Chapter 1

Determining Your Borrowing Power

In This Chapter

- Understanding how much mortgage debt you can truly afford
- Examining your monthly spending
- Assessing your likely homeownership expenses
- Considering your other financial goals

Do you feel less than fully informed about mortgages and related housing decisions? Well, you have lots of company. However, you *are* in a minority of people who recognize the gaps in their mortgage knowledge, and who are willing to invest a little of their time and money to get smarter. We know that much about you because you're reading this book.

You've made a wise decision to improve your mortgage and real estate wisdom. If Ken and Mary had done the same, they could have avoided some costly mistakes we know you won't make. Here, briefly, are their tales of woe.

Mary was a first-time home buyer. She began going to open houses on Sunday afternoons and, in a relatively short time, fell in love with a home. Unfortunately, she had to mortgage herself up to her eyeballs to get into it.

Not thrilled with her job, Mary continued to tough it out because she had that hefty mortgage to feed every month. She had to cut out travel and restaurant dinners with friends. Mary was miserable. To cheer herself up, she started charging more on her credit card. The spending hangover that hit when her next credit card statement arrived made the enjoyment short lived.

Ken was a homeowner who was induced by an advertisement to refinance. He switched adjustable-rate mortgages without understanding how long it would take him to recoup the associated financing costs (nearly 10 years, which was longer than Ken intended to keep his home).

The main reason Ken refinanced was that his previous adjustable-rate loan's interest rate increased rapidly when the adjustment index it was tied to rose sharply. A mortgage broker put Ken into an adjustable-rate mortgage with a much slower moving index right before rates started back down. He thus switched out of a faster moving loan *after* rates popped up, and he wasn't able to benefit nearly as fast when rates fell.

Now, trust us when we say that Ken and Mary aren't stupid. However, when it came to making important mortgage decisions, Ken and Mary were certainly not smart. Mary didn't understand what amount of mortgage debt she could truly afford. Ken didn't understand how to make refinancing decisions.

In this chapter, we help you tackle the first vital subject to consider when the time comes to take out a mortgage — how much mortgage can you really afford? ***Note:*** We intend this chapter primarily to help people who are buying a home (first or not) determine what size mortgage fits their financial situation. If you're in the mortgage market for purposes of refinancing, please also see Chapter 11.

Only You Can Determine the Mortgage Debt You Can Afford

Sit down and talk in person, by phone, or on a Web site with any mortgage lender, mortgage broker, or real estate agent, and you'll be asked about your income and debts. Assuming you have a good credit history and an adequate cash down payment, the lender can quickly estimate the amount of mortgage debt you can obtain.

Suppose a mortgage lender says that you qualify to borrow, for example, $150,000. What a lender is basically telling you when it says it will lend you $150,000 is that, based on the assessment of your financial situation, $150,000 is the *maximum* amount that this lender thinks you can borrow on a mortgage before putting yourself at significantly increased risk of default. Don't assume that the lender is saying that you can *afford* to carry that much mortgage debt given your other financial goals.

Your personal financial situation, most of which lenders, mortgage brokers, and real estate agents won't inquire into or care about, should help direct how much you borrow. For example, have you considered and planned for your retirement goals? Do you know how much you're spending per month now and how much slack, if any, you have for additional housing expenses including a larger mortgage? How are you going to pay for college expenses for your kids?

Scrutinize Your Monthly Spending

Unless you have generous parents, grandparents, or in-laws, if you want to buy a home, you need to save money. The same may be true if you desire to trade up to a more costly property. In either case, you can find yourself taking on more mortgage debt than you ever dreamed possible.

After you trade up or buy your first home, your total monthly expenditures will surely increase. Be forewarned that if you had trouble saving before the purchase, your finances are truly going to be squeezed after the purchase. This pinch will further handicap your ability to accomplish other important financial goals, such as saving for retirement, starting your own business, or helping to pay for your children's college education.

Because you can't manage the unknown, the first step in assessing your ability to afford a given mortgage amount is to collect and analyze your monthly spending. If you already track such data — whether by pencil and paper or on your lightning-quick, six-gazillion-megahertz computer, you have a head start. But *don't* think you're finished. Having your spending data is only half the battle. You also need to know how to analyze your spending data (which we explain how to do in this chapter) to help decide how much you can afford to borrow.

