"The gem cannot be polished without friction, nor man perfected without trials." –Chinese Proverb

"There is no worse tyranny than to force a man to pay for what he does not want merely because you think it would be good for you." – Robert A. Heinlein

Tax and Financial Strategies

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WEALTH CREATION STRATEGIES

Temporary Tax Incentives Intended to Spur Your Spending--But Think First

We should be skeptical of buying anything for which government provides a particular inducement. These include tax credits or deductions, especially temporary ones. Many who took solar and wind energy credits in the 1980s ended up with sizeable financial losses because their equipment didn't produce enough income to cover the cost, despite the sizeable tax savings from the credits.

By the time such credits are announced whatever problem the government is trying to fix is often well on its way to being resolved by market forces. Oil prices collapsed from their highs of last year, while housing prices were plummeting until the government intervened.

By artificially propping up demand, tax credits, subsidies and deductions allow manufacturers to hike prices or delay dropping them. Such schemes also cause a misallocation of resources by encouraging over-production of some goods. If you rush out now and buy a new car or energy-saving device, your price net of tax savings might be higher than the price without any tax savings after the credits, etc. disappear. With this caveat, the new credits and deductions related to energy, housing and rental properties include:

1. **First-time homebuyers' credit.** The credit is 10% of the price of a primary residence for those who have not owned one for the last three years, with an $8,000 cap. It's a refundable credit, which means it's treated as if the money had been withheld (even if your tax liability is zero, you get it "refunded"). It applies to a single-family residence, the owner's share of a duplex (or even larger building), condominium, mobile home and even a boat if that's your main home. In the case of multiple buyers the credit can be allocated among qualifying owners in whatever way they agree.

The credit is, under current law, *available only for purchases* **completed** *by November 30, 2009.* However, beware: the credit is phased out at a rate of $4 for every $10 in additional income for those with Adjusted Gross Incomes of $75,000 to $95,000 ($150,000 to $170,000 for married taxpayers), which creates a potential 86% marginal tax bracket for those with income in those ranges (28% federal, 9.55% CA state, 7.65% Social Security, 1.1% SDI and 40% phase-out of the credit). On the other hand, an election can be made to claim the credit on the 2008 tax return on either an originally-filed or amended return, which may be crucial for those with income exceeding the thresholds in 2009. The credit must be paid back if the home ceases to be one's principal residence within the three-year period following the purchase.

While the caveats mentioned above apply, I'm not completely averse to taking advantage of the credit if prospective rent (factoring in the fact that rents in many areas are plummeting) on an identical home exceeds the total cost of ownership (including interest, tax, maintenance, insurance, amortized cost of replacing systems and opportunity cost of the down payment). Many areas of the country that didn't experience bubble prices, as well as bubble areas that have already collapsed 70% (for example, some areas of the Antelope Valley, lower deserts, Central Valley and Inland Empire in California), may already be at or near this price-point. While an $8,000 slice off of already low prices could be worth looking at, a 2% effective reduction in price off a $400,000 home ($8,000 maximum credit divided by $400,000 = 2%), or even 4% off of a $200,000 price ($8,000/ $200,000 = 4%) could easily be wiped out by an insignificant drop in values.

2. **A deduction for sales tax** (or, in states without a sales tax, "fees or taxes that are based on the vehicle's sales price or as a per unit fee") **on up to $49,500 of the cost of a new vehicle** for purchases made February 17 through December 31, 2009. This is available to those who don't itemize and is in addition to any itemized deduction for other sales tax or state income tax. Interestingly, while the cap per vehicle is the tax on up to $49,500, there is no cap on the number of qualifying new vehicles. Beware: the deduction phases out when "Modified" Adjusted Gross Income (MAGI) exceeds $125,000 ($250,000 married) and disappears completely at MAGI of $135,000 ($260,000), creating yet another phantom tax bracket of as high as 15% per vehicle purchased (depending on the sales tax deduction and nominal marginal tax bracket). Also note that someone in a 33% marginal tax bracket will save at most only 3.3% off the price of a vehicle (33% of a 10%

sales tax is 3.3%), which is less than the drop experienced as you drive your brand new vehicle off the new car lot.

