[[

FINANCIAL PLANNING FOR THE THIRD MILLENNIUM

VOLUME I

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INTRODUCTION

Earning money is one thing; keeping it is quite another. Some 15 years ago, a Democrat Congressman stated on the floor of the House of Representatives that all money belonged to the government and the people could only keep the amount the government said they could. That actually is correct since the government can take all money by simply taxing it. The Congressman received polite applause from his fellow congressmen. Unfortunately that belief seems to pervade Washington and most state capitols.

We, Americans must work over half the year to pay all of our federal, state and local taxes, and that still isn't enough to pay the government bills. The federal deficit is still increasing; so are most state deficits. In 1993 the California deficit increased by $1 billion per month. What is frustrating is that the government simply raises taxes. It could cut government spending simply by implementing the same financial practices used by businesses. Farmers harvest crops; politicians harvest taxpayers. Most people do not believe that we get full value for our tax dollar, whether it be for the $1,000 toilet seat used in the book we are trying to help people make more money and keep it legally. If a person does not care about making and keeping money, there is nothing to be gained from reading this book.

Besides the government taxing our assets, we also have to contend with all of the vagaries of the financial world: inflation, a poor economy, job loss, retirement, disabilities and nursing care. These are the normal concerns of life. They should be recognized, and there should be a plan developed for facing and dealing with them. To do so requires money, usually a lot of it. Such money is not obtained by paying it in taxes nor is it amassed by putting it in a jar and burying it in the ground.

As a lowly citizen and even a lowlier taxpayer, there are only a few things that we can do legally to fend against government seizure of our money and to help it grow.

This book is designed for the average middle class person. Rich people have their own advisors. There are no advanced financial planning techniques in this book designed to be used by wealthy individuals only. On the opposite end of the spectrum extremely poor people have no estate to manage. Only the social security and debt chapters of this book will be of use to them. The average

As Napoleon's sister said on her death bed, "Nothing is forever except death and taxes." Unless a person plans for the disposition of his estate after death, an expensive probate is required and unnecessary estate taxes have to be paid. All of which will come out of the estate, reducing the amount the heirs will receive. In other words, part of a decedent's estate will go to the government rather than loved ones. This result is avoided with good estate planning, which should be part of every person's total financial plan. Consequently, there are two companion estate planning volumes to complete the package started by Financial Planning Volumes I & II.

Since financial independence is the goal of everyone, a good financial plan helps to guide the growth of a person's money. This book discusses the major types of investment that are available to the average person. This book does not talk about every type of investment, but it does speak on those available to a person with a small to medium amount of disposable income.

This book deals with the possibility of facing bad times. Discussions on social security, supplemental security income, disability, Medicare, nursing homes and even debt are discussed in possibilities by incorporating potential government benefits into a financial plan.

This is a practical book. It could be expanded into an entire treatise with every chapter becoming a book in itself, but that is not necessary. The basic information is distilled to the point that the average person can read any chapter and find the basic information needed to make an informed decision. These are recommendations concerning common tactics and investment strategies that should be employed by the average middle class person as part of his investment plan.

We live in a great country with a great deal of opportunity. No one ever takes advantage of every opportunity that is presented to them. What is important is that a person take advantage of enough opportunities so as to be protected from adversity in the future.

PART ONE

INDIVIDUAL FINANCIAL PLANNING

Part One of this book addresses those areas that are most often considered by an individual in creating and implementing a financial plan. Fundamental tax law is presented at the very beginning of this book to create a basic understanding on which to build.

Part One covers the following areas of financial planning which affect most persons with assets in some fashion:

1. Tax Planning.
2. Investment in a Home.
3. Real Property Rental.
4. Collecting Debts in Small Claims Court.

The purpose of financial planning is to keep as much money and assets from the government as possible. Once the government gets its hands on a person's property, it's gone. This is not hyperbole. It's an absolute fact.

A person should not rely on social security to provide for support in old age. The social security system is tottering on

In 1945 it was estimated that 16 people paid into the system for every person receiving benefits. In 2010, it is estimated that 1.6 persons will be paying for every person receiving benefits.

The reason behind this increase in people receiving benefits is that the life span for people has increased. In 1940 life expectancy was 65 years of age. When social security was created it was believed that people would die within a year or so after they started receiving benefits. The plan was designed around that assumption.

Modern medicine and a change in life style have changed that scenario significantly. As a result, people who have not planned for their retirement may find themselves destitute in their golden years even though they are receiving social security.

This book is written for people attempting to create an estate. In the movie The Barefoot Countessa, a wealthy man tells Humphrey Bogart, "Taking one hundred thousand dollars and raising it to a million dollars is work. Taking a hundred million dollars and raising it to one hundred and ten million dollars is inevitable." It is hard to get started, but once a person is successful, it gets increasingly easier to make and keep money. It is toward that goal

CHAPTER 1

TAX PLANNING

I. INTRODUCTION

Tax planning is the process of reviewing tax alternatives available to determine how to reduce the obligation to pay taxes. Tax planning requires that the person know the tax code and be familiar with his tax situation. The best tax planning takes advantages of the tax breaks and opportunities authorized by the Internal Revenue Code to reduce taxes legally.

Tax planning is totally legal and the right of every American. Justice Learned Hand of the United States Supreme Court once ruled,

> "Over and over again courts have said that there is nothing sinister in so arranging one's affairs so as to make taxes as low as possible. Everybody does so, rich or poor, and do right, for nobody owes any public duty to pay more taxes than the law demands. Taxes are enforced exactions, not voluntary contributions."

Income taxes are an important consideration in the financial lives of most people. They usually play the determinative role in financial planning. With taxes constantly increasing as a result of the government's attempt to raise revenue, every financial decision must be reviewed to ascertain its tax consequences. It is by the obscure provisions of the Internal Revenue Code.

The IRS provides free tax information and services. IRS publication 910, Guide to Free Tax Services, describes the publications and services available to taxpayers. There are over 100 publications by the IRS containing tax information. Videotaped instructions for completing tax returns have been prepared by the IRS in both Spanish and English. They are available in some public libraries. Braille materials are also available at regional libraries in conjunction with the Library of Congress. The IRS offers the TELE-TAX service which is a telephone service that provides recorded tax information on over 140 subjects. The TELE-TAX service will also tell a taxpayer the status of a refund.

In addition, the IRS also operates a telephone service for hearing impaired persons who have access to TDD equipment. Call 1-800-829-4059.

The IRS provides toll-free numbers in every state for taxpayers to call regarding tax questions.

Congress mandated that the IRS create a Problem Resolution Program for taxpayers that are unable to resolve their problems with the IRS. A taxpayer may write to the local IRS District other ways.

II. UNDERSTANDING TAXATION

Every person, business or entity that earns money must pay taxes. The amount is an increasing scale based on the amount of earnings. An individual taxpayer's tax rate, filing requirements and standard deduction are determined by his filing status. The five filing statuses are:

1. Single. Unmarried or legally separated on the last day of the tax year. State law determines if a person if married or legally separated.
2. Married filing jointly.
3. Married filing separately.
4. Head of Household. A qualifying widow or widower with a dependent child.
5. Qualifying widow or widower.

Congress has provided tax exemptions. These are set amounts that taxpayers deduct from their income before calculating taxes. Tax exemptions reduce a taxpayer's income before tax is computed. There are two types of tax exemptions which are personal exemptions and dependency exemptions. A taxpayer is entitled to one exemption for himself and, one for his spouse. These are the personal exemptions. An exemption for a spouse with individual income can dependent of a taxpayer. As with a personal exemption, each dependency exemption reduces the taxpayer's gross income before tax calculation. There are five tests for dependency that must be met before an exemption is allowed.

