lot more, you probably should not lease unless you can negotiate the lease payment to reflect the difference at the outset. For example, if you drive as much as 40,000 miles a year, you would have to pay as much as $5,000 to $11,000 extra at the end of the leasing agreement.
- Do I generally continue to drive a vehicle after I have made the last payment? If you do, you are not a good candidate for leasing. Though your monthly payments will be higher while buying, after that last payment you will own an asset that goes on providing you with free transportation.
- Do I always trade for a new car before I pay for the old one? If so, you are a good candidate for leasing. If you are always making payments, it makes sense to make your payments as low as possible.

- Is my job situation or business stable? If you buy a car and have trouble making the payments, you can always sell the car to pay off your loan. However, if you lease a car and have trouble making the payments, you do not have the same rights.
- If you own your own business, ask yourself if leasing is the better arrangement for a company car. In this case, consult your accountant.

- If I decide to lease, what should I do with my present car? If you are offered less than the market value for your car, consider selling it yourself.

When you lease a car, you are the lessee, the parent company is the lessor. The lessor buys the vehicle from the factory or from an automobile dealer. Lessors include well–known firms like GMAC (General Motors Acceptance Corporation) and Ford Motor Credit and other firms you have never heard of.

These companies determine the terms of the lease. For instance, they decide the effective interest rate on the lease and the terms concerning breaking your lease. The originator is the company that fills out your form. Automobile dealerships, banks, credit unions, or entirely separate companies can be originators. Of course, these companies also make money from the transaction. According to the *National Vehicle Leasing Association*, which has more than 400 members, there may be more than 10,000 leasing companies in America.

Following are common terms used in a leasing arrangement.

- MSRP is the manufacturer's suggested retail price for the new vehicle. By law, this figure has to be on the window of every new car. Used cars will not have an MSRP. Some recreational vehicles and trucks will not have an MSRP.
- An acquisition fee is what you to pay the leasing company for arranging financing on your vehicle. It is what the company charges to acquire your lease. Not all leasing companies charge an acquisition fee.

- The capitalized cost is the selling price of the vehicle you plan to lease. This price includes such items as the total cost of the vehicle, title and license fees, taxes, acquisition fees, insurance, and warranty costs. All leasing companies refer to capitalized costs in their internal documents but generally do not share this information with the consumer.
- The cost of money is a phrase used to explain the effective interest rate you will pay. This makes it is harder for you to compare the cost of money from lease to lease. Until recently, very few leasing companies showed the interest rate because they were not required to do so. Some leasing companies take advantage of uneducated consumers by charging high usage fees.
- The capitalized cost reduction, sometimes simply called “cap” reduction, is the nonrefundable down payment.
- The residual value is the amount of money the leasing company says your vehicle will be worth when your lease ends. The leasing company uses this figure to help determine your lease payment and also uses it to determine any penalties if you break the leasing agreement.
- Gap insurance makes sure you do not owe any money if your leased vehicle is wrecked or stolen. This coverage is in addition to your normal collision insurance and is not automatically included in all leases. Some leasing companies will charge you. It is important for you to have this insurance.
- Early termination is how much money you will owe the leasing company if you terminate your lease early. Unfortunately, many leases make it virtually impossible for the average consumer to determine how much this penalty is because company’s use a complicated formula to derive it.
- Excess mileage is the number of miles you drive the car beyond your free miles.
- Insurance and warranty items are such things as credit life, credit disability, extended warranties, and vehicle maintenance agreements. You are never obligated to purchase these items.

- Excess wear and tear is charges for extra wear and tear the company considers beyond normal. Definitions of “normal” can vary widely.
- A security deposit is required. These are generally refundable under certain circumstances as defined in the leasing agreement.
- Purchase option fees are simply extra profit for the leasing company.
- Disposition fees cover the cost of preparing your old lease vehicle for sale after you turn it in. This charge typically includes final cleaning and the cost to ship the car to an auction or a used car dealer.

CHAPTER SEVEN

OWNING vs. RENTING a HOUSE

A white picket fence surrounds the house and borders a lush green lawn. The fence keeps the family's collie dog close to home. Parked in the driveway are a blue van and a small economy car. In the backyard is a large weeping willow tree with a swing suspended from one of its majestic branches. Bright colored flowers highlight the yard. The house is a two–story colonial, white, with dark green shutters. Inside the house, there is a large kitchen, a formal dining room, a living room, a family room with a fireplace, a laundry room and two full bathrooms.

Kase works as a lawyer for a growing law firm. Because they live in a small town, he can walk to work. Gail spends her days doing the family's shopping, preparing the meals, and acting as a chauffeur for their two children. She is a Girl Scout mother, PTA president, and is a volunteer worker at the hospital three days a week. Tyler, who is twelve years old, loves to read and play chess. Jessica, who is ten, is a star swimmer, plays tennis, and likes to help her mother prepare the meals. Both of them are honor students in school. Despite their busy schedules, the family always has time to have a sit down dinner together in the dining room.

Does this describe many American families you know? What percentage of the American population do you think comes close to meeting this idyllic picture of a stable, one–income family? Less than 3 percent of the population even comes close to the above description. Divorce is pandemic in America, single parent families are common and majorities of mothers of young children are in the workforce.

DOWN PAYMENT AND CLOSING COSTS

With the median income per person in America being about $32,000 a year, the American dream of being a homeowner is beyond the reach of many people. The relatively high prices of houses, the high closing costs and a prohibitive down payment have precluded many potential homebuyers from the market. Depending on the market, banks normally require, in cash, 10 to 20 percent of the appraised market value of a house before they will consider granting you a loan. The average house in America sells for approximately $200,000; this translates into about $40,000 at 20%—too much for most people.

Even if a person did have $40,000, the monthly payments would be prohibitive. The monthly payment on $160,000 over 30 years at a 7% interest rate is $1,064. The monthly payment over 15 years is $1,438. On top of this you will have to pay property taxes and insurance. Property taxes and insurance will depend on the locality and the price of the house. There are several amortization calculators available on the internet. The one I used is at http://www.bankrate.com.

Additional expenses are closing costs (sometimes called settlement costs), which usually run about $4,000. Closing costs may include the following:

- lawyer fees
- appraisal of the property
- house inspection
- title search charges
- title insurance
- survey of the land
- termite inspection
- broker's commission
- government charges
- taxes
- points (prepaid interest equal to one percent of the loan)
- an origination fee (usually equal to one percent of the loan)

The market will determine your down payment and closing costs depending on whether we are in a seller’s market or a buyer’s market. A seller’s market is a market where the demand for loans is high. In this case, as a homebuyer, you are competing with many others seeking a loan—this gives the lending institution bargaining power. A buyer's market is a market that favors buyers over sellers. In this type of market, as a homebuyer, you, rather than the bank, are in a good bargaining position. In a buyer’s market, most lending institutions will lower some of their costs.

SHOULD YOU BUY OR RENT a HOUSE?

Assuming you can afford it, why should you buy a house instead of rent. By owning your own home, you can put nails in the walls, paint, have several dogs and cats, add a deck, cut down a tree, remodel the kitchen, and choose the color of the carpets. You are paying for something that could appreciate, and when you pay off the mortgage, the house is yours free and clear. Now you can live in the house in your older years and only have to pay property taxes and utilities. In some communities, low income home owners are even exempt from paying property taxes. You can also sell the house, rent it, or use it as collateral for a low cost loan. When you buy instead of rent, Uncle Sam helps you. For every one hundred dollars you pay in interest, the government will give you back some of it when you file your taxes. If you are in the 15 percent tax bracket, for every one hundred dollars you pay in mortgage interest, the IRS will refund you $15; if you are in the 28 percent tax bracket, you will be refunded $28. Because so much of what you pay in the early years of a mortgage is interest, this adds up to a big tax break.

With all these advantages, it is no wonder that owning your own home is part of the American dream. Before you take the plunge into a thirty–year mortgage, however, let us consider the advantages of renting.

Even if you can afford to purchase a house, you may have reason to rent. Renting affords you more mobility than owning a house. What happens if you get a job transfer and have to move? Can you sell the house for a fair price? The answer is maybe yes and maybe no. Let's suppose you bought the house two years ago and paid $4,000 in closing costs. Shortly after moving in, you paid another $4,000 for painting and minor repairs. Meanwhile, for the past two years, most of your mortgage payment went toward interest. Unless the house has appreciated, most of these costs will be a loss if you have to make a quick exit. The situation is even worse if the market value of the house declines.

Or, what happens if you cannot sell it for some reason? In this case, you may have to rent it out so that you can move. Moreover, if you rent the house for more than two years, the IRS considers the house rental property rather than a private dwelling—drastically altering your tax situation. For one thing, you give up being able to defer any capital gains tax when you sell it.

The longer you are going to be in your home, the more sense it makes to buy, especially when you buy a house that appreciates. However, what happens if your house depreciates?

When the price of your house declines, the value of your mortgage can exceed the market value of the house. Having a negative equity in the house is not good. If you do not have enough equity in your house, it may be impossible to refinance to take advantage of a lower interest rate or to extend the length of the loan for lower monthly payments. It also makes it very difficult to sell. If you sell the house for less than you owe on the house, you will have no house and yet will still owe the bank for the difference

An option to putting your money into the down payment and closing costs of a house is to rent and work on paying off your debts. Alternatively, you could invest the difference. Although investing has risks—renting and then investing more than you could if you had the expenses of a house—is an option that you should consider.

Finally, if you are on a tight budget, renting is by far the better choice. By renting, you will not be surprised with sudden and unexpected expenses, such as a furnace that gives out in the dead of winter or the expense of buying a new roof. It is better for you to rent and live within your budget than it is to buy a house and have an out–of–control budget.

MORTGAGE LOANS

The advantage of a long-term loan is the lower monthly payment. However, the longer the loan period, the more interest you will pay. If you can afford the higher monthly payments, a shorter-term loan will save you lots of money and time. Usually, the advantage of taking out a fifteen-year loan is a percentage break of one–half a point.

A 10-year loan has two advantages over longer-term loans, lower closing costs and the likelihood that the bank will keep the loan. When banks sell loans on the secondary market, they normally sell long-term loans before short-term loans. (A secondary market is a market in which the trading of previously purchased securities occurs.) What does this mean to you? It may not make any difference to you—but it could. Let us suppose that your mortgage is with a local bank. Because your local bank is very accessible, anytime you have questions, want to make a change, or simply want help, there is a familiar face waiting to help you. However, if the bank sells your mortgage to a bank 2,000 miles away, getting personal attention may be difficult.

When you apply for a mortgage loan, make sure that the word “hypothecation” or “re-hypothecation” is nowhere in the fine print. Some lenders will offer you a lower interest rate if you agree that creditors can use your house as collateral for loans. Financiers call this process hypothecation. Re-hypothecation occurs when lender B uses the house to borrow from lender C and lender C uses the house as collateral to borrow from lender D etc. There is a limit in America on the extent of re-hypothecation, Canada has laws banning the practice, but in England, there are no limits to how many times an asset can be re-hypothecated. So, even though your mortgage originates in the U.S. it can be sold in England and can therefore can be re-hypothecated many times. What does this mean to you? Let us suppose that you have been making your monthly payments on time for ten years. After ten years, someone defaults on his or her loan. Because someone is this chain of contracts used your house as collateral for a loan, the creditor can legally reprocess your house to make good on the loan. Consequently, you lose your house despite the fact that you have made all the payments. Can this happen to you? Consider that the hypothecation market worldwide a $600 trillion dollar market.

PRIVATE MORTGAGE INSURANCE

The amount of down payment you would need for a mortgage loan depends on the market and the type of loan. You would need about 20% for a conventional mortgage in a booming market; in a depressed market when banks are anxious to lend you money, you can get a loan with less than 20%. However, if you put less than 20% down, you will be required to purchase private mortgage insurance. After your loan balance reaches 80% of the original loan, you can cancel the private mortgage insurance. This is something you should do since the insurance is only protecting the bank and not you. Do not expect the bank to notify you when your loan balance reaches this 80% threshold.

FIXED OR VARIABLE INTEREST RATE LOAN?

Before the Great Depression of the 1930's, the most common type of loan was the variable interest rate loan, sometimes called an adjustable rate mortgage (ARM). During the 1930's, lending institutions were hurt as interest rates plummeted along with the economy. Consequently, banks switched from variable rate loans to fixed interest rate loans to protect themselves from falling interest rates. Fixed rate loans were common until the inflationary 1970's when many banks switched to variable rate loans to protect themselves as interest rates rose. Through most of the 1980's and into the 1990's, inflation and interest rates stabilized. As a result, most banks now offer customers a choice of either fixed rate or variable interest rate loans.

Is a fixed or a variable interest rate loan best? The answer to this question is, “That all depends.” If you believe that interest rates will increase over the loan period, you want a fixed interest rate loan; if you believe that interest rates will fall over the loan period, you want a variable interest rate loan. Unfortunately, no one can tell for sure what will happen. If interest rates are low, and you would be vulnerable to rising interest rates, go with the fixed interest rate loan. However, if interest rates are high and you believe they will come down over the loan period, then go with the variable interest rate.

What should you look for in a variable interest rate loan? Because banks always peg interest rates to some index, consider the index when buying a house. A common index is the five–year Treasury security. Some banks use other indexes, such as one–year Treasury bills, the Prime Interest Rate, and the London Interbank Offering Rate (called LIBOR). The interest rate will be a certain percentage above the index. The adjustment can take place every month, once every six months, once a year, once every two years, or even once every three years, depending on the loan agreement.

Also consider the cap which is the highest interest rate you will pay for the loan. A common cap is two percentage points a year up to a total of six percentage points over the loan period. So if you can get a variable interest rate loan that has a six–point cap, you can calculate what the interest rate would be in the worst case scenario. You are taking an unknown risk without a cap.

Banks review mortgage loans with a balloon payment after three to five years. At the end of the term, the lending institution can either renew the loan at an agreed upon interest rate, or demand full payment. If the loan is renewed, the bank will charge a small fee to reprocess the loan. If the bank demands payment and you cannot pay of the loan, the bank can repossess your house.

Beware of teaser rates. A teaser rate is a very low interest rate offered over a short time, usually one year, after which the rate will increase. A teaser rate may attract you to the lending institution, but if you take the bait, you could be stuck paying a much higher interest rate after the first year of the loan. However, teaser rates are not necessarily bad if the loan has a cap and the beginning interest rate is low enough.

Few people keep the same mortgage for 30 years. Therefore, if you think you will be in your new house for a short time, a variable interest rate loan is attractive because of the lower beginning interest rate. However, if you believe that you will be in the house for a long time, a fixed rate loan is preferable to a variable rate loan.

If you decide on a variable interest rate, pay close attention to the rate as it changes over time. When the bank raises the interest rate, does it raise the rate more than the limit stipulated in the mortgage agreement? Does the lending institution lower the interest rate when the relevant market instrument drops? Is the spread between the market instrument rate and your interest rate accurate? When the lending institution rounds up to the highest interest rate, to what extent does the rounding take place? And just as important, make sure that the bank does not make a mistake when it calculates your monthly payments.

COMPARING MORTGAGES

When shopping around for a mortgage loan, here are some things to consider:

1. annual percentage rate
2. length of loan period
3. monthly payment
4. percentage of down payment
5. application fee
6. points
7. title insurance
8. mortgage insurance
9. prepayment penalty
10. balloon payment

11. adjustment index
12. adjustment time period
13. interest rate cap

Graduated Payment Mortgage (GPM)

A graduated payment mortgage is bank–subsidized and enables you to make artificially low monthly payments for the first three to five years of the loan. In these early years, the monthly payments will increase each year until the end of the subsidized period, eventually reaching the level that would exist with a standard loan. Therefore, for the first three to five years of the loan, every dollar you pay is interest**.** At the end of the stipulated period, you will owe more than you borrowed. For example, consider an $80,000, 30-year standard mortgage at 8 percent interest—your monthly payment would be $587. However, in the first year of a GPM, your monthly payments may be only $487. Therefore, at the end of first year of the loan, your mortgage indebtedness has increased by $1,200.

The upside to this type of mortgage is that it allows you to buy a house you otherwise could not afford. However, you are betting that your income will increase over the next several years to match the payment increase. The downside to this type of loan comes into play when you sell the house shortly after moving in. Because you now owe more than you borrowed, unless you had a large down payment, you may not be able to pay off the loan after selling the house. If you cannot pay the loan off in full, the bank will file a judgment against you in its attempt to collect the money.

Government Sponsored Loans

The Federal Housing Administration (FHA), the Veterans Administration (VA) and the Federal National Mortgage Association (Fannie Mae) can help qualified people obtain a mortgage loan. These agencies do not lend money, but give guarantees to the lending institution, protecting it from default. Because the government guarantees the lender a low risk situation, the lender can offer you a lower interest rate than it normally would. The interest rate on an FHA mortgage is about .5 percent lower than would be the case with a conventional mortgage loan. If you are a first–time home buyer seeking a loan for a modestly priced house, you may qualify. You can apply for a government guaranteed loan through an FHA or VA approved lender.

Will you qualify for an FHA loan? Following is the basic FHA loan qualification guidelines:

- Two years of steady employment, preferably with the same employer.
- Last two years income should be the same or increasing.
- Credit report should typically have less than two thirty day late payments in last two years with a minimum credit score of 620 or higher or in some cases no credit score at all.
- Bankruptcies must be at least two years old, with perfect credit score since discharge.
- Your new mortgage payment should be approximately 30% of your gross (before taxes) income.

These are some of the most basic of FHA guidelines for qualifying for a FHA loan. If you answered yes to most of these statements, you probably qualify for a FHA loan.

What documents do you need? The loan approval process is 100% dependent on your documentation. To ensure a smooth transaction, it is imperative that you have all of your documents gathered prior to your initial loan application. Following is a list of all documents you will need.

Employment Information

- Most recent two years complete tax returns with all schedules.
- Most recent two years W-2's, 1099's etc.
- Most recent pay stubs covering one month period.
- If you are self-employed you will need three years of tax returns and YTD profit and loss statement.

Savings information

- Most recent three months complete bank statements for any and all accounts with all pages.
- Most recent statement from retirement, 401k, mutual funds, money market, stocks, etc.

Credit Information

- Most recent statements from your bills, indicating minimum payments and the account numbers.
- Name, address, and phone number of your property owner, or 12 months of cancelled rent checks.
- Should you have no credit history, copies of your most recent utility bills.
- If applicable, copy of complete bankruptcy and discharge papers.
- If applicable, if you co-signed for a mortgage, car, credit card, etc., you will need 12 months of cancelled checks, front and rear, indicating that you are not making payments.

Personal Information

- Copy of your driver's license.
- If applicable, a copy of your Social Security Card.
- If applicable, copy of complete divorce, palimony, or alimony papers.
- If applicable, a copy of your green card or work permit.
- If applicable, if you own another house – see below

If you Refinance or you own Rental Property

- Copy of note and deed from current loan.
- Copy of property tax bill.
- Copy of hazard (homeowners) insurance policy.
- Copy of payment coupon for your current mortgage.
- If applicable, if the property is multi-unit, you will need a copy of all rental agreements.

How Your Income is considered when applying for an FHA Loan

- How much of your total income will you spend on housing?
- What is your monthly housing expense as a percentage of your monthly income?
- The FHA allows you to spend about 35% of your income on your house.
- There should be a small difference between your new monthly payments and your previous monthly payments.

Your Credit Report

- The FHA looks for a perfect credit report.
- However, they will allow minor past credit issues with sufficient explanation.
- The last two years of your credit history are most important.
- Banks will consider instances of a lost job, job transfers, or medical bills.
- You must pay any tax liens and judgments.
- The FHA does not require a credit score item called FICO; therefore, you can qualify even without a credit report.

The most popular FHA home loan is the 203(b). This fixed-rate loan often works well for first time homebuyers because it allows individuals to finance up to 97 percent of their home loan that helps to keep down payments and closing costs at a minimum. The 203(b) home loan is also the only loan in which 100 percent of the closing costs can be a gift from a relative, non-profit, or government agency.

The FHA rolls insurance into the total monthly payment at 0.5 percent of the total loan that is roughly half of the price of mortgage insurance on a conventional loan. After five years or when the loan balance reaches 78 percent, the additional mortgage insurance drops off the total monthly payment.

An FHA loan can help you even if you have very little money for the down payment and closing costs. The required down payment is 3 percent on the first $25,000 and 5 percent on any amount over $25,000. In addition to the down payment, you must pay mortgage insurance and an annual charge. The mortgage insurance comes to about 3.8 percent of the loan amount; the annual charge comes to .5 percent of the loan amount. You will have to pay this charge for the first 5 to 10 years of the loan.

If you are a veteran, you may qualify for a Veterans Administration Loan (VA Loan). Here are some basic eligibility requirements for a VA Loan:

- 90 days or more of active duty during wartime or 181 days or more of active duty during peacetime
- You were not dishonorably discharged
- You are active duty and meet the above requirements

- You are the surviving spouse of a veteran who died during service or because of service-related injuries and you have not remarried.

If you are a reservist, you will need six years of service and an honorable discharge, or if the service has deployed you for 90 days or more in a combat zone, you will be eligible for a VA Loan. If this may apply to you go to http://www.homeloans.va.gov/elibibility.htm.

In many instances, an eligible veteran may pay only closing costs and no down payment; however, 100 percent financing of the appraised value of the house can be done only once with a VA loan. Modestly priced houses are suited for VA loans. VA loans include a 1.875 % funding fee (which is lower if there is a down payment of 5% or more) which the borrower pays at closing or is in the mortgage.

THE FEDERAL NATIONAL MORTGAGE ASSOCIATION

Fannie Mae has programs to help buyers who have limited cash for a down payment and closing costs. The “Fannie 3/2” Program is available from local lenders to limit required down payments for qualified buyers. “Fannie 97” helps the homebuyer who can handle monthly mortgage payments but doesn’t have cash for the down payment. It requires only a 3% down payment from the borrower’s own funds, and the borrower needs to have only one-month’s mortgage payment in cash savings, or reserves, after closing. Some programs have come into being to help banks liquidate homes owned by Fannie Mae because of the foreclosures resulting from the financial crises of 2009. The HomePath Mortgage Financing program is available from local and national lenders. Borrowers who meet certain income criteria may qualify for a 97% loan-to-value mortgage and may obtain their down payment from a gift, grant, or loan from a nonprofit organization, state or local governments, or employer. The HomePath Renovation Mortgage Financing program is a comparable program available only on homes that will be a primary residence that are in need of light renovations. For more details on these programs go to http://www.fanniemae.com.

SHOULD YOU PAY POINTS?

You can buy yourself a lower interest rate on a mortgage loan by paying points. Essentially a point is prepaid interest and can be paid in full at the time of closing or rolled into the loan. One point is equal to one percent of the loan amount. For example, a bank may advertise that the price of a 30–

year loan is 8% with zero points, or 7.5% with one point. What this means is that if, at closing, you pay the lending institution one percent of the amount borrowed, you can buy yourself the lower rate.

You can use points paid on a new mortgage as a tax deduction. However, when you refinance a loan you can use only a part of the points you have paid as a tax deduction in the year you take out the loan—the bank amortizes the rest over the loan period.

Assuming you can afford it, should you buy yourself a lower interest rate by paying points up–front? If you plan to stay in the house for a long time, the answer is yes. If you plan to stay in the house for a short while, the answer is no. For example, if you paid $1,000 in points, how long will it take you to save $1,000 due to the lower interest rate? If you calculate that it will take seven years, but you only live in the house for five years, then you lose.

WHEN SHOULD YOU REFINANCE YOUR MORTGAGE?

