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"The two enemies of the people are criminals and government, so let us tie the second down with the chains of the Constitution so the second will not become a legalized version of the first."

"In questions of power, then, let no more be heard of confidence in man, but bind him down from mischief by the chains of the Constitution."

- Thomas Jefferson

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WEALTH CREATION STRATEGIES

The Draconian State: Part 2
Foreign Financial Assets are Subject to "Taking" by the Federal Government

In part 1 of "The Draconian State," I explained the new requirement to report foreign accounts, foreign financial assets and certain foreign real estate on a new form (Form 8938) included in individual tax returns. I lamented the "draconian" aspect of the penalties associated with a failure to report such assets. Most people have a vague idea that "draconian" means "severe," but few have a grasp of the degree. For an idea of how far down the road we've succumbed to the Draconian State, it may be helpful to understand the source of the word, the Greek legislator Draco (http://en.wikipedia.org/wiki/Draco_(lawgiver)). The history makes sense of the term as an appropriate one for the penalties our government, "of the people, by the people and for the people," is now imposing on many of our fellow citizens.

In 621 B.C. Draco replaced the prevailing system of oral law and blood feud with a written code of law. While this was a helpful invention for the literate, his code was known for its uncompromising harshness. The death penalty was prescribed for even minor infractions; when asked why such harsh penalties were invoked, he is said to have responded that minor crimes deserved it and (unfortunately) there was no greater punishment for more serious crimes. Steal a loaf of bread, Jean Valjean, and you can look forward to the French dungeons and untimely death.

"Draconian" is an appropriate adjective for penalties the IRS may impose for failing to report a foreign account because the penalties are way out of proportion to the purported crime. After all, owning a foreign asset isn't illegal; only the failure to report it has been deemed by Congress to be a legal wrong. Why would Congress have gone so overboard? Because they assume non-reporters must be money launderers, who fall under the anti-money laundering statutes of Title 31 of the U.S. Code. Legal scholars and rational philosophers have long held that the severity of punishment should match the gravity of any crime. In this case, the U.S. is seeking large portions of the asset itself for failure to inform the government that you own it—an unprecedented assault on private property for the 99%+ of lawbreakers on this issue who are not money launderers.

Since about 1970, a $10,000 penalty has been on the books for failure to report the existence of foreign financial accounts exceeding $10,000 at any point during a given year, even if the account(s) was (were) closed at year-end and the average value was less than $10,000 (reported on the FBAR, or Foreign Bank Account Reporting Form TDF 90-22.1). This penalty is for non-willful non-disclosure—in other words, you didn't know the law and no one knew to tell you. The old adage, "ignorance of the law is no excuse," applies. And it applies even if you didn't know you owned the account—for example, your Swiss father opens a Swiss account in your name, or adds your name to his as co-owner, without your knowledge (but you find out later). Tough. It applies even if the account earns no interest or dividend income and even if you had it before you moved to the United States. Even if you don't hold cash, but rather stock certificates, collectibles or metals in a foreign safe deposit box—these, too, are subject to the reporting rules and penalties for any failure to disclose. If you own it, the government wants to know about it—but oddly, only if it's a financial asset (including foreign pensions). They're not interested in foreign real estate, so long as it's not held in a trust. Watch this—Mexican real estate owned by Mexican non-nationals must be held by a Mexican trust. How the hell are you supposed to know this? Of course, rental income on foreign-based real estate, as well as any sale of such real estate, must also be reported.

"But we're letting you off easy."

If required disclosure forms haven't previously been filed and the highest account balance at any time during the

last eight years was over $75,000, the penalty is, under the current "amnesty" program (amnesty only in the sense they generally won't go after you criminally), 27.5% of the highest account balance for the years during which the accounts have not been reported. Willful non-compliance found outside the amnesty program can result in a fine of $100,000 or half the value of the account, whichever is greater, and subjects the individual to possible criminal prosecution, which can result in fines up to $250,000 and jail time up to five years. Under the "amnesty" program, you must also file amended returns for the last eight years and report and pay tax, penalties and interest on whatever income had previously gone unreported. The idea behind the 27.5% penalty is if you didn't report the accounts, you probably haven't reported the income earned by these funds, and the government is letting you off the hook on reporting anything prior to eight years ago. Since not even the IRS can go back a decade or more and find and tax the earnings on such funds, Congress created a one-size-fits-all penalty, which is assessed even if you earned little or nothing on those funds all those years. As an aside, while both major political parties are to blame—and keep in mind I've been a registered Libertarian ever since the founding of the Party in the 1970s—Congress has gone much further in worsening the reporting requirements and penalties under Democratic administrations. On the other hand, Republicans have been largely complicit. Don't blame the IRS; they're only the policemen.

