FPA FINANCIAL PLANNING PERSPECTIVES

Getting Today's Best Returns from a Home Renovation

It's a much different picture renovating a home in 2007 than in 1997. Fueled by huge gains in the price of real estate, homeowners a decade ago were tapping home equity with little care since prices were expected to keep climbing, more than covering the cost of such improvements.

Today, with the slowdown in real estate and the widening damage in the subprime loan market, home prices aren't rising much – and falling in some places. And lenders tend to be a lot choosier these days about who to do business with. So before considering a home renovation, it makes sense to make sure your financial house is in order:

Start with your credit report: If you're considering borrowing, make sure your credit report and payment records are in the best possible shape. As in most economic crises, lenders go from being permissive to squeamish in an instant, so even people with good credit behavior are going to be under the microscope. Start by checking your credit report -- you have the right to get all three of your credit reports – from Experian, TransUnion and Equifax – once a year for free. You can do so by ordering them at www.annualcreditreport.com, but do so at staggered times throughout the year so you can catch potential errors in your report as they happen. Also, if you need to clean up any bad behavior – late bills, heavy credit card debt, clean it up before you wander back into the real estate market. Remember that a bad credit score can raise the total cost of your mortgage.

See what kind of payoff your chosen renovation will have: During the housing boom, people thought virtually any renovation would offer big returns. That wasn't true then, and it's particularly untrue now. Take the time to figure out what renovations have the best chance for return on investment now – go to *Remodeling* magazine's annual *Cost vs. Value* report online (http://www.remodeling.hw.net/content/CvsV/CostvsValue-project.asp?articleID=381305&sectionID=173) and check 2006 project cost averages for your region of the country. In this market, renovate because it's going to bring you comfort or pleasure, not because you're expecting immediate profits.

Know how long you'll need to stick around: When you sell, remember that most married couples can exclude from their taxable income up to $500,000 of gain and most individuals filing single or married filing separately can exclude up to $250,000. It's required that you must have owned and used your home as your principal residence for two out of five years before the sale. The exclusion is generally applicable once every two years. However, if you are unable to meet the two-year ownership and use requirements because of a change in employment, health reasons or unforeseen circumstances, then your exclusion may be prorated.

Beware the bump in property taxes: The great thing about a more valuable home is the potential higher value when you sell. The bad thing is a visit from the county assessor – more valuable property tends to lead to higher tax assessments. Make sure you cannot only afford the cost of renovation, but what you'll need to pay higher taxes if your home is reassessed.

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Don't forget to deduct applicable sales tax: If sales tax was imposed on a major renovation or if your state or locality imposes a general sales tax on the sale of a home or the cost of a substantial addition or major renovation, you might be able to deduct it. This alternative is particularly valuable in low-tax states, and the sales tax paid on the purchase of some large items including the purchase of a home or major addition can be added to the table amounts.

Make sure your renovation makes your home salable: A discussion with a real estate agent or someone familiar with the value of improvements in your immediate neighborhood can tell you what will add to value or take it away. For instance, a big addition can take away from the value of a home if it's not aesthetically in tune with the rest of the neighborhood. Obviously, any renovation that keeps your house on the market longer better be worth it now because it might damage your sales prospects later.

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Trick or Treat: Why You Should be Scared of Financial "Help" on Late-night TV

Misinformation and insomnia make great bedfellows. Late-night television is filled with too-good-to-be-true solutions for everything from unmanageable mortgages and other debt woes to healthcare. These advertisers must know that their primary target is a viewer with money problems that keep them awake.

The words "As seen on TV" should be an immediate alert to seek confirmation of that advice elsewhere, like with a financial planner. If TV advertising or network programming – even advice on popular daytime cable business shows – offer financial advice, it's wise to seek a second opinion. Some key areas to watch closely:

Credit cleanup: There's one ad that features a woman in a darkened kitchen literally cowering whenever the phone rings – when her answering machine picks up, it's the sound of a familiar and persistent bill collector. It's very effective and promotes a particular credit repair service with an 800 number. There's nothing illegal about credit repair services as long as they work within present legal guidelines, but if you're having credit problems, credit repair agencies should be a last resort. Why? Because most of these agencies charge fees to help you manage debt in ways you can do on your own. A 2006 Georgetown University study[1] reports that counseled borrowers are much more likely to declare bankruptcy during the two years following counseling.

Payday loans: TV ads for payday loans show friendly, clean offices that allow people to borrow small amounts of money -- $300 is an average -- against their paycheck for a short period of time – usually two weeks or a month at rates sometimes exceeding 15 percent. The industry has gotten hugely popular and profitable in recent years -- a 2003 University of North Carolina study [2] noted that while "virtually no payday loan outlets existed 10 years ago, industry analysts estimate there are now up to 14,000 of them, with total loan originations of between $8 billion and $14 billion in 2000 alone." Payday loan agencies can be legal places of business, but they are an even worse source of cash than high-rate courtesy checks from credit card companies.

