IN THIS CHAPTER

- Understanding how much mortgage debt you can truly afford
- Estimating your likely homeownership expenses
- Considering your other financial goals

Chapter 1

Determining Your Borrowing Power

If you're like most folks, the single biggest purchase you'll make during your lifetime will be when you buy a home. And, to make that purchase, you'll likely have to borrow money by using a loan called a mortgage. The cumulative payments on that mortgage will far exceed the sticker price on your home due to the interest you'll pay.

Most people thinking of purchasing a home focus solely on the price of the home. If you're in the enviable position of being able to pay all cash, then the price is really all you need to consider in determining whether you can afford a given home. But the vast majority of people purchase real estate with financing. So although the purchase price is important, the reality is that the mortgage terms that you're able to secure and negotiate will determine the monthly payment that you can afford and will dictate the maximum price you can pay for your new home.

In this chapter, we help you tackle this 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 or by phone, or use a website to gather information and then meet face to face with a reputable mortgage lender, and you'll be asked about your income and debts. Assuming that 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, $200,000. In this case, the lender is basically telling you that, based on the assessment of your financial situation, $200,000 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 overall personal financial situation — most of which lenders, mortgage brokers, and real estate agents won't inquire into or care about — should help you decide 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 much of a reserve or rainy day savings fund do you have? How are you going to pay for college expenses for your kids? Are you or will you soon be helping to care for elderly relatives?

In the following sections, we start you on the path to answering these questions.

Acknowledge your need to save

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 housing expenditures and housing-related spending (such as furnishings, insurance, and utilities) will surely increase. So 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 own or 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 data about your monthly spending (see the following section). If you already track such data — whether by pencil and paper or on your 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 comfortably.

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 on the town — and cozying up to your calculator, banking and credit card transactions, pay stubs, 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, IRS agents, actuaries, and other bean counters who crunch numbers for a living). However, if you don't endure some pain and agony now, you could end up suffering long-term pain and agony 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. That simply isn't realistic. What you're interested in here is capturing the bulk of your expenditures and allowing for some margin for unanticipated expenses, plus savings for an emergency fund. 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, transportation, entertainment, 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 get an accurate monthly average. You also want to include any known changes in upcoming expenses. Maybe your child will be starting preschool next year at a private institution or your car is getting old and you know you'll soon want to get a new vehicle.

Later in this chapter, we provide a handy table that you can use to categorize and add up all your spending. First, however, we need to talk you through the specific and often large expenses of owning a home so you can intelligently plug those numbers 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 great grasp on their current or likely future homeownership expenses. So we include this section to help you assess your likely homeownership costs.

Making your mortgage payments

A *mortgage* is a loan you take out to finance the purchase of a home. Mortgage loans are generally paid in monthly installments typically over either a 15- or 30-year time span. Chapter 4 provides greater detail about how mortgages work.

In the early years of repaying your mortgage, nearly all your mortgage payment goes toward paying interest on the money that you borrowed. Not until the later years of your mortgage term do you rapidly begin to 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 $5,000, your lender may not allow your expected monthly housing expense to exceed $2,000. 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 real estate and equipment depreciation, which increases a self-employed person's net income for qualification purposes).

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 or ongoing monthly obligations. Specifically, mortgage lenders examine the required monthly payments for other debts you may have, such as student loans, auto loans, and credit card bills. They also deduct for alimony, child support, or any other required payments. 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 out 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.

SO YOU THINK YOU CAN HANDLE EXCESS BORROWING?

WARNING

Some people we know believe 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 usually cross-check the information on your mortgage application with IRS Form 4506T (the lender receives your actual tax return you filed, which certainly didn't overstate your income), borrowers who fib on their mortgage applications are caught and their applications denied.

So although we say 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. It may be painful to learn that you don't qualify for the loan you need to purchase that home of your dreams, but you're likely better off in the long run not overextending yourself with mortgage debt.

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.

Suppose you work through your budget and determine that you can afford to spend $2,000 per month on housing. Determining the exact size of a 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 (and association dues if the property is a condominium or has community assets like a swimming pool).

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. Alternatively, you can do the same calculations by using many of the best financial calculators available for less than $50 from companies like HP and Texas Instruments. (In Chapter 8, we discuss the ubiquitous online mortgage calculators, which are often highly simplistic.)

Paying 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.

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. (Check the government section of your local phone directory to find the phone number or search for the name of the municipality and "property tax" online.) 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. In California, many recently developed areas have special assessments (such as *Mello-Roos* districts), which are additional property taxes to pay for enhanced infrastructure and amenities, such as parks, police/fire stations, golf courses, and landscaped medians.