1. Member of Household or Relationship Test. The dependent lives with the taxpayer or is a relative.
2. Citizenship Test. The dependent is a U.S. citizen or resident, or a resident of Canada or Mexico.
3. Joint Return Test. The dependent has not filed a joint return with his spouse.
4. Gross Income Test. Generally, a dependency exemption is unavailable if the person sought to be claimed has earned more than $2,050 for the year. This does not apply to the earnings of a child or a student under 24 years of age.
5. Support Test. More than half of the support of the person must be provided by the taxpayer during the year.

A situation may exist where several persons contribute at least ten percent (10%) to the support of a person, such as children supporting an elderly parent. In such a case, no one individual can meet the support test. When this happens, each person providing more than ten percent (10%) of the support may agree to let one claim the exemption. Each person agreeing not to claim the exemption must sign a written statement to that effect. Form 2120

Filing Status	Taxable Income Subject to Exemption Phaseout
Single	$126,600
Married filing jointly	$189,950
Married filing separately	$94,975
Head of Household	$158,300
Qualifying Widow(er)	$189,950

If the taxable amount is less than the amount shown in the above table, the taxpayer continues to deduct the exemptions on the Form 1040 as usual. The amount of the exemption phaseout is computed using the tax rate schedules.

III. ACCOUNTING METHODS

The Internal Revenue Code requires all persons in business to elect one of two forms of accounting methods. The two methods of accounting are the cash method and the accrual method. The requirement for an individual to deduct business expenses as they are paid or to deduct them as they occur (maybe before they are paid) depends on the accounting method employed. Once elected, a taxpayer cannot change accounting methods without the consent of the IRS.

Under the cash method of accounting, the taxpayer reports all items of income in the year that they are actually or deducted when incurred; not when paid.

Income is considered constructively received by a taxpayer when it is credited to a taxpayer's account or is set apart in any way that makes it available to the taxpayer. Actual possession of the income is not necessary. If a person cancels a debt that is owed him by a taxpayer, the amount of the canceled debt is income to the taxpayer and must be reported. Income received by an agent of a taxpayer is constructively received by the taxpayer and must be reported.

Regardless of the method used, prepaid income is generally reported when received if the funds are available to the taxpayer.

If the taxpayer is on the accrual method of reporting, advance payments for services to be performed by the end of the tax year can be deferred from income until the taxpayer actually earns them by performing the services, Publication 538, Accounting Periods and Methods, covers in detail the advantages and detriments of both methods.

Once an accounting method is chosen it cannot be changed without IRS approval. A taxpayer, however, can use a different method for each business the taxpayer may have. If the taxpayer expenses of both spouses are combined and treated as one. In the vast majority of cases filing a joint return is best because it usually results in a lower total tax than if each spouse filed a separate return. The tax advantage arises because the married-filing-separate returns employ the same income levels as a joint return but at higher tax rates.

There can be instances when it is better to file separate returns. One such situation might be when one spouse has high medical bills that do not exceed the required percentage of income for deductibility on a joint return but would be deductible on the separate return. In the same vein large miscellaneous itemized employee deductions might not reach the two percent (2%) floor for adjusted gross income on a joint return but might be deductible on the separate return. The only way to know which return is best for the couple is to compare the taxes owed under both returns. The couple should then use the return under which the least amount of taxes are owed.

V. TAX EXEMPT BONDS AS GOOD TAX PLANNING

Tax exempt bonds are one of the few tax avoidance vehicles still available. A tax exempt bond is a special bond issued by a available to the taxpayer is greater.

The following is a chart of the interest a taxpayer would have to be paid on a regular bond to match a tax-free bond yield:

	TAX-EXEMPT YIELD						
	4%	5%	6%	7%	8%	9%	10%
TAX RATE	REGULAR BOND YIELDS						
15%	4.74%	5.88%	7.06%	8.24%	9.41%	10.59%	11.77%
28%	5.56%	6.94%	8.33%	9.72%	11.11%	12.59%	13.89%
31%	5.80%	7.25%	8.70%	10.14%	11.59%	13.04%	14.49%

Before anyone invests in tax-free bonds, they should determine whether the income from the bonds will result in an alternative minimum tax being paid. Generally a wealthy person who otherwise shelters income from regular income tax may still have to pay a minimum tax. This is called the alternative minimum tax. Most investors need not be concerned with the alternative minimum tax because the exemption for the tax is $45,000 for joint return, $33,750 for single returns and $22,500 for married persons filing separately.

VI. THE DEDUCTIBILITY OF MEDICAL BILLS

To the extent that medical bills are not covered by insurance and exceed seven and one-half percent (7.5%) of the taxpayer's bills does not affect the deductibility of the expense. The medical deduction also extends to prescription drugs including insulin and other qualified miscellaneous medical expenses.

Miscellaneous medical expenses are:

1. Cost of purchasing and training a seeing-eye dog or other such helpful animal.
2. Lodging expenses while traveling for treatment.
3. Medical expenses paid for a dependent. The taxpayer must keep records of all medical bills in order to deduct them.

VII. TAX TREATMENT OF ALIMONY PAYMENTS

The alimony rules changed in 1985. Anyone paying or receiving alimony pursuant to divorce or separation agreements executed prior to 1985 will continue to have those payments governed by the tax law in effect at that time. Persons paying or receiving alimony pursuant to a divorce or separation agreement executed after 1984 will have the tax characteristics of the payments governed by the Tax Act of 1984:

1. The payments must be received by or on behalf of former or separated spouse under a divorce or separation agreement,
2. The payments must be in cash or its equivalent,
3. When legally separated or divorced, the payor and payee

whether the payor spouse itemizes or not. The Tax Act of 1984 created a special alimony recapture provision for "excess alimony payments." The purpose of this rule is to prevent the parties from claiming a tax deduction for a property settlement by simply calling the payments alimony.

Under the Act alimony payments made in the second year following the separation will be recaptured to the extent that they exceed the third year's payments plus $15,000. Likewise, there will be recapture of the first year's alimony payments to the extent the second year's payments exceed them plus $15,000. Occurrences which do not trigger recapture of alimony payments are:

1. When the payments are made pursuant to a temporary support order.
2. When the payments are from an instrument requiring the payor to pay a fixed percentage from a business.
3. For the year the payments end, the payee remarries or the payor or payee dies.

Recapture of alimony payments may occur when:

1. The payor misses too many payments.
2. Payments are reduced because of modification of the agreement or a reduced need on the part of the payee or a reduced ability to pay by the payor.

Anyone divorced or separated after 1985 who is paying or receiving

U.S. that is the principal residence of the worker plus a child or children for over one-half of a tax year. The taxpayer must also meet the following requirements:

1. Be married and filing a joint return and entitled to a dependency exemption for the child or children, or
2. Be a surviving spouse, or
3. Be a person qualifying as a head of household whose unmarried child or children are part of the household.

The earned income credit is refundable to the extent that it reduces the tax below zero. An eligible taxpayer may elect to receive an advance payment of the credit through the taxpayer's paychecks. Form W-5 can be used by a taxpayer to notify his employer that he chooses to receive the advance payments rather than wait for a tax refund after the return is filed.

IX. THE GASOLINE TAX CREDIT

A credit for federal excise taxes on gasoline and special fuels exists for fuel used for the following:

1. Farming purposes.
2. Non-highway purposes of a trade or business.
3. Operation of an intercity, local, or school bus.

A one-time credit or refund is allowed to the purchaser of a qualified four-wheeled diesel-powered vehicle, one with a gross

4136 and attached to the taxpayer's Form 1040.

