AVOID THESE DEBT REDUCTION PITFALLS

TABLE OF CONTENTS

INTRODUCTION

Carrying a lot of debt almost seems to be the American way. But the challenges debt can pose are no laughing matter. Debt has the ability to negatively affect your future plans, outlook on life, ability to retire comfortably, and even enjoyment of life.

Unfortunately, many of us know from experience just how much impact debt can have on one's life. Yes, debt is one of life's great stressors.

Consider how much better you would feel if your debt were completely eliminated. You would be free to spend your money on whatever you want rather than debt payments. Oh, what a different, liberating lifestyle you could have! Getting out of debt can be one of the very best things you can do for yourself and your family.

Eliminating your debt requires conscious effort and a plan.

Perhaps your plan is making the minimum payments until you get caught up. The minimum payment is designed to maximize the profit of the credit card company. It can take 30 years or more to pay it all back, and that assumes that you never use the card again. Do you really want to carry that old debt like a monkey on your back for the next 30 years?

So the question is, *"Which plan is the right plan for me?"* Sometimes, the best path can be largely determined by looking at the disadvantages of the different options that are available.

We're going to look at six of the most common debt reduction options and point out the potential pitfalls of each. That way, you can decide if any of these options are right for you with your eyes wide open, so you can determine if the advantages for you outweigh the disadvantages.

The debt reduction options that we'll examine are:

- ✓ Debt Settlement
- ✓ Debt Consolidation – Home Equity Loan
- ✓ Unsecured Debt Consolidation Loan
- ✓ Credit Counseling
- ✓ Bankruptcy Chapter 7
- ✓ Bankruptcy Chapter 13

The main pitfalls are the potential effects that these options can have on the following areas:

- ✓ Credit scores
- ✓ Taxes
- ✓ Cost
- ✓ Time
- ✓ Potential for legal action against you

Let's get started...

"Rather go to bed supperless, than rise in debt."

–Benjamin Franklin

DEBT SETTLEMENT

Debt settlement is negotiating a reduction in the amount of your debt. In the process of debt settlement, you stop making payments on your debt, either because you're unable to make payments, or because you're trying to gain leverage.

Stopping your payments is very important in debt settlement because, if you continue making your payments, what's the incentive for the creditor to accept a settlement?

The idea is that the creditor will accept a lesser amount than the true balance as payment in full. They're likely willing to take something now rather than risk getting nothing later.

Most collection agencies are permitted to settle for less than the full amount, and it happens all the time. Settlements are typically a one-time payoff and are frequently around 50% of the total amount due. The amount can vary, depending on the creditor and the skill of the negotiator.

Potential pitfalls:

1. **Credit.** Since you're not making payments, your failure to pay will be reported to the credit bureaus. It may take some time to save up enough money to pay the settlement and during that time you'll be reported as delinquent.

    ✓ While you're working on saving enough, the creditor calls can be unrelenting, though several annoying phone calls a day are likely the least of your challenges at this point.

2. **Taxes.** With debt settlement, there are tax implications. For example, if you're able to settle a $10,000 debt for $6,000, that $4,000 difference can be taxed as income. However, there are few things to consider:

    ✓ ***If you're insolvent at the time of the settlement, you don't have to pay taxes on the "forgiven" amount.*** The IRS considers you to be insolvent if your total assets are less than your total liabilities.

- ✓ It might still be worth it in the end, depending on your tax rate and other circumstances. Look at the total cost and savings.

3. **Cost.** The total financial cost of debt settlement is typically lower than any of the other options except Chapter 7 Bankruptcy.

   - ✓ There are firms that will, for a fee, negotiate your debt settlement with your creditors for you. Often, they charge a percent of the total amount of your debt reduction. However, you can also do the negotiating yourself and avoid such fees.

4. **Time.** This solution can take some time. You'll have to miss several payments, if you haven't already, before the creditors are willing to negotiate. It will also take time to save sufficient funds, depending on your income, other expenses, and the amount of the debt.