Collect Your Spending Data

What could be more dreadful than sitting at home on a beautiful sunny day — or staying in at night while your friends and family are out frolicking on the town — and cozying up to your calculator, checkbook register, credit card bills, pay stub, and most recent tax return?

Examining where and how much you spend on various items is almost no one's definition of a good time (except, perhaps, for some accountants, actuaries, and other bean counters who crunch numbers for a living). However, if you don't endure some pain and discomfort now, you could end up suffering long-term pain and discomfort when you get in over your head with a mortgage you can't afford.

Now some good news: You don't need to detail to the penny where your money goes. What you're interested in here is capturing the bulk of your expenditures. Ideally, you should collect spending data for a three- to six-month period to determine how much you spend in a typical month on taxes, clothing, meals out, and so forth. If your expenditures fluctuate greatly throughout the year, you may need to examine a full 12 months of your spending to obtain an accurate monthly average.

Later in this chapter, we provide a handy table that you can use to categorize your spending. First, however, we need to talk you through the specific and often large expenses of owning a home so that you can intelligently plug those into your current budget.

Determine Your Potential Homeownership Expenses

If you're in the market to buy your first home, you probably don't have a clear sense about the costs of homeownership. Even people who presently own a home and are considering trading up often don't have a good handle on their current or likely future homeownership expenses. So we included this section to help you assess your likely homeownership costs.

Mortgage payments

As we discuss in detail in Chapter 4, a *mortgage* is a loan you take out to finance the purchase of a home. Mortgage loans are generally paid in monthly installments over either a 15- or 30-year time span.

In the early years of repaying your mortgage, nearly all of your mortgage payment goes toward paying interest on the money that you borrowed. Not until the later years of your mortgage do you begin to rapidly pay down your loan balance (the *principal*).

As we say earlier in this chapter, all that mortgage lenders can do is tell you their own criteria for approving and denying mortgage applications and calculating the maximum that you're eligible to borrow. A mortgage lender tallies up your monthly *housing expense,* the components of which the lender considers to be the mortgage payment, property taxes, and homeowners insurance.

Understanding lenders' ratios

For a given property that you're considering buying, a mortgage lender calculates the housing expense and normally requires that it not exceed 40 percent or so of your monthly before-tax *(gross)* income. So, for example, if your monthly gross income is $6,000, your lender may not allow your expected monthly housing expense to exceed $2,400. If you're self-employed and complete IRS Form 1040, Schedule C, mortgage lenders use your after-expenses *(net)* income, from the bottom line of Schedule C (and, in fact, add back noncash expenses for items such as depreciation, which increases a self-employed person's net income for qualification purposes).

WARNING!

If you think that you can handle borrowing more than the lender allows

Some people we know believe that they can handle more mortgage debt than lenders allow using their handy-dandy ratios. Such borrowers may seek to borrow additional money from family, or they may fib about their income when filling out their mortgage applications.

Although some homeowners who stretch themselves financially do just fine, others end up in financial and emotional trouble. You should also know that, because lenders sometimes cross-check the information on your mortgage application with the IRS, increasing numbers of borrowers who lie on their mortgage applications are caught and their applications denied.

So although we've said that the lender's word isn't the gospel as to how much home you can truly afford, telling the truth on your mortgage application is the only way to go.

We should also note that telling the truth prevents you from committing perjury and fraud, troubles that catch even officials elected to high office. Bankers don't want you to get in over your head financially and default on your loan, and we don't want you to either.

This housing expense ratio completely ignores almost all your other financial goals, needs, and obligations. It also ignores property maintenance and remodeling expenses, which can suck up a lot of a homeowner's dough. Never assume that the amount a lender is willing to lend you is the amount you can truly afford.

In addition to your income, the only other financial considerations a lender takes into account are your debts. Specifically, mortgage lenders examine the required monthly payments for other debts you may have, such as student loans, auto loans, and credit card bills. In addition to the percentage of your income that lenders allow for housing expenses, they typically allow an additional 5 percent of your monthly income to go toward other debt repayments.