Sometimes it makes sense to replace your present mortgage with a lower interest rate mortgage. Generally, lenders limit refinancing to 75 percent of the current market value of the house. So if you have sufficient equity in your house, when should you consider refinancing? A traditional rule of thumb is the “Two-Two-Two” rule: if you have lived in your house for at least two years, the new interest rate is at least two percentage points below your present interest rate, and you plan to stay in the house for at least two more years, consider refinancing.

Some financial advisors suggest refinancing even if the spread between your current interest rate and the market interest rate is less than two percentage points. For example, if you have a fixed rate loan and a large balance due on your mortgage, or if you plan to live in the house for many years, you can realize savings with less than a two-point spread.

If you are considering refinancing, contact your current lender first, who may be willing to waive some of the expenses, especially if you have had your present mortgage for a short time. Your current lender may be able to save you money on such things as the title search, inspections, and so on. Also, if you use the lawyer who did the original mortgage to do the refinancing; your expenses could be less because he may already have the pertinent information on file. Otherwise, the expenses of refinancing are the same as with the original mortgage.

When considering refinancing your mortgage, don't forget that any points you pay are not tax deductible in the year you pay them, but that the cost has to be amortized over several years. If you pay points, this will add to the expense of refinancing.

CAPITAL GAINS TAXES

What is a capital gains tax? When you buy something and then sell it for a higher price than you paid for it, you may owe a tax on the difference between the buying price, which is the base price, and the selling price. A capital gain is the difference between the base price and the selling price. For example, if a capital gains tax applies to your situation, then when you make a home improvement, the IRS views the expense as part of the price you paid for the house. Therefore, your base price increases by the amount of the home improvement.

By raising your base price, you lower your tax liability. For example, let's suppose you bought your house for $90,000 and spent $3,000 on home improvements. Were you to sell the house for $100,000, your capital gain would be $7,000, rather than $10,000, because you have raised the base price by $3,000.

However, there is a difference between improvement and upkeep. For example, the cost of a new fence would raise your base, but upkeep is not considered. Upkeep does not raise your base price. Keep all receipts of home improvements for tax purposes.

Do you have to pay a capital gains tax on a house if you sell it for more than you paid for it? You can exclude $250,000 in profit from the sale of your main home. If you are married, the government allows you to exclude a total of $500,000. What do I mean by main home? You need to have owned and lived in the home for a minimum of two years. These two years do not necessarily need to be consecutive as long as they are within the past five years. You can use this "2 out of 5 year rule" to exclude your profits from the sale of your home each time you sell. You can only use this exclusion once every two years. However, there are exceptions:

- You can exclude a part of the gain if you are relocating with your current company or because you are switching companies.
- If you are selling your house for a medical or health reason, you will have to document it. This is not like a letter from mom and dad that you used to get for school. You will need a letter from your physician filed away with your personal records in case

of an audit. You may want to get more supporting documentation on top of the letter like scans, results, and treatment.

- If you must sell your house for something unforeseen, then the above suggestion to maintain documentation stays true. The IRS says an unforeseen circumstance is "the occurrence of an event that you could not reasonably have anticipated before buying and occupying your main home." What are a few examples? Natural disasters, war, terrorism, employment, death, divorce, separation, or multiple births from the same pregnancy are some examples.

If you meet one of the three exceptions noted above, you are eligible for a partial exclusion. You are essentially pro-rating your exclusion based on the amount of time you lived in your house. You take the amount of months you lived in the house, divide it by 24 months (two years), and multiply that by $250,000, or $500,000 if you are married. For example, if you and your wife live in a house for 12 months but then must sell it because she had triplets, you would be entitled to exclude: (12/24) $500,000=$250,000. You must count anything over a $250,000 as a capital gain.

If you owned your home for one year or less, you must report the gain as a short-term capital gain. If you owned the house for more than one year, you must report the gain as a long-term capital gain. Cost basis is an important factor to figure out when trying to estimate what your capital gains tax will be. Your cost basis will be influenced by the purchase price + purchase costs (escrow, realtor) + improvements + selling costs (escrow, realtor) – accumulated depreciation (home office) = Cost basis. Once you know your cost basis, obviously your selling price, the cost basis will give you either the gain or the loss.

At the time of this writing most home sellers will not be affected by a capital gains tax because for most sellers on today's market the selling price is less than the amount of the outstanding mortgage; this is what is called "being under water." It is common today for someone to owe, let us say, $400,000 on a house, but the market price is only $200,000. For this reason, many of these people are simply walking away and leaving the house to be reposed by the lender. Of course, what goes down can go back up. In other words, if you buy a house when prices have hit the bottom, then in future years when you sell the house you will have a capital gain.

REAL ESTATE SHORT SALES

The bursting of the real estate bubble associated with the financial crises of 2008-2009 increased the use of real estate short sales. A real estate short sale is the sale of a property in which the proceeds are less than the balance owed on a loan secured by the property sold. This procedure is an effort by mortgage lenders to come to terms with homeowners who are about to default or are defaulting on their mortgage loans. You must obtain a broker's price opinion or an appraisal to estimate the probable selling price of the property for the purposes of the short sale. The short sale typically occurs to prevent home foreclosure by finding the economic means for the mortgage lender, often a bank, to recover as much of the loan balance owned on the property as possible.

In a foreclosure, the borrower typically cannot make scheduled mortgage payments and the lender repossesses the property in an effort to recover the loan balance. The lender will agree to a short sale only if they believe that the proceeds generated by the sale will bring a lower loss than foreclosing on the property. You may be able to get a good deal buying a house via a short sale. Keep an eye out in the local newspaper for short sales where you want to buy.

HOW TO BUY AND SELL A HOUSE

A real estate agent can be helpful when you are house hunting. An agent can show you a wide range of houses and act as a mediator between you and the seller. Conversely, when you are on the selling end, the agent's job is to find a qualified buyer and handle the complexities of the transition.

Most real estate companies get 6% of the selling price—3% going to the listing agent and 3% going to the selling agent. The area you live in and the market at the time will largely determine who pays what and how much. For example, in a depressed market the seller may pay most of the 6 percent to attract buyers. In a booming market, the buyer will pay most of the 6 percent. In addition, if necessary, the real estate company will take a cut and accept less than the standard fee to make a sale.

If you are interested in a house but want a "second opinion", enlist the services of a home inspector. For a reasonable fee, a home inspector will check out a house from top to bottom, inside and out, to determine if it's as sound as it is appealing.

A good real estate agent can be invaluable when you're on the selling end of the housing market. An agency can expose your house to a wider circle of prospective buyers in a shorter time than you could. They are also up to date on the legalities of real estate and can eliminate much of the hassle of selling a house.

If you can stand the hassle, however, there are benefits to selling a house yourself. The best-case scenario would be to sell at the price an agency could fetch while pocketing the commission. Short of this, you could sell for what you would receive using an agency minus 6% and not lose anything. This is an attractive idea if you need a buyer in a hurry and can offer a price lower than market value.

Never sell a house without having it appraised by a professional appraiser and never sell a house without the help of a lawyer. An appraiser will make sure that the price you ask is in line with the market price. This is important for two reasons. Most importantly, the first people who look at your house are usually your best prospects. If the price scares them off, typically they will not be lured back later by a lower price. Secondly, banks will not grant a mortgage loan for an amount beyond the appraised value, so you must price your house accordingly.

It is essential that you properly handle, with the help of a lawyer familiar with real estate, the legalities of the sale to avoid legal problems now or in the future. Your lawyer will see to it that you have a disclosure statement, which makes a full disclosure of the condition of the house, or a disclaimer where the buyer buys the house "as is". These documents protect you from a lawsuit over pre-existing conditions, such as a leaking basement or faulty furnace, as long as you made them prior to the sale.

Make sure that the house looks good before you put the "for sale" sign on the front lawn. Some simple, inexpensive things can help you get your asking price, such as a few coats of paint, spruced up landscaping (a well–cut and weeded lawn and perhaps a few more colorful plants) and clean carpets and windows. Make the house as appealing as you can by having it clean and in order. A house looks smaller with too much furniture in the rooms, so get rid of the clutter. Create a homey atmosphere with fresh flowers and some fresh bread.

Permanent interior home improvements are such things as

- counters
- cupboards
- garbage disposal

- tubs
- cabinets
- lighting fixtures
- alarm systems
- built in book cases
- fireplace
- new furnace
- new water heater
- attic and ceiling fans
- telephones and telephone jacks.

Permanent exterior improvements can be such things as

- porches
- decks
- garages
- septic tanks
- driveways
- sheds
- patios
- fences
- swing sets
- gutters and drainpipes
- trees and shrubs.

Any moveable items left behind are also tax deductible. Moveable items can be such things as

- appliances (washers, microwave ovens, water hoses etc.)
- mirrors
- fireplace equipment

- game room equipment
- exercise equipment
- garden tools and lawn mowers.

Additionally, any money you spend in upkeep to help sell the house within ninety days of the sale raises your tax base. Following are examples of improvements made just before the sale that could be tax deductions:

- Paint
- Carpeting
- flooring such as linoleum
- windows
- shades and drapes

WARRANTIES

New home warranties can be a problem. Consider the case of Richard and Beverly. When the couple was considering buying a new home, the 10 year insured warranty the builder offered helped seal the deal. However, after five years of living with cracked walls and bursting pipes, the couple no longer thinks much of the warranty. After the walls began to crack and the structure started to sag, the Langford's contacted the builder. The builder then patched, painted and then added 14 piers to the foundation. When the problems continued, a dispute between the builder and the warranty company ensued, leaving the couple with a cracked foundation.

The couple found that new home warranties are sharply limited. Warranty companies who deem houses with structural defects as unsafe will void the policy. Even when companies agree to claims, payouts can be months, even years, in coming. Warranty companies have frequently provided quick fixes rather than permanent solutions to even major problems, such as faulty foundations.

Of course, most homebuyers do not encounter major problems. Of those who do and have warranties, there are few complaints. However, when buying a new home, do not assume that the warranty is the same as insurance—it is not. It is always a good idea to hire an independent home inspector before making what could be the biggest purchase of your life.

NEVER GIVE UP

What is the formula for being able to buy a house? Any banker will tell you that it is stable income, a habit of saving, and good credit. However, if your financial history is not sterling, does that mean you should simply give up on the American dream? Sometimes determination and persistence can overcome barriers to home ownership.

When Juanita began looking for a house, she quickly learned the importance of a good credit report. Several years prior to this, she had some financial difficulties that were damaging to her credit report. After spending 8 months looking for a house, she found exactly what she wanted. Her $80,000 salary as a college professor should have qualified her for a loan, but several lending institutions rejected her because she was a first time homebuyer and because she had a tarnished credit report.

At this point, she began a campaign to clean up her credit report by writing letters to some of her creditors. She asked each one to change the bad rating she had received—since it was either wrong or based on information that was old. Some creditors responded right away and others only after several letters. A big part of the problem was two charge–offs, one for $300 and the other for $500. As soon as she paid these off, the creditors were willing to remove the charge–off statements on her credit report.

At this point, she went to her bank and showed the loan officer what she had done. The bank officials were so impressed with her efforts that they decided to grant her a loan. They could tell that she was not a person with chronic credit problems, but someone who had simply gone through some financial difficulties.

If you ever feel like giving up, consider this story. When Jim and Suzie decided they wanted to buy a house after renting for several years, they ran into a roadblock. No lending institution wanted to lend them money, even though Suzie had a monthly income of $4,300 as a secretary and he was making $7,200 a month in his own business. A part of the problem was a house they still owned in another state which they needed to sell in order to have a down payment. Another problem was that Jim was self–employed for only two years. The bank was concerned that he did not have enough of a track record to assure them that he had a stable business income.

Fortunately, they found a mortgage company that went the extra mile to help them secure a loan. They were able to qualify for a loan under a community homebuyer program. What encouraged the loan company to work with the couple was the fact that they had established a strong pattern of success in the way they handled their bills.

CHAPTER EIGHT

TAXES

In 1942, lawmakers doubled income taxes and taxed millions of Americans who never paid taxes to the government. However, even at this time at the onset of WWII, many Americans were not willing to pay the new tax. In those days, taxpayers sent a check to the government once a year to pay their taxes. As spring arrived in 1943, it became clear that many citizens might not ante up and file returns. Henry Morgenthau, the Treasury secretary, confronted colleagues about the nightmarish prospect of mass tax evasion: "Suppose we have to go out and arrest five million people?"

Enter Beardsley Ruml, man of ideas. Like other retailers, he had observed that customers did not like big bills. They preferred installment payments, even if they had to pay interest to relieve their pain. Therefore, Ruml devised a plan that he unfolded to his colleagues at the Fed and to anyone who would listen in Washington. The government would get business to do its work, collecting taxes for it. Employers would retain a percentage of taxes from workers every week and forward the money directly to Washington's war chest. No longer would the worker ever have to look his tax bill square in the eye. He need never even see the money he was foregoing. Thus withholding, as we know it today, was born.

To tame resistance to the new notion, Ruml offered a powerful sweetener: The federal government would offer a tax amnesty for the previous year. It was the most ambitious bait-and-switch plan in America's history. Ruml advertised his project as a humane effort to smooth life in the disruption of the war. He noted it was a way to help taxpayers out of the habit of carrying income tax debt.

ACCOUNTANTS AND TAX ADVISORS

Richard worked at a foundry during the week and played in a band on the weekends. Not knowing anything about the tax system, he took what few tax records he had to a local certified public accountant (CPA). Thinking that the accountant would take care of everything, he was shocked to learn that he owed the government $800. Because he did not have $800, he decided to find out everything he could about taxes and the tax system.

He learned that tax preparers and tax accountants use the information you give them, but they rarely go beyond the obvious looking for ways to save you money. Once more, these professionals are more concerned with not making any mistakes then they are in taking doubtful deductions. They are also less likely to explore tax deductions that may be atypical. This was particularly true for Richard because of his sideline music business. Richard still took his taxes to a professional, but he did as much as he could beforehand.

In his quest to lower his tax liability, Richard learned the difference between the different tax advisors. An accountant will simply take what you give him and plug the numbers into the right places on the tax form without trying to save you money. A financial advisor will do more than an accountant to save you money, but even he will not scrutinize all possibilities. It is to the financial advisor's advantage to play it as safe as possible. Any professional will rather forgo a possible deduction than run the risk of being wrong. Therefore, unless you have a very complicated tax situation, consider doing your own taxes. You can use one of several tax programs on the market to help you with your federal and state taxes.

But, let's suppose that you do have a complicated situation and need help. How do you select the best tax advisor? If you are aware of any significant tax issues you expect your preparer to handle, look for someone experienced in that area. For example, if you have a sideline business in the form of a Limited Liability Corporation, you want a lawyer experienced in business taxes. Or if you have recently sold some property at a loss, you want a tax preparer knowledgeable in real estate.

Select a tax preparer who has been in business for several years. Should you opt to work with a less experienced preparer, be sure he or she has access to experienced professionals who can address any complex tax issue that may arise. The complexity of your return, not necessarily the amount of your income, should guide you in whether you need help, and, if so, in selecting a preparer.

There are essentially five categories of preparers:

- A certified public accountant, or CPA, is an accountant who has passed an examination that includes an entire section on tax issues. Many of them specialize in taxes, but others may emphasize different areas such as auditing financial reports for companies. If they are members of the American *Institute of Certified Public Accountants*, they must meet continuing education requirements. They can represent you when dealing with the IRS.

- An enrolled agent is a person who has earned the title by passing a two–day, four–part examination given by the IRS, and who has had a background check by the IRS. Enrolled agents must complete 72 hours of continuing education every three years. If they belong to the national association, they must complete 30 credit hours of course work each year. This title has been in existence since 1884.

- Commercial agents are persons who work for national chains, such as H & R Block, during the tax season. By way of training they provide a 12-week course every year for their agents. Upon completion of the course, a person will take a three-hour exam. H&R Block gives those who pass the exam four additional weeks of training in computer preparation of tax forms and in updated tax regulations.

- There are accountants who do taxes but who do not have a CPA designation. Many of these people are tax advisors but have not taken the exams and are not obligated to meet the experience requirements of other preparers.

- Tax attorneys, like CPAs and enrolled agents, can represent you before the IRS. They must meet regulatory and continuing education requirements to keep their designation. Most tax attorneys, however, do not specialize in tax return preparation except for estate taxes. Most of them are involved in tax planning and tax litigation.

Some tax preparers work for a fixed fee based on the number of forms to be completed; others charge hourly rates. In either case, be sure to clarify in advance how much or on what basis the preparer will charge you to do your return. No matter how much you pay to have your taxes done, ultimately you are responsible for the accuracy of your tax return.

HOW DOES OUR TAX SYSTEM WORK?

America's basic federal income tax law is very simple, but the exceptions to the rule run thousands of pages, making it so complicated that no one can comprehend the whole thing. However, here is how it works. At the end of the year you have X number of dollars in income; this is your gross income. From this gross income, there are two subtractions - exemptions and deductions.

Exemptions represent people you are financially responsible for who meet the government criteria as a dependent, including yourself. Each exemption is worth X number of dollars. You count as one exemption, your spouse counts as one exemption (if filing a joint return) and each of your dependent children counts as an exemption. For example, if you claim five exemptions and an exemption is worth $2,000, $10,000 escapes taxation. The government subtracts this amount from your gross income.

The second category is deductions. For example, if you are paying on a mortgage, the interest you pay can be a deduction from your tax bill; another example is the money you give to charity. If these two categories (exemptions and deductions) are greater than the government stipulated standard deduction for that year, you fill out the long form and itemize your deductions. The standard deduction will depend on your filing status. If your exemptions and deductions are less than the standard deduction you qualify for, you can use the short form and simply claim the standard deduction. Now there is no need to itemize anything.

After you subtract your exemptions and deductions, or take the standard deduction, you arrive at your taxable income. Then you compare this taxable income with the current tax table, and deduce how much you owe in federal income taxes for the year. If you paid more than this amount during the year, you are eligible for a refund. If you paid less than this amount during the year, you owe the government the difference.

What is a Progressive Income Tax System?

The federal income tax of the United States is a progressive income tax. A progressive tax levies a lower tax rate on low-income people than on high-income people. With this form of tax system, the government taxes every dollar at a certain rate depending on which tax bracket that dollar falls. As your income increases, eventually additional dollars earned above a certain income level the government will tax at a higher rate than those dollars earned at the lower level. Following is an explanation of how a progressive (graduated) income tax system might work according to the tax law of 2009. The figures below reflect taxable income, income after allowances for exemptions and deductions.

Let us suppose you are filing as a *Single Person*, in this case:

- For every dollar you earn between $0 and $8,350 you will owe 10%.
- Between $8,350 and $33,950 you will owe 15% on each dollar.
- Between $33,950 and $82,250 you will owe 25% each dollar.
- Between $82,250 and $171,550 you owe 28% each dollar.
- Between $171,550 and $372,950 you will owe 33% for each dollar.
- For every dollar you make above $372,950 you will owe 35%.

This is what it would look like if you were Married Filing Jointly:

- For every dollar you earn between $0 and $16,700 you will owe 10%.
- Between $16,700 and $67,900 you will owe 15% on each dollar.
- Between $67,900 and $137,050 you will owe 25% each dollar.
- Between $137,050 and $208,850 you owe 28% each dollar.
- Between $208,850 and $372,950 you will owe 33% for each dollar.
- For every dollar you make above $372,950 you will owe 35%.

This is what it would look like if you were filing as Head of Household:

- For every dollar you earn between $0 and $11,950 you will owe 10%.
  - Between $11,950 and $45,500 you will owe 15% on each dollar.
  - Between $45,500 and $117,450 you will owe 25% each dollar.
  - Between $117,450 and $190,200 you owe 28% each dollar.
  - Between $190,200 and $372,950 you will owe 33% for each dollar.
  - For every dollar you make above $372,950 you will owe 35%.

This is what it would look like if you were Married Filing Separately:

- For every dollar you earn between $0 and $8,350 you will owe 10%.
- Between $8,350 and $33,950 you will owe 15% on each dollar.
- Between $33,950 and $68,525 you will owe 25% each dollar.
- Between $68,525 and $104,425 you owe 28% each dollar.
- Between $104,425 and $186,475 you will owe 33% for each dollar.
- For every dollar you make above $186,475 you will owe 35%.

WHAT ABOUT YOUR TAX RETURN?

What should be your goal in terms of your end of year tax situation? Your goal should be to be eligible for a tax refund, but not too much of a refund. You should not view a tax return as a form of savings. For one thing, you are not earning any interest, and for another thing, you have no control over this money as long as the government has it. Instead of getting a big tax return, beef up your automatic savings and then use some of your savings to pay any taxes due if necessary.

You do not want to get back too much from the government—but you do not want to owe too much either. To prevent an audit, make sure that you have paid at least 90 percent of your tax bill by the time you file your tax return. For example, if your total tax bill is $10,000 and you have only paid $8,000 throughout the year (80% of tax owed), you could face an audit.

Can you control how much you will owe or get back at the end of the year? Yes, you can. You can control how much you get back by specifying the number of exemptions on your W–4 form with your employer. When you file your tax return, you must claim what the tax law entitles you. However, on your W–4 you are allowed to claim from one to sixteen exemptions; the more exemptions you claim the less money your employer takes out of your paycheck. Conversely, you can request that your place of employment take out additional money from your paychecks beyond the exemptions. If you think you will get back too much, you can lower the number of exemptions on your W–4. If you think you will owe too much, you can increase the number of exemptions and/or request X number of additional dollars be taken out of your paychecks. The easiest way to determine this is to consider your last year's tax situation. If your tax situation this year will not change too much from last year and you are unsatisfied with your tax picture from last year, adjust your W-4 form with your employer so that your situation will be different next year.

The deadline for filing your taxes is April 15. If you want more time, get all your records in order and you can automatically get an extension by filing IRS Tax Form 4868. Filing this form will give you an extra four months, until August 15, to submit your tax return for the previous year. You can usually receive another two–month extension if you request it in writing. This will move the due date to October 15. You can postpone the filing date, but you cannot postpone paying the taxes you owe. If you expect to get a tax return, postponement is no problem—but if you owe, you must pay interest on the money that was due on April 15. There are no penalty charges on this debt.

Filing the Short Form

Richard did not have enough deductions to exceed the standard deduction, so he filed the short form and simply claimed the standard deduction. The standard deduction is the amount all taxpayers, except some dependents, may deduct when filing an income tax return. The amount of the deduction depends on your filing status. The standard deduction increases every year to compensate tax payers for inflation. Presently the majority of all tax payers claim the standard deduction.

Schedule C

Even though Richard filed the short form, he could still file Schedule C because he owned his own business. Anyone who has a business, even a sideline business, can file Schedule C. Richard discovered that several of his business expenses qualified as deductions on Schedule C. Note that these deductions are in addition to the standard deduction and can help shield from taxes a part of your income, even income made on a job.

Following are some expenses he used as tax deductions:

- travel
- lodging
- music equipment
- music publications
- interest paid for business related expenses
- business telephone calls

Adding up all of his business income he discovered that he made $8,000. His business expenses came to $20,000. Subtracting $20,000 from $8,000 gave him a loss of $12,000. Since his taxable income from the foundry was $40,000, he could subtract the $12,000 from the $40,000, giving him a lower taxable income of $28,000. Because he was in the 15% tax bracket, he saved himself $1800 in taxes (.15 x $12,000 = $1800).

The IRS will allow a business loss for two of five years; by filling out the proper form, you can claim a third year loss. After that, however, the IRS will classify your business as a hobby and not allow you to claim a loss

If the IRS challenges the business status of your sideline activity, you can file IRS Form 5213; Election to Postpone Determination That Activity is for Profit. This delays the final determination of the activity's business status until after you have been in business for five years and gives you extra time to qualify the activity as a business. In the meantime, you can claim business deductions. However, if the activity fails to qualify as a business at the end of the five–year period, you will owe back taxes and penalties.