If you make a smaller down payment — less than 20 percent of the home's purchase price — your lender is likely to require you to have an *impound account* (also called an *escrow account* or *reserve account*). Such an account requires you to pay a monthly pro-rata portion of your annual 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. An impound account keeps the homeowner from getting hit with a large annual property tax bill.

WARNING

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 on an outdated, much lower property valuation. If you purchase the home, your property taxes may be significantly higher based on the price that you pay for the property. Conversely, if you happen to buy a home that has decreased in value since it was purchased, you could find that your property taxes are actually lower.

Tracking your tax write-offs

Now 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 million 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 additional borrowing 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's for the repayment of the principal amount of your loan) approximately offsets the overlooked state tax savings.

TABLE 1-1 2017 Federal Income Tax Brackets and Rates

Singles Taxable Income	Married-Filing-Jointly Taxable Income	Federal Tax Rate (Bracket)
Less than $9,325	Less than $18,650	10%
$9,325 to $37,950	$18,650 to $75,900	15%
$37,950 to $91,900	$75,900 to $153,100	25%
$91,900 to $191,650	$153,100 to $233,350	28%
$191,650 to $416,700	$233,350 to $416,700	33%
$416,700 to $418,400	$416,700 to $470,700	35%
More than $418,400	More than $470,700	39.6%

Investing in 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, which includes both casualty and liability coverage. 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 you can afford, to help minimize the cost.

TIP

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. Some prized possessions like jewelry, antiques, and collectibles are often excluded from your base policy and can require a special added coverage policy with limits that need to be set based on the replacement value of the items.

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, in addition to sufficient casualty and liability insurance, lenders require you to purchase *private mortgage insurance* if you put down less than 20 percent of the purchase price when you buy. This is risk insurance that protects the lender by making the mortgage payments to the lender if you're unable to. This could be because you have a loss of income whether from a job loss or an injury/illness.

REMEMBER

Private mortgage insurance is an extra cost that will factor into the calculation for the amount of your loan and reduce your ability to borrow. You may be able to avoid paying private mortgage insurance by using 80-10-10 financing. We cover this technique in Chapter 6.

Budgeting for closing costs

As you budget for a given home purchase, don't forget to budget for the inevitable laundry list 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 just isn't sufficient.

TIP

Some sellers may be willing to assist buyers by paying a portion of the closing costs. This is particularly true with new home subdivisions by major builders but is always negotiable with any seller. However, expect to pay a higher interest rate for a mortgage with few or no upfront fees.

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 several thousand dollars, depending on 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 a few 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.* Oddly, there are places like Northern California where the seller (not the buyer) pays for the "main" title policy. This is purely a matter of "local custom." Ask your agent what the custom is where you are buying.
- **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 you close on your home purchase on October 15, and the sellers have already paid their property taxes through December 31. You have to reimburse the sellers for property taxes they paid from October 15 through the end of the year. The prorated property taxes you end up paying in your actual transaction are based on the home's taxes and the date that escrow actually closes and cost from several hundred to a couple of thousand dollars. In some parts of the country, if you paid more than the prior owner for the property, you may also receive a supplemental property tax bill from your tax collector, after you close escrow, seeking payment for the incremental increase in the property taxes for your prorated period of ownership.

- **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 advocated in *Home Buying For Dummies* (Wiley), you should always have a home professionally inspected before you buy it. Inspection fees usually cost at least several hundred dollars (larger homes cost more to inspect of course). Be sure to carefully review this report and ask for additional information or hire a specialized contractor to conduct further investigation for any noted item of concern. If you are able, accompany the inspector when he inspects the property.
- **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 charges 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 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 last day of the month 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 generally 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. These extra expenses usually total about $200 to $300. ***Note:*** Ask your mortgage lender for a complete listing of all fees and charges.

Managing maintenance costs

In addition to costing you a monthly mortgage payment, homes also need flooring, window treatments, painting, plumbing, electrical and 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 that is often much greater than the cost to have made those simple repairs).

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 $240,000 on a home, you should budget about $2,400 per year (or about $200 per month) for maintenance.

With some types of housing, such as condominiums or planned unit developments (PUD), you pay monthly dues into a common interest development (often referred to as a homeowners association), which takes care of the maintenance for the community. In that case, you're responsible for maintaining only the interior of your unit. Check with the association to see how much the dues are currently running, anticipated future monthly or quarterly dues increases or special assessments, what services are included, and how they've changed over the years.