3. **A 30% credit for qualified *energy efficient property* installed in an existing main home**. Eligible property includes insulation and *qualifying energy-efficient* exterior windows and doors, non-solar hot water heaters, roofs and HVAC (heating, ventilating and air conditioning) systems. The maximum credit is limited to $1,500 for such improvements placed in service in 2009 and 2010. Since the tax savings may be a substantial percentage of the total cost and contractors are experiencing some rather lean times, this may be an ok time to update those windows, doors, insulation and, perhaps, even HVAC.

4. **A 30% credit for qualified residential *alternative energy equipment***, which includes photovoltaic systems (i.e., solar panels), solar hot water heaters (but not for pools), geothermal heat pumps and wind turbines placed in service before the end of 2016 in a dwelling unit used as the taxpayer's home or second home. To complicate matters, it's also available for fuel cells, but only for those installed in a main home. None of these credits apply to rental or commercial-use property. Even with the 30% credit, this remains a questionable overall value. One authority calculates a break-even period of at least a dozen years, which means while you may see your investment *returned* in that time frame, you still won't have a return *on* your investment. And we really don't have any history to help us determine whether there is much resale value. Even kitchens and baths are said to return at most 80% on a resale.

5. **50% "bonus" depreciation is allowed on purchases of *new* qualified property that is (generally) *placed into service* by December 31, 2009.** While irrelevant for most small businesses due to the current Section 179 expense allowance (under which most equipment can be deducted in the year of purchase whether new or used), it is *very helpful for owners of rental property*, who may take the bonus amount on such items as new free-standing appliances, carpeting and land improvements (such as new driveways, walkways and landscaping), as well as qualified leasehold improvements. Although non-leasehold improvements affixed to the real property must be depreciated over 27.5 years (39 years for commercial buildings), this might be the year to invest in those "other" items. Bonus depreciation is also helpful for business owners purchasing new vehicles, although it's limited to $8,000 and many see a larger tax savings over several years by taking the standard mileage rate in the first year in lieu of depreciation (my tendency), which allows one to elect either the standard rate or actual costs in future years. (The selection of bonus or any other accelerated method of depreciation in the first year precludes one from taking the standard mileage rate in all future years.)

6. **A new version of the old "Hope" education credit, now called the "American Opportunity Tax Credit."** It has been increased in size, can be partially refundable (treated like withholding) and is phased out rather than "cliffed" out (as is still true for the Higher Education Tax Deduction). The maximum credit is 100% of the first $2,000 of qualified tuition, fees and related expenses for each of the first four years of post-secondary education in a degree or certificate program, and 25% of the next $2,000 of such educational costs, for a total maximum credit of $2,500, *per eligible student*. "Related expenses" now include course materials such as books. Up to 40% of the otherwise allowable credit is refundable (if your tax is otherwise zero, $1,000 in qualifying education expenses will generate a $400 refund) and the credit is phased out between "Modified" Adjusted Gross Income (**MAGI**) of $80,000 and $90,000 ($160,000 and $180,000 for joint filers). I suggested in a series of articles published in 1993 that education intended to produce taxable income should be in some way deductible, even if it's not "continuing" education (for which deductions have long been allowable). Congress first saw the wisdom of this idea in 1998 and the value of the credits or deductions have, in general, done nothing but increase ever since. Rarely does Congress do anything worthy of accolade. This is one of those rare moments. Let us cherish it.