After talking to other people about his tax situation, Richard found several others who were using a sideline business to shelter some of their income from taxes. For example, Bill was a friend who loved to go to the car races every weekend. He was also an avid photographer. After reading up on how to save money on his taxes, he learned to combine these two interests to cut his tax bill. He simply used his camera to take pictures at the racetrack, then developed, enlarged and laminated them. Now every time he went to the track he hawked his pictures and was able to sell several each time. This was sufficient to qualify his activity as a business expense.

Following are some examples of Bill's business expenses as a sole proprietor. Notice how Bill was able to turn his hobbies into business deductions.

- cameras
- film
- dark room equipment and chemicals
- postage
- film publications
- laminating expenses
- bank charges on a business account
- travel to and from the frame shop and the race track
- copying expenses
- tickets to the race track

Your objective is to make money on a sideline business while shielding as much income as you can from Uncle Sam. Does the government expect you to arrange your tax affairs to save money on taxes? Read what Judge Learned Hand once stated.

> *"Anyone may so arrange his affairs that his taxes shall be as low as possible. He is not bound to choose a pattern that will best pay the Treasury. No one owes any public duty to pay more than the law demands."*

KEEPING CAREFUL RECORDS

You should always pre-plan rather than post-planned. If you think about taxes only when you do your tax return, it is too late. You must plan this year to save money on your taxes next year. This is especially true if you have a sideline business. You should have receipts for everything as well as a way to itemize your tax-deductible mileage and your business expenses.

Use something to keep track of your tax receipts. That something can be a pouch, a file folder, or a glass jar. Label it “tax receipts” with the tax year. Now all business related tax receipts go into the container. Enter expenses using a spreadsheet or a financial program. Remember, organization and good record keeping are keys to financial success.

A logbook is necessary whenever you drive a car for business purposes. For example, let us suppose that you drive 50 miles for some supplies. Keep a logbook in your car and enter the odometer reading at the beginning and end of the trip. The difference between the two, 100 miles, is the mileage you can use as a tax deduction.

How much is the 100-mile trip worth to you? If you are allowed a deduction of 25 cents a mile, then your tax deduction is worth $25 (25¢ x 100 = $25). If you are in the 15% tax bracket, this is a savings to you of $3.75 (.15 x $25 = $3.75). If you are in the 28% tax bracket, the deduction is still $25, but it is worth $7.00 to you in lower taxes (.28 x $25 = $7.00).

Use a calendar to record your mileage as you may have to prove that a trip is a business expense. Keep track of who you met and why. Also, get receipts for any business expenses. If a store clerk gives you a generic receipt, get the receipt stamped with the company's name and address. A credit card is useful to keep track of business expenses.

A separate checkbook for business will help you keep your business expenses separate from your personal expenses. This will help you at the end of the year when you do your tax return. If you do it right, all checkbook entries are business expenses. A checkbook with your company's name on it will also help verify that you own a business.

THE HOME OFFICE

If you have a small part time, home-based business, you can use certain related expenses as tax deductions—provided you claim a profit. If you cannot claim a profit without the home office deduction, you cannot claim the home office deduction. If you qualify, you can claim a deduction based on the square footage of your office. This is how it works. Based on a rental or mortgage payment of $1,000 monthly and office space that takes up 10% of your living quarters, you have a tax deduction of $100 (10% x $1,000). The same is true for rental insurance, utilities and cleaning expenses.

Claiming your home office as a business expense can be a tricky matter, however. For one thing, you have to show that you use your office for business and nothing else. Do you have a television in your office? Do you sometimes watch it for pleasure? If yes, you may not use the home office deduction.

Also what the government gives with one hand, it takes away with the other hand. If you declare a home office expense of $2,000, for example, and then sell your home, your base has to reflect the $2,000 deduction. Suppose that you bought the house for $100,000 and sell it for $120,000, giving you a profit of $20,000. But if you claimed $2,000 as an office deduction in the past, then your base is $98,000. Therefore, your profit is $22,000 rather than $20,000, increasing your tax liability.

CORPORATIONS

Because of low liability risk, Lewis claimed himself as a sole proprietor on his tax form. A sole proprietor is one who exclusively owns and operates a business, having no partners and selling no stock. If he were more vulnerable to lawsuits, however, he would have paid a couple hundred dollars and formed a Chapter S Corporation or a Limited Liability Corporation (LLC). Chapter S Corporations are for small businesses who want legal protection.

Some business owners are more prone to liability than others are. For example, consider Sam who owned his own gas station. One day a customer slipped on a grease slick and broke his back. The customer then sued Sam for damages. When his insurance company found reason not to pay for damages done, Sam lost everything— his savings, his business, his house, his cars and even his marriage.

Sam would have been better off forming a Chapter S Corporation, which keeps the assets of the business and one's personal belongings separate. If Sam had formed a Chapter S Corporation, he would have lost his business, but not his personal assets. This is because the law recognizes a business as a person.

Similar to a Chapter S Corporation is a Limited Liability Corporation. A limited liability corporation (LLC) offers the tax and legal advantages of partnerships and S corporations yet operates under fewer restrictions. Unlike S corporations, LLCs automatically dissolve if even one member dies, resigns or goes bankrupt—unless all the remaining members vote to keep the company going. Any LLC member can withdraw from the business at any time and demand a payment from the other members equal to the fair market value of his or her interest in the business. And unlike stockholders in an S corporation, LLC members cannot sell or transfer their management rights to investors outside the LLC without approval of the co–owners.

ITEMIZED DEDUCTIONS

If you were to put all the federal income tax manuals in one stack, the stack would be fifty feet high and would be about fifty thousand pages long! The result is that we have a tax law that is so complicated that no one can understand all of it. Consequently, do not be afraid to take any deductions that you think you qualify. Just be sure that you keep accurate records of everything you claim and can justify all your claims. If you do not qualify for filing the long form, that is, your total deductions do not exceed the standard deduction, and must therefore file the short form and claim the standard deduction, can you take advantage of any loss you incurred through a business? The answer is yes. You can file a Schedule C even if you file the short form. Conversely, you have to claim a profit if you made a profit.

If you file the long form, the interest you pay on your mortgage will probably be your largest deduction. Except in cases of points paid on a refinanced mortgage loan, any interest you pay is fully deductible in that same year. Any interest you pay on a home–equity loan for amounts up to $100,000 and any interest you pay on loans used for investments are fully deductible in the year you pay the interest.

Be careful, however, when you claim interest on a loan when the money is used for investment purposes. In this case, you can only claim a deduction up to the amount of income you make from that investment. For example, if you pay $5,000 interest on a loan where the money was used for an investment, but do not claim a profit on that investment, you cannot declare the $5,000 as a tax deduction, even though it is a business expense.

Medical, dental, and hospital expenses (not paid by insurance) that go beyond a certain percentage of adjusted gross income are tax deductible. Following are examples of medical expenses:

- medicine and drugs
- medical insurance premiums
- medical services and medical equipment

- home improvements made for the physically disabled
- and transportation costs related to medical services

The IRS allows taxpayers to deduct certain types of taxes. The three main categories are property taxes (house and land), personal property taxes (automobiles and boats, etc.), and income taxes (state, local, and foreign).

Another category is casualty or theft loss (not paid by insurance) that goes beyond 10 percent of adjusted gross income. Following are some deductible losses:

- casualty losses incurred by storms
- vandalism and fires totaling more than $100
- theft of money or property totaling more than $100 (substantiated by a police report)
- mislaid or lost property if the loss results from an identified event that is sudden, unexpected, or unusual.

You can deduct miscellaneous expenses that exceed 2 percent of your adjusted gross income. Following is a list of miscellaneous expenses:

- union or professional association dues and membership fees
- IRA custodial fees
- purchase and maintenance of specialized clothing needed on the job (hard hats, protective shoes, gloves etc.)
- uniforms that would not be worn for private use
- tax counsel and tax preparation fees (includes cost of computer tax programs)
- books and periodicals used in a profession
- fees paid to secure employment through an employment agency
- costs of traveling between two jobs
- medical examinations required but not paid for by an employer
- transportation cost for job hunting in one's present career

- expenses for typing, printing, career counseling, and mailing resumes for seeking a job in one's present career
- miscellaneous expenses that allow 100 percent deductions include gambling losses not offset by gambling income and business expenses for handicapped persons.

Deductions that anyone can take advantage of when filing the long form are charitable contributions, that is cash contributions (meaning bank checks, certified checks etc.) to qualified organizations such as churches, schools and other nonprofit groups. The federal government must certify any nonprofit organization. Be careful on this one. For example, let's suppose that you give $2,000 to your church and deduct that amount from your taxes. If in an IRS audit the government finds that your church has not officially applied for and received tax exemption status, it will disallow the deduction.

Donating old clothes and other items to a thrift shop or your church can save you money on your taxes. The receiving institution will give you a receipt for the items and you write down the value. You can claim up to a certain dollar amount. A word of caution, do not claim the maximum amount allowed as this might raise a red flag. Also travel expenses incurred while doing volunteer services for a charitable organization are tax deductible.

Notice here that there is a bit of unfairness in this tax system. If you are well off enough financially and can afford to borrow a large sum of money to buy an expensive house, this should qualify you for the long form. Now, suppose you give your church $2,000; this $2,000 can be used as a tax deduction. However, suppose that you cannot afford to buy a house and you rent. Now suppose you give a $2.000 offering to your church, you cannot use the $2,000 as a deduction because you filed the short form. Let us say you are in the 15% tax bracket, 15% of $2,000 is $300. Because you could afford a house, the government gives back to you $300, but if you could not afford to buy a house, you do not get the $300.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a refundable credit that is available to certain individuals and families who have low-to-moderate levels of earned income (wages, salary, tips, bonuses & net earnings from self-employment) and are taking care of at least one or two minor children. In certain cases, a taxpayer with low earned income and no children may also qualify. A refundable credit is a tax credit that you can use to generate a refund even if you have no tax liability.

The IRS has a variety of tools available to see if you qualify. You can access them at http://www.irs.gov/individuals/

Higher Education Tax Credits

For 2009, there are three tax credits available to help you offset the costs of higher education by reducing the amount of your income tax. They are the Hope Credit, the Lifetime Learning Credit and the American Opportunity Credit.

The HOPE Scholarship Credit allows taxpayers to claim a maximum credit of $1,500 (100 percent of the first $1,000 of tuition and fees and 50 percent of the next $1,000 of tuition and fees) for expenses paid on behalf of the taxpayer, the taxpayer's spouse, or a dependent for the first two years of post-secondary education at an eligible institution. You must be enrolled at least a half-time basis for at least one academic period during the year for the expenses to be qualified.

The Lifetime Learning Credit allows you to claim a lifetime learning credit of up to $2,000 ($4,000 for students in Midwestern disaster areas) for qualified education expenses paid for all eligible students. There is no limit on the number of years that you can claim the lifetime learning credit.

A tax credit reduces the amount of income tax you may have to pay. Unlike a deduction, which reduces the amount of income subject to tax, a credit directly reduces the tax itself. The lifetime learning credit is a nonrefundable credit. This means that it can reduce your tax to zero, but if the credit is more than your tax, the government will not refund the excess to you. The government may limit your allowable lifetime learning depending on your income and the tax.

The American Opportunity Credit covers your tuition and certain related expenses (including student activity fees) required for enrollment or attendance at an eligible educational institution. Books, supplies, and equipment needed for a course of study are included even if not purchased from the educational institution. This credit does not include expenses for room and board and does not include expenses for courses involving sports, games, or hobbies (including noncredit courses) that are not part of your postsecondary degree program.

There are several differences between these three credits. For example, you can claim the American opportunity credit based on your expenses for no more than four tax years, which includes any tax years you claimed the Hope credit. However, there is no limit on the number of years for which you can claim a lifetime learning credit based on your expenses.

Individual Retirement Accounts

An Individual Retirement Arrangement (or IRA) is a retirement plan account that provides some tax advantages for retirement savings in the United States. There are a number of different types of IRAs, which may be either employer-provided or self-provided plans. The types include: Traditional IRA, Roth IRA, SEP IRA, SIMPLE IRA, Self-Directed IRA, Coverdell Education Savings Account.

With a Traditional IRA contributions are often tax-deductible (often simplified as "money is deposited before tax" or "contributions are made with pre-tax assets"). All transactions and earnings within the IRA have no tax impact, but the government taxes withdrawals at retirement as income. Depending upon the nature of the contribution, a traditional IRA may be referred to as a "deductible IRA" or a "non-deductible IRA."

Established by the Taxpayer Relief Act of 1997 (Public Law 105-34), a Roth IRA (Individual Retirement Account) can invest in securities, usually common stocks or mutual funds (although other investments, including derivatives, notes, certificates of deposit, and real estate are possible). As with all IRAs, there are specific eligibility and filing status requirements mandated by the Internal Revenue Service. A Roth IRA's main advantage is its tax structure.

In contrast to a traditional IRA, contributions to a Roth IRA are not tax-deferrable. Withdrawals are generally tax-free, but not always and not without certain stipulations. An advantage of the Roth IRA over a traditional IRA is that there are fewer withdrawal restrictions and requirements. Transactions inside the Roth IRA account (including capital gains, dividends, and interest) do not incur a current tax liability.

A SIMPLE IRA is a type of tax-advantaged employer-provided retirement plan in the United States that allows employees to set aside money and invest it to grow for later use. The SIMPLE IRA is funded by a pretax salary reduction. Like other salary reduction contributions, these deductions are subject to social security, Medicare, and FUTA taxes. Contribution limits for SIMPLE plans are lower than for most other types of employer-provided retirement plans: $11,500 for 2010, as compared to $16,500 for convention defined contribution plans (Section 402(g) limit) like 401(k), 401(a), and 403(b) plans. For the non-profit 501(c)(3) employer, there is no advantage in establishing a SIMPLE plan over a 403(b) plan since the 403(b) does not require any more expensive administration.

A Self-Directed Individual Retirement Account (SDIRA) is an IRA that requires the account owner to make investment decisions and investments on behalf of the retirement plan. IRS regulations require that either a qualified trustee or custodian hold the IRA assets on behalf of the IRA owner. The trustee/custodian will maintain the assets and all transaction and other records pertaining to them; file required IRS reports; issue client statements; assist in helping clients understand the rules and regulations pertaining to certain prohibited transactions; and perform other administrative duties on behalf of the Self-directed IRA owner for the life of the IRA account. Self-directed IRA accounts are typically not limited to a select group of asset types (e.g., stocks, bonds, and mutual funds), and most truly self-directed IRA custodians will permit their clients to engage in most investments, if not all, of the IRS permitted investment types (an almost unlimited array of possibilities including foreign real estate). Some of the additional investment options permitted under the regulations include, but are not limited to, real estate, stocks, mortgages, franchises, partnerships, private equity and tax liens.

The plan allows parents and guardians to make nondeductible contributions to an education IRA (Coverdell ESA) for a child under the age of 18. This is a tax-deferred trust account created by the U.S. government to assist families in funding educational expenses for beneficiaries 18 years old or younger. While more than one ESA can be set up for a single beneficiary, the total maximum contribution per year for any single beneficiary is $2,000. Formerly called an education IR, the ESA allows families to increase investment earnings through tax-deferral as long as the funds you use the funds for educational purposes.

For example, if you contributed $500 to an ESA and it appreciated to $5,000 in 10 years, the government would tax the earnings. When the contributions are distributed, they are tax-free assuming that they are less than the account holder's annual adjusted qualified education expenses.

In the event that the distributions are higher than the expenses, the government taxes the gains at the account holders' rate, rather than the contributor's rate, which is typically higher.

Capital Gains Taxes

States tax transactions like dividends and capital gains. Equity is the value of an ownership interest in property, including shareholders' equity in a business. A capital gains tax (abbreviated: CGT) is a tax charged on capital gains which is the profit realized on the sale of a non-inventory asset that was purchased at a lower price. The most common capital gains are from the sale of stocks, bonds, precious metals and property.

Estate Taxes

The estate tax is a tax imposed on the transfer of the "taxable estate" of a deceased person. The estate tax is one part of the Unified Gift and Estate Tax system. The other part of the system, the gift tax, imposes a tax on transfers of property during a person's life; the gift tax prevents avoidance of the estate tax should a person want to give away his/her estate.

In addition to the federal government, many states also impose an estate tax, with the state version called either an estate tax or an inheritance tax. Since the 1990s, opponents of the tax have used the pejorative term "death tax." If you leave an asset to a spouse or a charitable organization, the tax usually does not apply. The government imposes a tax on other transfers of property made as an incident of the death of the owner such as a transfer of property from an intestate estate or trust or the payment of certain life insurance benefits or financial account sums to beneficiaries.

THE TAX AUDIT

The IRS uses three different criteria in an audit. Random selection is one criterion. No matter what your income is or how many deductions you have, everyone has a small chance for an audit.

The next group is via a target group selection. If you are a part of a target group, you have a greater chance that the IRS will audit you. Who is in this group? The IRS will more likely audit people in groups from whom they believe they can collect the most money for their time. People in this group are doctors, lawyers, dentists, accountants and business executives.

A point system is the third criterion. Under these criteria, the IRS compares the deductions on your tax form to what they consider the norm for a person in your profession with a similar income and living in your area. The greater the difference between your tax return and the norm, the higher the number of points you receive. If your score gets too high, you have a chance that the IRS will audit you. If a computer selects you, two IRS agents have to agree that there is a good chance of collecting additional taxes or they will not audit you.

Federal law says that the "time and place for an audit must be convenient to both parties." To gain more time, simply send a certified letter saying that the time is not convenient for you. This will automatically postpone the audit. After several postponements, you will get a call from someone to set up a time that is convenient for you. Before you agree to an audit, you need to get some information from the auditors. Ask the IRS to give you in writing the answers to the following questions:

- Why are you being audited?
- Why does the IRS believe that they can collect more taxes from you?
- Is there an error on your tax return that could be rectified without a formal audit?
- Can you furnish copies of pertinent documents by mail?
- Which parts of your return is the IRS auditing?

The IRS has to give you specific answers and must limit the audit according to the answers to these questions. You also have the right to know exactly what papers you need to bring to the audit. This is where your organization and detailed record keeping will pay off. The more organized you are, the smoother the audit will go for you.

Consider the following if the IRS audits you:

- The auditor has the right to look at your documents only once. If an auditor wants to look at your papers a second time, he has to get permission from the U.S. Secretary of the Treasury.
- Do not leave any papers that you do not have copies of yourself. If the IRS misplaces any of your important papers, you are still responsible for verification of anything on your return.
- Never offer any information that the government does not ask. Do not get into a casual conversation with the auditor!
- Do not complain about the tax system.
- And always be polite and act with confidence.

There are alternatives if you do not agree with the outcome. You can ask to see the supervisor who will hear your concern and may decide in your favor. You can contact the *Problem Resolution Office of the IRS* (800 829-1040). The IRS set up the Problem Resolution Office to be a mediator between taxpayers and the IRS; they have the power to resolve taxpayers' disputes.

If you are still not satisfied, you can always take the IRS to small claims court**.** This sounds serious, but it is a simple thing to do, especially if the dispute is less than $10,000. You are not required to have an attorney and the procedure is informal. The judge simply hears both sides of the story and decides. The decision made at this point is final.

If the taxes in dispute are greater than $10,000, using the regular appeals and review system is necessary. Here you will need the advice of a lawyer, as the process is more complicated.

The statute of limitations in tax cases is three years from April 15 of the year the disputed taxes were filed or from the date you filed the return, whichever is later. If you have understated your taxable income by more than 25 percent, the statute of limitations is six years. You also have three years to amend a return and two years to claim any overpaid taxes.

THE PRICE OF CIVILIZED SOCIETY

When Justice Holmes uttered his now famous remark that taxes were the price we pay for a civilized society, the year was 1904. Federal, state and local taxes combined were $20 per person (in 1904 dollars) and only $340 per person in inflation adjusted 1999 dollars. Now, according to a Tax Foundation Special Report, the "Price of Civilized Society" is about $41,000 for every man, woman and child in the United States and about $116,000 per taxpayer. It takes the average American 1/3 the year of earning income just to pay taxes!! Go to http://www.usdebtclock.org/ for the latest statistics on the federal debt.

WHY DO AMERICANS PAY SO MUCH IN TAXES?

Americans pay more and more in taxes each year. For example, in 1930 the average income person had to work only 18 days out of the year to pay his total taxes. What has changed? One reason Americans pay so much in taxes is that each exemption is worth less than was the case in earlier years. As discussed above**,** exemptions exempts X number of dollars from taxation. However, the total amount the average taxpayer can claim as an exemption is a lot less than was the case in earlier years.

For example, in 1948, four exemptions would have shielded almost 70% of your income from federal income tax—today the same four exemptions will shield only 17% of your income from federal taxes.

Congress passed the *Omnibus Budget Reconciliation Act of 1993* on August 10, 1993. This act increased taxes for nearly everyone, especially high income people, and it limited deductions. Then in the years 2001 to 2003, we experienced a series of tax cuts that lowered the tax brackets as follows as of 2003:

- $140,000 for married individuals filing jointly and for surviving spouses
- $127,500 for heads of households
- $115,000 for single individuals
- $70,000 for married individuals filing separately
- $5,500 for estates and trusts

In addition, the IRS enacted a new 39.6 percent tax for people with incomes exceeding $250,000 per year. The IRS indexes these tax rates for inflation, which means that the thresholds will increase every year as prices increase.

The middle class is paying considerably more in taxes than in previous years, but they are contributing less as a percentage of the total tax revenue. The top 1% of taxpayers, by income, paid nearly 30% of federal taxes in a recent year, according to estimates by the Washington research group *Tax Foundation.* That is up from just over 20% ten years earlier. The bottom half of taxpayers paid less than 5% of federal taxes in a recent year, down from 7% ten years earlier.

CHAPTER NINE

BONDS & MUTUAL FUNDS

At New Life Bible College Loren learned that ministers can decline joining the Social Security System within the first two years of their ministry. Should he decide to pay into the system, he figured that it would cost him about $200 a month. Consequently, he decided to make a comparison between saving the $200 a month himself in a tax deferred savings plan and putting the money into the Social Security System. After 40 years, he figured that he would receive about $1,000 a month from Social Security and would be eligible for Medicare. After doing some research, he learned that the average return on a debt obligation, a vehicle that would pay him interest, was about 4 percent over 40 years. The average return of the Standard and Poore's 500 in the stock market was about 10 percent over a 40 year period. Basing his calculations on these numbers, this is what he found.

- A 4 percent return would give him a total of $236,397. Assuming he would continue making a 4 percent return on his savings, and assuming he quit putting more into savings at the end of 40 years, his annual income would be $9,456 or $788 a month—not considering taxes.
- A 6 percent return would give him a total of $398,310. After 40 years, if he put this money into a debt obligation that earned him a 4 percent return, his annual income would be $15,932 or $1,328 a month—not considering taxes.

- An 8 percent return would give him a total of $698,310. After 40 years, if he put this money into a debt obligation that earned him a 4 percent return, his annual income would be $27,929 or $2,327 a month—not considering taxes.
- If he put all of his savings into the stock market and earned the historic average return of 10 percent, he would have a whopping $1,265 in savings. After the 40 years is up, if he transferred this money into a debt obligation that earned him a 4 percent return, his annual income would be $50,595 or $4,216 a month.