Financing home improvements and such

In addition to necessary maintenance and furnishings, 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 an estimate. It depends on 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? If you currently don't live in a common interest development (that is, a community with a homeowners association), you'll quickly learn about dues and sometimes special assessments, which are rarely anticipated and included in your budget.

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

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

Item	Current Monthly Income Average ($)	Expected Monthly Income Average with Home Purchase ($)
Income		
Gross salary	________	________
Bonuses/overtime	________	________
Interest/dividend	________	________
Miscellaneous	________	________
Total Income	________	________
Taxes		
Social Security	________	________
Federal	________	________
State and local	________	________
Housing Expenses		
Rent	________	________
Mortgage	________	________
Property taxes	________	________
Homeowners association dues	________	________
Gas/electric/oil	________	________
Homeowners/renter insurance	________	________
Water/sewer/garbage	________	________
Phone (landline and/or cellphone)	________	________
Cable TV/Internet	________	________
Furnishings/appliances	________	________

Item	Current Monthly Income Average ($)	Expected Monthly Income Average with Home Purchase ($)
Improvements	________	________
Maintenance/repairs	________	________
Food and Eating		
Groceries	________	________
Restaurants and takeout	________	________
Transportation		
Fuel/gasoline	________	________
Maintenance/repairs	________	________
State registration fees	________	________
Tolls and parking	________	________
Bus/train/ subway fares	________	________
Appearance		
Clothing	________	________
Footwear	________	________
Jewelry (watches, earrings)	________	________
Laundry/dry cleaning	________	________
Hair	________	________
Makeup	________	________
Other	________	________
Debt Repayments		
Credit/charge cards	________	________
Home equity/installment loans	________	________
Vehicle loans	________	________
Educational loans	________	________
Other	________	________
Fun Stuff		
Entertainment (movies, concerts)	________	________
Vacation and travel	________	________

(continued)

TABLE 1-2 ***(continued)***

Item	Current Monthly Income Average ($)	Expected Monthly Income Average with Home Purchase ($)
Gifts	________	________
Hobbies	________	________
Pets	________	________
Health club or gym	________	________
Youth sports	________	________
Other	________	________
Advisors		
Accountant	________	________
Attorney	________	________
Financial advisor	________	________
Healthcare		
Physicians and hospitals	________	________
Prescriptions	________	________
Dental and vision care	________	________
Therapy/counseling	________	________
Insurance		
Vehicle	________	________
Health	________	________
Life	________	________
Disability/long-term care	________	________
Educational Expenses		
Courses	________	________
Books	________	________
Supplies	________	________
Kids		
Child care	________	________
Diapers/formula	________	________

Item	Current Monthly Income Average ($)	Expected Monthly Income Average with Home Purchase ($)
Toys	________	________
Child support	________	________
Other		
Charitable donations	________	________
Alimony	________	________
________________	________	________
________________	________	________
________________	________	________
________________	________	________
________________	________	________
Total Spending	________	________
Amount Saved	________	________
(subtract from Total Income)		

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 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 on your goals and how good your investing skills are. For most people to reach their financial goals, they must annually 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're 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 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, vehicle 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 healthcare, 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. With so many products available online these days, and local bricks-and-mortar stores willing to price match, a little research can go a long way to finding real savings.
- **Buy in bulk.** Most items are cheaper per unit when you buy them in larger sizes or volumes. Superstores such as Costco, BJ's Wholesale Club, Sam's Club, Target, and Walmart offer family sizes and competitive pricing.

Establishing financial goals

Most people find it enlightening to see how much they need to save to accomplish particular goals. For example, wanting to retire while you still have good health 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 — 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.

WARNING

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 prematurely from a retirement account, you owe not only current income taxes but also hefty penalties — 10 percent of the amount withdrawn for the IRS plus whatever penalty your state collects.

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. Some companies offer first-time homebuyers a little financial assistance, so make sure you ask. Because you are borrowing your own money, the monthly payment (including interest) all goes back to your account. Also, monthly payments back to your retirement account do not count against your debt ratios.
- **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're allowed to withdraw up to $10,000 (lifetime maximum) per individual IRA account (so a married couple can access $20,000) 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 net only 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 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 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 homebuyers 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 down payment of at least 20 percent. 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 or 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. 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.

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.

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 the past two centuries, stocks and real estate have produced annual average rates of return of about 9 percent. On the other hand, there are no guarantees that you'll 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).