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CAPSTONE FINANCIAL

PERSONAL FINANCIAL REVIEW

20/20

Volume 21, Issue 2

Plastic Money Means EXPANDING MONEY

Imagine you're at an auction, and an exquisite antique vase is about to come on the block. When you viewed the auction items earlier, you placed a value of $100 on the vase. It's late in the auction, you've planned your bidding carefully, and have exactly $100 in cash left in your wallet.

Price Equals Value

When the bidding reaches $90, you and one other bidder are still in the game. So, what's the likely outcome? If the bidding goes to $100, you'll either get the vase or drop out of the bidding. The amount of cash you have left equals the value you assigned to the vase, effectively limiting the amount you can pay.

Assuming you're alone and can't borrow money from a friend, what you're *willing* and *able* to pay is controlled by how much money you have. In this situation, "price equals value."

Expanding Value

Let's now modify the scenario slightly to see how the outcome might change. Instead of it being late in the auction, the vase is one of the early items to go on the block, and the first item you'll bid on. You have $500, the total amount you've allotted for the entire auction. The bidding has reached $90. What should you do? What are you most likely to do?

Since you originally placed a value of $100 on the vase, you should be prepared to drop out if a $100 bid doesn't secure the vase. However, unlike the first scenario, in which you only had $100 left, you have a full wallet. Depending on how much you want the vase, it's possible you'll exceed your initial limit and continue bidding, particularly if you thought a bid slightly over $100 might be successful. What's the big deal about going over a little? After all, you may not even be successful on other items of interest.

In this case, it's probably not a "big deal", but you've expanded your definition of value. What was originally a $100 value has expanded to,

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A Vacation Home: THE ULTIMATE HIDEAWAY

Are you dreaming of a mountain cabin or an oceanfront bungalow hideaway? Then you may want to consider that a vacation home can offer some tax savings. Whether you choose to use the home solely for enjoyment or combine business and pleasure by renting the property part-time, it is important to understand the tax laws for a second home.

As long as the combined debt secured by the vacation home and your principal residence does not exceed $1.1 million, you can deduct all of the interest paid on a mortgage used to buy a second home. This advantage is restricted to two homes. Should you purchase a third home, interest on that mortgage is not deductible. However, regardless of how many homes you have, you may be able to deduct all of the property tax paid.

One break enjoyed by homeowners—the right to immediately deduct points paid on a mortgage—applies only to a principal residence. Points paid on a loan for a second home must be deducted gradually, as the mortgage is paid off.

Personal Residence

Your vacation home is considered a personal residence if you rent it for no more than 14 days a year. In such a situation, you may retain the rent tax free without jeopardizing your mortgage interest and tax deductions. However, you may not deduct any rental-related expenses. If you rent out the house on a continual basis, things may become more complicated. Depending on the breakdown between personal and rental use, different rules may apply.

If you buy primarily for pleasure but rent for 15 days or more, the rent you receive is taxable. Because the house is still considered a personal residence, you may deduct all of the interest and property tax. You may also be able to deduct other rental-related expenses, including the cost of utilities, repairs, and insurance attributable to the time the house is rented. In some cases, you may be able to deduct depreciation. When the house is considered a personal residence, rental deductions cannot exceed the amount of rental income you report. In other words, your second home cannot produce a tax loss to shelter other income. In most cases, the interest and taxes assigned to the rental use of the house combined with the operating expenses more than offset rental income, thus limiting your ability to write off depreciation.

Rental Property

Now consider your tax situation if you buy a property primarily as an investment and limit your personal use of the property to 14 days a year (or 10% of the number of rental days, whichever is greater). Because the house is a rental property according to the Internal Revenue Service (IRS), your deductions can exceed the amount you receive in rental income.

If your rental income does not cover the cost of renting the house, you may be able to claim a taxable loss. Rental losses are classified as passive and can be deducted only against passive income, such as that from another rental property that realizes a gain. If you do not have passive income to shelter, the losses have no immediate value; however, unused losses can be used in the future when you have passive income.

There's an exception to this rule, however, that permits taxpayers with adjusted gross income (AGI) under $100,000 ($50,000 if married filing separately) to deduct up to $25,000 ($12,500 if married filing separately) of passive losses against

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PLASTIC MONEY MEANS EXPANDING MONEY

perhaps, a $110 value. Notice how easy it is to lose your sense of value when something you *want* becomes something you feel you *need*.

The "Value" of Increased Buying Power

So now, let's change the example once more. This time, in addition to cash, the auction house will accept payment by credit card. What can happen to your sense of value when your buying power has increased?

It seems that many of us may be less quality conscious in our buying behavior, may not negotiate as skillfully, and may pay more when buying by credit card than when making an identical purchase with cash. If the bidding were to surpass $100, you may be willing to pay far more than your original assessment of what the vase was worth.