This couldn't happen to me…could it?

To give an idea of how draconian these penalties are, let's compare with, say, a room rental in your home. Now, while I believe my clients report all their income and strongly encourage them to do so, I have little doubt there are hundreds of thousands if not millions of room rentals across the country for which such income goes unreported (I'd guess the compliance rate isn't much greater than the legal hiring of household help—which is estimated to be around 5%). Let's say you have such a room rental, which takes up about a fifth of your $500,000 home. We'll assume you have evaded tax on the income for a number of years. Let's further say Congress promulgates a law that states if you haven't reported the rental income, you must pay a 27.5% penalty on the value of the rental portion of your home, or $27,500, *and* you must file amended returns for the last eight years and pay whatever tax, penalties and interest is due on the net rental income. Can you imagine the uproar?

A foreign account balance might exceed $75,000 and you may well have paid tax to a foreign government the entire time, resulting in a foreign tax credit that reduces if not eliminates federal income tax on the earnings (but not state income tax). Even if you owe zero tax, you'd still owe a ($75,000 x 27.5% =) $20,625 penalty because the account was outside of the U.S. and you didn't previously report it.

Government often deals with perceived problems with a one-size-fits-all approach, which is a method that would subject any private company to marketplace ruin.

Congress recently compounded reporting requirements and penalties by requiring the filing of the new form with individual income tax returns. Form 8938 largely duplicates information already reported on the FBAR form and duplicates penalties that may be imposed for non-disclosure or non-filing of the FBAR. It was a last-second rider that many Congressmen didn't know was in the "HIRE" bill passed in the early 2010 Congress, slipped in by Congressman Carl Levin, D-MI, with the full support of President Obama (http://renounceuscitizenship.wordpress.com/2011/10/29/obama-explains-the-rationale-for-fatca-lauds-work-of-carl-levin/). Those who watch the video may come away thinking "Oh, they are just going after companies and wealthy individuals who are evading taxes!" Think again. There are roughly seven million Americans living overseas; of these, only 400,000 file income tax returns. Since the United States is among only two countries on the planet that tax the income of its citizens who live overseas (the other one is North Korea—such esteemed company), it's likely the other 6.6 million expatriates, retirees and the like simply have no idea they are required to file U.S. tax returns and report foreign bank accounts in which they have more than $10,000 total at any time during the year. Expatriates are slowly getting wind of these requirements. If you imagine the expatriate community living in fear of penalties and sanctions, you would be correct.

For over three decades, almost no one was aware of the FBAR rules and government enforcement was lax. The required form was (and is) not filed with regular income tax returns and isn't even sent to the IRS. It even has its own unique deadline (June 30). Enforcement began to be ramped up only in 2003. Still, little was understood or known about this law or the people who might be affected; I was unaware of any continuing education courses on the topic until this year. I have mentioned it in the client letter or as an insert at least twice, once in 2003 and again in 2008. A couple of clients came forth each time and asked, "Does this apply to me?" but unbeknownst to me it didn't get everyone into compliance. Due to the hoopla over the new form and the government's belated compliance initiatives, many more are finding out about their prior obligations and the penalties they have to pay—and are scared to death.

Millions have immigrated to the United States since 1970. None of the immigrants with whom I have spoken remember an immigration official ever telling them, "By the way, the United States taxes residents on worldwide income," nor does any recall being told, "By the way, the United States requires that you report any foreign financial accounts you own or over which you have signature authority." If you imagine the immigrant community living in fear of penalties and sanctions, including the possibility of deportation, you would be correct.