These figures piqued his interest—but he was concerned about the effect that inflation would have on his savings over time. If he made a 4 percent return on his money but the average inflation rate was also 4 percent, his real return would be zero. One advantage to Social Security is that the government indexes payments to inflation. As prices increased every year—so would his Social Security payments. The downside to joining the Social Security System was the uncertainty of its future and that he would have no control over his money. Another downside to SS is that he can leave no inheritance.

So what did he decide to do? He decided to do both. By participating in the Social Security System, he was a part of a national system that almost everyone in America had a stake. However, as a hedge against the future, he decided to save $200 a month himself. But where should he put this money? To answer this question he decided to learn everything he could about investment principles and different savings plans.

One of the first things he learned was that no matter what he did he incurred a risk. What is the risk of getting a sure return of 4 percent on a debt obligation? The risk is the money foregone if you could have made a 10 percent return on your money. For example, let us suppose you put $200 a month into a tax-free debt obligation that gave you a return of 4 percent. How much will you have after 10 years? You would have $29,450. However, if you had put this money into stocks and earned a 10 percent return tax free, you would have $40, 970 in savings. So by putting your money into a debt obligation instead of into stocks, you lost $11,520. But what if you put your money into stocks and lose money? That's the whole point—whatever you do, you are taking a risk.

Another thing that Loren learned was the different ways that taxes affect savings. He learned that tax laws treat savings in one of three ways:

- With some savings vehicles, you pay taxes on income when it is earned and then again on the income from the investment.
- With other savings vehicles, you pay taxes on your earned income but can defer paying taxes on the return that an investment brings you.
- With still other saving vehicles, you do not pay taxes on earned income put into a savings vehicle and can defer paying taxes on any return.

So, if you could save $200 a month—what are your options? This and the next chapter will explore the advantages and disadvantages of different savings vehicles.

WHAT ARE BONDS AND STOCKS?

Now what is the difference between a bond and a stock? If you are a bondholder, you are a lender. You are lending money to whoever is selling the bond. All of the details of a bond are included on the bond's certificate (which is just a printed piece of paper). It states (a) the value of the bond (known as the face value) (b) the interest rate, (c) how often the interest is paid, (d) who issued the bond, and (e) the maturity date. If the business that issued the bond goes broke, you rank very high on the list of creditors in bankruptcy court. In fact, next to the IRS and the company's employees, bondholders are the highest-ranking creditors.

By contrast, a stockholder is an owner of the company. You have no idea how much money you're going to earn and there is no specific date on which your money will be returned. If the issuer of the stock does not make any money neither do you, and if the company goes broke, so do you. If the company goes bankrupt, you rank last in bankruptcy court.

GOVERNMENT SECURITIES

Although people perceive banks to be free of default risk (but not free of inflation and taxes risk), there is even a better way to avoid default risk. A better way to avoid a default risk is to invest in securities issued by the Federal Government of the United States. These investments are safe because the U.S. Government guarantees them. This guarantee, printed on each bond the issues, is a "full faith and credit obligation" of the Government of the United States of America "for timely payment of principle and interest." This guarantee is worth something because the U.S. Government has never defaulted on a loan. Bank accounts, with their federal insurance protection, are a distant second. Although with record deficits and a deteriorating economy, this could change in the future.

UNITED STATES SAVINGS BONDS

There are two ways to buy savings bonds: electronic or paper. You can open a secure online account with the U.S. Treasury through Treasury Direct (http://www.treasurydirect.gov) and manage your purchases, redemptions, and savings portfolio with no paperwork or paper bonds. You can also buy paper bonds through your local bank or through your employer's payroll deduction plan, if available. Open a Treasury Direct account online and then buy anytime, 24 hours a day, from your computer. For convenience, you can schedule recurring deductions from your personal bank account. You can even have your bank or employer send funds directly to your Treasury Direct account. As of January 2012, the IRS no longer offers paper savings bonds.

United States Savings bonds provide excellent opportunities for savers. This is true especially for elders who depend on current income from their investments and those who are saving to buy something in the near future such as a boat or a college education, and do not want to risk their principle in the short term. U.S. savings bonds are of two types - the EE bond and the I Bond. Series EE Savings Bond is a U.S. government bond purchased for 50% of its face value. At maturity, it is worth its face value. Therefore, the higher the interest rate, the shorter the time it takes to reach its face value. You can purchase EE bonds electronically at face value in any amount ($25-$5,000). Series EE Bonds earn fixed rates of interest for the life of the bonds. Fixed rates announced May 1and November 1.

A Series I Savings Bond is a U.S. government bond Sold electronically at face value in any amount ($25-$5,000). The Treasury sells I Savings Bonds at full value in standard denominations ($50, $75, $100, $200, $500, $1,000, $5,000, $10,000). Series I Bonds offer real rates of return over and above inflation. The Treasury announces new rates every year on May 1 and November 1. This means you should be earning a return greater than the inflation rate. With both bonds you can earn as much as $5,000 per year; you can earn interest for up to 30 years and redeem them after 12 months. However, if you redeem them before five years there is a three-month loss of interest. Both bonds are exempt from state and local income taxes.

BUYING U. S. TREASURY SECURITIES

The U. S. Treasury issues four types of marketable securities—Bills, Notes, Bonds, and Treasury Inflation Protected Securities (TIPS). These securities are direct obligations of the United States Government. Prevailing interest rates will determine the value of bonds in the secondary market. (Remember, a secondary market is a market in which the trading of previously purchased securities occurs). Longer-term bonds pay a higher interest rate because of the greater risk to the purchaser. The issuer of a debt obligation will be willing to pay a higher interest rate for a longer time than for a shorter time. Economists call this the risk to return ratio.

When interest rates go up, bond prices fall; when interest rates go down, bond prices rise. Why is this? When interest rates are rising, in order to attract purchasers away from alternative savings vehicles, a seller of a bond has to offer a low price. Otherwise, potential purchasers will simply go elsewhere to get a higher return. However, when interest rates are falling, the seller of a bond is put into a better bargaining position. Now, because potential purchasers cannot so easily go elsewhere to get a higher return, the seller of an outstanding bond can command a higher price.

The primary distinction between a bill, note, and a bond is the length of time, or term, it takes to mature. Treasury bills are short–term obligations issued with a term of 13 weeks, 26 weeks, or 52 weeks. Treasury bills do not bear a stated interest rate as do Treasury notes and bonds. The Treasury sells bills at a discount from par. This means that the owner does not receive interest payments during the life of the investment. The difference between the price of the bill and the amount paid at maturity (par), or when the bill is sold prior to maturity on the secondary market, represents the interest on the bill.

Treasury notes are medium–term obligations issued with a term of at least one year, but not more than ten years. You can purchase treasury bonds in denominations anywhere from $100 to $1,000,000. Treasury bonds are long–term obligations issued with a term greater than ten years, commonly from 20 to 30 years. There is an active secondary market for treasury bonds. This means that people buy and sell these bonds many times before they mature. Whoever owns the bond when it matures can cash it in for the face value. How is it determined how much a bond will sell for in the secondary market? The price is determined by the market; it will be whatever the buyer and seller can agree upon.

Treasury notes and bonds bear a stated interest rate and you receive semi–annual interest payments which the Treasury deposits in your bank account. The longer the maturity period on these securities, the higher the interest rate you receive. While the schedule for the sale of notes and bonds may vary, the Treasury generally observes the following schedule:

- The Treasury issues two–year notes and five–year notes on the last business day of each month;
- The Treasury issues Three–year notes and Ten–year notes every three months on 15th of February, May, August and November;
- The Treasury issues thirty–year bonds on the 15th of February and August.

The Treasury announces original issues through the press and stipulates the term (issue and maturity dates) with each new issue of a bill, note and bond. You can purchase Treasury securities through commercial banks, brokers, security dealers, Federal Reserve Banks and Branches, or the Bureau of the Public Debt. Unless you buy securities through the Federal Reserve or the Bureau of the Public Debt, the security you purchase will be in the name of the bank or brokerage house. The reason for this is that there is a time constraint in terms of getting all the paper work done when buying or selling a security. The process is simplified, and therefore speeded up, if the security is in the name of the actual purchaser.

However, by listing your security in the name of the broker, you are taking a risk that the brokerage house, or bank, will fail. In that case, you would have to work with the Securities Investor Protection Corporation to have your money refunded. For this reason you may want to hold the securities in your own name if you buy through a broker or bank. Also, when you buy through a bank or a brokerage house, you will pay a fee per issue.

The simplest and least expensive way to buy securities is from a Federal Reserve Bank or the Bureau of the Public Debt through the Treasury Department's Direct System**.** Under this system there are no added costs and you will have a broad choice of options, such as the ability to establish clear ownership and survivorship rights.

Buying securities directly is most suitable if you plan to hold your investment until maturity. Treasuries that you buy directly you cannot sell before maturity on the secondary market. To do so you must transfer them to a broker or a bank, but this process involves time–consuming paper work and fees. So if you think you may want to sell your securities before they mature, buy through a broker; otherwise buy direct.

The address of the Bureau of the Public Debt is http://www.publicdebt.treas.gov/.

The following is the opening statement from its web page:

> *"You haven't heard of the Bureau of the Public Debt before? We're a small agency within the Department of the Treasury. Our customers are your neighbors, co-workers, and most likely you, too. You're our customer if you've ever bought any type of Treasury security for yourself or, as millions have done in the case of savings bonds, as a gift for someone else.*
>
> *Our job is to borrow the money needed to operate the federal government and to account for the resulting debt. In a nutshell, we borrow by selling Treasury bills, notes, and bonds, as well as U.S. Savings Bonds; we pay interest to investors; and, when the time comes to pay back the loans, we redeem investors' securities. Every time we borrow or pay back money, it affects the outstanding debt of the United States."*

Treasury securities are subject to all Federal taxes, such as income tax, estate, gift or excise taxes, and may be subject to Federal tax withholding where applicable. As with any federal government instrument, interest earned on Treasury securities is exempt from state and local income taxes. Most taxpayers must report this interest for federal income tax purposes for the year in which bills mature or you sell them. For more information on the tax treatment of Treasury securities, contact your nearest Internal Revenue Service office or a local broker.

ZERO–COUPON BONDS

If you can afford a larger initial outlay than is required when buying U. S. Savings Bonds, your return on investment will be larger with other types of bonds. A type of bond similar to a Series EE savings bond is a zero–coupon bond. Zero–coupon bonds (sometimes called zeros or deep discount bonds) are municipal, corporate, or U. S. Treasury bonds issued at prices below their face value; therefore, they pay no interest income while you hold them. The interest, usually compounded semi–annually, accumulates within the bond itself. Your return is the difference between the original price and the selling price. You can sell zeros on the secondary market.

Your initial investment in a zero may be as little as $250. The low initial outlay is an advantage over other types of bonds—other than U. S. savings bonds. Other types of bonds usually require an initial outlay of $1,000 to $5,000 or more. Zeroes appeal to investors who seek a predictable increase in value with very little risk.

Zero–municipal bonds are more favorable to high-income people because of the tax advantages. This is because interest is exempt from federal income tax and, if held to maturity, investors do not have to pay a capital gains tax. A person in the 28 percent tax bracket saves $28 dollars for every $100 he can exempt from taxes, but a person in the 15 percent tax bracket saves only $15 for every $100 he can exempt from taxes. Because of this tax advantage, the interest you can receive is less than offered on other types of bonds.

You can only buy zero–coupon bonds from a brokerage house, the Federal Reserve, banks, or certain other financial institutions. Brokerage houses act as intermediaries between the original seller and the ultimate buyer of stocks and bonds. These institutions buy large denominations of the bonds from the U. S. Treasury, corporations, and municipalities, and then deposit them in a bank. As interest payments from the primary issuer accumulate, the bank uses the money to pay off those investors whose zeroes have matured. This arrangement allows brokers or financial institutions to sell zeroes with maturities ranging from a few months to nearly thirty years.

Taxable zeroes have a drawback, however. Even though you do not receive interest payments, the broker will report this “phantom” to the IRS every year as though you did receive the income. The exception to this is when you buy municipal zero–coupon bonds—these type bonds are exempt from federal taxes. Another way to avoid paying taxes on this “phantom” interest each year is by holding the bonds in a tax-deferred plan, such as an IRA. A third way to avoid paying taxes is to have the bond in the name of a child who will not pay taxes on the interest.

Like any bond, zeroes carry risks. In the period between issue and maturity, their value will fluctuate as interest rates change. If you decide to sell a zero before maturity, you may have a loss—it all depends on the prevailing interest rates. If interest rates rise, the value of your bond will go down, and as interest rates fall, the value of your bond will rise. Furthermore, there is always the risk the issuing company will default on its contract with you.

Consider what happened in the 1980's. An investor bought a 7-year zero coupon bond issued by Braniff Airlines. The bond's yield to maturity was 10%, about the same as other rates at the time. However, in the 6th year, Braniff went broke, and the bond became worthless. Because the investor had not received interest each year, he not only lost his $10,000, he lost the interest that had been accumulating inside the bond as well.

If this were an ordinary bond, at least the investor would have received a check for the interest on a regular basis, usually every six months. Had he owned a regular Braniff bond, he would have received checks during the six years equal to 60% of his investment. Instead, he got nothing. This makes zero coupon bonds much riskier than ordinary bonds.

MUNICIPAL BONDS

Municipal bonds are IOU's issued by state and local governments and by special purpose government agencies such as airport commissions or housing authorities. Instead of handling the paperwork that selling bonds to individuals entails, municipalities prefer to sell large quantities of bond issues to an underwriter who in turn sells the bonds to brokerage houses. These brokerage houses then keep a supply in-house which they promote and sell to the public. Usually municipal bonds are sold piecemeal for $1,000 or less.

Municipal bonds come in two general varieties - general obligation bonds and revenue bonds. Government authorities issue general obligation bonds and meet their debt obligations with tax revenue. Therefore, the taxing authority of the municipality backs general obligation bonds.

Cities sell revenue bonds to raise money for specific projects such as roads, water systems, schools, and bridges. The revenue generated from these projects goes to pay the bondholders. Revenue bonds are more vulnerable to default than general obligation bonds because revenues from the projects may not live up to their projections; cities pay interest only if the project brings in enough money. Although cities normally invest this money locally, it is possible for them to do other things with the money. Some cities buy debt instruments from insurance companies in hopes of making a higher return than they pay to their own bondholders. If a city has invested a large portion of their money with an insurance company, and the insurance company goes out of business, the city can default on its bonds. As a result, even AAA-rated municipal bonds are not perfectly safe.

Interest on these bonds is federal income tax free, and state income tax free if the municipality is in your home state. There is a difference between the tax-equivalent yield of a municipal bond and a corporate bond. For wealthier individuals in higher tax brackets, it may make sense at times to own a municipal bond instead of a corporate bond because the municipal bond, although offering a lower interest rate than the corporate bond, may offer for that individual a higher tax-equivalent yield. That means that higher income individuals can gain more on the tax saved then they lose by the lower interest rate. Lower income individuals tend to lose more when buying “munis” because their lower tax bracket means they cannot claim as much on their taxes when buying munis.

However, any profit you make selling muni–bonds is subject to federal and state capital gains taxes because the IRS considers this profit as capital gain and not income. Another downside to these tax-free bonds is that the fees you pay can never be a tax deduction. This is because fees and other costs are only tax deductible if the investment yields taxable income (as opposed to a capital gain). Several mutual funds offer their clients municipal bonds by states—for example, if you live in Virginia, you can buy Virginia municipal bonds through a mutual fund.

Municipal bonds offer two distinct advantages. One advantage is that these bonds are not usually callable for ten years. What this means is that the municipality cannot pay you off before the ten-year limit is up, thus robbing you of interest income. However, consider what happens when the issuer makes a call on a bond - that is, the issuer gives you your money back before the bond matures.

Say the government issues a bond at 10% and interest rates later drop to 4%. The government could save a lot of money if it were to cancel all those 10%’ers, return principle to investors, and issue fresh bonds at the new current rate of 4%. In other words, if you bought that 30-year bond expecting to enjoy 10% interest for many years to come, you could find yourself getting all your money back much sooner, which would force you to reinvest at the new lower interest rates. Of course, if interest rates rise from 10% to 15%, the government will not call the bonds. Thus, the situation leaves investors with a bond that pays 10% while new investors buy new bonds that pay 15%. In other words, when it comes to callable bonds, heads the government wins — tails you lose! Therefore, it is an advantage to you if a bond you buy is not callable!

Another advantage is that some states guarantee their municipal bonds in case of a default. In the case of default, if a city or county has state money coming to it, the state will intercept the money and give it to the bondholders.

So why should not everyone invest in municipal bonds? Because of the tax advantages, municipal bonds generally pay lower interest rates than taxable bonds. Therefore, most average income people lose more in interest than they will gain by not paying taxes on their return. If you are in a high tax bracket though your tax savings may compensate you for the lower interest.

Governments use a simple formula to calculate the effective interest rate on tax–free bonds. An effective interest rate is the real interest rate on an investment, considering the amount of tax money you must pay. For example, if you earn a 10% return on an investment for which your taxes are 4%, your effective interest rate would be 6%.

Suppose a bond is offering a return of 5 percent; let's also assume a 28 percent tax bracket and state tax rate of 6 percent. The two tax brackets combined equals 34%. Take .34 from one, and you get .66. When you divide .05 by .66, you get .0757 or 7.57%. Therefore, if you are in a combined tax bracket of 34%, the effective interest rate for you on a 5% bond is 7.5%. When considering buying municipal bonds, avoid buying bonds that the rating agencies rate less than AA by independent rating agencies, such as Standard and Poor's. The conservative investor should stay away from bonds that have less than a double A rating.

INSURED MUNICIPAL BONDS

Some 42% of all muni bonds issues outstanding are insured. Many people feel buying insured bonds is smart investing when in reality it is nothing more than smart marketing by Wall Street. Consider this: When a stockbroker calls Mrs. Gullible to sell her a bond, his biggest challenge is to overcome her fear of default risk. The broker can say “yes” thanks to outfits like the Municipal Bond Insurance Association, which controls 44% of the insured muni market, and AMBAC, the second largest insurer of muni bonds. In its sales literature, the MBIA says if a muni defaults, it will reimburse investors, and the cost for this protection is about five dollars per thousand dollars of bond principle.

In other words, insuring a bond that pays 5% interest would cost you ½ of 1% per year. That does not sound like much — until you realize that it is equal to 10% of the total interest you are due from the investment! That is a steep price to pay for insurance. This is especially true when you consider that the only way the insurance can pay off is for the government that issued the bond to go broke. Remember, in life there are no guarantees, only opportunities!

Even if the MBIA paid a claim, the payoff would not be what most investors would expect. The MBIA does not promise to repay your principle should a bond default. Instead, it will simply pay you the interest the bond should have been paying; you will have to wait until the bond's normal maturity date to get your money back — and that could be decades.

The whole idea of insured muni bonds is silly. Not only are you cutting your interest rate, but the entire premise suggests that MBIA is stronger than the government that issued the bond. The upshot to this is for you to avoid buying insured municipal bonds.

There is a new type of government bond out named Build America Bonds. In 2010, the Obama Administration and Congress decided to subsidize federal and municipal borrowing. Unlike traditional munis, these new bonds are not tax exempt but rather carry a direct federal subsidy of one third of their interest payments. Thus on a bond with 7% interest rate, the issuing city or state pays roughly 4.5% of the interest, and the feds pay 2.5% of the interest. The Securities Industry and Financial Markets Association estimates that cities and states will sell about $85 billion in Build American Bonds in 2010, this is on top of the $450 billion in new tax exempt bonds sold in 2010. These Build American Bonds will help you as the purchaser of the bonds because cities and states will be able to offer a higher interest on the money they borrow than otherwise would be the case. Of course, the downside is that the subsidy will encourage bond sellers to borrow more money which will increase debt.

GINNIE MAES

Ginnie Maes are issued by the Government National Mortgage Association, a federal agency created by Congress in the 1960's, in response to concerns that banks did not have enough cash to provide loans to tens of thousands of would-be home buyers.

Here is how GNMA works: Bill borrows $100,000 from his bank to buy a house at 10% interest for 30 years. His bank sells the mortgage to GNMA, freeing up its capital to provide more loans.

GNMA assembles mortgages from banks throughout the nation into groups, or “pools,” of $4,000,000. Each pool contains identical mortgages — the same face amount, interest rate, and maturity date. GNMA then divides each pool into $25,000 units and sells them to investors, taking half of one percent in fees. Bill's mortgage is now part of an investment paying 9.5% for 30 years. This is why economists call Ginnie Maes "mortgage pass-through certificates."

Bill makes his monthly payment to the bank that sends it to GNMA, which gives it to the investors who bought the pool in which Bill's mortgage is a part. GNMA payments to investors are issued monthly just like Social Security checks. To protect investors against the possibility that Bill might default on his loan, GNMA promises to meet the obligation if Bill does not. Ginnie Maes, therefore, are direct "full faith and credit" obligations of the United States Government. The U.S. Treasury must satisfy the debt if Bill does not.

Bill's monthly payment is part interest and part principle. Therefore, so is the monthly check that investors receive from GNMA. No other investment does this — not CDS, bonds, stocks, or mutual funds — and this unique feature is key to the confusion. While the interest portion will be relatively constant, the principle portion can fluctuate — sometimes dramatically. For instance, a Ginnie Mae investor who normally receives $140 a month ($110 in interest and $30 in principle) could suddenly receive a check for, say, $3,400 — several thousand dollars more than usual.

This can occur whenever the mortgages within the pool increase their payments since GNMA applies excesses to the principle. This could happen if Bill sells his home or refinances, thus paying off his mortgage; if Bill dies, and his insurance company pays off the mortgage; or if he defaults, and GNMA pays off as required.

Because of the prepayments, the typical life of a Ginnie Mae is 12 to 15 years. Nowhere else can you obtain a 30 year bond that will return your money, plus interest, in a shorter period of time with guaranteed terms. One thing that is different about Mae's is that you will receive your principle along with interest each month. So at the end of the 30 years there is nothing left. This can be even more profitable if you reinvest this monthly return on capital each month — this compounding effect can boost the total return above that provided by the Ginnie Mae itself.

MUTUAL FUNDS

- A mutual fund is an investment company that combines the funds of investors who have purchased shares of ownership in the company. The company, in turn, invests these funds in the stock market, the bond market, or the money market.

- A stock is a share of ownership in the assets, earnings, and future direction of a corporate form of business.
- The stock market is a place where people buy and sell stock
- The bond market is a place where people buy and sell long term bonds—bonds that take more than a year to mature.
- The money market is a place where people buy and sell securities.
- A Security is a bond that takes less than a year to mature. However, all government bonds are commonly called securities.

Mutual funds are for people who wish to diversify their holdings. These people have neither the time nor the inclination to test their wits against the stock or bond market and they want professional help with little expense. Following is a discussion of how a typical mutual fund might work. Disregarding commissions and fees, if you invest $1,000 at the beginning of the year and gain 10 percent in that same year, your return is $100.

There are no commissions charged when you make a deposit in a no–load fund and you pay only a small fee when you withdraw money. So how does a no–load fund make money? The fund managers receive an annual management fee, from 0.2 percent to more than 2 percent of the return. You will find this fee, called the expense ratio, on the first or second page of the fund's prospectus**.** Your quoted return is the return the fund has made after subtracting this fee from the gain. Historically, some no–load funds are among the best performing funds.

Mutual funds can have front–end loads and back–end loads. A front–end load is a commission you pay when you put money into a fund; a back–end load is a commission you pay when you take money out of a fund. Back–end load funds typically charge a 5 percent fee if you withdraw your money in the first year. This fee generally declines by 1 percent a year until it disappears after five years. So, if you do select a load fund, and you plan to stay invested for more than five years, a back–end load is preferable to a front–end load fund.