X. THE ALTERNATIVE MINIMUM TAX

The alternative minimum tax was designed to assure that wealthy corporations and high-income individuals do not avoid taxation altogether through legitimate investments and tax planning. The calculation of the alternative minimum tax is figured on Form 6251. If the minimum tax is greater than the taxpayer's regular tax, he must pay the alternative minimum tax amount.

The minimum tax applies to taxpayers who have the following tax preference deductions which exceed $45,000 if married filing jointly, $33,750 if single or head of household, or $22,500 if married filing separately:

1. Accelerated depreciation.
2. Tax-exempt interest from private activity bonds.
3. Intangible drilling costs for oil or gas wells.
4. Depletion allowance for natural resources.
5. Tax shelter farm losses.
6. Passive activity losses.
7. Installment sales of certain property.
8. Mining exploration and development costs.

Children 13 years of age or younger may also have to pay a minimum tax at the same rate their parents would have to pay.

traveling to a place of work from home or to home from a place of work are not deductible. It makes no difference how far a taxpayer has to commute or even if work is done during the trip.

If a person gets his work assignments from a union hall, travel from home to union hall and from union hall to the job are not deductible. There is no deduction for the travel to the union hall. The union is not an employer; so travel from there to the job is not travel to another work place and is not deductible.

XII. DEDUCTIONS FOR DISASTER LOSSES

Special tax treatment is available to persons who have suffered losses from a disaster in an area in which the President awards federal disaster relief. The taxpayer may deduct the loss caused by the disaster in either:

1. The year in which the loss occurred or
2. The preceding year.

Non-business casualty losses may not be deducted for damage suffered on insured property unless the taxpayer files an insurance claim for the property damage within a reasonable time after the loss.

The taxpayer should compare the tax effects in claiming the loss for both the year suffered and the preceding year. The

Homeowners are allowed interest deductions for loans on their homes and second homes subject to these limitations:

1. The total debt to acquire the home may not exceed $1,000,000, and
2. The total amount of home equity debt may not exceed $100,000.

This exception allows homeowners to take a home equity loan on their homes of $100,000 or less and reduce consumer loans whose interests are not deductible. Using home loans in place of consumer loans is wise tax planning because interest on home loans is deductible while other personal loans are not.

XIV. CAN GIFTS BE USED TO REDUCE TAXES IN A FAMILY?

One of the best ways of avoiding or reducing taxes in a family is to split the income among the family members. Income splitting is beneficial: graduations in individual income tax rates reduce total income tax liability for the family when income is shifted to family members in a lower tax bracket. Two family members paying taxes on $25,000 each is cheaper than one paying taxes on $50,000.

A transfer to a child younger than 14 years of age might not result in a tax saving because the "kiddie tax" generally will require the income to be taxed at the parents' rate.

The child's wages are deductible as a legitimate business expense by the parent. To be deductible, the services must actually be rendered by the child. In addition, the child's wages must be reasonable for the services rendered. Accurate record keeping is needed to document that the payments to a child are for work actually done and not gifts.

XVI. PROVIDING FOR A CHILD'S COLLEGE THROUGH THE TITLE GUARANTY PROGRAM

The title guaranty program is relatively new but offers significant benefits to parents seeking to provide for their children's future college education. Under this program a parent pays a lump sum to the trust established by the state's tuition program and identifies the child as the beneficiary. Under the terms of the trust the child will be entitled to four years of college services at no additional cost to the parent. The trust may also provide cash refunds in the event the child does not attend the college.

This program provides a way for parents to prepay a child's college education at a lower tax rate. The payment is viewed as a gift by the parent and applied to the unused portion of the unified attending a college under this program. The increased value must be reported as income by the child. Still, there will probably be no taxes since the child will be in a low tax bracket.

For example, assume that a parent pays $15,000. Ten years later when the child attends college a four-year education costs $31,000. The income to the child will be $16,000 spread over the four college years. The child will report $4,000 per year income: the increased value of the education.

XVII. THE INVESTMENT TAX CREDIT

An investment tax credit is a special credit in the tax code for investment in a trade or business involving any of the following:

1. Qualified rehabilitation of an older building,
2. Investment in solar or geothermal energy equipment, or
3. Investment in qualified timber property.

The investment tax credit is combined with the targeted jobs tax credit, the alcohol fuels credit, the research credit and the low-income housing credit to make up the general business credit. Each of the credits is calculated separately and then totaled for the general business credit. The general business credit is used to apply credit limitation and carryback and carryforward rules.

1936.

In addition, a twenty percent (20%) credit is available for certified historic structures listed in the National Register or located in registered historic districts and certified as being historically significant.

The basis of the building is reduced by the amount of the investment tax credit claimed.

The solar and geothermal credit was scheduled to expire at the end of 1991. Instead, its name was changed to "energy investment credit." Now there is a ten percent (10%) energy investment credit for solar or geothermal energy equipment placed in service during the year. The credit is limited to such depreciable property that is constructed, reconstructed, erected, or newly acquired that meets certain required performance and quality standards.

A ten percent (10%) reforestation credit on an amortizable basis is allowed on any qualified timber property that a taxpayer acquires during the year. This basis may not exceed $10,000 ($5,000 if married filing separately). A qualified timber property is any woodlot or other site in the United States that contains trees in significant commercial quantities and that is held by the taxpayer for the planting, cultivating, caring for, and cutting of

3. Costs of labor and tools used in the replanting.

An investor (such as a limited partner) in a qualified timber property may claim his share of the investment tax credit on the investor's tax return.

XVIII. TAXATION OF SOLE PROPRIETORSHIPS

A sole proprietorship is a business that is totally owned and operated by just one person or a husband and wife and is not incorporated. The owner is taxed directly on all income from the business. The sole proprietor reports the business income and expenses on Schedule C of his Form 1040.

The sole proprietor must pay estimated tax and self-employment tax on business net income. A sole proprietor may take deductions for business expenses that are reasonable and ordinary. In addition, a sole proprietor may take a deduction of twenty-five percent (25%) of the health insurance premium for himself, a spouse and dependents.

XIX. TAXATION OF A PARTNERSHIP

A partnership is a legal entity composed on two or more individuals or companies to conduct a business, usually for profit. A partnership does not pay any taxes. The partnership merely reports all of its income and expenses by filing a tax return.

XX. TAXATION OF A REGULAR CORPORATION

A regular corporation is referred to in the tax code as a C corporation because that is the chapter of the tax code which deals with it. A C corporation is subject to a different taxing structure than an S corporation, partnership, or sole proprietorship.

The income of a C corporation is subject to double taxation. The corporate income is taxed first when the corporation files its corporate tax return for the net earnings of the corporation. The C corporation income is taxed again when the corporation pays dividends to its shareholders. The dividends that a shareholder of a C corporation receives are includible in the income of the shareholder on his Form 1040 Schedule B.

For example, assume that a C corporation has $1,000,000 in net profit, it pays approximately $340,000 in taxes. After it distributes the remaining $640,000 in dividends to the shareholders, they pay taxes on the amount they receive. Assuming that all shareholders' tax rates are twenty-eight percent (28%), they will pay an additional $179,200 in taxes. The total tax on the corporate income of $1,000,000 is $519,200. In other words, the joint tax on corporate income exceeds fifty-one percent (51%).

C. IRA's (Individual retirement accounts).

D. SEP's (Simplified Employee Plans).

E. Real Estate Shelters.

F. Oil and Gas Shelters.

G. Equipment Leasing.

The type of tax shelters most familiar to taxpayers involve the acquisition and leasing of property with the intent of deriving a special tax benefit beyond the ordinary investment in the property. The basic aims of tax shelters are to use available tax opportunities to the fullest extent and to reduce current taxes and, if possible, future taxes and past taxes.