Unintended consequences

Worse, foreign financial institutions will be required by 2013 or 2014 (depending on whether an extension is granted) to report to the U.S. govern-

ment accounts held by U.S. citizens, dual citizens and anyone else with a nexus to the United States, under threat of enormous sanctions imposed on non-compliant institutions by the United States government, the big bully in the arena. If you imagine this might make foreign banks and brokerage firms reluctant to open new accounts and keep existing accounts in the names of U.S. citizens or anyone with a name or background suggesting they *could* be a U.S. citizen, you would be correct. Many banks and investment firms have simply closed or announce they intend to close the accounts of U.S. citizens by the beginning of 2013. If you imagine this might prompt many U.S. citizens living abroad, even the tax-compliant, to renounce their citizenship, you would be correct—again. If you imagine this might prompt many productive foreigners—investors and entrepreneurs—who were considering immigrating to the United States to alter their plans, you would be correct. The melting pot that was formerly the greatest nation ever on planet Earth will now be desirable only to those without money, arriving on our shores seeking handouts rather than opportunity.

If you imagine this might put a crimp in international trade, you would also be correct, doing what Smoot-Hawley did in 1930 to help exacerbate the Great Depression: it just might be an unintended consequence (government rules are filled with those) of an overreaching attempt to tax U.S. citizens abroad and U.S. residents on worldwide income. If you imagine this amounts to a surreptitious form of currency control, you would also be correct. If you imagine all of this borders on international imperialism (and internal economic fascism) and a possible neutron bomb to global finance, you'd find many international finance experts cheering you on. They would add this is already engendering a profound anti-American sentiment among those who never before harbored such feelings.

One of the extraordinary aspects to this overreach is that the "voluntary disclosure programs," on which penalties as large as 27.5% of assets must be paid, have netted the U.S. Treasury only about $4 billion so far. The U.S. government spends (wastes) this amount every two hours. The program is increasing the stress of living (worry is a huge stressor) and even ruining the lives of many of our most productive and innocent citizens and will reduce the odds that innovative non-citizens will want to immigrate to the United States—all to pay for two hours of government waste.

My country, I hardly know ye…

Senator Chuck Schumer, D-NY, and Bob Casey, D-PA, want to further punish those who dare cut ties with the United States, formerly the land of the free. After Eduardo Saverin, one of the founders of Facebook, decided to renounce his citizenship (never mind that he'd already been living in Singapore since 2009 and renounced his citizenship in September 2011), saving nearly one hundred million dollars in taxes on the sale of his Facebook shares, the Senators denounced him as a tax dodger, claiming "He owes us for his billions!" They introduced legislation to impose a 30% "exit" tax on departing citizens' unrealized capital gains under the guise of what they call, in typical Congressional Orwellian blame-the-producer fashion, the "Ex-Patriot Act." Can you imagine Gov. Jerry Brown of California trying to impose an "exit" tax on Californians moving to greener and less taxing pastures in other states, which perhaps he'll want to try if his November ballot initiative passes, which will raise taxes on the most productive Californians by 30%? Not even King George imposed such a tax on British citizens departing for America before 1776—although he taxed Americans in America, albeit at a far lower rate than Americans are now taxed by their own government. The limitations Senators Schumer, Casey, *et. al.* is they aren't kings (although a recent Supreme Court decision likely removes such constitutional constraints). Isn't the arrogance of those who covet your property, the fruits of your labor, breathtaking?

At an educational seminar on this subject I attended early this year, I asked a fellow tax professional who had escaped Ceausescu's Romania if he thinks he made the right decision. He said, "I'm beginning to wonder." And now that the Supreme Court has all but eviscerated the United States constitution by ruling Congress can do anything it pleases under its taxing powers, we should all wonder.

Those who think they own you and the product of your work effort claim that these wealthy individuals made their wealth because of the "freedom" they had in the United States to build great wealth. Who owes whom? If we forget the fact they got their wealth by creating products and providing tens of millions of consumers with things they want, such as being able to find friends and family from 40 years ago and communicate with them in ways never before even thought of, yes they owe us. I suppose this is easy to forget by the ungrateful, many of whom comprise politicians and their bureaucratic minions who have never produced anything worthwhile in their lives (instead, they take from producers and give their work-effort to non-producers—and in so doing encourage parasite-host relationships that have been known to cause the collapse of civilizations). Never mind that Saverin and other producers, in helping to develop exciting and innovative products, have already "paid back"—they supply us with extraordinary products, for which we willingly pay them. Never mind, too, the fact that those who renounce their citizenship already must pay a one-time expatriation tax based on the embedded profit in all their assets and that the number of people renouncing their U.S. citizenship has increased by 750% from 2008, when 235 people renounced, to 2011, when 1,780 did so. Ignore, too, that Saverin may have renounced his citizenship because he couldn't get a Singaporean or other foreign financial institution to open an account for him, or to keep one open after 2012.