Comparison of education tax benefits

	American Opportunity Tax Credit (new)	Lifetime Learning Tax Credit (continuing)	Higher Education Tax Deduction (scheduled to expire after 2009)
In the law for	2009-2010	Indefinite	2009
Type of post-secondary education	First 4 years of undergraduate education, enrolled on at least a half-time basis in a program leading to a degree, credential or certificate	For any year of post-secondary education at an accredited institution, with no limit on intensity (one class qualifies) or type of program	For any year of post-secondary education at an accredited institution, with no limit on intensity (one class qualifies) or type of program
Maximum benefit	$2,500 credit	$2,000 credit	$4,000 deduction
How calculated	100% of first $2,000 in qualified expenses; 25% of second $2,000, per student	20% of first $10,000 per return	$4,000 deduction per return ($2,000 for higher income taxpayers—see below)
Qualified expenses include	Tuition, fees, course materials	Tuition	Tuition
Income limits, MAGI	$80,000-$90,000 ($160,000-$180,000 joint filers)	$50,000-$60,000 ($100,000-$120,000 joint filers)	$4k drops to $2k at $65,000 ($130,000 joint); zero at $80,000 ($160,000 joint)

Other Tax Law Changes

I rarely mention changes in the law for which planning is either limited or not possible, but couldn't resist when I stumbled upon the language in the "America Recovery and Reinvestment Act of 2009" which authorized a $250 "bonus" payment to Social Security recipients (most of whom received the payment in May). Are you ready to get a feel for why Shakespeare felt compelled to write, "First, kill all the lawyers"?

"*Subject to paragraph (5)(B), the Secretary of the Treasury shall disburse a $250 payment to each individual who, for any month during the 3-month period ending with the month which ends prior to the month that includes the date of the enactment of this Act, is entitled to a benefit payment described in clause (i), (ii), or (iii) of subparagraph (B) or is eligible for a SSI cash benefit described in subparagraph (C).*"

In English, eligible Social Security recipients get $250. Also in English, other changes include:

1. Up to $2,400 in yearly unemployment benefits *per person* are tax-free in 2009 and 2010.
2. A new credit, "Making Work Pay Credit," slices up to $400 per worker off of withholding and the final tax bill, subject to a phase-out at $75,000-$95,000 MAGI ($150,000-$190,000 for joint filers). *This could create an under-withholding problem* for those who earn at a rate lower than the thresholds and either (a) have non-wage income, (b) spouse's income, or (c) bonuses that when totaled exceed these thresholds; or who have multiple employers regardless of total income (*including those working in the entertainment industry with multiple W-2s*). In other words, your withholding will drop but your tax might not, leaving you with a smaller refund or larger balance due when filing your 2009 tax return. (Example: each employer will withhold up to $400 less. Ten employers could withhold $4,000 less. You may have a problem.)
3. The little $250 teacher-supplies deduction continues through 2009, as does the sales tax in lieu of state income tax deduction option. The mortgage insurance deduction for home buyers who signed contracts in 2007 or later and with incomes under a phase-out range of $100,000-$109,000 is extended through 2010.
4. A new 15-year depreciation period for certain retail and restaurant-related improvements.
5. A new restrictive rule on who can claim a child when unmarried parents live with each other. While previously there was a case for either parent to claim the deduction based on their agreement, under this rule only the higher-income parent can claim the child beginning in 2009. *This will adversely affect several of you.*
6. An increase in the refundable Earned Income Credit for families with three or more qualifying children.
7. The Alternative Minimum Tax exemption amount is increased again through 2009 (the so-called "patch" was made early this year!).
8. The minimum failure-to-file penalty, which is assessed if a tax return is filed more than 60 days after the due date including extensions, is increased to the smaller of $135 (was $100) or the unpaid tax.

This last one is due to a Revenue Ruling: credit and debit card fees related to tax payments have been ruled deductible as a miscellaneous itemized deduction subject to the 2% AGI limitations. *I will continue to discourage this practice, since after-tax costs will* ***still*** *exceed the benefits.* However, those who pay in this manner may benefit by admitting it to us when we prepare your tax return.

A stunning tax increase, especially for Californians with kids

While California taxpayers know they are paying a lot more this year, one change will prove to be a shocker come tax-time: the credit for dependents (think: children), which was about $300 in 2008, drops to about $100 per dependent for 2009 (the credit for taxpayers and spouses). Let's say you're married with four children. Credits totaled $1,400 in 2008 ($100 for each of the parents and $300 for each of the kids), but only $600 in 2009. If your tax before these credits was $2,200 in 2008, your after-credit tax just doubled, rocketing from ($2,200 - $1,400 =) $800 to ($2,200 - $600 =) $1,600. You may wish to adjust your withholding to account for this huge percentage tax increase. The quick and easy way to adjust is by reducing your California withholding exemptions on form DE-4 by two for each dependent. Roughly, for every exemption claimed the withholding drops by $100 over the course of a year's worth of paychecks for those in the highest tax bracket. If married, the higher-income spouse should make this adjustment. Those with moderate incomes may need to make further downward adjustments. Those normally due a sizeable refund may not want to bother adjusting, but should expect a smaller refund.