A. TAXATION OF AN S CORPORATION

An S corporation is a corporation given special tax treatment. It consists of a corporation with no more than 35 shareholders who have elected to have the corporation receive S status. The effect of the S corporation election is to have the corporation taxed as if it were a partnership.

In an S corporation the income is attributed to shareholders in accordance with their stock ownership. The S corporation itself pays no federal income tax. The shareholders pay the taxes on the corporate income. For example, assume that an S corporation earns $1,000,000. It pays no taxes. The shareholders include the to become an S corporation. An S corporation is an excellent tax shelter for avoiding double taxation. A C corporation must pay a corporate tax on its income before it pays dividends to the shareholders. The shareholders must then pay taxes on those dividends. The S corporation does not pay taxes on its income. Instead S corporation income is treated as though it had all been paid to the shareholders, whether it was or not. The shareholders then pay taxes on the attributed income, achieving a substantial reduction in taxes and an increase in income.

For example, assume that a C corporation has two shareholders and $1,000,000 in profits. At an assumed federal corporate tax rate of thirty-three percent (33%) the federal corporate tax is $330,000. If the entire profit is paid as dividends to the shareholders, they have to pay another twenty-eight percent (28%) personal income tax or $187,600. If the corporation were an S corporation, the federal tax would be twenty-eight percent (28%) on the entire $1,000,000: $280,000.

B. USE OF A 401(k) PLAN

A 401(k) plan is also called a "cash or deferred arrangement" (CODA), a "cash option plan" or a "salary reduction plan". It deductions are limited to the lesser of $2,000 or 100% of the employee's wages, an employee may defer a maximum of $8,475 into a 401(k) plan. Another advantage is that 401(k) plan participants can use favorable lump sum distribution rules whereas under an IRA all distributions are taxed in full.

The use of 401(k) plans is a fringe benefit that in reality does not cost the employer. The contribution which the employee makes into the plan is with money that the employer would have paid regardless of whether a plan had been implemented or not. Therefore the adoption of a 401(k) plan by an employer makes good sense because it provides a fringe benefit to the employees which helps foster employee loyalty and contentment.

C. INDIVIDUAL RETIREMENT ACCOUNT (IRA)

An IRA, Individual Retirement Account, is one of the few tax shelters that is available to low and working class taxpayers. An IRA is virtually the exclusive tax shelter of low and working class taxpayers. It is reduced as income increases. The maximum amount that can be contributed is as follows:

1. For a single individual or a married person filing a separate return, the maximum contribution is the lesser of $2,000 or the actual compensation earned. If the

2. For married couples filing a joint return, each spouse may contribute the maximum amount to their IRAs subject to the adjusted Gross Income limits. If one spouse does not have enough income to justify a $2,000 contribution, that spouse may make contributions equaling the lesser of
   (a) $2,000 reduced by active participation discussed above, or
   (b) the sum of:
      (1) the includible compensation of the lower paid spouse, and
      (2) the includible compensation of the higher paid spouse reduced by the deduction allowed to higher paid spouse for IRA contributions.

   In essence, the lower earning spouse may "borrow" compensation from the higher earning spouse to meet the contribution requirements for a maximum contribution.

   The Adjusted Gross Income Phaseout for 1999 begins at $51,000 and from the year 2007 it is raised to $80,000 at a 10% rate for each dollar earned over $80,000.

An active participant in a qualified retirement plan may be ineligible to participate in an IRA. For that reason it is necessary to know what constitutes an active participant. The Internal Revenue Code defines an active participant is an individual or spouse on a joint tax return who has had a contribution made to a defined contribution plan account for his plan is an individual who is included under the plan's eligibility rules even if no benefit accrues to the individual. Since there are limitations for contributions to an IRA for an individual or spouse participating in a qualified retirement plan, the individual must know what constitutes a qualified retirement plan. A qualified retirement plan is any pension or profit-sharing plan described in the Internal Revenue Code:

1. A section 401(a) plan: a defined benefit, contribution or profit-sharing plan.
2. A 401(k) plan discussed above.
3. An annuity plan under section 403(a).
4. An annuity contract described in section 403(b).
5. A plan established by the United States, a state, or political subdivision or agency or instrumentality thereof, except for a plan described under section 457(b).
6. A simplified employee pension under section 408.
7. A plan under section 501(c)(18).

As can be seen from the above list, nearly all pension plans will be qualified retirement plans. Anyone making an IRA contribution must first determine that the employer does not maintain a qualified pension plan which may prohibit such IRA contribution.

Active participation in a qualified retirement plan ends when contributions made to an IRA. (IRC section 4973(a)).

A person, however, who is covered by a qualified plan can contribute the lesser of up to $2,000 per year or his compensation plus, after January 1997, an additional $2,000 for a working spouse which will not be deductible on their tax return. Example: George is married with a nonworking spouse, earns $22,000 per year and is covered by a qualified plan. The couple can contribute a maximum of $4,000 to their IRAs but can not deduct the contributions on their tax return. There can be a tax advantage in contributing the extra amount to the IRA: the earnings of the contributions are tax free until the time of distributions.

Non-deductible IRA contributions are not taxable when withdrawn because taxes have previously been paid on them when they were originally earned. The earnings attributable to the contributions are taxable.

When there is a withdrawal, the owner must file Form 8606 to designate the portion of the withdrawal attributed to a return of the non-deductible contributions and the portion attributed to the earnings on them. Example: George contributes $5,000 to the IRA. $2,000 is deductible and $3,000 is non-deductible. If the $5,000 IRA is worth $10,000 at the time of withdrawal, $3,000 is not taxable, and the remaining $7,000 is taxable.

The following are important points to bear in mind:

1. For a regular IRA, early withdrawals prior to age 59 ½ are subject to severe penalties in addition to federal income tax.

2. Mandatory withdrawals, determined by a fixed formula, must begin by age 70 ½ or there will be a fifty percent penalty on the

not tax exempt and for that reason, there are some significant tax advantages over a regular IRA.

Since the contributions to a Roth IRA are not deductible, they can be withdrawn at any time without penalty or income taxes being assessed. For example, assume that $20,000 is contributed over 10 years to an IRA which grows to $30,000. The $20,000 contributions can be withdrawn at any time without penalty or taxes but the $10,000 in growth remains subject to the regular IRA rules.

Another advantage is that heirs can inherit a ROTH IRA without having to pay income taxes on the money in the Roth IRA.

There is also no requirement that mandatory withdrawals begin at age 70 ½ and in fact additional contributions can be made as long as the taxpayer is working.

Finally, having a pension or 401(k) does not prevent having a ROTH IRA as long as the person is below a fixed adjusted gross income of $95,000 if single and $150,000 for a married couple.

D. SIMPLIFIED EMPLOYEE PENSION (SEP)

A simplified employee pension (SEP) is a simple written plan that allows an employer to make tax deductible contributions towards the employer's and the employees' retirement. The SEP participant's gross income is the lesser of fifteen percent (15%) of the participant's compensation or $30,000. If the employer exceeds this amount, the participant will be subject to a six percent (6%) excise tax on the excess contribution. A SEP requires the following:

1. That the employer contribute to each employee who has reached the age of 21 years,
2. That each employee has worked for the employer three of the last five years, and
3. That each employee received at least the indexed dollar amount of compensation for the year (in 1990, it was $342).

A plan that discriminates by excluding otherwise eligible employees will not qualify for tax exemption. An employee can also contribute to the SEP-IRA subject to the normal IRA contributions limits.