5. **Potential for legal action against you.** There is always the possibility of the creditor filing a lawsuit against you for failure to pay. This consequence is unlikely unless the debt is for a large amount or your creditor believes you have the assets needed to satisfy the debt.

- ✓ So, for example, if you owe $75,000 and have a vacation home that's paid for, you might be sued.
- ✓ It most cases, a lawsuit is unlikely for several reasons:

    a. It's expensive. Lawyers are expensive. Unless you owe a lot, it's not worth the expense for them to take you to court.

    b. If you don't have any assets, what's the point? You can't get blood from a turnip, as they say.

    c. You could still file for bankruptcy, and are probably more likely to if they push you. Debt collectors can be ruthless, but they typically won't take drastic action that will lead you to view bankruptcy as a viable option because, ***if you file for bankruptcy, they might get nothing.***

By far, the number one rule of debt settlement is: Get everything in writing before you write a check. Don't ever believe anything that you're told on the phone.

> ***"I say to you never involve yourself in debt, and become no man's surety."***
>
> ***–Andrew Jackson***

DEBT CONSOLIDATION – HOME EQUITY LOAN

If you’re a homeowner, you can use a home equity loan to pay off your debts, providing there is enough equity in your home. The loans offer a low-interest way to get a handle on your debts.

The funds of the loan are applied to the debts, and you make a single payment each month. These loans are typically easier than some to qualify for, since the loan is secured against your home. While the method has a lot to offer, there are some possible disadvantages to consider as well.

Potential pitfalls:

1. **Credit.** This method has no negative impact on your credit. ***It may even help your credit,*** if you didn't already have a home equity credit line open in your credit history and as long as you make your payments on time.

- ✓ One component of your credit score is the total amount of your available credit you’re using. Having more credit available to you improves your utilization ratio.

- ✓ It will also help your credit if you're currently late on your debt payments and you're now able to pay them off in full with the equity loan or get back on track with on-time payments.

- ✓ However, it’s important to ensure that you *can* handle this loan payment before you take out the loan. If you can’t make the payments for this loan on time, this line of credit will be one more black mark against your credit history and score.

2. **Taxes.** The laws are somewhat complicated, but most people can deduct interest paid on home equity loans if the loan is secured against a first or second home.

   The interest that's deductible is usually only that which is paid on the first $100,000 worth of the loan. Be sure to check with your tax professional for the details of your own situation.

3. **Cost.** The total cost can be significantly less than what you're currently paying in interest and fees on your debts, depending on the interest rates involved and the length of the loan.

    - ✓ You'll still be paying your other debts in full, so you won't have savings on the principal amounts like you would if you used the Debt Settlement option.

    - ✓ ***Your savings is in the amount of interest you pay,*** but that's only true if the length of the loan is reasonable. To maximize your savings, keep the loan term as short as you can handle and always calculate the total cost before you make a decision.

4. **Time.** The total time to pay the debts in question is very minimal, as long as the funds are used to totally eradicate your debts. The length of time to pay the home equity loan? That depends on the length of the loan.

5. **Potential for legal action against you.** If you make the payments on the home equity loan, there's no risk. ***If you don't make your payments as required, your home will eventually be foreclosed***

upon. The time frame varies from state to state.

The real potential pitfall is that you might pull out the credit cards again and rack up new debt in addition to the home equity loan. You have the capacity to make your situation twice as bad as it was before. Don't put yourself into an even more challenging situation!

The other pitfall is if you don't pay the new loan. If you're taking on new debt that has collateral (like a home equity loan) to pay off unsecured debt (like credit cards), ***your personal liability is much greater.***

Credit card companies can't do a whole lot to you, but the bank that holds your second mortgage certainly can. Be sure you can make the new payment; for this type of loan, it's imperative.