However, stay away from a back–end fee that does not decline. Because the value of your fund increases over time, a back–end fee can be more expensive than a front–end fee because a back-end-fee is based on a larger figure as the value of your fund increases over time. You may also have to pay additional fees depending on the mutual fund.

You should pay close attention to the fund's expense ratio. Whether the fund is a load fund or a no–load fund, it will have an expense ratio. The expense ratio is the percentage of a fund's net assets that is used annually to cover management fees, transaction costs, administrative and office overhead, legal and auditing fees and marketing costs. You can find a fund's expense ratio in its prospectus under the heading “annual fund operating expenses.” A no–load fund can have a high annual expense ratio to make up for the no–load. Investors sometimes call a fund with a high annual expense ratio a level–load fund. Investors call the marketing cost for a mutual fund a 12b–1 fee. Avoid paying a 12b–1 fee of more than a quarter percent annually.

Unlike the one–time load, annual expenses are an ongoing cost that can drag down a fund's overall performance. Because many costs remain fixed despite the size of the mutual fund, expense ratios are lower for larger funds than for smaller funds. Some mutual funds charge a front–end load, a back–end load, and have a high expense ratio.

MUTUAL FUND OFFERINGS

Once you choose a mutual fund, you will have the choice of buying into the money market, various stock funds, or bond funds. Depending on which family of funds you invest in, there are varying levels of risk. A family of funds is a group that contains different stocks or bonds, but each is similar to the others. Even investing in a particular family of funds offers varying levels of risk. Generally speaking, the greater the risk you are willing to take, the greater the potential return. This is what economists call risk return trade–off.

A money market mutual fund (MMMF) is a mutual fund that pools the cash of thousands of investors and specializes in earning a relatively safe return by buying securities that have very short-term maturities, generally less than one year. Some money market mutual funds buy only debts of the U.S. government and are therefore very safe. Another type of MMMFs invests only in tax-free debts which earn lower yields but pay tax-free returns to you. Mutual funds calculate interest daily and you can withdraw your money at any time. MMMFs typically pay the highest rate of return on a daily basis by small investors generally 0.50 to 1.00 percent more than interest bearing checking accounts.

Money market mutual funds require a minimum deposit of $500 to $1,000. A MMMF is convenient to use for special financial needs because you can withdraw money by using checks.

However, the minimum check limit is often $200 to discourage use of a money market mutual fund as an everyday checking account. Mutual funds permit electronic transfers.

The federal government does not insure money in a mutual fund. However, because of the high quality of the investments, economists consider MMMFs extremely safe, and no modern money market mutual fund has ever lost its shareholders' money. Accounts in money market mutual funds provide a convenient and safe place to keep money while awaiting alternative investment opportunities. Mutual funds enhance safety when the mutual fund company buys insurance to cover potential losses.

To open a money market mutual fund simply call a mutual fund company. Some of the largest money market mutual funds are:

Dreyfus Fund (http://www.dreyfus.com or 800 782-6620)

T. Rowe Price Fund (http://www.troweprice.com or 800 541-8832)

You can also buy stocks through a mutual fund. The market determines the value of your stock in the stock market. If the demand increases in relation to the supply, the price per share will increase; if the demand for the stock declines in relation to the supply, the value will decline. As a stockowner, you experience either a capital gain or loss as the price per share changes. When you sell your stock, your capital gain or loss is the difference between the buying and selling price.

A mutual fund may offer a choice among several distinctive stock funds. For example, some funds contain stocks of smaller companies that are volatile, but potentially have a high return, while others will have stocks of larger, more stable companies. Even environmentally minded people can buy into their own social conscience fund. Since most mutual fund families have several stock funds, the one you choose depends on your preference, your age, and how much money you have to invest. The younger you are, the more time you have to take advantage of long-term growth while weathering the fluctuations of the market. A company's prospectus will explain the characteristics of each stock fund offered. Now let's consider buying bonds through a mutual fund. You can make money three ways in the bond market.

The first and most obvious way is to earn interest income. Interest dominates bond returns for long holding periods, but for short time periods, you can make money two additional ways.

A second way to make money is to let the mutual fund reinvest your accrued interest back into the bond market. Consequently, this compounding increases your base without you putting new money into the fund. For example, let's suppose you put $5,000 into a bond fund that pays 6% interest every six months. Six percent of $5,000 is $300. By leaving this $300 in the bond fund, in the second six–month period you will receive 6% on $5,300, which is $318. Consequently, every six months your base increases because of this compounding effect. Note, however, that bond funds do not pay a fixed income. The funds buy fixed-income securities, but interest rates change constantly. Everyday your fund invests new money at varying rates of interest. Your dividends change from month to month. As interest rates change, so will your income.

The third way to make money in the bond market is by selling a bond for more money than you paid for it. In this case, you make a capital gain on the bond. This is especially true with a no–load mutual fund because there are no commissions when you sell a bond. Buying and selling bonds in the bond market is much the same as buying and selling stock in the stock market. Since the market determines the value of a bond during the time before it matures, an increase in the price of a bond in the market will mean a potentially bigger profit if that bond is sold. But you can also lose money with a bond fund. When interest rates rise, the market value of existing bonds declines, and so does the value of bond mutual funds.

ADVANTAGES & DISADVANTAGES OF MUTUAL FUNDS

When you invest in bonds through a mutual fund, you are effectively a short–term bondholder even if you stay invested in the fund for a long time. This is because mutual funds sell bonds before they mature. Therefore, the values of the fund's shares directly reflect the daily price swings of bonds within the fund. Consequently, these price changes become an important factor in your total return.

Generally when interest rates fall by 1 percent, the typical mutual fund specializing in long term bonds (maturing in more than ten years) will yield a return of about 10 percent. However, being involved in the bond market when interest rates are rising can be a devastating experience.

The downside of owning bonds within a mutual fund is that you are vulnerable to a fall in bond prices. If you own a bond outright yourself, you have the choice of holding unto it or selling it when bond prices fall. By holding onto your bond, you can receive your principle back plus any accrued interest. If you own a bond through a mutual fund, you can experience a loss when bond prices fall.

This is because bonds rarely mature when held within a mutual fund. Consequently, you can suffer a loss when the mutual fund sells your bonds in a down market.

Being a short-term bondholder has an advantage over being a long-term bondholder because many corporate and municipal bonds are callable. A callable bond is one that the seller can simply pay off when it is in his favor to do so. In times of falling interest rates, the bond seller can save money by paying off high interest debt and replacing it with lower interest debt. Usually when the seller calls a bond within a certain period, the company has to pay the holder a penalty fee. With or without a penalty fee, he has to accept the payoff. Consequently, the shorter the time one holds a bond, the less likelihood of a call.

Throughout the year, a mutual fund makes and loses money several different ways. It can make or lose money by selling stocks and bonds resulting in capital gains or losses. It can make income by receiving dividends from stock and interest from bonds. Capital gains are subject to capital gains taxes, and income is subject to income taxes. Each year mutual funds are required to distribute to shareholders any income that exceeds fund expenses. Economists call this the annual distribution**.**

Distributions are taxable in the year they are paid. This is true whether you leave the money in the mutual fund or take it out. Any income you are entitled to, whether you leave it in or take it out is subject to income tax, and any capital gain is subject to capital gains tax. Consequently, you should buy into a mutual fund shortly after the distribution date rather than just before the date. If you buy into the fund just before the date, you can pay taxes on phantom income or capital gain. Of course if no income was made, you would not be subject to taxes regardless of when you buy into the fund. Mutual funds normally pay distributions during December. When you receive distributions from your mutual fund, you will receive IRS Form 1099–DIV.

Do distributions in the common stock funds increase the value of your account? No. If you reinvest your distributions, the value of your account will be the same immediately before and after a distribution. When you receive a distribution, the value of your shares within the fund goes down. On the other hand, if you do not accept your distribution in cash but reinvest it, you will own more shares; but the value of each share is less—thus the value of your investment stays the same.

EVENT RISK

In 1988, Nabisco was one of the largest, best-known companies in America. They make Oreo cookies, Ritz Crackers, Lifesavers, and Camel cigarettes. At that time, the company was worth $22 billion and was completely debt free. Consequently, it had a AAA rating.

Then, what seemed impossible happened. In 1988, Kohlberg, Kravits and Roberts decided to buy Nabisco. Based on current stock prices, KKR calculated that it could buy Nabisco for $22 billion, and then sell off the pieces of the company for a total of $26 billion — giving itself a profit of $4 billion in profit.

How did KKR so this? With $5 million of its own money, KKR borrowed $26 billion from banks and investors around the world, using Nabisco itself as collateral for the loans. This is the same way that you can buy a house. With a little money down, you borrow a huge sum of money by posting the home as collateral. If you default on the loan, the bank becomes the owner of your house. By posting Nabisco as collateral, Nabisco became obligated for the debt. In other words, KKR saddled a debt free company with $26 billion worth of debt — $4 billion more than the entire company was worth.

When KKR announced the takeover, Standard and Poor's and Moody's rating agencies cut Nabisco's rating to a B from AAA. Before the takeover a Nabisco bonds were trading at full face value, or a $10,000 for a $10,000 bond. But B rated bonds were trading for just 73 cents on the dollar, or $7,356 for a $10,000 bond. Consequently, if you owned a Nabisco bond — you lost 27% of its market value overnight.

What happened to Nabisco is an example of event risk. Event risk is defined as an occurrence within a company that is both unexpected and beyond the control of management, yet which produces an adverse effect on the value of the company's securities.

RATE, YIELD, AND TOTAL RETURN

Suppose you put $10,000 into an 8% CD that matures in 10 years. How much money will you earn? If you earn simple interest, the bank pays you $800 per year, and you will have $18,000 in 10 years ($800 interest per year for 10 years is $8,000, plus your original $10,000.) Simple interest means there is no compounding, and therefore the rate and the yield are the same. In this example, they are both 8%.

What happens if the CD compounds interest annually? At the end of the first year, you would earn $800 in interest. The CD would add this $800 to the $10,000, giving you $10,800. At the end of the second year the 8% interest would be applied to the $10,000 (.08 times $10,800) giving you $864 in interest. The CD would add $864 to $10,800, giving you a total of $11,664. In the third year, the CD applies the 8% to the $11,664, giving you a total of $12,997.12. The CD repeats this process thru the tenth year. At the end of 10 years you would have $21,589 — not $18,000. Thus, an 8% CD compounded annually over 10 year's yields the same as an 11.6% CD that does not compound. Therefore, the more often a CD compounds interest, the more money you earn.

Traditional safe-haven bond markets can see their yields scrape the bottom of the barrel. In mid-2012, Treasury auctions sold at record-low borrowing cost. In economic uncertain times investors tend to seek the safety of government bonds instead of investing in stocks. In 2012, ten-year Treasurys yielded only 1.5%, near a record low. Yields fall when bond prices rise. Bond prices are determined by the market, which is the demand and supply of bonds in the market. Because your return is the difference between what you pay for the bond and what the face value is at maturity, the more you pay for the bond initially, the lower your yield.

INTEREST RATE RISK

Interest rate risk causes more people to lose money than any other type of investment risk. Jose is at home when the telephone rings. It is a cold-calling stockbroker. The broker says "Jose, instead of keeping your money in the bank at 3% interest, I can give you a bond issued and guaranteed by the U.S. Government, which pays 8% interest annually, pays that interest on a monthly basis, is free from state income taxes, and is liquid at all times. Jose, consider what I am offering you is safer than the bank, it earns more interest than the bank would pay you, it is as liquid as the bank, and it lowers your taxes. What do you say? Can I put you down for $10,000?"

Everything that the broker said is true. Government bonds are safer than banks, they pay higher interest rates, they are lower in taxes, and you can sell your bond whenever you want. However, the liquidity part of that pitch is a bit weak — and is the cause of more investor losses than anything else on Wall Street. Here is how it works.

Say Jose accepts the pitch and invests $10,000 to buy that 30-year government bond with its 8% interest rate and $10,000 face value. Let us further say that two years later he decides to sell his bond, because he needs the cash to buy a car. Let us also say that during this time, interest rates have changed, and the government is now issuing new bonds with new 10% interest rates.

Enter Mary, another investor. She is interested in buying the same type of bond that Harry happens to be selling. This presents Mary with a choice: She can buy either Jose's government bond from Jose, or she can buy a brand new one from the government. Since both have a face value of $10,000, which one will she buy? It is obvious that she will buy the new government bond, which pays 2% more than Jose's bond.

Now what does Jose have to do to convince Mary to buy his bond instead of buying a new government bond? He cannot change the interest rate of the bond, so he will have to lower the price of the bond. He must sell the bond for less than its $10,000 face value.

In this example, for Mary to make as much money on Jose's bond as she would have earned on Uncle Sam's bond, she must buy it for $8,000. In other words, paying $8,000 for a $10,000 bond at 8% is equal to paying $10,000 for a $10,000 bond at 10% interest.

In this example, Jose must sell his bond for $2,000 less than what he paid for it. Try to explain to him how he managed to lose 20% on his money in a government guaranteed investment!

As interest rates change in the economy, the value of existing bonds will change as well — but in the opposite direction. The ratio is roughly 1 to 10. That is, for every 1% change in interest rates, there is a corresponding 10% opposite change in prices Thus, Jose found that when rates rose by 2%, his bonds fell 20% in value.

Now, what happens if Jose keeps his bond until it matures? In this case, the government will pay him his $10,000. This illustrates that the government's "full faith and credit guarantee" is only for the "timely payment" of interest and principle to whoever owns the bond at that time.

GOLD

Ordinarily gold is not a good investment because it is highly volatile and very speculative. The only reason investors buy it is that they think someone else will pay more for it in the future than they pay today. Gold does not pay dividends, and while one share of stock can split, becoming two shares, your ounce of gold will never become two ounces. However, people use gold as a refuge in times of trouble. When the economy goes into a recession and fear sets in, many people will cash in their stocks and put their money into gold. When the economy improves, people will sell gold and purchase stocks.

Inflation makes gold prices rise. A hundred years ago, a $20 gold piece (one ounce of gold) would have bought a fine quality man's suit. Today, that gold coin is worth at this writing about $400, and it still buys a quality suit. Clearly, gold prices move with inflation and interest move in the same direction as inflation. Notice that this is the opposite of bond prices. When interest rates rise, bond prices go down. Owning gold via mutual funds alleviates the need for you to worry about safekeeping.

THE MONEY MOVEMENT STRATEGY

When you have funds to invest in the markets, you have a choice of putting your money in the stock market, the bond market, or the money market. How do you know which is the best investment? Invest in stocks when interest rates are low and in a valley. Stock prices will generally rise because investors will continue putting their money into the stock market when interest rates are low. People who would not normally invest in stocks will be more willing to take risks because of the low returns on interest–bearing funds. Therefore, when interest rates are low, the value of most stocks will fluctuate, but the general trend will be upward. Interest rates may stay in a valley for years, and while they are generally low, stick with stocks.

CHAPTER TEN

STOCKS AND ANNUITIES

In The Richest Man in Babylon, Arkad takes the advice of Algamish, the wealthy merchant, and learns to save 10 percent of all he earns. Algamish returns after a year and asks Arkad what he has done with his savings. This is Arkad's reply,

> *"'I have given it to Azmur, the brick maker, who told me he was traveling over the far seas and in Tyre he would buy for me the rare jewels of the Phoenicians. When he returns, we shall sell these at high prices and divide the earnings.'*
>
> *'Every fool must learn,' Algamish growled, 'but why trust the knowledge of a brick maker about jewels? Would you go to the bread maker to inquire about the stars? No, by my tunic, you would go to the astrologer, if you had power to think. Your savings are gone, you have jerked your wealth–tree up by the roots. But plant another. Try again. And next time if you would have advice about jewels, go to the jewel merchant. If you would know the truth about sheep, go to the herdsman. Advice is one thing that is freely given away, but watch that you take only what is worth having. He who takes advice about his savings from persons, who are inexperienced in such matters, shall pay with his savings for proving the falsity of their opinions.' Saying this, he went away.*
>
> *'And it was as he said. For the Phoenicians are scoundrels and sold to Azmur worthless bits of glass that looked like gems. But as Algamish had bid*

me, I again saved each tenth copper, for I now had formed the habit and it was no longer difficult.'

'Again, twelve months later, Algamish came to the room of the scribes and addressed me.' 'What progress have you made since I last saw you?'

'I have paid myself faithfully,' I replied, 'and my savings I have entrusted to Agger the shield maker, to buy bronze, and each fourth month he does pay me the rental.'

'That is good. And what do you do with the rental?'

'I do have a great feast with honey and fine wine and spiced cake. Also, I have bought myself a scarlet tunic. And some day I shall buy me a young mule upon which to ride.'

To which Algamish laughed, 'You do eat the children of your savings. Then how do you expect them to work for you? And how can they have children that will also work for you? First get thee an army of golden slaves and then many a rich banquet may you enjoy without regret.'

So saying he went away. Nor did I see him again for two years, when he once more returned and his face was full of deep lines and his eyes drooped, for he was becoming a very old man. And he said to me, 'Arkad, hast thou yet achieved the wealth thou dreamed of?'

And I answered, 'Not yet all that I desire, but some I have and it earns more, and its earnings earn more.'

'And do you still take the advice of brick makers?'

'About brick making they give good advice,' I replied.

'Arkad,' he continued, 'you have learned your lessons well. You first learned to live upon less than you could earn. Next you learned to seek advice from those who were competent through their own experience to give it. And, lastly, you have learned to make gold work for you.'"

CAUTIOUS INVESTING

Arkad learned the value of taking advice from knowledgeable people. When it comes to investing, however, small investors do not often adhere to this advice. If you have less than $100,000, the industry considers you a small investor. A stockbroker's would rather handle large portfolios than small portfolios. Therefore, you may not get the quality attention you expect although you are paying for the service.

When a stockbroker gives you attention, as a small investor, be careful that the advice you receive is more to your benefit than the stockbroker's benefit. For example, every time you buy and sell stock, you pay a commission. It is to the advantage of the advisor to encourage you to buy and sell often as this is more money in his pocket. Also, be careful not to buy more than is good for you. Since advisors often work on commission, the more they sell you, the more money they make. Even dealing with your friendly banker can get you in trouble. For instance, some banks will offer an incentive to their sales representatives for selling house–brand mutual funds. These house–brand mutual funds may or may not be the best ones for you.

As a rule of thumb, be wary of sales reps offering you advice without discussing with you the details of your finances and your investment goals. Make sure that advisors meet your financial needs. Look for an advisor who will compile for you a customer profile outlining your age, assets, income, risk tolerance, and goals, and will then base his suggestions on that limited list. Fee only financial advisors will advise you for a set fee. This type of advisor may be more expensive at the onset then an advisor who charges you in accordance to the stock you buy or sell, but may be less expensive over the long run, especially if you are an active investor.

Some brokerage houses have a quality control manager. In these cases, the quality control manager will review the advisor's recommendations by calling you and asking questions about your investments. Some will even undo any transactions that you are dissatisfied with sales reps giving bad advice for their own gain can receive a negative comment on their record and you can sue them.

THE COMMODITIES MARKET

As a small investor, you should stay away from commodities because commodities are the riskiest of all legal investments. Unexpected and unforeseen events can greatly change the price of a commodity. For example, an early frost can wipe out half the coffee crop in Brazil, causing the price of coffee on the world market nearly to double within a few weeks. Some examples of commodities are grains (corn, soybeans), livestock (feeder cattle, pork bellies), metals (gold, silver), and financial (British pound, U.S. Treasury bonds).

One type of market is the commodities futures market. You, as the buyer, agree to accept delivery of the product at a future date for a specified price. If the market price of the commodity goes above this contract price, you gain. If the price goes below the specified price, you lose. Of course, the opposite is true for the seller. When the price goes above the contract price, the seller loses; when it goes below the contract price, the seller gains.

You, the investor, have no control over your investment in the commodities market as you do in the stock market. In the stock market, when the price of your stock falls, you choose whether to sell and suffer a loss or to retain the stock. However, in the commodities market, you do not have to buy or sell in order to win or lose. If prices go up, the broker will credit your account; if prices go down, the broker will be calling you to collect.

You will also pay higher commissions in the commodities market than in the stock market because brokers buy and sell commodities every four or five days. Since you pay a commission with every buy and sell order, your sales commissions can add up fast.

THE STOCK MARKET

Why do people invest in stocks? People invest in stocks because the odds of gaining are in their favor. With stocks, the most you can lose is 100% of your investment, but your gains are potentially unlimited. Here are several reasons why people invest in stocks.

Stocks can grow in value and generate income. Stock dividends are much more reliable than stock prices. By reinvesting your dividends back into stocks, you own more shares, which in turn generate more income, which generates more shares, which generates more income, which generates more shares, and so on. Stocks are a hedge against inflation. By 2010, due to inflation, you would have needed $100,000 to buy what you could have bought with $10,000 in 1926. If your money was in the stock market, this would be no problem for you because $10,000 invested in 1926 would have been worth $12,000,000 by 2010, or 130 times as much as the rate of inflation.

The first advantage is the timing of when you pay your taxes. Let us compare stocks and interest earning asset and dividends. If you earn $800 in interest, you pay taxes on that interest in the year you make the interest. The same is true for stock dividends. In both cases, this is true even if you reinvest the interest or dividends. But, if you own an investment which grows in value the growth is considered to be a capital gain, and you do not have to pay taxes on capital gains until you sell the investment. Thus, if you buy a stock for $10,000 and it grows in value to $10,800, you do not have to pay taxes on your $800 gain until you sell the stock. So the first tax break is that capital gains are tax deferred until you sell.

The second advantage is that your capital gains may be lower than your income tax rate. The tax laws treat these differently. Traditionally the tax rate on capital gains has been less than the tax rate on earned income (wages, dividends, interest). These laws are subject to change depending on how Congress views investment income. As of this writing, the tax rate on capital gains (unearned income) is less than the tax rate on earned income, but I suspect that the rate on capital gains will increase to the level of earned income.

The third tax advantage of stocks is that the capital gains pass to your heirs free of capital gains taxes. For example, say you invest $10,000 in stocks and watch them grow to $25,000. Now let us suppose you die, since you never sold the stocks, you never paid the capital gains tax. Do your children pay the capital gains tax? No, at least they do not pay the tax right away. If they sell the stock right after they inherit the stock, they would pay no capital gains tax. However, if they hold onto the stock and it appreciates, and then they sell the stock, they will pay a capital gains tax on the difference between the value when they inherited the stock and the price they sold the stock. The third tax break is that capital gains pass tax-free to heirs at death. Of course, laws can change, especially tax laws.

STOCKS, BONDS, AND THE MONEY MARKET

Which is the best investment over time - stocks, bonds, or the money market? Stocks take the prize by a wide margin. From the 1920's to 2012, stocks averaged an annual return of about 10 percent. Because inflation has averaged about 3 percent over this period, the real return on stocks has been about 7 percent. This is a lot more than the return you could have made in the money or bond market.

Stocks do not beat inflation by a healthy margin every year, and sometimes they post horrifying short–term losses. However, if you stick with stocks for 10 years or more, you should have a decent chance of earning around six or seven percentage points a year above inflation.

The story of Wal–Mart is a good example of what can happen when you buy stock in a sound company from its beginning. On October 1, 1970, Wal–Mart went public with 300,000 shares selling for $16.50 a share. For a while, only 800 people owned this stock. Suppose you were one of these 800 people and bought 100 shares in those early days. Twenty years later how much would your investment of $1,650 be worth? It would have soared to $3 million by 1990!