E. REAL ESTATE SHELTERS

The most common tax shelter involves rental real estate. In the past few years, however, rental real estate as an investment has lost much of its tax saving potential. Passive activity tax laws no longer permit tax losses generated by passive real estate investments to be offset against the investor's active income (his wages or stock dividends or bond interest).

Anyone intending to invest in rental real property should be aware of the following tax characteristics affecting such property:

1. Passive Activity Rules. Unless an investor owns more than ten percent of the property or investment, the investment will be considered passive in nature. A limited partnership investment is considered passive regardless of how much the investor owns. If the investor meets the active participant test, he can deduct up to $25,000 of rental losses from non-passive sources. This $25,000 maximum is reduced for investors with over $100,000 adjusted gross income.
2. Straight Line Depreciation. All real property since 1986 must use straight line depreciation. No recapture of depreciation occurs on the property's sale.
3. Special Credits. There are special credits for rehabilitation and low income housing.

F. OIL AND GAS SHELTERS

Oil and gas tax shelters refer to those investments in programs for the drilling or development of oil and gas properties. Within the last ten years the tax benefits behind such shelters have gradually been reduced or eliminated. Thus, oil and gas projects presently are not highly profitable. Consequently, domestic oil and gas production has steadily dropped and foreign dependence has increased.

line method, or

b. Added to the basis of the property in the determination of cost depletion.

2. Passive Activity Rules. Investors who obtain working interests in wells are exempt from the passive activity rules. This is better tax treatment than is available in rental real estate. All losses can be deducted against non-passive sources.
3. Depletion Allowance. Investors are permitted a deduction for the depletion of the oil and gas removed from their properties. In addition, independent producers (those with less than 1000 barrels per day) are entitled to a percentage depletion.
4. Alternative Minimum Tax. Both the depletion allowance and the intangible drilling costs are tax preference items: the investor may be subject to the alternative minimum tax as a result of the investments.

G. EQUIPMENT LEASING

Equipment leasing offers the experienced investor several distinct tax advantages:

1. Assuming the investor is not in the leasing business, the lessor has the depreciation on the equipment. Accelerated depreciation may be used under the MACRS system, and this is better than straight-line depreciation over the useful life of the equipment.
2. If the lessor is not in the leasing business, the income

borrowed funds to be able to deduct losses from the equipment leasing, he must have his investment "at risk." The "at risk" rules require the investor personally to be responsible to repay the loans on the equipment. If the investor is not personally responsible to repay the loans, the investor may not deduct the interest payments on his income tax return.

XXII. PAYMENTS RECEIVED UNDER THE FEDERAL EMPLOYEES COMPENSATION ACT

Payments received under the Federal Employees Compensation Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. On the other hand payments received which are classified as "continuation of pay" are taxable for a maximum of forty-five (45) days while the legitimacy of the claim is being decided. Sick leave pay for the time that the claim is being processed is also taxable as wages and must be reported.

The employee may "buy back" sick leave for an earlier year so as to be eligible for non-taxable FICA benefits for that period. Buying back sick leave entitles the employee to a miscellaneous deduction subject to the two percent (2%) limitation of Schedule A of Form 1040.

amount from income. A qualified scholarship is any amount received that is for the following:

1. Tuition and fees to enroll at or attend an educational organization.
2. Fees, books, supplies, and equipment required for courses at the educational institution. Amounts used for room and board do not qualify for exclusion.

All payments received for services, such as teaching or conducting research, must be included in the recipient's income even though the receiving of the grant is possible only if certain services are performed.

Scholarship prizes won in a contest are includible income whether the recipient must use them for educational purposes or not. Educational assistance allowances paid by the Department of Veteran Affairs are not includible in gross income. Such educational allowances are not considered scholarships or fellowship grants.

XXIV. TAXABILITY OF WORKERS COMPENSATION BENEFITS

Payments received for an occupational sickness or injury are fully exempt from tax if the payments are made under a workers compensation act or a state statute similar to it. The exemption also applies to payments to a survivor if they would otherwise assigned light duties while still receiving benefits, the benefits received thereafter are taxable. If "workers compensation" reduces social security or railroad retirement benefits the worker is receiving, part of the "worker's compensation" may have to be included income. This issue is addressed in Publication 915, Social Security Benefits and Equivalent Railroad Retirement Benefits.

XXV. TAXABILITY OF BARTERING ACTIVITIES

Bartering is the trading of property for services or the trading of services for services without the payment of money. Under the Internal Revenue Code bartering is treated the same as the payment of money for the property or services. The persons receiving the bartered property or the services must include, the fair market value of the property or the services received on their tax returns as income. This is the government's attempt to tap the underground economy of an estimated hundred billion dollars per year.

For example, assume that a painter paints a house and the paint job is worth $1,000. At the same time, the owner, a mechanic, does a $1,000 repair job on the painter's truck. Each person has $1,000 income to include on their tax return.

on Form W-9.

XXVI. INSTALLMENT SALE METHOD OF REPORTING GAIN

A special tax method of reporting gain from the sale of property is used when at least two payments are received by the seller over a period longer than a year. Installment sale reporting is not usually available for dealers in the property. Moreover, this installment reporting is not available for reporting losses from the sale. Under this method a percentage of each payment reflects the percentage gain on the sale. Example: A car is sold for $2,000. It had cost the seller $1,000. The profit (gain) is $1,000 which is 50%. Payments are $83.33 per month for two years. Therefore, one half ($41.66 per month) is gain from the sale and must be reported on the seller's tax return.

Under the old law installment sale treatment was limited. The seller had to pay taxes on the full profit of the sale although full payment for the property would not be received till some time in the future. The advantage of current installment sale law is that the seller only has to pay taxes on the profits from the sale as they are received.

XXVII. TAX CHANGES BY THE JOB & GROWTH TAX RELIEF

as affecting individuals' estate and financial planning since President Reagan's first term. The major changes are as follows:

(A) CHANGE IN THE UNIFIED CREDIT

The federal unified credit which is the amount that a person can give away tax free while alive or after death which was $675,000 was raised immediately to $1,000,000 and will continue to rise to the year 2009 when it is abolished for one year then reinstated at $1,000,000 unless Congress votes to make the elimination of estate taxes permanent. The rate of unified credit schedule is as follows:

YEAR	EXEMPTION AMOUNT	TOP ESTATE TAX RATE
2002	$1,000,000	50%
2003	$1,000,000	49%
2004	$1,500,000	48%
2005	$1,500,000	47%
2006	$2,000,000	46%
2007	$2,000,000	45%
2008	$2,000,000	45%
2009	$3,500,000	45%
2010	ESTATE TAX REPEALED FOR ONE YEAR UNLESS MADE PERMANENT	NONE

income tax from higher to lower rate taxpayers, the 2001 Tax Act retains a modified gift tax. Beginning in 2010, total gifts made in excess of a lifetime $1,000,000 exemption would be subject to a gift tax equal to the top individual income tax rate at that time.

(B) CHANGE IN STEPPED-UP BASIS OF INHERITED PROPERTY.

Prior to the 2001 ACT, property inherited from a decedent was given a stepped up basis to fair market value. This meant that it could immediately be sold without incurring any capital gain taxes.

Now once estate taxes are fully repealed in 2010, the basis of assets received from a decedent will carry over from the decedent, rather than be stepped up to fair market value at the date-of- death or alternate valuation date as is now the law. Two exceptions to the rule will be available to help many estates:

a. $1.3 million of basis will be allowed to be added to certain assets; and
b. $3 million of basis will be permitted to be added to assets transferred to a surviving spouse.