> ***"There are but two ways of paying debt. Increase of industry in raising income, increase of thrift in laying out."***
>
> ***–Thomas Carlyle***

UNSECURED DEBT CONSOLIDATION LOAN

This option is very similar to the debt consolidation loan above, except that this loan is unsecured. You don’t have to put your home up for collateral.

As with the home equity loan, ***you would get a loan that would be used to pay off your debts, leaving you with only a single monthly payment.***

Potential pitfalls:

1. **Credit.** Any time you’re paying off debts that indicate recent late payments in your credit history, you're helping your credit score. You're also increasing the total amount of credit available to you, which helps your utilization ratio and improves your scores.

2. **Taxes.** There are no tax ramifications**.**

3. **Cost.** This depends on the terms of the loan. Consider the interest rate and length of the loan. Depending on the source of the loan,

your credit, and the terms of your current debts, the loan may have a lower interest rate than your debt. It might also be much higher!

- ✓ The high-priced loans commonly come from those finance companies that send you loan offers in the mail. ***Be sure to look at all the terms.*** Frequently, the terms are similar to some of the less desirable credit cards. The interest rate might be pretty good until you're late with one payment; at that point, it can skyrocket.

- ✓ That new interest rate is likely to apply all the way back to the very beginning of the loan, as well as to your remaining balance.

- ✓ Generally, if you can get a loan from your bank, you'll get much better terms, but consider that unsecured loans aren't easy to get from this source – especially if you're behind on any of your debt payments.

4. **Time.** Your debts will be paid very quickly, but you'll have the new loan with which to contend. The length of the loan is the determining factor.

5. **Potential for legal action against you.** You'll have no issues in this area unless you fail to make the payments on your new loan.

As with the home equity plan, be careful to avoid overextending yourself and creating additional debt by using your credit cards all over again.

> ***"Debt is the worst poverty."***
>
> ***–Thomas Fuller***

CREDIT COUNSELING

With this option, a credit-counseling firm works with your creditors to eliminate penalties and fees and can usually also lower your interest rates. ***You would make one payment to the credit counseling company, who then distributes the money to your creditors.***

The credit counseling company also pays itself out of these funds, so not all of your payment goes toward paying off your debts.

Consider how much the counseling firm is getting paid. The savings you're getting must be greater than the money you're being charged or there's no advantage to the credit counseling. It might not be worth it to you if their fee is too great.

Credit counseling companies are the source of many complaints. There are many unscrupulous firms that will take your money and not do a whole lot for you.

Be sure that you do your homework and find a good company if you decide to go this route.

Potential pitfalls:

1. **Credit.** Provided you follow the terms, this option has no negative impact on your credit scores, since your creditors agree to the new arrangement.

2. **Taxes.** There are no tax advantages or disadvantages.

3. **Cost.** This can vary dramatically. You'll really have to pull out your calculator to determine how much you're saving versus how much the credit counseling firm is charging you. You might be saving quite a bit or you might not.

4. **Time.** This will also vary based on the deal the credit counselor is able to obtain with your creditors.

5. **Potential for legal action against you.** Not an issue if you follow the program. Since the creditors agree to the new plan in writing, they won't be bringing a lawsuit against you to try to collect the debts.

If the benefits of credit counseling appeal to you, thoroughly investigate any firms with which you consider working. With a reputable firm, you could save money, time, and the stress of dealing with the creditors, and limit your debt paying activities to writing only one check each month.

"Do not accustom yourself to consider debt only as an inconvenience; you will find it a calamity."

–Samuel Johnson

BANKRUPTCY – CHAPTER 7

Chapter 7 bankruptcy will essentially wipe out all your *unsecured* debt. So it won't help you with your house or car loan.

When you file for Chapter 7 bankruptcy, in order to pay as much of your debt as possible, any non-exempt assets that you own can be seized by the courts and sold to pay your creditors. State laws vary regarding which of your assets are protected (exempt) and which can be sold (non-exempt).