Calculating your mortgage payment amount

After you know the amount you want to borrow, calculating the size of your mortgage payment is straightforward. The challenge is figuring how much you can comfortably afford to borrow given your other financial goals. This chapter should assist you in this regard, especially the previous section on analyzing your spending and goals.

Suppose that you worked through your budget and determined that you can afford to spend $2,000 per month on housing. Determining the exact size of mortgage that allows you to stay within this boundary may seem daunting, because your overall housing cost is comprised of several components: mortgage payments, property taxes, insurance, and maintenance.

Using Appendix A, you can calculate the size of your mortgage payments based on the amount you want to borrow, the loan's interest rate, and whether you want a 15- or 30-year mortgage.

Property taxes

As you're already painfully aware if you're a homeowner now, you must pay property taxes to your local government. The taxes are generally paid to a division typically called the County or Town Tax Collector. (If you make a smaller down payment — less than 20 percent of the home's purchase price — you may have an *impound account.* Such an account requires you to pay your property taxes, and often your homeowners insurance, to the lender each month along with your mortgage payment. The lender is responsible for making the necessary property tax and insurance payments to the appropriate agencies on your behalf.)

Property taxes are typically based on the value of a property. Because property taxes vary from one locality to another, call the relevant local tax collector's office to determine the exact rate in your area. (You should be able to find the phone number in the government section of your local phone directory.) In addition to inquiring about the property tax rate in the town where you're contemplating buying a home, also ask what additional fees and assessments may apply.

As you shop for a home, be aware that real estate listings frequently contain information regarding the amount the current property owner is currently paying in taxes. These taxes are often based upon an outdated, much lower property valuation. If you purchase the home, your property taxes may be significantly increased based on the price that you pay for the property.

Tax write offs

This is a good point to pause, recognize, and give thanks for the tax benefits of homeownership. The federal tax authorities at the Internal Revenue Service (IRS) and most state governments allow you to deduct, within certain limits, mortgage interest and property taxes when you file your annual income tax return.

You may deduct the interest on the first $1,000,000 of mortgage debt as well as all the property taxes. (This mortgage interest deductibility covers debt on both your primary residence and a second residence.) The IRS also allows you to deduct the interest costs on second mortgages known as home equity loans or home equity lines of credit, HELOCS, (see Chapter 6) to a maximum of $100,000 borrowed.

To keep things simple and get a reliable estimate of the tax savings from your mortgage interest and property tax write off, multiply your mortgage payment and property taxes by your *federal* income tax rate in Table 1-1. This approximation method works fine as long as you're in the earlier years of paying off your mortgage, because the small portion of your mortgage payment that isn't deductible (because it is for the loan repayment) approximately offsets the overlooked state tax savings.

Table 1-1 2004 Federal Income Tax Brackets and Rates

Singles Taxable Income	*Married-Filing-Jointly Taxable Income*	*Federal Tax Rate (Bracket)*
Less than $7,150	Less than $14,300	10%
$7,150 to $29,050	$14,300 to $58,100	15%
$29,050 to $70,350	$58,100 to $117,250	25%
$70,350 to $146,750	$117,250 to $178,650	28%
$146,750 to $319,100	$178,650 to $319,100	33%
More than $319,100	More than $319,100	35%

Insurance

When you own a home with a mortgage, your mortgage lender will insist as a condition of funding your loan that you have adequate homeowners insurance. The cost of your insurance policy is largely derived from the estimated cost of rebuilding your home. Although land has value, it doesn't need to be insured, because it wouldn't be destroyed in a fire. Buy the most comprehensive homeowners insurance coverage you can and take the highest deductible that you can afford, to help minimize the cost.

As a homeowner, you'd also be wise to obtain insurance coverage against possible damage, destruction, or theft of personal property such as clothing, furniture, kitchen appliances, audiovisual equipment, and your collection of vintage fire hydrants. Personal property goodies can cost big bucks to replace.

In years past, various lenders learned the hard way that some homeowners with little financial stake in the property and insufficient insurance coverage simply walked away from homes that were total losses and left the lender with the loss. Thus, nearly all lenders, especially those that sell mortgage loans in the financial markets, now require you to purchase *private mortgage insurance* if you put down less than 20 percent of the purchase price when you buy.

WARNING!