This demonstrates how your spending behavior, along with your smart-shopping ability, can change according to what's in your wallet. "Hard money" (i.e., actual dollars in your wallet or checking account) tends to be perceived as *finite*. When you run out of money, you've exhausted your buying power until you obtain more cash or receive your next paycheck.

On the other hand, "plastic money" (i.e., credit cards) can alter your perception of value, tempting you to pay more than an object is worth, and more than you can reasonably afford. You may even believe your purchasing power is *infinite*. In the moment, you may lose your sense of what constitutes a good deal, and become a less savvy consumer. Ultimately, you may end up paying too much, while confusing *need* with *want*.

Buying on credit may be convenient, especially when you're temporarily short of cash, but on a regular basis, this could have undesirable consequences. If you don't pay off your balance monthly, your purchases may end up costing you more when interest and finance charges add up. Also, as the amount of your total debt increases, your monthly budget tightens. Since growing debt requires larger monthly payments, you may have less money available for other spending and saving. A large amount of debt may also hinder you from getting the financing you need for more important purchases, like a new home or car.

One way to guard against credit card abuse is to ask yourself two questions when making a credit card purchase: First, would you purchase the item if you were paying cash? Second, would you pay the same price if paying by cash?

By staying focused on value, you can better distinguish between items you'd like to get and absolutely must-have purchases. This distinction can help you avoid the major pitfalls of buying on credit—overpaying on individual items and spending beyond your means. **20/20**

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A VACATION HOME: THE ULTIMATE HIDEAWAY

other kinds of income, including salaries. To qualify, you must actively manage the property. The $25,000 allowance is gradually phased out for taxpayers whose AGI is between $100,000 and $150,000.

If your vacation home is considered a rental property, the mortgage interest attributable to the time the premises are rented is a business deduction. The remainder cannot be deducted as home mortgage interest since the house doesn't qualify as a personal residence.

These tax laws also apply to apartments, condominiums, mobile homes, or boats with basic living accommodations. Generally, these are considered rental properties if they include a sleeping space, bathroom, and cooking facilities. If you are considering the purchase of a vacation home, keep in mind that, from a tax perspective, that mountain cabin or oceanfront bungalow may be the ultimate dream home. **20/20**

The Retirement Community ALTERNATIVE

Whether you are on the verge of retirement or it is years away, many of your current financial decisions are shaped by the questions of *where* you will live in the future and *how* your financial and social needs will be met. In addition to decisions about your own future, you may have aging parents who need help working through the complexities of choosing their own retirement housing.

Changing Needs

Your housing needs can be affected by any number of life changes, including seeing your children move out of the family home, experiencing changes to your health, or facing the loss of a spouse. Each of these life changes can raise questions regarding the physical layout of your home, the maintenance required to take care of it, and the location of necessary resources, as well as the need for continued social interaction.

If you have lived in the same neighborhood for many years, the thought of moving can be both difficult and emotional. In addition to a lifetime of memories, your family home offers the comfort of familiarity and an important sense of community. It also may be completely paid off by the time you retire. However, its size and maintenance requirements may become increasingly difficult to manage. The family home could also become isolating, especially after lifelong friends have moved away, or if located in an area with little or no access to social support systems.

Alternatives

Retirement communities are enjoying increased popularity as an alternative means to meet the housing needs of older adults. Many retirement communities offer an array of services, with costs directly related to the level of direct care provided. A complete community may have independent living options with condominiums and apartments; supervised assisted living for those who need help with basic daily activities, but not full-time skilled nursing care; and a nursing home wing for those individuals requiring more intensive medical care, all conveniently situated on one campus.

There are a number of advantages to such living arrangements. The security of knowing that medical care and support services are readily available and a resident can shift from independent living to a nursing home level of care without having to make difficult moving decisions is the main attraction of retirement communities. Financial concerns may also be alleviated in a total life care community, particularly if providing for later health care has been done *before* the need arises. In addition, most retirement communities offer planned activities and transportation to meet a variety of recreational and social needs. Many active older adults enjoy the socialization among peers that a retirement community provides.

Periods of Adjustment

Although these communities are designed to meet the needs of older adults, isolation from family and prior friends may involve an adjustment period for some people. For example, structured group activities to interact with others may impose on some people's sense of privacy, while others may dislike the idea of being confined to living solely among people their own age.

One of the most important questions to ask when visiting a community is *who* decides when the resident needs a higher level of care. This issue alone can affect an individual's sense of self-esteem and independence, as well as the cost of care. When couples move into a retirement community, it is important to consider how the necessity for an increased level of care for one spouse may affect the independence of the other spouse.

The decision to enter a retirement community involves a lot of thoughtful planning. Knowing *in advance* some of the factors involved may help facilitate the decision-making process for you and your loved ones. **20/20**