Common Misconceptions Concerning Debt

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Debt used wisely can leverage good investments to improve the return. Additionally, debt used wisely can allow a person to buy things they need, like a college education and a home, without having to pay the entire price in advance. However, debt used improperly can accumulate and turn into a straight jacket for many borrowers. Since debt can be a tool for your benefit or a weapon leading to your demise, I will cover a few common misconceptions about debt. First, here are some statistics about debt in the U.S.

According to the *Wall Street Journal*, "12 Debt Myths" by Rachel Ensign, February 25, 2013, total household debt in the U.S. is $11.31 trillion. The median amount of debt per household ranges from $39.000 for households where the adults are under age 25, to $104,000 for households between age 35-44 and then gradually back down again to $30,000 for households over age 75. Almost 25% of households have no debt. Interestingly enough, there is now more student loan debt ($956 billion) than credit card debt at $674 billion. Finally, the delinquency rate for all debt is currently 8.9%.

Misconception #1: DEBT AND MARRIAGE. Many people believe that once a person marries, that person is responsible for their spouse's debt. People also believe that if a couple divorces, the divorce decree determines what debt transfers to each person. Both of these statements are not entirely correct. The person or persons that signed the note or loan agreement are the people responsible for the debt. If one person borrows money and then marries, the spouse that did not sign the note is not legally responsible for the debt. Likewise, although a divorce decree might indicate who is supposed to pay for which debts, this does not undo the fact that both parties may have signed the note and are therefore both liable to the lender regardless of what the divorce decree states. In practice, the lender can go against both parties if they have signed the note. Then it is up to the divorcee who is not required to pay according to the divorce decree to sue the former spouse.

Misconception #2: TAX DEDUCTIBILITY OF DEBT. Many people believe that all interest from debt is deductible from taxable income or that at least all mortgage debt is deductible from taxable income. Actually, business interest expense is deductible for a business. Consumer debt interest, like credit card and auto debt is, however, not deductible from taxable income. Finally, although mortgage interest - both first mortgage debt and home equity debt - is deductible, it is only if the total amount of deductions exceeds the standard deduction. The standard deduction for 2012 was $5950 for individuals and $11,900 for couples. If itemized deductions exceeded this amount, the amount in excess was deductible. Typically, some of the larger Itemized deductions include charitable contributions and state income tax as well as interest on home loans. As an example, let's say a couple had $50,000 of income, and they had charitable and income tax and other itemized items (not including home interest) amounting to $6000. Let's say they have a home loan of $100,000 at an interest rate of 4% so they had $4000 of interest expense. Because the interest expense of $4000 plus the other itemized expense only total $10,000 (which is less than the couple's standard deduction of $11,900), the interest expense on the home does not save any taxes. If in this example the person had a $200,000 home and had $8000 of interest expense instead of $4000, this would raise their total itemized deductions to $14,000. In this case, $14,000 exceeds $11,900 by $2100; so effectively, $2100 of the home interest expense is deductible from taxable income.

MISCONCEPTION #3: IT'S ALWAYS BETTER TO PAY OFF DEBT RATHER THAN INVESTING. Although there is part of me that would like to say this is true, there are a couple of situations where the answer should be no. One situation is when a person is paying off debt rather than contributing to a 401k plan to take advantage of their company's 401k match. Many companies will match a person's contribution to their 401k up to 3% of their earnings. So if a person had $30,000 of income and would contribute 3% of their income or $900 to the 401k plan, their employer will contribute another 3% or $900 to match. Basically, this is a 100% return on a person's investment immediately. Even 22% credit card interest is not as expensive as not taking advantage of the company match. Secondly, especially with low interest rates, if a person is paying 3% or 4% on his mortgage, I can make a case that he can do better by investing additional money rather than paying ahead on the mortgage. With the historical compound rate of return for large stocks at 10%, this far exceeds a 3% to 4% savings by paying off the mortgage early.

These are just a few debt misconceptions. I will cover additional misconception in future articles.

Remember that every investor's situation is unique and that it is important to review your specific situation with a financial professional.

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