Foreign account holders could soon be imprisoned and forfeit all of their funds in such accounts if they don't fess up

U.S. residents are taxed on their "worldwide" income. The federal government has recently gone on a rampage hunting down taxpayers who are not paying taxes on non-domestic income. If you have money or other assets stashed overseas, you may have a HUGE problem. You are subject to taxes, potentially enormous penalties, forfeiture of those assets and imprisonment. Although the IRS has previously done a poor job of enforcing the law (or perhaps because of it), they are threatening far greater repercussions than before for those not settling up with the IRS by September 23, 2009, just a couple of months down the road. **I don't think any of my clients have such undeclared accounts, but any who do should CALL ME NOW**.

California Voters Sent a Message—or Did They?

The state legislature recently approved tax increases for 2009 and 2010 that catapulted the state's high-tax ranking to number one in the country. Several propositions that would have extended these increases for another few years were placed on the May ballot. Surprisingly, Californians rejected them by roughly two to one margins.

California voters have elected and re-elected arguably the most extravagant spenders of other people's money of any state. Democrats, with a huge majority, uniformly approved of the higher taxes. Republicans, hanging on to barely one-third of the seats, almost uniformly opposed them. California voters leaned Republican on arguably the most significant issue of the day while voting for Democrats. This is either schizophrenia at its finest, or the beginning of a popular revolt against high taxes.

Californians might have rebelled long ago had they known that state spending, had it been adjusted for population growth and incomes since 1997, would have been about two thirds of 2007's actual spending. To get a feel for the extraordinary increase in taxes, which translates to spending, over the decades, a history of sales tax rates can be helpful. This tax was a mere 5% during the early 1970s. *The rates below do not include district taxes averaging 1%*, which were probably nonexistent early on.

A history of sales tax increases, California style

Effective Date	End Date	State Rate	Local Rate	Combined Rate
4/01/09	Current	7.25%	1.00%	8.25%
7/01/04	3/31/09	6.25%	1.00%	7.25%
1/01/02	6/30/04	6.00%	1.25%	7.25%
1/01/01	12/31/01	5.75%	1.25%	7.00%
7/15/91	12/31/00	6.00%	1.25%	7.25%
1/01/91	7/14/91	4.75%	1.25%	6.00%
12/01/89	12/31/90	5.00%	1.25%	6.25%
4/01/74	11/30/89	4.75%	1.25%	6.00%
10/01/73	3/31/74	3.75%	1.25%	5.00%
7/01/73	9/30/73	4.75%	1.25%	6.00%
7/01/72	6/30/73	3.75%	1.25%	5.00%
8/01/67	6/30/72	4.00%	1.00%	5.00%
1/01/62	7/31/67	3.00%	1.00%	4.00%
7/01/49	12/31/61	3.00%		3.00%

According to Wikipedia, "Over the past 10 years state spending from state sources has more than doubled in nominal terms (not adjusted for inflation), and during the current governor's tenure state spending from state sources has risen almost 40 percent."

California Spending, Years in Comparison

	Fiscal Year 1997-1998	Fiscal Year 2003-2004	Fiscal Year 2007-2008
State spending	$68.5 billion	$104.2 billion	$144.8 billion

This wouldn't have been so awful had it occurred during a highly inflationary period such as the late 1970s. However, when we adjust for today's relatively low inflation we can begin to see just how profligate state government has been.

Had California Spending Increased With Inflation

	Fiscal Year 1997-1998	Fiscal Year 2003-2004	Fiscal Year 2007-2008
State spending	$68.5 billion	$78.5 billion	$88.5 billion

To be fair, however, we need to adjust for both inflation and population growth. Let's be fair.