The postcard must have gotten lost in the mail

In the ancient days, taxpayers received booklets with Form 1040, related forms and instructions by mail. The first page gave highlights of "What's New?" for the year in income tax law.

Recently, a smaller, much briefer "What's New" section can be found online in Publication 17—but how many taxpayers take the time to find and read this tiny section? Who even knows what Pub 17 is? How many of you have ever even gone to the IRS's web page, where you might—if you are lucky—find "What's New," which doesn't even include warnings of IRS sanctions on those who fail to report foreign-sourced financial income and/ or financial accounts? (No need to respond. We all know the answer is near-zero.)

This year's version of "What's New?" spares one, less-than half-inch paragraph to the new foreign financial asset form (8938), which must be filed by those with more than $50,000 in foreign assets (with some variations on the figure depending on filing status, average account balances and highest account balances during the year). Nowhere in "What's New" are the penalties for non-compliance mentioned, nor the seriousness with which Congress and the IRS views the matter if there is anything short of full compliance including, incredibly, an unlimited tolling of the statute of limitations on the entire return until a complete and accurate Form 8938 is filed. It refers you to the instructions for the new form by stating, "If you had foreign financial assets in 2011, you may have to file new Form 8938 with your return." Aside from providing a link, that's all it says. I have found over the years that I can write about something many times before it sinks in enough for clients, including those who scrutinize every article, to even begin to ask, "Does this apply to me?" Most people, busy with their lives, don't think about such things. Even after I wrote several articles extolling the virtues of Roth conversions, I'd estimate that for every client who even thought of asking me if they should consider a conversion, there were ten more who never asked but for whom I found such conversions were appropriate and often extremely profitable. What are the odds the lack of awareness that this affects many with overseas accounts is any different? How many people will be punished with loss of assets because the IRS never made a big deal out of it and few ever asked "Does this apply to me?" until it was too late to avoid draconian penalties?

They could have put greater emphasis on reporting requirements, with a focus on prospective penalties, in an attempt to make it difficult to miss. They could have at least sent a postcard. Non-compliant taxpayers wouldn't now be in a position to lose 27.5% of their hard-earned wealth held in foreign financial accounts, not to mention pay tax (which of course they owe), penalties and interest on any unreported income associated with those foreign assets, along with living in fear.

If you think this isn't relevant to you, think again.

There's an old parable, the original of which was about the Jews under Hitler. This version represents today's reality:

> First they came for foreign immigrants with money, and I did not speak out — because I was not a foreign immigrant with money. Then they came for the savers and investors, and I did not speak out — because I was not a saver or investor. Then they came for the innovators, and I did not speak out — because I was not an innovator. Then they came for the businessmen, and I did not speak out — because I was not a businessman. Then they came for me — and there was no one left to speak for me.

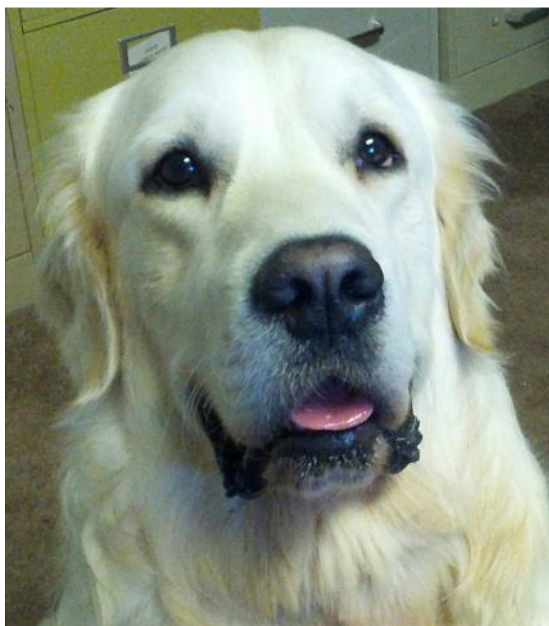
Other Onerous Penalties for Non-Compliant Taxpayers—and Even for Those Who Make Honest Mistakes

The FBAR and Form 8938 penalties are not the only ones way out of proportion to the purported crime. Congress has had a tendency in recent years to increase penalties for any non-compliance, for whatever reason, simply to raise revenue for a perennially broke government that continuously spends beyond its income on consumption items ("entitlements"). One is for failure to timely file S corporation returns, even if there is only one owner and even if there is no income. Whether the owner is due a refund on his personal return is of no import (S corporations pay no federal income tax; income or loss from an S corp flows through to the individual owners, who report it on their personal income tax returns). The penalties are now $195 per month late per shareholder. Up to twelve months of penalties can be imposed for something for which no one gets hurt except the owner, who is either due a refund, received belatedly, or owes taxes, on which he will pay penalties of 5% per month on late filings up to 25% plus interest. These are penalties on penalties.