However, to further complicate the matter, not all property is eligible for an increase in basis. Property acquired by a decedent by gift from a non-spouse less than three years before death is excluded (to prevent “gifts” of low basis assets in anticipation of

The federal capital gain rate was cut under the Budget Act of 1997. The new rates are:

Prior to Jan 1, 2001, the following were the capital gain rates:

1. 28% maximum on collectibles
2. 25% maximum on real estate gains attributable to depreciation
3. 10%/20% rate on stock, bonds and real estate. The rate is 10% on gains falling in the 15% bracket and 20% for gains above this.

Beginning in January 1, 2001, for assets held more than five (5) years:

4. 8%/20% rate on stocks, bonds and real estate held more than five years. The rate is 8% on gains falling in the 15% bracket and 20% for gains above this.

Beginning on January 2, 2006, there is another rate:

5. 8%/18% on stock, bonds and real estate held for more than five years and acquired after 12/31/00. The rate is 8% on the 15% bracket and $18% for gains above this. There is a special election possible after Jan 2, 2006 to “convert” property acquired before 12/31/00 into property acquired afterward.

For Taxpayers in the 10% and 15% ordinary income tax rate brackets, the rate on dividends and capital gains is reduced to 5% in 2003 through 2007, and to zero(0) in 2008.

The new rates apply to capital gains realized on or after May 6, 2003, and to dividend income received in 2003 and after.

D. INCOME TAX RATE CUTS

Under the 2001 Tax Act, there was a ***$958*** billion consolidation and reduction of the marginal tax rates for individuals. Under the 2001 Act was created a new 10 percent rate bracket. The other individual income tax rates (except the 15 percent rate) were also cut for 2001, effectively by 0.5 percent across the board.

There will now be six rate brackets for individuals. The new 10 percent rate is carved out of the existing 15 percent bracket .

Under the 2003 TAX ACT, the 10% bracket will apply to the first $14,000 of income for couples, $7,000 for singles, and $10,000 for heads of household, and adjusted for inflation thereafter).

UNDER THE 2003 TAX ACT

Under the 2003 tax act, reductions in income tax rates in excess of 15% for 2004 and 2006 are accelerated to 2003 which

The 2001 and 2003 Tax Acts reduced but could not eliminate the marriage penalty under Federal Tax Law. The marriage penalty will not change until 2005. Then in 2005 partial relief will be given in two form:

(1) Joint filers will be given a standard deduction that is twice the amount of standard deduction provided to single filers, phased in 2003 and 2004, and

(2) The high-end of the income level falling under the 15 percent tax rate bracket will be expanded to an amount equal to twice that of single taxpayers.

These changes will not help married taxpayers above the 25% tax bracket who do not take the standard deduction. Likewise the change does not impact taxpayers in the 15% bracket of the pre-2001 ACT. As such both groups of taxpayers will continue to subject to the full marriage penalty.

ALTERNATIVE MINIMUM TAX RELIEF

To ensure that the benefits of the marriage penalty relief are not subject to the alternative minimum tax, AMT, the exemption amount for the AMT is increased by $9,000 for married taxpayers and by $4,500 for single taxpayers in 2003 and 2004.

(F) HOME SALE TAX CUT

(G) IRA CHANGES

(1) FOR HOME PURCHASES

Penalty free withdrawals of up to $10,000 are now permitted pursuant to the Budget Act of 1997 for home purchase expenses by first time home buyers or their children or spouses if the person was without ownership interest in a home within 2 years of the purchase.

(2) FOR TUITION EXPENSES

Penalty free withdrawals from IRA's are now permitted for the payment of tuition expenses for the person, child, spouse or grandchild.

(3) IRA ACCOUNTS

A new type of IRA was created in the Budget Act of 1997 called the IRA Plus (ROTH) Account. Contributions to these accounts are not tax-deductible and count toward the $2,000 per year limit but the interest, dividends and capital gains earned are tax free until withdrawn as an IRA distribution.

Under the 2001 Tax Act, the contribution limits for both traditional and Roth IRAs rise from a $2,000 annual cap to $5,000 as follows: $3,000 for the years 2002- 2004; $4,000 for 2005-2007; and $5,000 for 2008 and thereafter along with annual adjustments

2002- 2005; $1 ,000 in 2006 and all years thereafter. These "catchup" payments can either be deductible or made to a Roth IRA, if the base-line AGI limits are met for regular contributions for the year.

(H) CREDITS FOR PARENTS

(1) CHILD TAX CREDIT

The 2003 Tax Act eliminated the phase in period of the $1,000 child tax credit and granted it immediately for 2003 and 2004. The $400 per child increase in the credit for 2003 will be paid immediately. Advance payments will be sent beginning inn mid-July 2003 to parents based on their 2002 return.

2. ADOPTION CREDIT

The 2001 TAX ACT increases the credit for adoptions to $10,000 for both special needs adoptions (currently at $6,000) and non-special needs adoptions (currently at $5,000). Starting in 2002, the ACT also doubles the income phase-out range*s starting point from $75,000 to $150,000.

3. DEPENDENT CARE TAX CREDIT

The 2001 Tax Act increases the dependent care credit rate from 30 to 35 percent. It also increases the amount of eligible em-

Under the Budget Act of 1997, a married couple with an income less than $150,000 or single parents with income less than $95,000 can establish education savings accounts similar to IRAs for children and contribute. Contributions are not deductible on the parents' tax return but earnings are tax free IRC Section 530(b).

The 2001 Tax Act raised the limit on contributions from $500 to $2,000. The new law also exempts special needs beneficiaries from the prohibition against contributions being made after a beneficiary turns 18. Starting in 2002, contributions will be allowable not only from individuals but also from corporations, tax-exempt organizations and other entities. Contributions counted toward any tax year will be permissible until April 15 of the following year, rather than being cut off on December 31.

Under 2001 Tax Act more taxpayers are eligible to contribute to an education savings account by raising the phase out limits. The 2001 Tax Act doubled the contribution phase-out range for joint filers of $ 150,000—$ 160,000 to double that of single filers ($ 190,000— $220,000).

The 2001 Tax Act also permits proceeds in education savings accounts to be used to pay for elementary and secondary school

There is a $1,500 a year tax credit for the first two years and $1,000 per year thereafter. This credit begins to phase out for couples earning $80,000 to $100,000 and individuals earnings $40,000 to $50,000.

(6) STUDENT LOAN DEDUCTION

The Budget Act of 1997 created two education related credits. The Hope Scholarship Credit : The first $1,000 of tuition and $500 of the second $1,000 of tuition. The Life Earning Credit: 20% of qualified tuition for any year the Hope Scholarship is not used. It is 20% if the first $5000 to the year 2003 which thereafter raises to $10,000.

The 2001 Tax Act extended the credits as follows:

(1) HOPE and Lifetime Learning tax credits can be claimed in the same year as education IRA distributions, as long as the IRA distribution is not used to pay for the same costs used to claim the education credit.

(2) Penalty-free contributions to education IRAs and qualified state tuition programs to be made in the same year.

The 2001 Tax Act raises the amount of student loan interest during the first 60 months in which interest payments are required.

The 2001 Tax Act removed the above restrictions. The 2001 Tax Act raises the income phase-out thresholds (to *$55,OOO - $65,OOO,* from $40,000-$50,000, for single taxpayers, and to $100,000-$130,000, from $60,000-$75,000, for joint taxpayers). The 2001 Tax Act also repeals completely both the annual dollar limit on the amount of the deduction and the 60-month limit.