With Inflation and Population Growth

	Fiscal Year 1997-1998	Fiscal Year 2003-2004	Fiscal Year 2007-2008
State spending	$68.5 billion	$85.3 billion	$99.1 billion

Now we can see just what spendthrifts—with other people's money no less—California state politicians have been since fiscal year 1997-1998.

California State Government Spending in Excess of Inflation and Population Growth

	Fiscal Year 1997-1998	Fiscal Year 2003-2004	Fiscal Year 2007-2008
State spending		22 %	46%

This is an enormous and, as we have recently learned, unsustainable growth in government spending. From 1979 through 1990, the Gann Amendment limited the growth in state spending to inflation and population growth. Not only does such a spending limit need to be reinstated, but also (with apologies to lower-income earners) the fact that high-income earners pay an inordinately large proportion of state income taxes needs to be addressed. In 2006, the top 15% of state taxpayers paid 84% of personal income tax. The top 1% paid 48% of all such taxes (up from 39% as recently as 2003). These taxpayers can vote with their feet. Recently, when Maryland increased its rate on top income-earners, one-third of those who were hit by the tax became non-residents the following year (they probably converted what were vacation homes in Florida to main homes). *Maryland actually lost revenue due to this tax rate increase* because the extra percent they took from the two-thirds of high income taxpayers remaining was more than offset by the 100% drop in tax collections from the one-third who fled. As mentioned in the May-June 2006 *Wealth Creation Strategies* (http://www.dougthorburn.com/newsletters/ThorburnMayJun06.pdf) in order to compete with other states for high-income earners the top marginal tax rate should probably be sliced to at least 7% and half that for long-term capital gains. The Laffer Curve suggests that, in the long run, income and tax revenues will both increase substantially under such a flattened-tax regime. This is, perhaps, even more true at the state than federal level.

A classic story from the May-June 2006 issue of Wealth Creation Strategies (http://www.dougthorburn.com/newsletters/ThorburnMayJun06.pdf) bears repeating:

> Ten old friends decided to meet for dinner each month. After being presented a bill for $1,000 at their inaugural feast, they voted to divvy up the bill in accordance with their earnings. The bill totaled $40 for the five lowest income earners combined. The sixth lowest paid $20. The fourth from the top paid $50, the third highest income earner $90 and the second $130. The highest income earner among friends paid $670. The other diners were shocked when the top earner didn't appear for the following month's dinner. The third month, only the lowest six income earners showed up. They decided fast-food was all they could afford.

A comparison study showing the additional cost of living in California vs. other states is worth updating as well.

The approximate additional tax paid by a single person for the privilege of living in California vs. a selection of other states follows, in bold:

Taxable Income	$100,000	$500,000	$1 million	$10 million
AK, FL, NH, NV, SD, TN, TX, WA, WY	**$7,000**	**$45,100**	**$93,300**	**$1,043,500**
CO	**$2,400**	**$22,200**	**$47,300**	**$580,500**
AZ	**$3,100**	**$21,100**	**$44,300**	**$540,500**
GA	**$3,600**	**$17,900**	**$36,100**	**$446,500**

Should I Refinance?

In a foolish effort to prop up the housing market, the powers-that-be in Washington, DC have been applying downward pressure on mortgage rates. Even if we disagree with such government intervention (the unintended consequences of which, in my opinion, will not only prolong the agony but also greatly aggravate the situation down the road), there's no reason not to take advantage of lower rates whenever possible.

The few who may qualify for a loan under standards that test for the ability to actually pay it back and with the new lower, more realistic appraisals should be careful, however, when replacing old loans with larger ones or on different properties (for example, borrowing against your home to pay off a loan on a rental or vacation home). There may be issues of non-deductibility, as well as extending the payback period. These can be crucial issues in a time when tax savings may be more important than ever and when debt feels, shall we say, uncomfortable.