If you have never invested in the stock market before, your greatest challenge will be watching the price of your stock fall. You will lose money if you are emotional and base your decisions on short–run price fluctuations. This is especially true since the price of a stock can fluctuate as much as 50% in any given year. Successful investors think long run, have faith in the free enterprise system, and base their decisions on basic principles. You must stick with the fundamentals, be optimistic, and ignore your emotions. "O.K.," you might say, "so over the long haul stocks have it, but how do I know which stocks to buy? How do I learn the fundamentals of investing?" There are several good books on the subject of investing as well as web sites.

A couple good books to start with are <u>One Up on Wall Street</u> and its sequel <u>Beating the Street</u> by Peter Lynch. Peter Lynch managed the Fidelity Magellan Mutual Fund from 1977 to 1990 while it became the most successful mutual fund ever. Suppose that you had invested $10,000 in the Fidelity Magellan Fund when Mr. Lynch became manager. Ten years later, you would have had $190,000!

Another classic book on the subject is <u>The Warren Buffett Way—Investment Strategies of the World's Greatest Investor</u>, 1994 by Robert G. Hagstrom, Jr. In 1956, Warren Buffett started an investment partnership claiming himself as the general partner. He started the partnership with $100 of his own money while seven limited partners contributed a total of $105,000. After thirteen years, he cashed out of the partnership with $25 million. In the fall of 1993, Forbes Magazine compiled a list of America's richest people. Warren Buffett was number one on the list with a net worth of $8.3 billion. Of the 69 individuals listed that year, Buffett was the only one who made his fortune in the stock market. In 2010, he was still in the top richest people in the world.

An excellent book, and the one I use in my Personal Investment Course at NRCC, is <u>Rule #1 The Simple Strategy for Successful investing in Only Minutes a Week</u>, 2007, by Phil Town. What is the rule? The first rule is, "Do not lose money." Consider that you have $10,000 in stock and you lose 10% in value as the stock price goes down. Suppose that the stock price increases by 10%. Are you back where you started? No, because 10% of $9,000 is $900, so you are still $100 short of where you started.

This is a book that not only gives you an investment philosophy but guides you step by step of how to evaluate stocks, how to do the research, where to find free online resources, where on these online sources you should look, and a simple formula to plug in the numbers that you find.

Phil Town's latest book is Payback: Making Big Money Is the Best Revenge, 2010. This latest book goes more into mutual funds then does the first book. You can find a wealth of facts and ideas on his web site, including a blog where you can read what other stock investors are saying about the current market. The address is http://www.philtown.com.

Another excellent book is How to Make Money in Stocks: A Winning System, 2009, by William O'Neil. In this book, he will teach you the greatest stock picking secrets. His web site is http://www.williamoneil.com.

The books listed above are great books, but if you want to learn about basic investing, the best author, in my opinion, is Robert Kiyosaki. His web site is http://www.richdad.com. The following are some of his books:

Rich Dad Poor Dad (the first book he wrote)
Rich Dad's Conspiracy of the Rich: the New Rules of Money
The Real Book of Real Estate
Rich Dad's Increase Your Financial IQ
Rich Dad's Cash Flow Quadrant
Rich Dad's Before You Quit Your Job
Rich Dad's Retire Young Retire Rich
Rich Dad's Prophecy.

Here is a list of useful web sites:

Research

http://www.smartmoney.com/
http://www.yahoo/biz.com/stocks
http://www.reuters.com/stocks

http://businessweek.com/investor

http://zoominfo.com

http://philtown.com

http://finance.google.com/finance

http://www.ratefinancials.com/

http://stockcharts.com/

http://www.sec.gov/

http://biz.yahoo.com/r/

http://moneycentral.msn.com/investor/research/welcome.asp

http://www.fool.com/investing.htm?source=ifltnvpnv0000001

http://www.allstocks.com/html/bigcharts.html

http://www.interactivebrokers.com/

http://www.valueline.com/

Investment blogs

http://clearstation.etrade.com/

https://www.tradeking.com/

http://www.socialpicks.com/

http://www.bullpoo.com/

http://caps.fool.com/

http://stocktickr.com/

http://www.zecco.com/Default.aspx

http://www.wikinvest.com/

https://www.optionsxpress.com/

http://www.topstockguru.com/

Online Brokers

http://scottrade.com/

https://us.etrade.com/e/t/home

http://www.firstrade.com/

https://www.tradeking.com/

http://www.fool.com/dbc/dbc.htm

http://www.zecco.com/Default.aspx

http://www.sharebuilder.com/

As an amateur, can you compete with the professionals in picking winning stocks? The major point the Mr. Lynch makes in his book Beating the Street is that not only can you compete with the professionals but you have the advantage over professionals and should do much better. In fact, this is why he named the book as he did—You Can Beat Wall Street. "The individual is free of a lot of the rules that make life difficult for the professionals. As an average investor, you don't have to own more than a handful of stocks and you can do the research in your spare time." (p.11). On page 12 he quotes the National Association of Investors Corporation (NAIC), an organization which represents over 10,000 local investment clubs. According to the NAIC, these local clubs beat the S&P 500 most of the time.

In his book One Up on Wall Street, Mr. Lynch gives the following advice: First, one should not rely solely on mutual funds, and second, one should ignore the stock market when buying stocks. "The market ought to be irrelevant. If I could convince you of this one thing, I'd feel this book has done its job," he states on page 78. He gives this advice on page 79: "If you rely on the market to drag your stock along, then you might as well take the bus to Atlantic City and bet on red or black."

Because the value of a company's stock is ultimately dependent on the soundness of the company, Mr. Lynch advises readers to seek out sound companies despite what is happening in the market. In fact, when he was the manager of the Fidelity Magellan Fund, he would often visit companies.

You should invest in companies that sell goods or services that are already familiar to you. For example, if you work in the medical field and know very little about computers, stick with buying stock in health–care companies and avoid high–tech companies. Peter Lynch is not necessarily recommending staying away from companies with complex products; it is just that most of us do not understand them and cannot keep up with pertinent changes in those respective industries. A computer scientist or a geneticist, however, can keep up with relevant changes in market conditions, supply costs, etc. in the high-tech computer industry and in the biological engineering industry respectively. If we stick with companies that offer products or services we are familiar with, we can more closely observe changes in the market for those products or services and can more easily determine possible future changes in those industries. Companies in less complex industries offer familiar products.

According to Mr. Lynch, you should buy stock in smaller companies rather than big companies. When a company gets too big, it can do everything right, but its stock price still may not increase very much. In certain markets, these stocks do well, but you will get your biggest price changes with small companies. When you invest in stocks, it is important for you to understand the basic business behind the stock, the simpler the business the better. Mr. Lynch writes this on page 121: “If it's a choice between owning stock in a fine company with excellent management in a highly competitive and complex industry, or a humdrum company with mediocre management in a simpleminded industry with no competition, I'd take the latter.” Another advantage of buying stock in a small company is the greater chance of a stock split. When a public company (a company that sells stock) sees the price of its stock increase, it can choose to split its stock. For example, if you owned 50 shares of a stock that was worth $20 a share, after a stock split you would own 100 shares worth $10 a share. The reason companies split their stock is to keep the selling price of a share low enough to attract buyers.

Buying stock in a company that has a dull name that does something boring is better than buying stock in a more exciting sounding company. A business engaged in a disgusting or depressing occupation, like waste removal or funerals, is even better. “If a company with terrific earnings and a strong balance sheet also does dull things, it gives you a lot of time to buy the stock at a discount. Then when it becomes trendy and overpriced, you can sell your shares to the trend–followers” (p. 123). Dull and boring businesses are exactly the kind that institutional buyers do not own and analysts do not follow, which is exactly what you want. Do not hesitate to invest in a solid, expanding company just because it is in a no growth industry. “In a no- growth industry, especially one that's boring and upsets people, there's no problem with competition. In a no growth industry you don't have to protect your flanks from potential rivals because nobody else is going to be interested” (p. 131). You also want to look for companies that have a niche in the market. Ice companies and rock quarries have little competition in their area of business.

Companies with patents have an edge in the market. A patent is a government grant to an inventor conferring the exclusive right to make, use, license, or vend an invention or process. Investing in a company that produces something people have to keep buying is better than investing in a company that produces luxuries. Also, avoid companies that pay their corporate executive officers (CEO) a fortune. Stay away from companies that have an overwhelming pension obligation.

During economic uncertain times, buy stock in companies with low debt. During recessionary times, low debt companies can often buy the holdings of their competitors at very low prices after these companies have gone out of business. Therefore, low debt companies can emerge from a recession with a larger market share than they had before the recession. A normal corporate balance sheet has anywhere from 25% to 33% debt and 66% to 75% equity. Young companies with heavy debts are always a risk.

STOCKBROKERS

So how do you buy stock yourself? Normally when you buy stock, you have to go through a stockbroker. A typical stockbroker will trade in stocks, mutual funds, government bonds, municipal bonds, and corporate bonds. When looking for a broker you have a choice of three types: full–service, discount, and a deep discount broker.

With a full–service broker, you will talk to the same person every time you trade, have a question, or need information. The broker will ask about your investment objectives, how much you want to invest, review what you may already own, and explain your options. The broker also should explain to you the mechanics of your purchases and your choices in making an investment.

What are the advantages of doing business with a full–service broker? A big advantage is the personal relationship. A full–service broker can work directly with you. By giving your stocks personal attention, the broker can maximize your return on them. This may not make much difference on 100 shares of stock, but it can make a big difference on 1,000 shares or so. A full–service broker also can help you structure your entire investment portfolio and keep you informed.

Discount brokerage companies may not provide free research, advice to clients, or any monitoring of your account. They may not promote certain stocks, bonds, or mutual funds, and commissions mostly cover the cost of processing transactions. For additional fees, a discount broker may offer as many services as a full–service broker. They also confirm trades in writing, send out regular account reports, and give market quotes over the telephone.

Deep discount brokers give you no–frills service at the lowest price. A discount broker may not trade in mutual funds and certain kinds of bonds. These brokers usually have few branch offices, minimum staffs, and their research is not available to the average investor. Many discount brokers may also have minimum requirements for trade orders. For example, they may require that you buy or sell at least five thousand dollars' worth of securities at a time.

You will find a big difference in price among the different types of brokers. Consider the purchase of 100 shares of stock at $30 a share. Following approximates the varying costs of this transaction: full service broker ($80), discount broker ($48), and deep discount broker ($33).

Most brokerage houses have minimum commissions of $20 to $50. Commissions by discount brokers are generally 50% to 75% less than that of full–service brokers. For example, if you buy stocks through a discount broker, the commissions on a share purchase of $1,000 would cost you about 3.75% of your investment. This means that your stock would have to show a 3.75% gain before you start making money. For transactions of $2,500 or more, your commissions will usually drop to 2% or less. Besides these commissions, you also have capital gains taxes and inflation to consider.

Consider the following when choosing among different deep discount brokers.

- Watch out for hidden fees**.** Some deep discounters are advertising relatively low rates. Other brokers inflate their low rates by charging for registering and delivering stock certificates in your name.
- Not all deep discounters will offer what you want to buy. Some only offer stocks and a few mutual funds. Others will offer stocks, bonds, mutual funds, and precious metals and others. Some will offer you research reports and others will not.
- Be aware of restrictions**.** Some deep discounters will require that you have at least five years of investing experience before they will do business with you. Others will require that you do at least 25 to 30 trades a year with them. Some will require that you open a margin account with them—a margin account enables you to make purchases on credit through the brokerage house.

PUTS AND CALLS

Despite what type of stockbroker you deal with, as an amateur investor, avoid puts and calls when buying shares of stock—unless you simply want the experience. A put gives you the option to sell a specified number of shares at a specified price before a specified date. A call gives you the right to buy a specified number of shares of stock at a specified price before a specified date. The call option is the most popular. For example, let us suppose that Mobile Oil is selling for $100 a share and you would like to buy 100 shares. A call option will allow you to buy 100 shares of Mobile stock over the next six months for $100 a share. Most options have maturities of nine months or less. Now let's suppose that the price of Mobile Oil stock goes to $125 a share. You can now exercise your option and buy 100 shares for the agreed upon price of $100 a share. You thus have a realized gain of $250.

A put option works the opposite of a call. For example, suppose that you buy 100 shares of stock for $100 a share. A put would give you the right to sell your shares during the specified time, six months or so. If the price of the stock goes down, you have the right to sell at the higher agreed upon price. If the price of the stock goes down to $75, you can sell it for $100 and make a gain of $250.

One problem with puts and calls is that they cost money. The price is usually between 2% and 10% of the price of the stock. For example, suppose that you buy 100 shares of Mobile stock at $100 per share. When the price of an option is 10%, the cost to you is $1,000. Now what happens if you buy a call and the price of the stock does not change by the specified date. You then have no capital gain, but forfeit your $1,000. Statistically investors never exercise 70% of options. Therefore, investors lose 70% of the time when buying an option.

Buying an option for a specific reason can be advantageous for the buyer. For example, let's suppose you plan to retire in six months and you want to cash in your company's stock but cannot sell until you leave. If you are concerned that the price of the stock will drop before you get a chance to sell, you can buy a put. This will give you the right to sell at the guaranteed price. The cost of the option is like buying insurance. Or consider this possibility: An investor has a huge profit on a stock and is concerned that the price of the stock is about to drop; however, he wants to sell in the next year to defer the capital gains tax. In a particular tax situation, even if the price of the stock does not change, the lower capital gains tax may offset the cost of the option.

INDEX STOCK FUNDS

How do you get rich in the stock market? Time the market so that you jump into it in the early stages of a bull market and get out in the early stages of a bear market. However, this strategy has one problem — how do you time the market? Indeed, few market timers beat the market. Most investors will lag behind the market over time because they are too skittish to stay fully invested in stocks through a prolonged bear market. These nervous investors end up dumping their stocks at low prices, thus locking in their losses. Similarly, these same investors may be too greedy during bull markets. Because they are making good returns in an up market, they hate to stop buying stocks, and end up buying too many at the onset of a bear market. Another problem with trying to time the market is that every trade entails a tax situation.

Instead of trying to time the market, it may be better to buy into an index stock fund. This is because over the years, most stocks have yielded a lower return than stocks within a common stock index. So, the odds are that you will gain more with an index fund than with individual stocks.

What are Index Stock Funds? Index funds are common stock mutual funds that focus on matching the performance of some index of the stock market. The *Dow Jones Industrial Average* (DJIA) and the *Standard & Poor's 500 Index* (S&P 500) are the best known and most widely quoted indexes. Two more indexes are the *Wilshire 5000 Index* (virtually all U.S. stocks) and *Morgan Stanley's Index* (1,000 international stocks) http://www.morganstanley.com/

With indexing, you give up trying to pick stocks to beat the market. Instead you simply choose stocks that mimic the market, as represented by a stock–market index. Indexing is popular among pension plans, though many do it with only a part of their assets. Indeed, many stock corporate pension plans are ensconced within index funds.

To understand the advantages of investing in an index fund, you have to know the difference between active management and passive management of a fund. Active management requires that the fund manager keep up with market trends. He has to decide what and when to buy, and what and when to sell. Passive management, on the other hand, entails buying a basket of stocks included in some index.

Consider two investors. One investor uses an active fund manager and the other uses a passive fund manager. Both funds do equally well. Which investor will make the most money? The investor that went with the passive fund will make the most money because of lower costs. A fund manager that is active in picking stocks will spend more time doing research than a passive manager. You, of course, must pay for this time.

An active manager also has higher overhead expenses than does a passive fund manager. The active fund manager must spend more time on the computer, subscribe to more reference manuals, and make more telephone calls than a passive manager makes. This means higher management fees and trading costs for you. In addition, to pay for these expenses, the active fund must keep sufficient cash on hand. Therefore, the fund invests less of your money as it keeps more cash on hand than a passive fund.

Consider these other advantages of an index fund. Because an index fund does not buy and sell many securities, they do not spend much money on brokerage fees. A low portfolio turnover (typically less than 10 percent a year) also means less realized capital gains or losses (profits or losses from the sale of securities). This compares with a standard fund that turns over 80 percent to 100 percent of its portfolio in a year. That means lower tax costs for you.

DIVIDEND REINVESTMENT PLANS

Stephanie compares investing to driving her 18–wheeler— “one mile at a time, one dollar at a time.” Stephanie, who is thirty–four years old, should know. She drives an 18–wheeler throughout the lower forty–eight states. When Stephanie was twenty–eight years old, she began to save $50 a month and now she has a portfolio of stocks worth $28,000. How did she do it? She learned how to buy stock without paying commissions or fees to a stockbroker. After buying a few shares of stock in a company, she joined the company's dividend reinvestment plan (DRIP). The company reinvested her dividends in additional shares. “I'd get a statement showing I'd purchased .0023 of a share, but then I could start to see it build,” she says. Her savings quickly grew because she did not have to pay commissions or fees to buy additional stock. The DRIP automatically reinvested her dividends to buy more shares of stock. She bought additional shares every month through automatic debits of her checking account.

One advantage of buying stocks yourself instead of through a mutual fund is that you do not owe capital gains taxes until you sell the stock. With a mutual fund, you have no control over the matter. If the fund sells your stock for a gain, you will owe capital gains taxes.

Dividend reinvestment plans (DRIPs) appeal to the small investors who want to buy stock inexpensively and do not want to play the stock market. If you want to buy stock in solid companies of your choice, and you want to keep your money invested in these stocks for the long haul, a dividend reinvestment plan may be for you.

Approximately 1,000 public corporations offer DRIPs. To participate in most DRIP programs, you usually have to be a current shareholder. If you are not a current shareholder, you may have to buy the initial share of stock through a broker. Check to see if your company has a DRIP offering if you are a current shareholder in a company. To qualify, the stock has to be in your name, not in a street name. Most plans allow for optional cash payments (OCPs) for as little as $10 a month to buy additional shares or fractional shares of stock.

Optional Cash Payments (OCPs) is a provision available with dividend reinvestment plans that allows the company to draft your bank account monthly. Some companies will automatically draft your bank account once a month; others will hold your money in reserve and buy stock every three months. They do not charge you commissions or fees when you buy stock, and they charge only a small fee when you sell stock. The DRIP invests dividends in more stock. Although the DRIP reinvests your dividends, you must pay income tax on the dividends.

Buying stock through a DRIP is a lot less expensive than buying stock through a stockbroker. For example, let's suppose you buy a round lot (one hundred shares) of a $25 stock through a stockbroker. The stockbroker's commission will normally be about $50 when you buy the stock and another $50 when you sell. Now let's consider the same transaction with a DRIP. Your commission to buy the same $2,500 worth of stock is zero. When you sell the stock, your commission will be about $25. Multiply these times the number of times you buy and sell shares of stock over time, and the savings of a DRIP can be considerable. A good resource for DRIPs is DRIP Central at http://www.dripcentral.com/. You can do a search for DRIP funds available at DRIP Wizard at http://www.dripwizard.com/home_dripsearch.asp

DOLLAR–COST AVERAGING

Whether you buy stock through a stockbroker or a DRIP, your objective is to make money. In theory, you can maximize your profit by buying stock when the price hits bottom, and selling when the price is at its peak. Yet how many people can maximize their profits by always buying stock at just the right times? Dollar-cost averaging is a plan that will help eliminate the guesswork of trying to time the market. The method consists of investing a set amount of money monthly in a stock. As the price of the stock goes down, your money will buy more shares, and as the price of the stock goes up, your money will buy fewer shares. Because you are continually buying more shares as prices fall, you increase your chances of gaining. An advantage of buying through a DRIP is that many DRIPs will debit your bank account automatically every month. So decide how much you can invest per month and have this amount automatically drafted from your bank account.

BUYING STOCKS

Always buy in round lots, meaning 100-share increments. Anything other than 100 shares is an odd lot, and odd lots carry with them penalties. Additionally, stockbrokers will not execute your trade as quickly as a round lot, which could make a difference in the price. Be aware that as a stock investor you will pay a spread, which is the difference between a stock's buy price and its sell price.

ANNUITIES

An annuity is an investment, usually through an insurance company, which you receive, fixed monthly payments for a lifetime or for a specified number of years. You pay for the annuity monthly, by making one lump sum payment, or a combination of both. For example, let's suppose that you receive an inheritance of $100,000 and then buy an annuity with this money. Insurance companies call this a single–premium annuity. The agreement is that the annuity will pay you, the annuitant, a set amount of money every month for life after you reach a certain age. There are fixed rate annuities and variable rate annuities. With a fixed rate annuity, your monthly income will remain the same for the rest of your life. With a variable annuity, your income will depend upon how well the annuity's investments do.

Annuities come in many forms. Some annuities will pay you for the remainder of your life after a certain age—others will pay only for a certain set time. Some annuities will pay only as long you live—others will pay your heirs after you die. If the insurance company pays your heirs after you die, the payments are lower while you are living.

However, there are drawbacks to annuities. One drawback is that the cost of accounting, commissions and marketing often exceed 2 percent per year. Another drawback is the high withdrawal and/or exit fees you have to pay if you change your mind and take money out of the annuity. Consequently, an annuity can lock you into a poorly performing fund. Another drawback to some types of annuities is the loss to your heirs when you die. For example, let's suppose you buy a single–premium annuity for $100,000 and begin receiving $900 a month upon reaching the age of sixty–five. Ten months later you die. What happens to the rest of your money? The insurance company keeps it. That's the deal. You can win or lose depending on how long you live. Before you buy an annuity, make sure you do your homework. Consider what happened to David Smith after he bought an annuity.

In 2010, David sold his business and decided to put $100,000 of the proceeds into an annuity. An insurance agent sold him a policy with the Mutual Security Life Insurance Company. The agent told Mr. Smith that the company was highly rated. It offered a guaranteed 11 percent return for seven years and carried only a two–year penalty period for early withdrawals. At the time, Mr. Smith began receiving monthly payments the value of his investment was $189,772. The annuity promised him eighty–four monthly payments of $2,920 each. His agent twice assured him that the Virginia Guaranty Association protected the contract agreement up to $300,000.

He received thirteen payments before Mutual Security went into liquidation due to financial difficulties, and the Mega Life and Health Insurance Company assumed its assets. At this point he received a new contract from Mega reducing the monthly payments. *Mega* also reduced the interest rate on the unpaid balance from 8.1 percent to 3 percent.

Mr. Smith wisely held the checks from Mega instead of cashing them. Meanwhile, he contacted a lawyer to help him receive payments according to the original contract. His lawyer succeeded in persuading the Virginia Guarantee Association to pay the claim. The association made a lump–sum payment to Mega. Mega, in turn, paid Mr. Smith the back payments they owed and reinstated the original contract terms.

What would have happened if Smith had cashed even one check sent to him by Mega? The lawyer would have lost the case because by cashing even one check the law would have bound Mr. Smith to the new contract agreement.

AVOID THESE BLUNDERS

- Beware of solicitations over the telephone. Though there are legitimate and capable people who solicit their services over the telephone, there are also unscrupulous people who offer you huge returns on your money. Either the investments involve a high risk, as in precious metals or commodities, or the caller is a crook.

- Even calls from a legitimate brokerage house may lead to some investment blunders. This is particularly true if the brokerage house offers you an opportunity to get in on a hot new stock offering. The problem with this is brokerage houses usually sell out hot new stock offerings before you get a fair shot at them. Consequently, you end up buying a day late and a dollar short.
- Never send money through the mail without first seeing a prospectus. Be especially cautious if the person asks you to send the check by overnight service.
- Do not buy stocks based solely on which stocks did the best last year. If you do, you will usually end up buying too late, in fact, you will usually take a loss. Alternatively, do not buy stocks based solely on the fact that they dropped in value last year. Just because a stock has fallen in value does not mean that it will necessarily recover in value this year.