Still another is a 20% substantial underpayment penalty on additional tax, which Congress compelled the IRS to impose whenever an audit increases tax by the greater of 10% of the total tax or $5,000. It's imposed on what you owe, even if the amount is less than $5,000. Let's say you inadvertently failed to report a pension withdrawal of $30,000, on which the mandatory 20% or $6,000 of tax was withheld. Let's say your real tax on this withdrawal is 28%, or $8,400. You'd think you'd owe $2,400 plus some interest, but you would be wrong. The 20% substantial underpayment penalty is assessed on the $2,400, because your *total* tax increased by over $5,000. Never mind that most of the tax owed was already

withheld; you owe $2,400 plus ($2,400 x .2 =) $480, or $2,880, plus interest. Never mind, too, the fact that we all know the 1099 reporting the income that went unreported was sent to the IRS and the certainty of getting caught for such non-reporting is virtually 100%, and that because you'd have to be really stupid to purposely fail to report such income it had to be completely accidental. And yes, I've seen cases like this, one of which I assisted a client in going to Tax Court, where the judge refused to forgive the penalty. It was a relatively small travesty of justice, but a travesty nonetheless. I could understand imposing such a penalty on income that goes unreported to the IRS by third parties or in cases where a taxpayer does this repeatedly. However, where it's already reported or it's a one-time error, it's unnecessary and inappropriate punishment. I believe the Founding Fathers would agree: it's draconian.

Can I Deduct the Cost of My Dog?



Dear Doug,
I heard you have a new puppy. So do we. Have you found any way of writing off the pup?
Signed,
Puppy Mom

Dear Mom,
Yes, we do and we have—eventually.

Our British cream-colored Golden Retriever, Bodie, will be bred with my wife Marty's partner's standard Poodle, creating Goldendoodles. We expect them to fetch about $1,000 each, with profits shared between the partners.

This doesn't necessarily mean we can deduct the expenses, including Bodie's initial cost, American Kennel Club registration "papers" and the continuing costs of puppyhood. If it's a hobby, the gross income is fully taxed, while the expenses may not be effectively deductible (expenses associated with "hobby" income are deductible only as a miscellaneous itemized deduction, which can be worthless for those who don't itemize deductions, are limited to the extent such expenses are less than 2% of the taxpayer's total income, and are worthless once the Alternative Minimum Tax is triggered). So, let's say you have $20,000 of income from several litters of puppies, you spent $30,000 creating those little pups, the IRS deems the venture a hobby and one or more of these issues (itemizing the costs doesn't help you nearly as much as you'd think) applies. Even though you lost money, you might end up paying as much as 42% federal and state income tax on that $20,000, or $8,400 in taxes. Other than issues regarding draconian penalties, this may be the worst possible result in the tax code, with the rules limiting gambling losses to winnings a distant second (and another story).

This, obviously, is an unacceptable result, so we want to do everything we can to prevent "hobby designation" from occurring (and those of you in "fun" businesses—not hobbies—in which you end up losing money should also heed this advice). Marty has done all she can to show intent to make a profit, which she truly believed was likely when she purchased Bodie. She paid quite a bit extra for breeding rights, which helps to show intent to be in business and earn a profit. She paid extra for the Los Angeles City license tags to "not" neuter Bodie, which also helps to show intent to earn a profit. She's tracking all of her expenses, which serves to demonstrate, at this stage of the start-up, that she's operating the activity in a business-like manner. So, going in to the venture with an upfront business-like attitude, style and modus operandi and treating it as such from the get-go helps to show business, not hobby, intent. However, the nine requirements the courts have set forth for showing a business as a business and not a hobby can be a challenge for many "fun" businesses:

1. Does she operate the activity in a business-like manner? (Yes.)
2. Does she have prior expertise? (With dogs, yes, and she actively seeks the advice of experts, including her very expert partner, which helps for purposes of this question.)
3. Is she devoting sufficient time to the activity? (Yes. It also helps that she tracks hours per week and mileage to care for Bodie, although these are limited for now.)
4. Is there an expectation the asset may appreciate? (Yes, if Bodie becomes famous as a sire—which could increase both income via stud fees and his value. And, as you can see by the picture, he's also movie material.)
5. Have there been past successes in similar activities? (Marty's a first-timer, so it's impossible to respond in the affirmative.)
6. What's the history of income and losses? (No way to know—the business hasn't started yet.)
7. Are there occasional profits? (Nothing to go on yet.)
8. What's the taxpayer's financial status? (Marty's not desperate, which works against her; on the other hand, she works only

part-time as a surgical scrub nurse, which does help.)

9. Is personal pleasure derived? (Except for Bodie's love affair with mud, his propensity to eat the cats' food and then puke, and his inclination to drool on newly-cleaned clothes, absolutely, but just because something is fun and doesn't end up profitable doesn't mean it wasn't intended to make a profit and, therefore, be a business.)

A related question is *when* are the expenses deductible? Since Marty and her partner are, under the tax code, not yet "in business," the expenses must be capitalized and amortized over Bodie's breeding life (we think three to five years). We believe amortization begins when the stork delivers.

The IRS might ask why he's not bred in the meantime, since he was ready, willing and able (oh boy was he!) at 8 or 9 months. Breeding would be premature because, for saleable "designer" pups, he must have hip, elbow, eye and cardiac clearances, the tests for which can't be done or are deemed by buyers irrelevant until he's two years old. Besides, his girlfriend isn't old enough yet.

Whether Refinancing or Buying, Should You Take a 15– or 30-Year Mortgage?

When reasonably certain of the affordability of permanently higher monthly payments borrowers should, at this time, consider taking 15-year loans. This applies whether refinancing or purchasing.

Many borrowers take 30-year loans, promising themselves they will pay extra towards principal in good times. Many even attempt to self-amortize over 15 years, but scale back not only when times are in the least bit lean, but even when "something comes up." It's amazing how often this something, whatever it may be, happens; those who stick to a shorter voluntary amortization schedule are few and far between. Those who make the decision up-front and are comfortable with the additional payment amount towards principal on a 15-year loan have the opportunity to save tens of thousands of dollars on the interest rate spread (15-year loans always offer lower rates than 30-year loans). This is in addition to saving, depending on the loan amount, potentially hundreds of thousands of dollars over the life of the shorter-duration loan without any difference in interest rates. With the current rate difference between 15-year and 30-year loans at an all-time record, the shorter loan is more profitable than ever. Those who can afford to take advantage of this unusual spread should seriously consider doing so *now*. Two "Dear Doug" letters follow, in which these ideas are expanded upon.

Should I Refinance? Should I Go 30-Year, or 15-Year? How Much Will I Save?

Dear Doug,

We're thinking about refinancing our home, on which we borrowed $250,000 three years ago when rates hit 5%. We've been paying $1,342 per month and the balance has dropped to $240,000. We understand rates are down to 3.875% on a new 30-year loan, but are reluctant to stretch out the payments another three years. We're thinking about a 15-year loan, but are concerned about obligating ourselves to the substantially higher monthly payment. What should we do? And, by the way, when should we act?

Signed,

Happy but concerned homeowner-in-debt

Dear Happy,

It seems as though your secondary question, "When should we act?" was almost an afterthought. Perhaps it's a bit of intuition or, from comments in the last issue of *Wealth Creation Strategies* regarding today's artificially low rates you logically deduced we might be nearing a long-term low. Yes, I would act as soon as possible to lock in these extraordinarily low rates. My wife and I have refinanced several times over the last decade and a half at what turned out to be short-term lows. While this could be yet another short-term low, it may be near the absolute bottom, so we're doing it again. To emphasize: we're refinancing right *now*.

You have several intriguing choices. You can take out another 30-year loan, which leaves you with numerous options in terms of repayment: pay it off over 30 years, over the term remaining on your existing loan (27 years), 15 years, or any other number of years up to 30, giving you the flexibility of reducing your payment while increasing the loan's amortization period if times get tough. However, a 15-year loan is appealing because, as of this writing, interest rates on these loans sit at a historic discount to 30-year mortgage rates. You save hundreds of thousands of dollars, but the required monthly payment is considerably higher. As an aside, I don't think an ARM (adjustable rate mortgage) makes sense now, since not only is the current ARM rate relatively close to the 15-year rate, but if I'm right about a bottom, the rate on an ARM will only move up.