One surprising fact about tax law is that while all interest used to be deductible with very few exceptions, it is now non-deductible, "unless." One of those "unlesses" is that on "**home acquisition debt**" up to $1 million. However, such debt may not be what you think. While confusing, try to follow this: it is debt incurred to buy, build or improve one's home and 2nd home, *less* the amount previously paid off, *plus* any amounts used for improving one's home when taken from the proceeds of the new loan. Say what? Let's try to explain by example.

Let's say you borrowed $300,000 when you purchased your home. You paid it down to $280,000 and decided to pull out $120,000. *Whether you refinanced in one $400,000 loan or took a 2nd trust deed (or "equity line of credit;" same thing) is irrelevant.* You used the proceeds of the $120,000 as follows, carefully "tracing" the use and not commingling it with other funds (if you do that, you may blow it and make the interest on the entire $120k non-deductible):

Let's refi and spend $120,000

Use of funds	$ amount	Non-deductible use	Deductible use
New furniture	$17,000	$17,000	$0
Free-standing spa	$8,000	$8,000	$0
Room addition	$40,000	$0	$40,000
Air conditioning system	$10,000	$0	$10,000
Repairs	$5,000	$5,000	$0
Paid off credit cards	$25,000	$25,000	$0
Pay for daughter's college	$15,000 *	$15,000	$0
Totals	$120,000	$70,000	$50,000

*I am not suggesting this amount is realistic.

Note that the "new furniture" and "free-standing spa" are not "home improvements," since they are not affixed to the real estate. Built-in bookcases and an in-ground spa would, however, qualify. "Repairs," whatever those are (there are plenty of gray areas surrounding this issue), do not qualify as "improvements" unless they are adjunct to a major renovation (again, whatever that is). Your "home acquisition debt" now totals ($280,000 + $50,000 =) $330,000.

The trouble is you borrowed $400,000. Is the interest on that $70,000 difference deductible?

You've probably heard you can deduct the interest on an "extra" $100,000 on your home. That $70,000 is less than the $100,000, so you qualify—unless you're subject to the Alternative Minimum Tax (**AMT**).

This $100,000 in debt that is NOT used to buy, build or improve one's home is called "**home equity debt**." The interest on this debt does NOT qualify as a deduction under the AMT rules. This often makes interest on such debt of no use to taxpayers with incomes exceeding $150,000-$200,000 (depending on other deductions and credits), since this is the income range at which the AMT usually begins to, shall we say, hit home.

(In a classic example of the absurdity of so much of what Congress decrees, a taxpayer who purchased their home with a mortgage in excess of $1.1 million was allowed to deduct the interest on $1 million, but NOT on the additional $100,000 in "home equity debt," since none of the debt was incurred for anything *other than* acquiring their home.)

There's also the issue of extending one's payback period. Someone with 12 years to go on his or her mortgage taking out a new 30-year loan with a lower interest rate will pay more interest over the life of the loan by an order of magnitude. However, if the old payments are made (the payments on the loan with 12 years left), with the excess applied to principal, the total interest will be less and the loan will be paid off sooner.

One couple could benefit mainly from the lower payment on a substantially larger loan. They owe $110,000 of original financing on their home, $50,000 on their vacation home and $15,000 on credit cards. Their total combined minimum payment is $1,200 per month. They could use $20,000 for some long-deferred home repairs.

I suggested they consider refinancing for $200,000 with a 30-year mortgage at 5.5%. Their "home acquisition debt" totals $110,000. Their "home equity debt" would total $90,000. They would not be subject to AMT. Their required minimum monthly payment would be $1,135. They would convert non-deductible credit card interest into deductible mortgage interest, lower their minimum payment and overall interest rate. They could fix up their home and enjoy it now, rather than fixing it up later for sale just in time for someone else to enjoy it. They agreed that this was a good idea.