It is usually a good idea to buy and then hold unto the stock for a long time. However, holding onto your stock without watching it can leave you riding a stock all the way to the top and all the way to the bottom. Never get emotionally attached to a stock—know when to say "hi" and when to say "goodbye.

- Do not believe that a guarantee is always a guarantee. For example, if you buy a bond valued at $25,000, the bond seller only guarantees this value when it matures. Before it matures, the value in the market can fluctuate depending on interest rates. Remember as interest rates rise, the value of your bonds falls.
- Be aware of conditional guarantees. For example, tax–deferred variable annuities may guarantee you your original principle back at death—but you have to die before this guarantee is any good.

CHAPTER ELEVEN

BUILDING A SECURE RETIREMENT

David had to retire from the factory job he had held for nearly twenty–six years. After having two heart attacks, he was too sick to work anymore. Fortunately, he had sufficient insurance to cover medical expenses. Then one day his previous employer sent him a letter canceling his benefits. Evidently his previous employer could no longer afford to pay $7,000 per retiree or $30 million a year in retirement benefits. Both David and his wife, Becky, had asthma and lung problems which cost the couple about $740 a month for treatment and another $300 a month for prescription drugs. Since both of them were too young to qualify for Medicare, they could no longer afford these medical costs.

David eventually died of medical complications. Now, not only did Becky lose her husband, but she had to live on one Social Security check. Because his check was larger than her check, she continued receiving his check and lost her own. To make matters worse, she lost all of David's pension benefits. As stipulated in his pension contract, while contributing to his pension plan, David could opt for full pension benefits or partial benefits upon retirement. If he were to choose to receive partial benefits, he would receive about 20 percent less, but his wife would continue to receive pension payments after his death. On the other hand, if he were to choose to receive full benefits, his spouse would not receive any payments after his death. Becky lost all of her husband's pension benefits when he died because the couple had chosen to receive the full benefit while David was living.

According to the National Center for Health Statistics, most wives outlive their husbands by seven years. About 60 percent of all men die married, while only 27 percent of all women die married. Many women over the age of sixty–five have to continue working or are forced to live in poverty because of insufficient savings and inadequate or no pension benefits.

HOW GOOD IS YOUR PENSION PLAN?

If you are depending on your pension plan and Social Security to take care of you during retirement—you should think twice. Having a personal savings plan is more important today than previously because pension plan contributions and payouts are being limited. The limitations are a result of frequent job hopping, recent practices of some employers, and a change in federal law.

If you are a frequent job hopper and leave jobs before you the company considers you vested, you may find yourself with inadequate retirement benefits when you retire. Although you can contribute to an employee's pension plan, unless your employer has vested you, you will not receive any benefits. Some plans will not offer benefits until you have worked for at least three years, when full vesting takes place.

Other plans grant vesting in stages. For example, you can become 20 percent vested after one year on the job. If you are 20 percent vested, you will receive only 20 percent of the full retirement benefit upon retirement. Your vestment will increase by 20 percent with each additional year you remain with your employer until your employer fully vests you. With this plan, vesting may take seven years, the maximum time limit legally allowed.

Even if your employer fully vests you, your retirement may not be secure if the company is struggling financially. Companies in financial trouble will occasionally raid the coffers of their retirement fund. If your employer goes out of business, you may have partial benefits or even no benefits at all.

Pension plans are of two forms: defined–benefit pension plans and defined–contribution pension plans. A defined–benefit pension plan bases retirement, survivors', or disability benefits on income and years of service. With a defined–contribution plan, the employer, employee, or both, set aside a certain amount of money monthly for retirement with a mutual fund company. The success of the investments determines the amount of the benefit after retirement.

Why has there been a movement away from defined-benefit plans to defined-contribution plans? Under defined-benefit plans, most corporations took control of employee's retirement money, and invested it back into the company in the form of stock. At times when the economy tanked and employees lost a lot in their retirement plans, they sued the companies for losing the money. So, companies said to themselves, we do not need to be subject to law suits, what we can do is take the responsibility off of ourselves and transfer it to an independent mutual fund company. Now when the economy heads south, we are no longer liable for losses that may occur in the employees' mutual funds. But the mutual fund does not want to be liable either, so they gave the employee several choices of where to keep their retirement money; they can chose between the money market, the bond market and the stock market. Now the liability lies strictly with the employee and not the company or the mutual fund.

Consequently, this puts a greater burden on the average person for their retirement benefits. If you manage the monies in your mutual fund well, that is you make good sound financial choices, you will benefit; but if you make wrong choices, you can lose big time. For example, suppose that you have all of your retirement money in the stock market within this mutual fund; now suppose that the stock market takes a big fall. Consequently, you lose a lot of your money because you failed to move your money into a safer investment; you did not move your money into the money market. This is why you have to be more financially educated than your parents were when they were your age. Of course, that is why you are taking this course!!

RETIREES BEWARE!

Retirees can receive from a defined–benefit plan when they decide to take their retirement payout in one lump sum instead of in installments. Previously the federal government has directed employers with defined benefit pension plans to reduce the lump–sum distributions to retiring employees by forcing them to use updated mortality rate tables aimed at limiting payouts. These new tables assume that people live longer as compared to the older tables, thus reducing the amounts you will receive in lump–sum distributions.

Normally such a move would be illegal under the Employee Retirement Income Security Act, which states that employers cannot cut back pensions they have already promised. However, Congress simply decided to waive these rules. Now, you might ask, how can Congress pass such an unpopular law without incurring the scorn of voters? The only way to pass such an unpopular law was to bury it in a larger bill that had nothing to do with pensions. The bill chosen was the General Agreement on Tariffs and Trade (GATT) bill passed by Congress in November of 1994. This document was more than

1,000 pages long. Since it gained so much publicity as a trade bill, few people suspected that it had anything to do with pensions received by Americans.

The above story illustrates why it is important for you to take charge of your own retirement. The federal debt in 2009 was about $12,000 trillion and the federal debt by the end of 2010 is expected to be about $12,000 trillion, meaning that the federal deficit will increase by two trillion dollars in just one year! In 2010, the Obama Administration passed a national health care bill which will add about 30 million people who will be insured for medical expenses. This will greatly add to the federal debt. Now in a period of a declining economy and lower tax revenues and growing debt, where is one place the government can save money? You guessed it – by paying retirees less.

RETIRE WITH THE BIGGEST PENSION CHECK YOU CAN GET

With a defined-benefit plan, consider what your retirement benefits would be if you were to work a few more years. A two–year delay in retirement can be significant. A five–year delay can make an enormous difference in your retirement benefits because the income you make in the final few years of service largely determines your pension benefits. You can increase your pension check by 25%, 50%, or even 100% just by staying on the job for a few more years. If you have a defined-contribution plan, the longer you work, the more years the company will fund your retirement plan.

However, if your company is downsizing and it offers you a retirement–incentive package—you might want to take it. Consider the possibility of not accepting the offer now and then soon losing your job. However, if you are in a secure position, make sure that you run the numbers before jumping ship. Postponing retirement can be beneficial in several ways. The longer you work, for instance, the more time you'll have to build up your savings and the fewer years you will need to draw from your savings to pay the bills. If your retirement plan is a defined-benefit pension plan, the longer you wait to retire, the larger your retirement benefits will be. Most pension plans have a provision that reduces the payments to employees who retire early, before the ages of 60 or 62.

With Social Security, if you retire between the ages of 62 and 65, you will receive between 80% and 100% of the benefits you would have received if you had waited to retire at the age of 65. Social Security will penalize you with lower monthly payments if you work and make above X number of dollars. If you wait until you are 67 or so to retire, then your benefits are not affected by any income you make on the job. I say 67 or so because the exact date depends on the year you were born. Your early retirement could also affect your spouse's benefits as well. If your spouse does not qualify for

Social Security benefits, he/she will receive one-half of your Social Security benefits when he/she reaches the age of 65. Additionally, if your spouse claims your Social Security benefits when you die, he\she will receive less because you were receiving less.

Is your pension less than you expected? If so, contact the National Center for Retirement Benefits (800 666-1000) in Northbrook, Ill., which double–checks payouts from pension plans. The NCRB charges nothing to check your pension payout but takes 50 percent of any money it recovers. It takes 25 percent or less if you had no pension and they secure one for you. This firm does not handle union or government plans. If you have reason to sue your employer, the Pension Rights Center (202 296-3776) will send you the names of pension lawyers in your state. They typically charge expenses and one–third of the money they secure for you.

RETIREMENT

If you fail to plan for retirement, then you are planning to fail. Due to a lack of planning, only about 3 percent of Americans retire financially independent; 27 percent must work to maintain their standard of living and 70 percent must rely on a combination of family and welfare to live. The Social Security Administration reports that 85 percent of all Americans reaching the age of sixty–five do not have as much as $250 in personal savings!

How much money do you need during retirement? The extent of your indebtedness, your health, your property taxes, the general cost of living in your area, and the inflation rate will determine your financial needs. Inflation will affect how much you will need as it erodes your buying power over time. Using the rule of 72*,* even a 4 percent inflation rate will cut your buying power in half in only 18 years ($72 \div 4 = 18$).

You can plan for your retirement by calculating your outgo and income during your retirement years. Medical expenses and taxes are two major outgoes to consider. If you plan to retire early in life, you should plan for medical coverage. You must fill the gap between an employer's plan and the start of Medicare. When you qualify for Medicare, you should fill its coverage gaps with health insurance. Do not wait too late—the later you wait the less chance of qualifying for health insurance. At the time of this writing, Congress has passed a health care bill; therefore, the rules will greatly change over the next several years. You must also learn to forecast your income tax payments—this is especially true if you were paying taxes via payroll withholding and therefore not used to making these provisions yourself.

You could have income from seven sources when you retire. These sources are Social Security, personal savings, an employer–sponsored and/or personal pension plan, an annuity, a part–time job or business, and possibly a reverse mortgage. Insufficient income in one area will require more income in the other areas. Consider each of these possible sources of income.

SOCIAL SECURITY

In 1983, Congress raised Social Security taxes and made other adjustments in the program to place it on solid ground. The objective was to have enough money in savings to meet the needs of the baby boomers as they retire. The goal was to have a $1 trillion fund built up by the year 2010. However, this is not to be because the government has replaced the funds in Social Security with specially created, nonmarketable Treasury bonds. Consequently, the government has borrowed all of the money from Social Security and other trust funds such as military, postal, railroad and Medicare.

So where does the government get the money to pay Social Security recipients? It gets the money from current Social Security payers. In the 1980's there were 20 payers for every retiree—in 2010 there are at least three payers to support each retiree, thus we face a shortfall. The solution to this pending shortfall will be to force participants to pay in more while receiving less upon retirement.

If you are a wage earner, look on your W–2 for FICA**.** FICA stands for Federal Insurance Contribution Act; this is your Social Security contribution. What is the Social Security tax rate for 2010? The Social Security tax withheld from employees during the year 2010 will be 6.2% of the first $106,800 of each employee's taxable earnings. The employee's earnings in excess of $106,800 are not subject to the Social Security tax. In addition to the Social Security tax, the entire amount of each employee's taxable earnings is subject to the Medicare tax of 1.45%. Employers must match the Social Security tax and the Medicare tax. This means the employer must remit to the federal government 12.4% of each employee's first $106,800 of taxable earnings plus 2.9% of each employee's earnings regardless of amount. Self-employed individuals are responsible for paying both the employee and the employer portions of the Social Security tax and the Medicare tax

You must earn a minimum of forty credits to qualify for Social Security benefits. With every $570 earned, you will receive one credit, with a maximum of four credits a year. Usually it takes ten years of gainful employment to qualify for Social Security benefits. If you do not qualify for your own Social Security benefits, you will receive an amount equal to one–half of your spouse's benefits.

If you do qualify for your own benefits, then, upon the death of your spouse, you will receive the higher of the two benefits. The same rules apply despite a divorce, even if you remarry - if the first marriage lasted for at least ten years. If you are disabled, you are eligible for these benefits at the age of fifty.

Your date of birth, the type of benefit, and your past earnings determine your benefits. If you were born before 1938, you will be eligible to receive full benefits at the age of sixty–five. If you were born after 1938, the full benefit age is increasing gradually from sixty–five to sixty–seven or higher.

You will receive partial benefits if you retire at a certain minimum age. The longer you wait to retire, the more money you will receive. Your average income between the ages of eighteen and the current retirement age determines your actual benefit. Three months before your birthday, Social Security sends you a statement that estimates your potential benefits. Remember, this is a statement of your earnings and an estimate of your benefits. After receiving your Social Security statement, check carefully to make sure Social Security's records of your earnings match your W-2 statements. It is important that Social Security have your correct earnings information, because this affects how your benefit level is calculated. You must report mistakes in the record to Social Security immediately.

Social Security provides several calculators that can be used to estimate your potential benefit amounts using different retirement dates and levels of future earnings. The calculators show your retirement benefits, disability, and survivor benefit amounts. These calculators are available at Social Security Online—Benefit Calculators.

If you are close to retirement, check your Social Security benefit information for possible errors. For example, your past employers may have made a mistake in reporting your top earning years. In addition, data clerks in the Social Security Administration can make mistakes. Even a name change because of marriage can cause a problem. Once you receive a breakdown of your earnings from Social Security, check the record against anything you can, like old W–2 forms, income tax returns, and pay stubs. If you are self–employed, you must have both tax returns and canceled checks to verify taxes you have paid. Call the number on the form when you have a problem. If you cannot resolve the situation, you may have to go through an appeals process.

If you are already receiving Social Security payments and believe that you should be getting more, you can make an appeal. The first step is to ask the Social Security Administration for a reconsideration of your claim. Reconsideration simply means that you want someone else in the department to review your account. If the reconsideration does not come back in your favor, you can apply for a hearing. An Administrative Law Judge will consider your claim. At this point you may want to have an attorney present with you.

If you have a situation, call the *National Organization of Social Security Claimants Representatives* (800 431–2804) for legal assistance. This is a nonprofit organization which will give you the name of an attorney in your area experienced in elder law. Most of these attorneys work on a contingency basis, meaning you do not pay them unless you benefit from the case.

For more information about Social Security benefits, you can order the Consumer's Guide to Social Security Benefits Including Medicare (800 872–0121). This book is updated every year and is a good resource for finding out if you are missing any benefits. The web address is http://www.nosscr.org/

How solvent is our Social Security System? Consider this – our national debt is about $12 trillion, of this $12 trillion, or 2/3 of it, the government owes to foreign countries, especially China and Japan that is $8 trillion. Another $2.5 trillion the government owes to the Social Security fund. The following is a quote taken from http://www.cleveland.com March 14, 2010:

> "PARKERSBURG, West Virginia - The retirement nest egg of an entire generation is stashed away in this small town along the Ohio River: $2.5 trillion in IOUs from the federal government, payable to the Social Security Administration. It is time to start cashing them in. For more than two decades, Social Security collected more money in taxes than it paid out in benefits -- billions more each year. Not anymore. This year, for the first time since the 1980s, when Congress last overhauled Social Security, the retirement program is projected to pay out more in benefits than it collects in taxes -- nearly $29 billion more.
>
> Sounds like a good time to start tapping the nest egg. Too bad the federal government already spent that money over the years on other programs, preferring to borrow from Social Security rather than foreign creditors. In return, the Treasury Department issued a stack of IOUs -- in the form of Treasury bonds -- which the government keeps in a nondescript office building just down the street from Parkersburg's municipal offices.

Now the government will have to borrow even more money, much of it abroad, to start paying back the IOUs and the timing could not be worse. The government is projected to post a record $1.5 trillion budget deficit this year, followed by trillion dollar deficits for years to come.

Social Security's shortfall will not affect current benefits. As long as the IOUs last, benefits will keep flowing. However, experts say it is a warning sign that the program's finances are deteriorating. Social Security will be broke by 2037 unless Congress acts. 'This is not just a wake-up call, this is it. We're here,' said Mary Johnson, a policy analyst with The Senior Citizens League, an advocacy group. 'We are not going to be able to put it off any more.'

For more than two decades, regardless of which political party was in power, Congress has raided the Social Security trust funds to pay for other programs, masking the size of the budget deficit. The bonds are unique because the government prints on paper, while other government bonds exist only in electronic form. They are stored in a three-ring binder, locked in the bottom drawer of a white metal filing cabinet in the Parkersburg offices of Bureau of Public Debt."

EMPLOYER–SPONSORED PENSION PLANS

Employers that satisfy Internal Revenue Code requirements do not have to pay taxes on money deposited into a qualified pension plan. Additionally, as long as the money remains in the plan, the company pays no income or capital gains tax on the gains. While pension plans cover most public sector employees, employer–sponsored retirement plans cover less than half the private sector employees. Because fewer businesses are offering employer–sponsored pension plans to their employees, the number of workers covered by these plans declines every year. Even for recipients of these employer–sponsored retirement plans, the payouts are often less generous than in past years.

DEFINED–BENEFIT PENSION PLANS

A formula determines the benefits of defined–benefit pension plans. A typical formula would entail years of service times the average salary times the replacement percentage equals the yearly pension benefit.

Defined–benefit plans are of two types, funded and unfunded. With a funded pension plan the employer makes annual payments to a trustee who may be the corporation, an insurance company, or the trust department of a bank. The trustee then invests these funds. Upon retirement the participant receives monthly income from the investments.

Unfunded pension plans pay out retirement expenses from current earnings. Social Security is one example. Most state and local plans are unfunded as well. Because governments have more control over their income than do businesses, these government plans are safe. However, although government plans are safe, the government can reduce benefits. Unfunded pension plans offered by businesses are more at risk than government plans because if a business experiences a credit crunch or goes bankrupt, it may not have the money to meet its commitments.

Sometimes Social Security is a part of a defined–benefit pension plan. With these plans, when you receive an increase in Social Security benefits, you will receive a corresponding decrease in your pension benefits. Unless your plan compensates you for the effects of inflation, your real income will go down every year as prices increase. Using the rule of 72, we can calculate that with an inflation rate of four percent, your buying power will be cut in half after eighteen years. Many plans provide for automatic inflation adjustments, usually tied to the Consumer Price Index.

DEFINED–CONTRIBUTION PLANS

A defined–contribution plan will require you to pay a certain percentage of your pay into it. Other names for these plans are money–purchase plans or salary–reduction plans**.** If you are self–employed, this type of plan requires you to contribute a certain percentage of your self–employment income into it—even if your company suffers a loss. Your benefits will depend on your age, income level, the amount of contributions you make to the plan and how well the investments do.

Defined–contribution plans can be contributory or non–contributory. A contributory pension plan will let you make supplementary contributions. Most federal, state, and local plans are contributory plans and require you to contribute from five to 10 percent of your income. If you leave your job, you will receive your money in the plan. A noncontributory plan works the same way except your employer makes all of the contributions. Most corporate pension plans are non–contributory.

The most popular forms of defined–contribution plans are 401(k) and 403(b) plans. These connotations refer to the section of the tax code under which each plan falls. Businesses can offer 401(k) plans to private sector employees. Educational and some nonprofit organizations offer 403(b) plans. You must pay the Social Security tax on the finances you put into these funds, but not federal tax. If you withdraw money from the plan before you reach the age of fifty–nine and one–half, the government will not only collect taxes on the withdrawn money, but will also charge you a 10 percent penalty. If you become disabled, or have large medical expenses, you can withdraw money without paying a penalty. When you die, your heirs can withdraw money without paying the 10 percent penalty as well.

For an employer's 401(k) plan to qualify for tax-deferrable status, participation of employees of different income strata is necessary. To encourage all of their workers to participate, many employers will supplement each employee's contribution, most commonly by matching the employee's contribution one for three. For example, if you were a part of this plan, your employer would put into the plan one dollar for every three dollars you put into it. However, some employers will contribute one dollar for every two dollars, and others will even match your contribution dollar for dollar.

Investment options with a 401(k) plan can be limited. For example, many plans offer the company's stock as the retirement vehicle. Other plans offer a fixed–income option, such as a CD from a financial institution or a guaranteed investment contract (GIC) from an insurance company. Still, others will offer choices within a mutual fund, stocks, bonds, and the money market. You can contribute up to 25 percent of your salary into a 401(k) plan unless your employer lowers the limit. Some 401(k) plans will allow you to borrow from your account tax-free. Of course, you are limited as to how much you can borrow and you have to repay the money if you leave your job.

A 403(B) plan, sometimes called a tax–sheltered annuity (TSA)**,** is similar to a 401(k) plan. With this plan, you can contribute up to 20 percent of your salary unless your employer lowers the limit. A 403(b) plan offers no matching provision, but the choices of investments may be greater than with a 401(k) plan.

Some pension plans are portable. A portable pension plan allows you to take your vested pension accounts with you whenever you change jobs at which time you can receive a lump sum payment. Unless you roll over the entire sum into another retirement plan, you will be required to pay income taxes on the money in the year in which you receive it. If you are below the age of fifty–nine and one half, you will have to pay a 10 percent penalty on any money not rolled over as well.

For example, suppose that you have $100,000 in a pension fund. If you roll over the money into another retirement plan, you do not pay any taxes or penalties. To make a direct transfer from your previous plan to a new one, simply write to the new trustee, giving the location of your current account and ask them to make a custodian-to-custodian transfer. Some retirement plans do not allow for portability of benefits. In these cases, you must leave the funds in the pension plan until you retire. However, if you decide to take possession of this money, the IRS will require your employer to hold back 20 percent to pay taxes, leaving you with only $80,000. If you are younger than fifty–nine and one half, you will owe a 10 percent penalty as well. The only way to get back your $20,000 is to deposit $100,000 in another tax-deferred plan within six months. In this case, the fund will refund $20,000 to you when you file your income tax return.

If you are under the age of fifty–nine and a half and want to withdraw money from your retirement plan, you can avoid paying the 10 percent penalty by accepting periodic payments of the money. You will owe income taxes on the money withdrawn, but not on the 10 percent penalty. The distributions you receive must continue until the age of fifty–nine and one half, or for five years, whichever is later.

Corporations often offer stock ownership plans and profit sharing plans to their employees. With a stock ownership plan, the corporation invests retirement funds into the stock of the company. If the stock of the company does well, your retirement benefits can increase significantly. Of course, if the stock does poorly, your retirement benefits will be lower.

Another type of defined–contribution plan is the profit–sharing plan**,** a plan that bases the level of contributions to the plan by the employer on the profits of the company. When corporate profits are low, the employer will contribute less to the pension fund than when profits are high. Thus, the quality of the plan depends entirely on the success or failure of the business. With a profit sharing plan, each year you can decide whether to contribute to the plan.

PERSONAL PENSION PLANS

There are a number of different types of IRAs, which may be either employer-provided or self-provided plans. The types include the following:

- Roth IRA contributions with after-tax assets, all transactions within the IRA have no tax impact, and withdrawals are usually tax-free.
- Traditional IRA - contributions are often tax-deductible (often simplified as "money is deposited before tax" or "contributions are made with pre-tax assets"), all transactions and earnings within the IRA have no tax impact, and the government

taxes withdrawals at retirement as income (except for those portions of the withdrawal corresponding to contributions that the government did not tax. Depending upon the nature of the contribution, a traditional IRA is a "deductible IRA" or a "non-deductible IRA."

- SEP IRA - a provision that allows an employer (typically a small business or self-employed individual) to make retirement plan contributions into a Traditional IRA established in the employee's name instead of to a pension fund account in the company's name.
- SIMPLE IRA - a simplified employee pension plan that allows both employer and employee contributions similar to a 401(k) plan but with lower contribution limits and simpler (and thus less costly) administration. Although it is termed an IRA, the government treats it separately.
- A Self-Directed IRA plan permits the account holder to make investments on behalf of the retirement plan.