Back in the ancient days (1998 through 2009) when 30-year rates were 5% to 8%, 15-year loans were never available for a greater than 10% discount to the 30-year loan rate. For example, in January 2009 a 30-year fetched 5.05% while the 15-year went out at 4.72%, for a (5.05 – 4.72 = .33

divided by 5.05 =) 6.5% discount to the 30-year rate. The largest discount we found prior to 2012 was 9.9%, when in December 2002 the 30-year rate was 6.05% and the 15-year was 5.45%. Now, you can get a 15-year mortgage for 3.125%, which is not only in absolute terms a record .75% less than the 3.875% rate available on 30-year loans, but also a record (.75% divided by 3.875 =) 19% discount to the 30-year loan. This huge discount alters the decision-making paradigm.

Let's get specific to your situation. You can:

1. Refinance for $240,000 for 30 years at 3.875%. Your monthly payment will drop to $1,129 per month, at a cost of $166,284 of interest over the life of your loan.

2. Refinance for $240,000 for 30 years but keep paying the $1,342 you're paying now. Your home will be owned free and clear in 22.33 years, shaving nearly five years of payments off your current loan. Total interest plummets to less than $119,000. Staying with a 30-year loan also allows you to decrease the monthly payment to $1,129 if things get tight, bearing in mind you won't pay the loan off as quickly and you'll pay more interest—and, because so often "something comes up," something may well come up.

3. Refinance for 30 years and "pretend" it's a 15-year loan by paying $1,760 per month. While this allows you the flexibility of reducing your monthly payment to as little as $1,129 in lean times, staying with the plan further reduces your total interest over the life of the loan to under $77,000, so long as something doesn't "come up."

4. Refinance for 15 years at 3.125%. While this obligates you to pay $1,672 monthly, or $88 per month less than the "pretend" 15-year immediately above, it shaves an additional $16,000 off the total interest, reducing that cost to less than $61,000. Compared to the total interest for the 30-year (option # 1), this saves $105,000.

5. Keep your current loan, but pay $1,672 monthly, mimicking the 15-year refi option. Your loan will be paid off in 18.25 years, requiring 3.25 years of additional payments vs. refinancing with a 15-year loan at 3.125%, for additional interest of $65,200. You could also use the ("pretend" 15-year) $1,760 per month option, which would result in paying off the loan in 16.83 years, costing nearly $39,000 more than refinancing with a 30-year loan at 3.875%. Clearly, unless you can't qualify for a new loan with favorable terms, this is not a good option and, well, something may "come up."

Summary of first four options for a $240,000 refinancing

Option #	Loan term (years)	Interest Rate	Monthly Payment	Total interest (rounded)	Years until paid off
Current loan	30	5.00%	$1342	$196,000*	27
1	30	3.875%	$1129	$166,000	30
2	30	3.875%	$1342	$119,000	22.33
3	30	3.875%	$1760	$77,000	15
4	15	3.125%	$1672	$61,000	15

***Additional interest over the remaining 27 years**

The least expensive option is #4, the 15-year refi, which saves more than ($16,000 divided by $77,000 =) 20% of the option #3 interest. This isn't a bad return in exchange for the requirement to pay $543 more per month than with the 30-year payment schedule, IF you can afford it. The problem with any of the first three options is—have you got this message yet?—you can (and likely will) become weak-willed and revert to the 30-year repayment schedule. Agreeing in advance to self-imposed constraints can be immensely profitable.

Comparing options #1 and #4, the rate of return on the additional payments is extraordinary. Take the difference between the yearly payments. Option #4, at $1,672 monthly, is $543 per month more than $1,129, or $6,516 in additional principal payments yearly. The total interest in year one for the 30-year and 15-year loans respectively is $9,224 and $7,319, for a difference of $1,905. You saved $1,905 on an additional investment of $6,516, for a 29% return on investment in year one. Wow.

Another way of looking at this is at year 15 you've paid $117,000 of interest on the 30-year loan and still owe nearly $154,000 in principal, while you've paid $61,000 of interest on the 15-year loan and owe nothing. So, you've already saved ($117,000 - $61,000 =) $56,000 of interest, which is 23% of $240,000. Intuitively, it seems you do really well by going with the 15-year option, especially at this point in time.