Another couple owes $227,000 at 5.75% with 12 years remaining on a 15-year mortgage, along with a 6% $83,000 2nd with 15 years to go on an original 20-year payoff schedule. Payments total $3,500 monthly, which is not sufficient reason to refinance at 5.5% when the costs of refinancing are factored in. However, they also owe $170,000 at 6.75% on a rental property, with a $1,600 monthly payment on a 15-year mortgage with 13 years remaining. Taking into account tax risks (the use of the funds must be "traced" and caution is advised since there are other issues involved too complex to elaborate on here), I suggested they consider a (qualifying conforming Fannie Mae maximum) $417,000 30-year 5.5% loan on their home, paying off the $310,000 in existing loans on their home and paying down $107,000 on their rental. Their monthly payment on the new loan would be $2,368 which, with the $1,600 continuing payment on the $63,000 remaining balance on the rental is considerably less than the $5,100 they pay now.

The rental loan would be paid off in about 3.67 years, at which point they could accelerate the payment on their home. If they paid at the old rate of $5,100, they'd be done in 12.5 years and save $21,000 in interest. Since the up-front costs of the 5.5% new loan include points and other costs totaling about $8,000, the savings isn't huge. However, they decided the added flexibility would make it worthwhile: in lean times they could (after the rental is paid off) cut their payment by more than half ($2,368 v. the current $5,100). Another option is to pay off the rental out of the proceeds of a variable-rate 2nd on their home, which would not only lower their interest rate for the time being but also their required minimum monthly payment. While such loans are obviously risky, I am not opposed to them if relatively small. Currently, such a loan can cost as little as 4.5% (prime rate of 3.25% plus 1.25%) with an over-740 FICO score, requiring $236 monthly without any principal payoff. While I'd prefer a lower cap on rates, in the worst case the interest and required minimum payment would max out at 18% and $945. It might be profitable to wait for a more reasonable cap on rates before venturing into such a loan, unless the intent is to quickly pay it off.

And, in a related Myth-of-the-Season…

In a recent Liz Pulliam Weston's "Money Talk" column, a reader asked if there is any downside to refinancing a 30-year 6.625% fixed-rate loan on which there is only 15 years to go. The primary reason for refinancing, the reader wrote, was for the protection a lower required monthly payment would afford in the event of an unexpected drop in income such as loss of job. Weston correctly responded that refinancing to another 30-year loan would increase the total interest paid over the life of the loans, even if the rate dropped substantially. But Weston cut her answer short.

Unfortunately, she didn't suggest the obvious: that the interest paid over the life of the loan would decrease, perhaps substantially, if the reader continued making the "old" payment. This would provide, as noted in the article above, flexibility in the event of a drop in income, while at the same time a potential overall decrease in interest costs. Depending on the difference in rates, the borrower could even lower the payment for periods of time as needed and still come out ahead overall. This was a glaring omission in a response by an otherwise competent columnist.

Thoughts on the Economic Mess

On ethics and morals

"You cannot help the poor by destroying the rich.
You cannot strengthen the weak by weakening the strong.
You cannot bring about prosperity by discouraging thrift.
You cannot lift the wage earner up by pulling the wage payer down.
You cannot further the brotherhood of man by inciting class hatred.
You cannot build character and courage by taking away people's initiative and independence.
You cannot help people permanently by doing for them, what they could and should do for themselves."

--Abraham Lincoln

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for, that my dear friend, is about the end of any nation. You cannot multiply wealth by dividing it."

--Dr. Adrian Rogers, 1931

Bill Moyers: "…you supported Barack Obama, during the campaign. But you're seeming disillusioned now."
William K. Black: "Well, certainly in the financial sphere, I am. I think, first, the policies are substantively bad. Second, I think they completely lack integrity. Third, they violate the rule of law."

--William K. Black, lawyer, former

bank regulator, author of *The Best way to Rob a Bank is to Own One: How Corporate Executives and Politicians Looted the S & L Industry*

According to *Wikipedia*, in the interview with Bill Moyers on April 3, 2009 on PBS, "Black asserted that our current banking crisis is essentially a big Ponzi scheme, that the 'liar loans' and other financial tricks were essentially illegal frauds, and that the triple-A ratings given to these loans was part of a criminal cover up….Black also stated that trying to hide how bad the situation is will simply prolong the problem, as happened in Japan's lost decade. Black stated that Timothy Geithner is engaged in a cover-up, and that the administration does not want people to understand what went wrong or how bad the banking situation is today."