Junk fees

Junk fees are loan charges paid directly to your lender or mortgage broker. Examples of these pernicious profit centers are a fee for processing your loan application, a fee for preparing your loan documents, a fee to underwrite your loan, a fee to warehouse your loan, and the ever-popular miscellaneous fee.

Legitimate mortgage fees, conversely, are fees paid to third parties — including the firm handling your escrow, appraisers, credit reporting agencies, notaries, and country recorders. We cover these fees in the section on closing costs.

If your closing costs include junk fees that weren't disclosed in the good faith estimate of loan costs your lender should've given you within three business days after you submitted your loan application, call your loan officer immediately. You can generally negotiate with the lender to either reduce or eliminate its garbage fees.

TIP

You can avoid paying private mortgage insurance by using 80-10-10 financing. We cover this delightful technique in Chapter 6.

Budgeting for closing costs

As you budget for a given home purchase, don't forget to budget for the inevitable pile of one-time *closing costs.* In a typical home purchase, closing costs amount to about 2 to 5 percent of the purchase price of the property. Thus, you shouldn't ignore them when you figure the amount of money you need to close the deal. Having enough to pay the down payment on your loan is just not sufficient.

As we discuss in *Home Buying For Dummies* (Wiley), if you're short of cash, you can negotiate with the property seller to pay some or all of your closing costs. Expect to pay a higher interest rate for a mortgage with few or no upfront fees. And, all other things being equal, expect to pay and borrow more to entice the seller to pay your closing costs.

Here are the major closing costs and our guidance as to how much to budget for each:

- **Loan-origination fees and charges:** Lenders generally levy fees for appraising the property, obtaining a copy of your credit report, preparing your loan documents, and processing your loan. They'll also whack you 1 to 2 percent of the loan amount for a *loan-origination fee.* Another term for this prepaid interest charge, as we explain in Chapter 9, is *points.* If you're strapped for cash, you can get a loan that has few or no fees;

however, such loans have higher interest rates over their lifetimes. You may be able to negotiate having the seller pay these loan-closing costs. The total loan-origination fees and other charges may add up to as much as 3 percent of the mortgage amount.

- **Escrow fees:** These costs cover the preparation and transmission of all home-purchase-related documents and funds. Escrow fees range from several hundred to over a thousand dollars, based on the purchase price of your home.
- **Homeowners insurance:** Lenders generally require that you pay the first year's premium on your homeowners insurance policy at the time of closing. Such insurance typically costs from several hundred to a thousand dollars plus, depending upon the value of your home and the extent of coverage you desire.
- **Title insurance:** *Title insurance* protects you and the lender against the risk that the person selling you the home doesn't legally own it. This insurance typically costs from several hundred to several thousand dollars, depending on your home's purchase price. Happily, the premium you pay at close of escrow is the only title insurance premium you'll ever have to pay *unless you subsequently decide to refinance your mortgage.*
- **Property taxes:** At the closing of your home purchase, you may have to reimburse the sellers for property taxes that they paid in advance. Here's how it works. Suppose that you close on your home purchase on October 15, and the sellers had already paid their property taxes through December 31. You will have to reimburse the sellers for property taxes they paid from October 15 through the end of the year. The prorated property taxes you'll end up paying in your actual transaction will be based upon the home's taxes and the date that escrow actually closes and will cost from several hundred to a couple of thousand dollars.
- **Attorney fees:** In some eastern states, lawyers are involved (unfortunately from some participants' perspectives) in real estate purchases. In most states, however, lawyers aren't needed for home purchases as long as the real estate agents use standard, fill-in-the-blank contracts. If you do hire an attorney, expect to pay at least several hundred dollars.
- **Property inspections:** As we advocate in our best-selling book *Home Buying For Dummies*, you should always have a home professionally inspected before you buy it. Inspection fees usually cost in the neighborhood of several hundred dollars.
- **Private mortgage insurance (PMI):** If you make a down payment of less than 20 percent of the purchase price of the home, mortgage lenders generally require that you take out private mortgage insurance that protects the lender in case you default on your mortgage. You may need to pay up to a year's worth of premium for this coverage at closing, which can amount to as much as several hundred dollars. One terrific way to avoid this extra cost is to make a 20-percent down payment.