Legal settlement and annuity loans: In recent years, legal financial institutions have sprung up to buy annuities or lend against structured court settlements that otherwise would take years for an individual to collect. There's one ubiquitous ad that mentions the words "cash now" at least three times within a 30-second spot. There may indeed be solid reasons for selling off all or parts of these income streams, but you'll pay for the privilege.

Mortgage and home-equity loans for the problem borrower: Even with the current subprime lending debacle, advertising continues for no- and low-downpayment loans at attractive rates –

1 http://www.gwu.edu/~business/research/centers/fsrp/pdf/Evaluating%20the%20Effectiveness%20of%20Credit%20Counseling_Phase%20One.pdf

2 http://www.ccc.unc.edu/documents/CC_Payday_lending.pdf

as if these institutions are the only ones able to make affordable loans while most reputable lending institutions have pulled in their oars. Again, these lenders are reaching out for desperate borrowers, but don't buy the hype. A financial adviser, qualified real estate attorney or experienced licensed real estate agent are better sources of borrowing advice no matter what your current financial circumstances.

National bankruptcy and personal-injury law firms: Despite a tightening of the U.S. bankruptcy laws, there are still plenty of attorneys on the airwaves promising to "rescue" you by helping you file. Indeed, there are legitimate reasons to file bankruptcy as well as file lawsuits against people or institutions that have done you harm. The concern about these multi-state law firms promising you a successful bankruptcy or legal defense is that they tend to handle thousands of cases in multiple states without a lot of personal service. You may not get the same quality advice as you can get in your own community, including whether or not to file in the first place. Such matters are too serious to be solved by dialing an 800 number -- for many, bankruptcy can and should be avoided, and many lawsuits for personal injury and other causes may not be winnable. A financial planner cannot dispense legal advice unless they are a licensed attorney, but they can generally give you the pros and cons of such legal actions and refer you to qualified legal counsel if necessary.

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Thinking About a New Mortgage in 2008? It's a New World Out There

If you're thinking about moving or refinancing next year, it's good to make a plan now for how you'll approach lenders. The current debacle in the subprime mortgage market has made all lenders somewhat skittish about future business, and while getting a loan will be possible for most borrowers with acceptable credit, it makes sense to make yourself attractive as a borrower while anticipating fees and conditions you might face.

Get some advice: Given changing mortgage conditions, it might make sense to see how mortgage debt fits into your overall financial picture. You might consider meeting with a financial planner to review how much loan you can afford based on your own financial circumstances. If you're buying a new home, bring your agent or lawyer into the loan discussion – they may not only have good contacts, they may also help you negotiate a better deal.

Clean up your credit: A good credit report is always essential in a lending process, but even more critical now. Various reports say that lenders want credit scores that are at least 10 to 20 points higher than standards for various loans only six months ago. Things may stabilize after the first of the year, but don't count on it. Remember you have the right to a free credit report annually from each of the major credit rating agencies -- Experian, TransUnion and Equifax – and you may order them from www.annualcreditreport.com, but do so at staggered times throughout the year so you can catch potential errors in your report as they happen.

Cut your revolving debt: The holidays are coming, so resolve not only to curb your spending but also to attack your credit card debt. A large amount of unsecured debt is a negative on mortgage applications, so even if you can't eliminate it all, make sure those balances get considerably smaller before you apply. Keep in mind that credit scores are generally higher for borrowers who borrow 30 percent or less of their credit limit on any revolving account.

Be prepared for larger downpayments: Current borrowers have been getting a shock after they've applied – in certain cases, lenders have been coming back to them demanding larger downpayments in order to qualify for the loan they want. The days of less than 5 percent downpayments on private loans may be scarce for awhile – 10 percent and up may be more common in the future. The best loans still come when putting 20 percent or more down.

Don't ignore fees: One of the things a real estate attorney can help with is a closer understanding of mortgage fees and the reality of how they can change by closing. This is very important because you'll be deluged in paper once the process starts. There is not, nor has there ever been, a mortgage with "no closing costs" as you'll hear on TV and radio. Lenders – whether mortgage banks, credit unions or mortgage brokers – are in the business to make money, and you need to understand exactly how they plan to make it. Don't be surprised if mortgage lenders make up some of the profit from slowing real estate sales in higher fees or charges. Be aggressive about questioning fees, and don't be afraid to walk away from a lender who won't explain them or adjust fees that are clearly onerous.

Be willing to settle for a smaller property: One of the realities of the tougher mortgage market is that lenders won't be enabling many borrowers to go into larger homes than they can

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afford. Unless you have a lot of downpayment money and great credit, it might be time for a reality check. Lenders who gleefully told borrowers six months ago that they could spend up to 50 percent of their pretax income on a monthly mortgage payment are now pushing for 40 percent or less.

If you're self-employed: It's never been terribly easy for self-employed people to get credit, but get used to more of a hassle when applying today. The market for low- or no-documentation loans is getting tighter. This is why it's particularly important for people who can't verify income to have spotless credit.

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