"Without the Securities and Exchange Commission….the three officially recognized raters—Standard & Poor's, Moody's and Fitch—couldn't have provided their seal of approval….The triple-A ratings they assigned were accepted without examination all over the world, although the world should have known that the ratings were negotiated and paid for by those rated."

--Thomas G. Donlan, *Barron's*, May 18, 2009

"Rather than following policies that would have allowed for a sustainable recovery, our policy makers opted for a stunningly unethical strategy of making bondholders whole with well over a trillion dollars in public funds, watering down accounting rules to allow banks to go quietly insolvent while reporting encouraging 'operating profits,' looking beyond the continued shortfall of loan loss reserves in relation to loan defaults, and doing nothing meaningful with regard to foreclosures, whose rates continue to soar and which face a fresh wave later this year and well into 2010 and 2011."

--Hussman Funds Weekly Market Comment, www.HussmanFunds.com June 8, 2009

The bureaucrats who designed the bailout are "either in the pocket of the banks or they're incompetent. It's…a tax on all American savers. This is a strategy trying to recreate the bubble." Relying on low interest rates to help put a floor under housing prices is a variation on the policies that created the housing bubble in the first place. "That's not likely to provide a long-run solution. It's a solution that says let's kick the can down the road a bit."

--Joseph Stiglitz, Chairman of the Council of Economic Advisers, 1993-1997 under Bill Clinton, in an interview April 17, 2009

On a continuing real estate crash

"There [are] still an enormous amount of toxic loans in California:

January 2009:

Subprime loans in California:	**391,959**
Average balance:	**$323,117**
Total outstanding:	**$126,648,616,203**
Alt-A loans in California:	**666,386**
Average balance:	**$441,909**
Total outstanding:	**$294,481,970,874**

… Now do the quick math. If the median price of a home in the state is now $224,000 and the average balance of a subprime loan is $323,000 and for Alt-A loans it is $441,000, do you think we have a tiny problem? The new mortgage program [one of the bailout provisions] only goes up to 105 percent of the home's market value. So most of these loans are not going to qualify [for a refinancing], as they should not. If we help these mortgages out, [we are] bailing out bubble priced homes. This is like bailing out Pets.com during the tech bust at a high share value."

--Dr. Housing Bubble, http://www.doctorhousingbubble.com March 16, 2009

On deflation

"There seems to be a lot of market chatter today about how the dramatic fiscal and monetary stimulus is going to reignite inflation. Let's get a grip. We have a real unemployment rate of nearly 16% and a capacity utilization rate that looks about to decline to 65%. There is simply too much spare capacity to absorb to be concerned about what the government is going to do except prevent an outright deflationary environment from taking hold….By ignoring housing prices, CPI massively *understated* inflation for years. The CPI is massively *overstating* inflation now.

--Mish's Global Economic Trend Analysis, http://GlobalEconomicAnalysis.blogspot.com April 16, 2009

"It's true that a ballooning stock of money relative to available goods and services could be inflationary. But only if it is used to increase the total amount of credit….The still burgeoning economic decline confirms that a credit implosion that will substantially reduce the $52 trillion in outstanding U.S. credit market debt is just starting."

--The Elliott Wave Financial Forecast, www.ElliottWave.com February 27, 2009

"Clearly debt is not the lifeblood of the economy. By extension, credit is not the lifeblood of the economy, either. Rather it is savings that is the lifeblood of the economy, because without adequate savings, extending credit is nothing but a pyramid scheme that eventually implodes, which is of course what happened."

--Mish's Global Economic Trend Analysis, http://GlobalEconomicAnalysis.blogspot.com March 9, 2009

"Why has it not (yet) been inflationary? Well, the Fed can provide all the money it wants, but it cannot force institutions to lend….The destruction of credit is happening far faster than the Fed is printing."

--Mish's Global Economic Trend Analysis, http://GlobalEconomicAnalysis.blogspot.com December 11, 2008

"There is no means of avoiding the final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or later as a final and total catastrophe of the currency system involved."

--Ludwig von Mises, *Human Action: A Treatise on Economics*