- **Prepaid loan interest:** At closing, the lender will charge interest on your mortgage to cover the interest that accrues from the date your loan is funded — generally one business day before the closing — up to the day of your first scheduled loan payment. How much interest you actually have to pay depends on the timing of your first loan payment.

  If you're strapped for cash at closing, try the following tricks to minimize the prepaid loan interest you'll owe at closing:

  - First, ask your lender which day of the month your payment will be due and schedule to close on the loan as few days in advance of that day as possible. (Payments are usually due on the first of the month, so closing on the 1st or a few days before is generally best.)
  - Or ask whether your lender is willing to adjust your monthly due date closer to the date you desire to close on your loan.
  - Also, never schedule a closing to occur on a Monday because the lender will have to put your mortgage funds into escrow the preceding Friday, causing you to pay interest for Friday, Saturday, and Sunday. (Some lenders may be able to accommodate a Monday closing by same-day wiring the funds for an afternoon closing.)
- **Other fees:** Recording fees (to record the deed and mortgage), courier and express mailing fees, notary fees — you name it, and you can expect to get whacked another $20 to $50 for it. These extra expenses usually total about $100 or $200.

Maintenance costs

In addition to costing you a monthly mortgage payment, homes also need painting, roof repairs, and other types of maintenance over time. Of course, some homeowners defer maintenance and even put their houses on the market for sale with lots of deferred maintenance (which, of course, will be reflected in a reduced sales price).

For budgeting purposes, we suggest that you allocate about 1 percent of the purchase price of your home each year for normal maintenance expenses. So, for example, if you spend $180,000 on a home, you should budget about $1,800 per year (or about $150 per month) for maintenance.

With some types of housing, such as condominiums, you pay monthly dues into a homeowner's association, which takes care of the maintenance for the complex. In that case, you're only responsible for maintaining the interior of your unit. Check with the association to see how much the dues are running and how they've changed over the years.

Home improvement, furnishings, you name it!

In addition to necessary maintenance, also be aware of how much you may spend on nonessential home improvements such as adding a deck, remodeling your kitchen, and so on. Budget for these nonessentials unless you're the rare person who is a super saver, can easily accomplish your savings goals, and have lots of slack in your budget.

The amount you expect to spend on improvements is just a guess. It depends upon how *finished* a home you buy and your personal tastes and desires. Consider your previous spending behavior and the types of projects you expect to do as you examine potential homes for purchase.

Consider the Impact of a New House on Your Financial Future

As you collect your spending data, think about how your proposed home purchase will affect and change your spending habits and ability to save. For example, as a homeowner, if you live farther away from your job than you did when you rented, how much will your transportation expenses increase?

Table 1-2 can help you total up all your current and estimate future expected spending.

Table 1-2 Your Spending, Now and After Your Home Purchase

Item	*Current Monthly Average ($)*	*Expected Monthly Average with Home Purchase ($)*
Income	________	________
Taxes		
Social Security	________	________
Federal	________	________
State and local	________	________
Housing Expenses		
Rent	________	________

(continued)

Table 1-2 *(continued)*

Item	*Current Monthly Average ($)*	*Expected Monthly Average with Home Purchase ($)*
Mortgage	________	________
Property taxes	________	________
Gas/electric/oil	________	________
Water/garbage	________	________
Phone	________	________
Cable TV	________	________
Furniture/appliances	________	________
Maintenance/repairs	________	________
Food and Eating		
Supermarket	________	________
Restaurants and takeout	________	________
Transportation		
Gasoline	________	________
Maintenance/repairs	________	________
State registration fees	________	________
Tolls and parking	________	________
Bus or subway fares	________	________
Appearance		
Clothing	________	________
Shoes	________	________
Jewelry (watches, earrings)	________	________
Dry cleaning	________	________
Haircuts	________	________
Makeup	________	________
Other	________	________

Item	*Current Monthly Average ($)*	*Expected Monthly Average with Home Purchase ($)*
Debt Repayments		
Credit/charge cards	___________	___________
Auto loans	___________	___________
Student loans	___________	___________
Other	___________	___________
Fun Stuff		
Entertainment (movies, concerts)	___________	___________
Vacation and travel	___________	___________
Gifts	___________	___________
Hobbies	___________	___________
Pets	___________	___________
Health club or gym	___________	___________
Other	___________	___________
Advisors		
Accountant	___________	___________
Attorney	___________	___________
Financial advisor	___________	___________
Health Care		
Physicians and hospitals	___________	___________
Drugs	___________	___________
Dental and vision	___________	___________
Therapy	___________	___________
Insurance		
Homeowners/renters	___________	___________
Auto	___________	___________
Health	___________	___________