How Much Down Payment Should We Make on Our New Home?

Dear Doug,
Your retrospective look at the housing bubble in issue #47 of *Wealth Creation Strategies* was very interesting. We believe we are among potential homeowners who fall within your parameters of being able to safely purchase now. We agree prices could fall further, especially when interest rates increase

after the Fed-created low-interest rate bubble blows up, but we expect to be in our home for at least ten years. In addition, we expect the total cost (including interest, maintenance, property taxes, insurance and the amortized cost of long-term replacement of systems) to run considerably less than rent for a comparable home. This should compensate for the decrease in property values that may occur when interest rates return to more normal levels.

We can put our hands on 20% of the $250,000 purchase for a down payment, but family and friends are telling us to put down as little as possible. We're stressed. What should we do?
Signed,
Stressed-out new homeowners-to-be

Dear Stressed,
This is a great question. The answer involves looking at interest rates—but not in the way you might think.

Most view this problem simply: you borrow 80% at 3.875%; or borrow 96.5% via an FHA loan at 3.875% plus Property Mortgage Insurance (PMI)—currently at 1.15%, for a total cost of 5%; or some other combination loan, down payment and total cost (the larger the down payment, the lower the PMI). Many mortgage shoppers think of "just" the difference in overall cost, including both interest and PMI, but this compares apples with oranges. To properly analyze how much to put down, we need to calculate the *additional* cost of a loan greater than 80% of the purchase price. To do this, we need to pretend they are two separate loans.

Keeping it relatively simple, let's compare three options: 80% (20% down), 90% (10% down) and 96.5% (3.5% down). The 80% $200,000 loan currently runs 3.875%; the 90% $225,000 loan incurs a PMI cost of .5%, for a total interest and PMI cost of 4.375%; the 96.5% $241,250 loan costs 3.875% plus 1.15% PMI, or 5%. Keep in mind you pay the interest and PMI on the *entire* loan, not just the amount of the loan over $200,000. You will find the cost of borrowing the additional amount runs substantially more than 5% on that "chunk" of the loan.

In year one, the $200,000 loan costs $7,687 of interest. The $225,000 loan runs $9,770 of interest and PMI. The $241,250 loan costs $11,982. The additional interest/PMI cost (column E in the table below) divided by the incremental additional loan amount (column D) gives us the true cost of going with the larger loan amount/ lower down payment (column F).

The *real* cost of a greater-than 80% loan

Column A	Column B	Column C	Column D	Column E	Column F
Loan Amount	Effective Interest Rate (Rate + PMI)	Interest + PMI Year One	Incremental Loan Amount	Incremental Interest Cost Year One	Effective Interest Rate on Incremental Loan Amount*
$200,000	3.875%	$7,687			
$225,000	4.375%	$9,770	$25,000	$2,083	8.33%
$241,250	5.000%	$11,982	$41,250	$4,295	10.40%

***Column E divided by Column D, Year One.**

Worse, let's compare the additional cost of the $241,250 loan with the $225,000 loan. The interest/PMI difference is ($4,295 - $2,083 =) $2,212. Divide this by the incremental additional loan of ($241,250 - $225,000 =) $16,250 and you'll find the cost of borrowing that extra $16,250 is 13.6%.

While this additional cost decreases slightly over time, you get the idea: in the long run, low down payments are expensive. In an era of 1% rates on savings, incremental debt costing more than 5% is generally unwise. If you've got the funds, I usually recommend a down payment of at least 20% (which is what banks in a free market, which this is not, would likely require anyway). You should also take a look at adding even more towards principal via a 15-year loan, discussed in the Dear Doug above.

There are a few additional considerations that may affect your decision. First, PMI can be eliminated once equity exceeds 22%. Second, income tax savings on the interest and (for some) PMI should be taken into account on a case by case basis, because tax situations vary tremendously. Third, you should also look at the risk of decreased prospective income to support the mortgage payments and at the possibility you will need the cash for other purchases (furnishings and remodeling come to mind). The interest on consumer loans could quickly eat up the savings from having invested a larger down payment. A more complete analysis should take these and other factors (personal risk tolerance, likelihood of paying additional principal on a 30-year loan, high credit card balances, etc.) into account in deciding how much to put down on your new home.