Starting with the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), many of the restrictions on what type of funds could be rolled into an IRA and what type of plans IRA funds could be rolled into were significantly relaxed. Additional acts have further relaxed similar restrictions. You can roll most retirement plans into an IRA after meeting certain criteria, and most retirement plans can accept funds from an IRA. An example of an exception is a non-governmental 457 plan that you cannot roll into anything but another non-governmental 457 plan.

The tax treatment of the above types of IRAs - except for Roth IRAs - is substantially similar, particularly for rules regarding distributions. SEP IRAs and SIMPLE IRAs also have additional rules similar to those for qualified plans governing how contributions can and must be made and which employees are qualified to participate.

You can fund an IRA with cash or cash equivalents. Attempting to transfer any other type of asset into the IRA is a prohibited transaction and disqualifies the fund from its beneficial tax treatment. Rollovers, transfers, and conversions between IRAs and other retirement accounts can include any asset. Individuals can contribute up to 100% of earned income or $5,000, whichever is less. This limit is for Roth IRAs, traditional IRAs, or some combination of the two. You cannot put more than $5,000 into your Roth and traditional IRA combined ($6,000 for individuals aged 50 or more).

For example, if you are 45 and put $3,500 into your traditional IRA this year so far, you can put either $1,500 more into your traditional IRA or $1,500 in your Roth IRA. There may be an additional administrative step needed so that the trustee who holds the IRA proceeds actually transfers the $3,500 Traditional proceeds into the Roth category for their internal bookkeeping to survive an IRS audit.

ANNUITIES

An annuity from an insurance company is another vehicle that you can use as a personal pension plan. A tax–sheltered annuity (TSA) is an investment on which you receive fixed payments for a lifetime or for a specified number of years. An annuitant is a person who receives the payment. You can make monthly payments into an annuity over a period, or you can make one lump sum payment. Either way, you will receive a certain amount of money, usually monthly. For example, the annuity might pay you $500 a month starting with your 65th birthday. Payments could continue until your death. If you die before or shortly after you are eligible to receive the payments, you get back less than you put in. However, if you live a long life, you should get back more than you put in. In essence, people who die early subsidize the people who live longer.

The most common type of annuity is a straight life annuity; it will make set payments to you every month until you die. Another type of annuity is a variable annuity, which will pay you according to how well its investments perform. Most annuities are single life annuities that only pay an individual. However, some annuities offer joint survivorship, which continues to pay even after the death of one recipient.

Sometimes annuities can shelter from taxes money taken out of a pension plan, like a 401(k) or a 403(b) plan. For example, suppose that you are seventy and one half years old, the age at which you have to start withdrawing money from your 401(k) plan. Money you do not needed at that time you can put into an annuity and thus escape taxation. However, although annuities do function as tax shelters, it is not a good idea to use them as such, at least before you take advantage of every other possibility. Why? Unlike tax deferred retirement plans, the government does not shelter this income from taxes. In this respect, annuities are similar to U.S. Savings bonds. You must pay taxes on the income, but the money that is in the fund can accumulate tax-free until it is withdrawn.

Because of the length and wording of some annuity contracts, understanding the terms may be difficult. Another caution concerns fees and commissions; as with some mutual funds, you can pay front end loads and back–end loads. Usually during the first seven years, there are early withdrawal penalties and other costly fees and penalties. As a result, the return on your invested money can be quite low. Federal regulations require that every variable annuity give you a prospectus that specifies all of the costs associated with the policy.

Finally, make sure that the company you go with is a sound one. Do not give into the temptation of going with a company just because it offers you a high return on your investment. Some companies entice you with high return—but you are taking a high risk. What happens if you put all of your retirement money into an annuity, and the insurance company goes out of business? Unlike your bank deposits that the Federal Deposit Insurance Corporation insures, your annuity has no insurance. If your bank goes bankrupt, it may take several months, but you will get your money back. However, you have no protection if your insurance company goes under. Variable annuities are safer than fixed annuities because variable annuity investments are off limits to insurance company creditors.

REVERSE MORTGAGES

A reverse mortgage is another possible source of income for retired homeowners. If you would like to continue living in your house, but do not have enough income, a reverse mortgage may give you the income you need. A reverse mortgage allows you to use the equity in your home as collateral for a loan. You must repay this loan with interest when you sell the house. This arrangement will not affect your Social Security payments. The money received is a loan and not considered income for tax purposes. You must continue to pay property taxes and house insurance.

At the closing, you can choose one of three payment plans:

- The tenure option gives you equal monthly payments if the house is your principle residence.
- A line of credit allows you to draw up a maximum amount of cash at, and in the amounts of that which you chose for as long as you live in the house.
- A modified tenure option combines a line of credit with monthly payments. You are free to change payment plans anytime.

Consider a reverse mortgage in more detail. For you to qualify for a reverse mortgage both you and your spouse must be sixty–two years old or older and you must own the house, or nearly own the house. The lender will determine your payments by your age, the interest rate on the loan, and the appraised value of the house. Until the point that the seller dies and the buyer takes possession of the house, the homeowner has to pay interest on any money received. The seller must also pay an origination fee, closing costs, and a premium for mortgage insurance—the same as with a regular mortgage.

When the seller(s) dies or vacates the house, the bank will sell it to satisfy the loan obligation. After the lender has received his money, the seller(s) can keep any monies left over from the proceeds of the house. If the proceeds are insufficient to satisfy the loan agreement, the beneficiaries must pay the difference from the estate

CHAPTER TWELVE

ESTATE PLANNING

As husband and wife, Ross and Jan served in the army together for fifteen years before Ross died unexpectedly. Although Ross had a life insurance policy through the army, Jan did not receive a dime. Jan did not receive any benefits because someone told Ross that since Jan was also in the military, he could not name her as his beneficiary. Their son became the beneficiary. After Ross died the son received benefits for three years until the age of twenty-one. Jan now realizes that Ross could have named her as his beneficiary and consequently she could have received benefits for as long as she lived. Jan missed a lifelong income because her husband took advice from someone who did not know the facts.

When you get financial advice, make sure it is from a qualified financial planner or other qualified persons. Also, make sure that you understand the fees and commissions involved beforehand. Make sure that you get full answers to your inquiries about expenses as some planners will deflect your questions, give you only a partial answer, or simply blow smoke in your eyes. Some financial planners will push only financial products that they get the highest sales commissions from which may or may not be the best products for you.

Consider what happened to Jim and Lou. Jim's company forced him to accept an early retirement offer. He sought the advice of two financial planners about how to best handle the $170,000 worth of stock in the company's 401(k) plan. The first financial planner would earn commissions on the financial products she sold the couple. She advised them to put their money into stocks, bonds, a tax deferred annuity and some whole life insurance for Lou. The only visible cost was the $150 the Henderson's paid up–front for the initial meeting and subsequent recommendations. However, after the couple did some investigating on their own, they discovered that they would end up paying $8,000 to $12,000 in sales commissions for the stock funds and life insurance.

They consulted with a fee only financial planner. This planner would charge them a maximum of $2,000 to develop a full plan and to execute it for them. The financial plan she suggested did not require any commissions. The Henderson's balked at the up–front costs until they realized that the costs involved with the first planner would be at least $8,000 more!

If you are interested in receiving financial advice, call the National Association of Personal Financial Advisors, http://www.napfa.org/, for a list of financial advisors in your area. NAPFA is the nation's leading organization dedicated to the advancement of Fee-Only comprehensive financial planning. You can also contact the American Institute of Certified Public Accountants, http://www.aicpa.org/, for a list of accountants in your area who do financial planning.

YOUR PARENTS

There comes a time when you should talk with your parents while they are healthy and able to discuss important financial/legal matters. Have them show you where they keep their wills, insurance policies and bank statements.

- Get a complete list of expensive items with the date of purchase and the price. This will give you a basis price for tax purposes if you sell the items. If you sell the assets at the time of their death, you will not owe any capital gains tax.
- Ask your parents if they have any valuable jewelry hidden away in the house. You do not want to sell the house with valuables still in it, unknown to you.
- Make sure to get a health–care proxy. A health-care proxy will give you the right to make health–care decisions such as whether to approve an operation. Rules vary from state to state, but often this document is incorporated into a living will. A living will outlines the measures that would be acceptable to prolong life.

- Get a general power of attorney. This legal document gives you the right to sign tax returns, transfer assets into a trust fund and make financial decisions for your parent, should he or she become incompetent. Some assets, like brokerage accounts, may require specific powers of attorney, since some financial institutions do not honor a general power of attorney. This power of attorney is important because your parent(s) can live many years while not being healthy enough to make decisions on their own.
- Know the whereabouts of your parent(s) will if they have one. A will is a legal document which directs the distribution of one's assets upon death. The more complex your parent's financial situation, the more important it is that they have a will.
- In certain cases, a living trust may be necessary. A living trust is a legal document that places control of one's assets under a trustee. A trustee is a person or institution that manages the financial assets of another. You can be the trustee. You should have any legal document notarized. Notarization makes it harder for a third party to challenge the validity of the signature.
- When your parents die, their bank accounts are frozen. Therefore, if they keep important papers in a safe deposit box, make provisions now so that you have the legal right to gain access to it when the time comes. Or have them keep important papers at home in a fire proof box.

PROPERTY

What happens to your assets when you die? If you are single and own property, you are free to make provisions and distribute the property in any way you wish. However, things are a little more complicated if you own property jointly with someone else. You can own the property by tenants in the entirety, joint tenants, and tenancy in common, or as community property. The legalities of each type of ownership and the rules affecting each depend on the state in which you live. Following is a general discussion of these four different types of joint ownership of property.

- Only married couples can own property as tenants in the entirety. Usually this provision applies to real estate. When you hold property as tenants in the entirety both you and your spouse have to agree before you can sell the property. When your spouse dies, the property automatically reverts to you. Tenants in the entirety supersede anything to the contrary that is in a will.

- You can jointly own property in equal or unequal shares with another person or persons. The law calls this Joint tenancy. You can hold common stocks, mutual funds, savings accounts, checking accounts, real estate or just about anything in this fashion. The law allows you to sell your share without the permission of the other joint owners. When an owner dies, his share automatically reverts to the others. The deceased's will has no effect in the distribution of stated property when held in this fashion.
- Tenancy in common is another way of owning property jointly with others and is similar to joint tenancy. Unlike joint tenancy, however, when one person dies, ownership does not automatically revert to the other owners. Here the deceased's will takes precedence. When there is no will, authorities will distribute the property according to state law.
- Some states recognize community property. In states that allow community property**,** everything a husband and wife have they equally own. In states where this type of ownership is legal, all jointly held property reverts to the survivor when the other dies, no matter what is in a will.

INTESTACY (THE STATE OF DYING WITHOUT A WILL)

Unless you own property jointly, after your death authorities will distribute your property according to state law, unless you have a will. A will, however, is not valid unless you write it according to the statutes of your state. What happens to your property should you die without a will? The answer to this question depends on your situation and state law. You do not need a will if state laws are commensurate with your wishes. State laws can be very complex about who is an heir, especially without a spouse or children. Even when there are children, the situation is not always easy and can be expensive to administer.

In some states, in the absence of a will, the state will divide the deceased's assets equally among his wife and children. The state will freeze the children's assets until they reached the age of eighteen. Until that time, a state- appointed guardian would manage the minor children's money. The guardian would need to make detailed annual reports to the courts as to the management of the children's assets.

THE CONTENTS OF A TYPICAL WILL

In 1995, Chief Justice Warren Burgar, who served as the nation's chief justice on the Supreme Court longer than anyone else this century, died with an estate valued at $1.8 million. Unfortunately, his heirs will owe over $450,000 in federal and state taxes on the estate because Chief Burgar's will was hastily worded. A part of the problem was some misspelled words.

More importantly, however, he did not grant the executors power to sell his real estate. He also failed to waive bond or surety, making it necessary to get a bonding company to insure the executors against any claims of negligence. The will was not "self–proving" under Virginia law, meaning that the two witnesses to Burger's signature could be required to testify in person that they saw him sign it. All of these things added to attorney fees and unnecessary court costs. With a properly drawn will, they could have avoided many of these costs.

Wills differ from person to person and from state to state, but have common provisions. Every will must have an executor. An executor is a male named in a will (a female is known as an executrix) to whom the state gives legal authority to carry out the directions and requests of the will. An executor is a person who does the following:

1. Reads your will.
2. Gives notice of your death to your bank and other financial institutions.
3. Contacts insurance companies.
4. Calls newspaper for obituary.
5. Pays necessary bills.
6. Petitions the court to probate your will. This includes finding your witnesses and verifying heirship.
7. Takes an inventory of all your assets. This includes appraising the value of the assets for tax purposes.
8. Carries out any specific duties set down in your will.
9. Makes all your tax returns, federal and state, income and inheritance.
10. Contacts all of your creditors.

11. Is responsible for the distribution of your assets according to your will.
12. Secures final discharge as executor.

Your will should name a substitute executor in case the first executor should be unable to perform his or her duties. The executor could be a friend, relative, or a professional. Most banks have trust departments that act as executors. The executor must know the whereabouts of the original will.

Whether a will is computer generated or drawn up by a lawyer, you should be generally aware of what a will contains.

- All wills should have an introductory statement. Introductory statement states that you are the testator and that this document is your last will and testament, which revokes all previous wills. A testator is a person who makes a will.
- There should be an explanation of how to pay your debts and final expenses.
- If you have minor children, you should appoint a guardian for the children. This provision is especially important if you are a single parent. If you are single and you die, the courts will be responsible for appointing a guardian, unless you specify a guardian in your will.
- A will should list the specific gifts to the persons.
- A will should specify the specific dollar amounts, or percentages, received by those listed in the will, from the proceeds of the estate.
- All wills must be witnessed according to state law, dated, and signed.

CODICILS

You can amend a will by a codicil, a supplement added to a will by an attorney used to make certain changes. Circumstances such as marriage, divorce, a move to another state, the birth of a child, a substantial change in your assets, or the death of heirs or executors demand a change in your will. Your lawyer would advise you to have a new will draw up rather than use a number of codicils, to avoid confusion.

LETTERS OF LAST INSTRUCTION

A letter of last instruction should accompany a will because you can be easily modify it. A letter of last instruction is a signed letter providing additional information for the orderly transfer of your estate. Unlike a will, this letter is informal and requires no legal counsel. The intent of the letter is to give detailed instructions that you have not specified in your will. The letter should include such things as funeral instructions, the donation of your organs, and an outline for the distribution of your assets and their location.

Particularly important is the location of your will, automobile titles, property deeds, safe deposit box, insurance policies, tax returns, canceled checks, the locations of savings accounts, accounts at brokerage firms, and a list of people to notify upon your death. Your attorney and executor should each receive a copy of the letter. You should also keep one at home along with a copy of your will.

TAXES RELATING TO ESTATES

The Estate Tax is a tax on your right to transfer property at your death. It consists of an accounting of everything you own or have certain interests in at the date of death (Refer to Form 706 (PDF)). The fair market value of these items is used, not what you paid for them or what their values were when you acquired them. The total of all of these items is your "Gross Estate." The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.

Once you have accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at your "Taxable Estate." These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities.

After you compute the net amount, you add the value of lifetime taxable gifts to this number and the tax is computed. The government then reduces the tax credit. Presently, the amount of this credit reduces the computed tax so that only total taxable estates and lifetime gifts that exceed $1,000,000 will actually have to pay tax. In its current form, the estate tax only affects the wealthiest two percent of all Americans.

Most relatively simple estates (cash, publicly traded securities, small amounts of other easily valued assets, and no special deductions or elections, or jointly held property) do not require the filing of an estate tax return. A filing is required for estates with combined gross assets and prior taxable gifts exceeding $1,500,000 in 2004 - 2005; $2,000,000 in 2006 - 2008; and $3,500,000 effective for decedents dying on or after January 1, 2009.

Your estate will owe income taxes for the last year of your life. Your executor must file and pay any federal and state tax owed. Can the IRS audit you after you are dead? Yes. It is standard operating procedure for the IRS to examine the federal income tax returns of a decedent for three years prior to his death. This is another good reason for having good records and for your heirs to know the whereabouts of your records.

What happens if you sell inherited property? Do you owe any capital gains taxes? A stepped up basis determines the value of property that passes through an estate. This means that the state determines the base value of the property according to its market value at the time of death. You pay capital gains taxes only on the difference between the value of the property at the time of death and the selling price.

In addition to federal taxes, you may also face state taxes. Approximately thirty states collect death taxes independently of federal taxes. Some of them collect death taxes on estates valued at $100 or more. States can impose either an estate tax or an inheritance tax as a death tax. The state imposes an estate death tax on the net value of the property. The net value is the gross value minus deductions and tax credits. The state will assess inheritance taxes, on the other hand, on each beneficiary's share of the estate. Problems can arise if a person has two homes. For example, let's suppose that your parents have a winter home in one state and a summer home in another state. Let's suppose also that both states have death taxes. Which state will collect the death taxes? The answer is, possibly both. The rules that determine tax liability vary from state to state.

TRUSTS

All wills have to go through probate. Probate is the process of legally establishing the validity of a will before a judicial authority. Sometimes probate is a simple and inexpensive matter; however, when estates are large and complex, probate can be lengthy and expensive. In order to avoid probate, you can have a lawyer set up a living trust.

A trust is a legal title to property held by one party for the benefit of another. The person giving the assets is the grantor. The person who is responsible for managing the assets is the trustee. Although the trustee manages the assets and holds title to them, the grantor gives specific management instructions in a written trust agreement. A living trust, also known as an inter vivos trust, is a legal document used to hold assets, such as stocks, bonds, bank accounts, and real estate, etc. The law calls it a living trust because your assets, as the grantor, or any part thereof, get transferred to the trust while you are still alive.

Because a trust is a legal document, it will not do what you intend for it to do unless it complies with the laws of your state. The trust document provides instructions for managing the trust property and it will direct the distribution of your property after your death. Although the ultimate function of a trust is similar to a will, it is superior to a will because of the benefits it provides while you are still living.

Living trusts are of three kinds: revocable, irrevocable and testamentary. With a revocable living trust, you the grantor can control the assets held under the trust, amend the trust or revoke it and you can add assets or delete them. Though the trust does not reduce estate taxes upon your death, it does eliminate the need for probate. Because the trust does not go through probate, nothing is on public record.

A big difference between a revocable living trust and an irrevocable living trust is that you can amend a revocable living trust. With an irrevocable living trust, you forfeit the title to any asset placed in the trust. This offers a benefit in that the law does not consider these forfeited a part of your estate upon death. As with a revocable living trust, an irrevocable living trust eliminates the need for probate. A big disadvantage of an irrevocable living trust is that you must pay gift taxes on anything put into the trust.

A testamentary trust becomes effective upon your death according to the terms written in your will. The terms of the trust come into being only after you probate the will. Since the trust does not go into effect until after your death, you retain control over the assets. You pay no gift taxes on assets shifted into a testamentary trust.

DEALING WITH NURSING HOME EXPENSES

Medicare and private insurance do not cover the cost of long-term care. Consequently, should a family member need nursing home care, the average American family would lose their entire life savings in thirteen weeks.

Consider Mike and Marguerite. Mike had to retire at the age of sixty to care for Marguerite who had Alzheimer's disease. His salary had been in the $70,000 range. Mike carried no debt and was not concerned about their finances as he should be able care for Margruite with their savings and his retirement income. After a time, however, Margruite's condition worsened and Mike realized she needed the care of a nursing home at the cost of $40,000 a year! At this rate, their savings would be gone in just two years.

Mike then learned of the Spousal Impoverishment Act. Thanks to this act, Mike is entitled to keep approximately half of their assets and to use Marguerite's half to pay for her nursing home expenses. After Margruite depletes her money, Medicare and Medicaid will meet her expenses.

Medicare is a program of the Social Security Administration that provides payment for hospital and medical expenses of person's age sixty–five and over and some others. Medicare, however, does not pay for long-term care as would be the case with Alzheimer's patients. However, even an Alzheimer's patient can qualify for limited 100–day Medicare coverage in a nursing home. In order for a person to qualify for Medicare coverage he must meet certain criteria.

- The care must be medically necessary.
- At least three days in a hospital must precede the nursing home care.
- The nursing home must be a Medicare-approved skilled nursing home.
- The bed assigned to the patient must be Medicare certified.
- The nursing home must provide skilled care by medically trained professionals.

Most Medicare beneficiaries buy extra insurance to fill Medicare's gaps. The private policies pick up the cost of the first day in the hospital, some doctor bills and other charges that Medicare does not pay. Some medigap insurance policies supplement Medicare as to the 100–day coverage in a nursing home. For example, should you enter a nursing home and need skilled care, Medicare would cover the cost. However, if your physical condition improves to the point that you can get by with custodial care, the Medicare coverage would stop. At this point, you would need a medigap policy to take over for the remainder of the 100 days.

Health insurance does not pay for long term health care unless you buy a policy for this purpose. An insurance policy for long term care is expensive and the benefits can be limited. Insurance companies normally sell policies per individual; of course, couples can always buy two policies or a joint policy.

MEDICAID

Medicaid is a jointly financed program of the federal government and states that pays some medical expenses for indigent people. The federal government reimburses states 50 percent of their Medicaid expenses. Although the government recommends that the states adopt its regulations for Medicaid eligibility, it is not mandatory that states do so. Therefore, it is important that you know the rules as they apply to Medicaid in your state. Following is a general discussion of Medicaid, as it commonly exists.

The government divides your assets into three categories to decide Medicaid eligibility: countable, no countable and inaccessible. The countable assets are assets that you must reduce to zero before Medicaid will meet any of your expenses**.** Countable assets are cash more than $2,000 (can vary from state to state), stocks, bonds, IRAs, Keogh Accounts, CD's, annuities, investment property, cash value in a whole life insurance policy, vacation homes, second vehicles and every other asset not specifically listed as no countable.

You cannot count some assets are assets when you apply for Medicaid. They include a house, less than $2,000 in cash (can vary from state to state), jewelry (usually consisting of one wedding ring and one engagement ring), household goods, burial plots, and term life insurance. Inaccessible assets are assets that are unavailable to you and thus inaccessible to Medicaid. You can hold inaccessible assets within a trust.

Because of the Spousal Impoverishment Act*,* the law better protects married persons than single persons. If you are married and your spouse goes into a nursing home, Medicaid will take a snapshot of all your countable assets. The state will allow you to keep half the assets listed on this day. The dollar amount that the state allows you to keep can range from $12,000 to $60,000, depending on the state in which you live. Because of this stipulation, if your assets are sizable, you can end up spending more than half your combined countable assets. For example, suppose that you and your spouse have $300,000 in countable assets. Does this mean that you can keep $150,000? Not necessarily. If you live in a state that allows you to keep only $60,000, then you stand to spend a total of $240,000 out of the $300,000.

If you consider setting up a trust for Medicaid purposes, the law only protects the countable assets in the trust if it is an irrevocable living trust. If you have control over the assets, as with a revocable living trust, Medicaid will also have access to the funds. With an irrevocable living trust, although you lose control over the assets in the trust, you can still receive the income produced from those assets.

SOURCES FOR GETTING HELP

Following is a list of organizations that can provide helpful information concerning estate planning.

American Association of Homes for the Aging: http://www.aahsa.org/

American Council of Life Insurance: http://www.usinsuranceonline.com/

American Care Association: http://www.ahca.org/

Council of Better Business Bureaus: http://www.bbb.org/

National Council of Senior Citizens: http://www.nsclc.org/