This is rarely an issue, as most people filing for Chapter 7 don't have sufficient non-exempt assets for it to be worth the trouble and expense to seize and liquidate them.

State laws surrounding bankruptcy can vary dramatically; educate yourself before you take the plunge.

Possible pitfalls:

1. **Credit.** Bankruptcy may be seriously damaging to your credit scores, and the damage can be present for up to 10 years. However, most people filing for bankruptcy have a lot of debt and are very late with their payments already.

   If your credit has already taken a huge hit, filing for bankruptcy might not do as much damage as you'd think.

   - ✓ Credit scores often improve after all the debt and late payments are eliminated. However, it will still be challenging to raise the scores back to a high level anytime soon.

- ✓ Even as your credit scores rise, though, the fact that you declared bankruptcy will make it difficult to obtain new loans or credit. ***For many creditors, a bankruptcy in your credit history is an automatic decline.***

2. **Taxes.** The courts may take all or a portion of any tax refund you have coming your way. There are no other tax implications, but be sure to contact a tax professional in your state to go over the details of your own situation.

3. **Cost.** Depending on the complexity of your case, the total cost is usually only a few hundred dollars to file for the bankruptcy.

   - ✓ However, there are other future costs to consider. For at least 10 years, you might be stuck with higher interest rates on any new debt you take on, if you can obtain approval for the loan at all.

4. **Time.** It's just a couple of months from filing to the court appearance. Then a couple more months until the discharge. Discharging the bankruptcy means that it's completely finished. Until that time, the courts could technically still change their minds, but

this rarely happens.

5. **Potential for legal action against you. *Creditors are required by law to stop calling and harassing you upon notice of the filing.*** However, they do have the right to come to the court hearing and make statements, as well as challenge your filing, but there are very few instances where they would actually show up.

Bankruptcy is serious. Even so, creditors created much of the negative information that you might hear about bankruptcy, so consider the source. Sometimes, a fresh start can be your best option. Only you can decide what will work best for you.

BANKRUPTCY – CHAPTER 13

While Chapter 7 Bankruptcy allows complete discharge of most debts, Chapter 13 provides a partial discharge while you, too, pay part of the debts.

Again, while there are federal laws which apply, the related state laws regarding Chapter 13 Bankruptcy vary considerably from state to state.

Chapter 13 usually allows you to keep more of your property than with Chapter 7 (if you actually have a significant amount of personal property) and very effectively puts an end to any foreclosure actions against you. Banks are required to let you get caught up on your mortgage with a new timetable.

This is a significant advantage of Chapter 13 Bankruptcy and should be considered if you're in serious trouble with your house or tax payments and wish to remain living in your home.

Potential pitfalls:

1. **Credit.** This will vary, depending on how you were paying on your debt before filing for bankruptcy. If you were making your payments, your credit scores will get much worse. If you were way behind, it may actually improve once the bankruptcy is over. The negative effect of bankruptcy can last for up to 10 years on your credit report.

2. **Taxes.** Contact a professional. This is especially true when the bankruptcy is being used to deal with unpaid taxes. There are no tax

implications for any relieved debt.

3. **Cost.** Assuming you hire an attorney, the cost is usually around $2,500. This will vary with the complexity of the situation. As far as how much of your debt you will have to repay, that depends on how much disposable income you have. Get all the pertinent numbers before you file.

4. **Time.** The customary time is 36 months, but can be as long as 60 months. This is in addition to the time it takes to file and appear before the judge.

5. **Potential for legal action against you.** This is a legal process; there is no additional legal action.

"He looks the whole world in the face for he owes not any man."

–Henry Wadsworth Longfellow

CONCLUSION

There are several options to eliminating your debt more quickly than just making the minimum payments each month. All the options presented here have their advantages and disadvantages.

Always be sure to consider the potential effects of any option you may pursue on your credit scores, taxes, cost, time, and exposure to further legal action.

Give yourself the gift of being debt free and get started today.