(continued)

Table 1-2 *(continued)*

Item	*Current Monthly Average ($)*	*Expected Monthly Average with Home Purchase ($)*
Life	________	________
Disability	________	________
Educational Expenses		
Courses	________	________
Books	________	________
Supplies	________	________
Kids		
Day care	________	________
Toys	________	________
Child support	________	________
Charitable donations	________	________
Other		
________________	________	________
________________	________	________
________________	________	________
________________	________	________
________________	________	________
Total Spending	________	________
Amount Saved	________	________
(subtract from income on previous page)		

Acting upon your spending analysis

Tabulating your spending is only half the battle on the path to fiscal fitness and a financially successful home purchase. After all, many government entities know where they spend our tax dollars, but they still run up massive levels of debt! You must do something with the personal spending information that you collect.

When most Americans examine their spending, especially if it's the first time, they may be surprised and dismayed at the amount of their overall spending and how little they're saving. How much is enough to save? The answer depends upon your goals and how good your investing skills are. For most people to reach their financial goals, they must save at least 10 percent of their gross (pretax) income.

From Eric's experience as a personal financial counselor and lecturer, he knows that most people don't know how much they are currently saving, and even more people don't know how much they should be saving. You should know these amounts before you buy your first home or trade up to a more costly property.

If you're like most people planning to buy a first home, you need to reduce your spending in order to accumulate enough money to pay for the down payment and closing costs and create enough slack in your budget to afford the extra costs of homeownership. Trade-up buyers may have some of the same issues as well. Where you decide to make cuts in your budget is a matter of personal preference. Here are some proven ways to cut your spending now and in the future:

- **Purge consumer debt.** Debt on credit cards, auto loans, and the like is detrimental to your long-term financial health. Borrowing through consumer loans encourages you to live beyond your means, and the interest rates on consumer debt are high *and not tax deductible.* If you have accessible savings to pay down your consumer debts, do so as long as you have access to sufficient emergency money from family or other avenues.
- **Trim nonessential spending.** Although everyone needs food, shelter, clothing, and health care, most Americans spend a great deal of additional money on luxuries and nonessentials. Even some of what people spend on the "necessity" categories is partly for luxury.
- **Purchase products and services that offer value.** High quality doesn't have to cost more. In fact, higher priced products and services are sometimes inferior to lower cost alternatives.
- **Buy in bulk.** Most items are cheaper per unit when you buy them in larger sizes or volumes. Superstores such as Costco and Wal-Mart offer family sizes and competitive pricing.

Establishing financial goals

Most people find it enlightening to see how much they need to save in order to accomplish particular goals. For example, wanting to retire someday is a common goal. And the good news is that you can take advantage of tax incentives while you save toward retirement.

Money that you contribute to an employer-based retirement plan — for example, a 401(k) — or to a self-employed plan — for example, a SEP-IRA or Keogh — is typically tax deductible at both the federal and state levels. Also, after you contribute money into a retirement account, the gains on that money compound over time without taxation.

If you're accumulating down-payment money for the purchase of a home, putting that money into a retirement account is generally a bad idea. When you withdraw money from a retirement account, you not only owe current income taxes, but you also owe hefty penalties — 10 percent of the amount withdrawn for the IRS plus whatever penalty your state charges.

If you're trying to save for a real estate purchase and save toward retirement and reduce your taxes, you have a dilemma — assuming that, like most people, you have limited funds with which to work. The dilemma is that you can save outside of retirement accounts and have access to your down-payment money but pay much more in taxes. Or you can fund your retirement accounts and gain tax benefits, but lack access to the money for your home purchase.