7. COLLEGE TUITION DEDUCTION

The 2001 Tax Act creates an above-the-line deduction for qualified higher education expenses. For 2002-2003, a single taxpayer with adjusted gross income below $65,000 ($130,000 if married) will be entitled to an above-the-line tuition deduction of $3 ,000 each year. The deduction will increase, for the years of 2005 and 2005, to $4,000 for single taxpayers with incomes falling below $65,000 and for married taxpayers filing jointly with incomes below $130,000. The Act gives both single taxpayers with incomes up to $80,000 along with for joint filers with incomes up to $160,000 a maximum deduction of $2,000 in 2004 and 2005. This deduction cannot be claimed for the same student in the same year as a HOPE or Lifetime Learning credit is claimed for the student.

I. PENSION PLAN CONTRIBUTIONS

Under the 2001 Tax Act, the limits on contributions to pension plans rise considerably.

Beginning in in 2002, the limit on annual addi**tions to a defined contribution plan will** rise to $40,000.

For defined benefit plan, the annual limit on benefits will rise from $140,000 to $160,000.

For 401(k) plans, the limit on salary reduction contributions to IRC §401(k)-type plans (including 403(b) annuities and salary reduction SEPs) will rise from $10,500 to $15,000 by 2006 (scheduled to rise to $11,000 in 2002, and increase by an additional $1,000 each year until 2006).

J. SMALL BUSINESS EXPENSES AND DEDUCTIONS

The 2003 Tax Act made two significant tax changes which help small businesses.

1. The 2003 Tax Act increased the amount of investment that may be immediately deducted by small businesses from $25,000 to $100,000. The amount of investment qualifying for this immediate deductions begins to phase out at $400,000.

2. The additional first year bonus depreciation is increased

CHAPTER 2

INVESTMENT IN A HOME

The single most important investment that the average person makes is in a home. The American Dream is for a person to own his home. When the United States was first formed only persons of property could vote. Wealth, land and happiness have always been viewed as the same in America. The purchase of a home binds the buyer to the land more than any chain. The purchase of a home commits a person to make payments for as many as 30 years. Most of the liquid assets of a person will be used to make the mortgage payments. A sharp downturn in real estate prices can destroy years of appreciation. This chapter is designed to focus attention on the factors involved in a decision to buy a home. This chapter dwells on the issues of whether to purchase, when to purchase and how to purchase.

Once a purchase is made, the buyer must know the legal duties and responsibilities of a real estate owner. Real property law covers more than just the land itself. It also covers the rights strictly controlled and regulated by zoning and environmental laws.

The rights and duties of landowners form a rich and diverse body of law. Every state has its own body of real property law, but all share similar views of residential homes and the obligations of homeowners. By knowing what is expected of a homeowner a person can determine if home ownership is in his best interests.

The purchase of a home is a major step in a person's life. It usually involves dealing with lenders, appraisers, brokers and contractors. There will be application fees, loan fees, brokers' fees, taxes, assessments and other obligations. Still, the purchase of a home is probably the wisest course of action. Everything simply hinges on the knowledge, preparation and financial condition of the purchaser.

I. WHETHER TO PURCHASE A HOME OR NOT

The answer to whether or not a person should purchase a home requires the answer to several subquestions such as:

1. Does the person have a stable job?
2. What size of house can the person afford?

purchaser's financial soul.

The most important question is whether the person has a stable job. No lender will even consider loaning to a person who has no job or whose job is apt to be terminated in the near future. A poignant and true example occurred to a couple who owned a home in Willits, California that was for sale. A buyer came forward, was approved by a lender and contracts were prepared for final signature. The buyer was terminated unexpectedly from his position because of a slump in business. The bank immediately canceled the loan. Had the man been fired a month later, the sale would have been completed. Even though, however, he would have been unable to make the payments and ultimately would have lost both the property and his twenty percent (20%) down payment.

This true example drives home the fact that a person considering buying a home must have a secure job. Otherwise he takes the risk that loss of job will result in loss of the home and the equity in it. There is a common misconception that lenders are overly willing to help buyers who cannot make their payments. While that may be true in some cases, the truth is that most lenders cannot afford to wait an unlimited time for their money.

from the cost of the house that can be afforded. A newly married couple might only need a single bedroom home whereas a family of six may need a three bedroom home. Occasionally a buyer will purchase a smaller home than needed with the intention of immediately adding to it. This can be a cost-effective approach: it is usually cheaper to add than to buy with the addition already built. On the other hand there is the time and aggravation of getting building permits and dealing with contractors. A construction loan might be obtained from the same lender who is giving the purchase loan; another lender, however, may offer more favorable rates.

The bigger the home, the more it will cost to buy, the more it will cost to maintain, and the more it will cost in taxes. A person can quickly and accurately determine, in a general fashion, the cost of his needs by looking in the newspaper or at the multiple listings of a real estate agent. Since everyone seeks to sell his home for fair market value or more, these periodicals should contain a reasonable approximation of what a home will cost.

The buyer needs to know the maximum amount of down payment he must raise. Most commercial lenders will require the buyer pay lenders. In particular, qualified people should look to the following agencies:

1. Veterans' loans. The Veterans Administration and most state veterans' groups provide low interest loans with low down payments to veterans.
2. Special state loans. Many states have special loans for first- time homeowners. A real estate broker would be the best source of such information.
3. Most credit unions provide low interest loans and low down payments to their members. A qualified person could join such a credit union and apply for a loan when eligible.

First consult with a bank about its lending rate and down payment requirements and compare with other loan sources. There are mortgage brokers, who usually advertise in the Sunday paper, who specialize in obtaining loans for buyers who cannot get a traditional loan. Mortgage brokers usually arrange loans with lower down payments but higher interest rates: not as much money required for a down payment, but monthly payments will be higher.

A good rule-of-thumb in estimating monthly payments for a 30-

$724.16. This figure is just the cost to amortize the loan and does not include assessments for taxes.

Location of the home is one of the most important factors in any home purchase. The more desirable the area, the more the home is worth, and the faster it will appreciate. The reverse is obvious. The worse the area, the less it is worth, and the slower its value will increase. The ideal location is an area undergoing gentrification which is a part of a community where home values had been on a downward slide. The old homes are purchased at low prices, remodeled and sold to yuppies. There are many cities which have old Victorian homes that can be purchased for low amounts. These homes are worth considerably more than the amount invested when they have been renovated.

Locations near schools (but not next to them) are worth more than homes farther away to families with children. Homes closer to hospitals and stores are worth more to elderly purchasers.

The best way for a potential buyer to understand the nuances of location is to spend a few days reviewing a multiple listing book (an advertisement magazine offered by the area's real estate brokers displaying all the listed homes). A person can determine the local economy. If the local economy takes a sudden plunge, property values plunge as well. The example given above is a case in point. The couple did everything right except for correctly gauging the local economy. They bought a piece of real property below value in a area undergoing gentrification. They constructed a modular house and had an attractive home. After a year they placed it on the market at an appraised value that would have returned a nice profit. One day the major employer of Willits, a town of 5,000 people, closed its mill which resulted in 700 people losing their jobs. Property values fell through the floor. They were finally able to sell the house for a little above cost, but they lost thousands of dollars in time and labor. The lesson to be learned is that before property is purchased in a small town, the town's economy must be considered because property values are more affected by the local economy in small towns than in larger ones.

Most people find their homes through real estate agents. That is the simplest and easiest way. A real estate agent is paid by the seller. A real estate agent will only show homes with whom the agent has a listing (agreement to sell the property). A real estate agent will not show a potential buyer any property on which he does wherein all agents' listings are advertised. Any real estate agent can show any of the listed properties, and the listing agent (the one who got the listing from the owner) and the procuring agent (the one who got the buyer) will split the commission on the sale. The commission usually is 6% of the sales price although the amount is negotiable. In other words, if the sales price is $100,000, the commission is $6,000. The seller is really selling the property for $94,000.