You have two ways to skirt this dilemma:

- **Borrow against your employer's retirement plan.** Some employers' retirement plans, especially those in larger companies, allow borrowing against retirement savings plan balances.
- **Implement a first-time home-buyer IRA withdrawal.** If you have an Individual Retirement Account (either a standard IRA or a newer Roth IRA), you are allowed to withdraw up to $10,000 (lifetime maximum) toward a home purchase as long as you haven't owned a home for the past two years. Tapping into a Roth IRA is a better deal because the withdrawal is free from income tax as long as the Roth account is at least five years old. Although a standard IRA has no such time restriction, withdrawals are taxed as income, so you'll only net the after-tax amount of the withdrawal toward your down payment.

Because most people have limited discretionary dollars, you must decide what your priorities are. Saving for retirement and reducing your taxes are important goals; but when you're trying to save to purchase a home, some or most of your savings needs to be outside a tax-sheltered retirement account. Putting your retirement savings on the back burner for a short time in order to build up your down-payment cushion is fine. However, be sure to purchase a home that offers enough slack in your budget to fund your retirement accounts after the purchase.

Making down-payment decisions

Most people borrow money for a simple reason: They want to buy something that they can't afford to pay for in a lump sum. How many 18-year-olds and their parents have the extra cash to pay for the full cost of a college education? Or prospective home buyers to pay for the full purchase price of a home? So people borrow.

When used properly, debt can help you accomplish your financial goals and make you more money in the long run. But if your financial situation allows you to make a larger than necessary down payment, consider how much debt you need or want. With most lenders, as we discuss in Chapter 5, you'll get access to the best rates on mortgage loans by making a larger down payment. Whether or not making a larger down payment makes sense for you depends on a number of factors such as your other options and goals.

The potential rate of return that you expect/hope to earn on investments is a critical factor when you decide whether to make a larger down payment or make other investments. Psychologically, however, some people feel uncomfortable making a larger down payment because it diminishes their savings and investments.

You probably don't want to make a larger down payment if it depletes your emergency financial cushion. But don't be tripped up by the misconception that somehow you'll be harmed more by a real estate market crash if you pay down your mortgage. Your home is worth what it's worth — its value has nothing to do with the size of your mortgage.

Financially, what matters in deciding to make a larger down payment is the rate of interest you're paying on your mortgage versus the rate of return your investments are generating. Suppose that you get a fixed-rate mortgage at 6 percent. In order for you to come out financially ahead making investments instead of making a larger down payment, your investments need to produce an average annual rate of return, before taxes, of about 6 percent.

Considering the tax impact

Although it's true that mortgage interest is usually tax deductible, don't forget that you must also pay taxes on investments held outside of retirement accounts. You could purchase tax-free investments, such as municipal bonds, but over the long haul, you probably won't be able to earn a high enough rate of return on such bonds versus the cost of the mortgage. Other types of fixed-income investments, such as bank savings accounts, CDs, and other bonds, are also highly unlikely to pay a high enough return.

And don't assume that those mortgage interest deductions are that great. Many high-income earners, for example, still don't realize that they've lost the ability to fully deduct their mortgage interest on their tax returns. If your adjusted gross income (taxable income from all sources before subtracting itemized deductions and personal exemptions) exceeds $142,700 in 2004, you start to lose some of your mortgage interest deduction. You lose mortgage interest deductions by 3 percent multiplied by the amount that your adjusted gross income exceeds $142,700. In fact, you can lose up to 80 percent of your mortgage interest deduction. Couples are more likely to be affected by this provision because the $142,700 threshold is the same for couples as it is for single filers. This is another marriage penalty. It's not meant to be equitable — its aim is to collect more revenue.

In order for you to have a reasonable chance of earning more on your investments than it's costing you to borrow on a mortgage, you must be willing to invest in more growth-oriented, volatile investments such as stocks and rental/investment real estate. Over this past century, stocks and real estate have produced annual average rates of return of about 10 percent. On the other hand, there are no guarantees that you will earn these returns in the future. Growth-type investments can easily drop 20 percent or more in value over short time periods (such as one to three years).

Ruling out other options

If you're not taking full advantage of contributing to tax-deductible retirement accounts, especially employer plans that provide free matching money, such as 401(k)s or 403(b) plans, you should definitely think twice before making a larger down payment if doing so will hamper your ability to take advantage of these tax-reduction accounts. Making a larger down payment gives you no tax benefits.