Multiple listings attract sellers to list their property with a real estate agent. A person selling his own property cannot compete with the advertising multiple listing affords. The general rule-of-thumb is that a person should list the home with an agent (broker) if he is unable to sell within four months.

Most homes are sold through agents. Few are actually sold by their owners. Yet buying directly from a home owner not listed with an agent will save the cost of a broker. The problem is finding these homes. Homes for sale by owners are not in the multiple listings. Sunday newspapers are a source. People selling their own homes place signs in their yards, but the message is limited to the few buyers who happen to see it. In many cities there are small

Another source of homes is through tax sales and repossessions. These serve as the basis for those get-rich-quick seminars in real estate. A lucky person can find a bargain. In most cases the person will get a little break on price, but that may be offset by the time spent in waiting for the property.

A tax sale is when the local tax agency takes the property and auctions it to the public for back taxes. The property is purchased for just the payment of the back taxes if the buyer is the only bidder. The property doesn't normally get to the tax sale if it is encumbered by a lender's lien: if it is valuable, the lender redeems it far earlier in the proceedings. Usually the property sold at tax sales is undeveloped land that is not developable. Extreme care should be taken at any tax sale.

Foreclosure sales by lenders are a good way to acquire property. In most states, upon default on a deed of trust (discussed below) a lender can have the property sold at a public auction. He must first comply with notice provisions or pursuant to a court's mortgage foreclosure judgment. It is possible to purchase this property for the outstanding balance of the loans and the unpaid taxes at such auctions owed to the lender is reduced by the amount of the bid, and the lender takes title to the property. Once the lender owns the property, he wants to sell it. Most lenders are not in the business of selling property. They list with real estate brokers just like any other ordinary seller.

There is one difference between institutional sellers and ordinary sellers. The institutional seller tries to clear its books quarterly or at the end of the year. A nonrevenue producing item like a house is bad to have on their books. At these times a private citizen may offer to purchase a listed home directly from the institution at a significant savings. In a real case, a couple bought their home in this manner. The time was in a recent recessionary period and the house had been on the market for over a year. The couple offered the bank a ridiculously low amount. To their surprise, the bank counter-offered with a slight raise, and they eagerly accepted. The bank was grateful to unload a white elephant during a recession.

The best way to get such a bargain is to visit every bank and lending institution directly and speak with the home loan officer. Ask him if any homes have been repossessed. Ask about homes that

General Services Administration. The GSA often sells excess real property through a sealed bid procedure. A person can obtain information about getting on the GSA list by writing to the U.S. General Services Administration, Federal Property Service, Office of Real Estate Sales, 819 Taylor Street, Fort Worth, TX 76102-6115. Phone number (817) 334-2331.

III. TAKING TITLE TO THE PROPERTY

There are many ways to take title to real property. For most people the way is through a deed that specifies the title is being transferred in fee simple absolute: all rights, title and interest in the property are being conveyed, and no other person or entity owns an interest in the property. A fee simple is the total ownership rights recognized by law. It is capable of full and complete alienability. It passes by inheritance to both lineal and collateral heirs of the owner. A fee simple will last forever if it is a fee simple absolute. If it is a fee simple defeasible, the ownership rights may be altered on the happening of certain conditions.

A fee simple absolute is the most complete and absolute ownership of real property permitted by law. A fee simple absolute expressly: It was necessary to use the language "and his or her heirs" to create a fee simple absolute. Example: The deed had to read "To George and his heirs" in order to create a fee simple absolute. The language "and heirs" did not create an estate in the heirs but was still needed to show that a fee simple absolute had been granted. Today South Carolina is the only state that requires the language "and heirs" be on the deed to prove that a fee simple absolute was granted. All of the other states now, either by law or judicial decision, hold that a fee simple absolute is presumed to have been granted unless a grantor states otherwise on the deed.

IV. PURCHASE OF A LIFE ESTATE

A life estate is an estate in real property that lasts only as long as stated owners live. It does not terminate on the basis of a certain length of time. A conventional life estate comes into being as a result of the stated intent of the grantor to create it. For example, the words, "To A for life" means that A is entitled to complete possession of the property for his life. The right to possess the property ends on his death. Another example is "For A as long as B lives": A's right to possess the property ends when house. The owners can then take full possession of the home after their deaths,

Some retirement communities are based on life estates. These communities sell a right to reside for life in the homes in the community. The purchase of a life estate could be construed to be a life-time rental agreement with a one time rental fee.

Life estates can be worthwhile provided the person will live there long enough to recover what would have otherwise been paid in rent. The decision to purchase a life estate entails considerations other than money, such as future care and the life expectancy of the person.

V. WHEN TWO OR MORE PERSONS PURCHASE A HOME

Usually a home is purchased by an individual or a married couple. Occasionally people not married buy a home together. When two or more people buy a home together, their rights in the property are determined by the way they assume title to the property.   Property taken as joint tenants is different from property taken as tenants in common which is again different from property taken as tenants by the entirety. Buyers should understand their rights in the property under whatever type of deed they changing joint tenancy property to tenants in common would read as follows: George Smith and James Smith hereby sell, convey and transfer all of their rights, title and interest in the property described hereafter to themselves, George Smith and James Smith as tenants in common.

A. JOINT TENANCY

Joint tenancy is the concurrent ownership of real property by two or more persons with the right of survivorship. When a joint tenant dies, his interest in the property passes automatically to the surviving joint tenants. An owner's interest in the joint tenancy property passes without a probate and is not affected and cannot be changed by the terms of the owner's will.

A joint tenancy must be expressly created. The deed must have language similar to this: "To A and B as joint tenants." Anyone can be a joint tenant with anyone else. Usually spouses or parents and children are joint tenants so as to avoid probate of the property. A joint tenant owns an equal interest in the property regardless of whether that interest was purchased or acquired by a gift. A joint tenant's interest can be attached by his creditors.

A joint tenancy can be terminated and turned into a tenancy in co-tenant.

2. Mortgage by one joint tenant of his share of the joint tenancy without the consent of the others.
3. Lease by one joint tenant of the joint tenancy property without the consent of the others.
4. A few states permit the termination of a joint tenancy in a will. This is a minority view.

Joint tenancy is most commonly used between spouses. Some parents use these deeds with their children. The purpose is to avoid probate. On the other hand, joint tenancy deeds are not usually used in estate planning because they do not pass a stepped-up basis to the other joint tenants.

B. TENANCY IN COMMON

A tenancy in common is ownership among two or more persons of an undivided interest without a right of survivorship. The interest in the real property is entirely transferable and subject only to the claims of the owner's creditors. Tenancy in common is the way title is usually taken when the buyers are not married. A tenancy in common deed is a partnership deed. Such a deed states that each person owns an undivided interest in the entire real property and can dispose of it all in any manner. A tenant in

Only about twenty (20) states recognize tenancy by the entirety. It is a special joint tenancy estate between a husband and wife. Neither spouse can obtain a partition of the estate or defeat the right of survivorship of the other spouse. It cannot be terminated by the unilateral act of one spouse.

A tenancy by the entirety is terminated only by:

1. Divorce, which changes the tenancy into that of tenants in common.
2. Mutual agreement of all the joint tenants.
3. Execution against the property by a joint creditor of both spouses. A creditor cannot execute a judgment on one spouse against property held in tenancy by the entirety.

A tenancy by the entirety can be afforded special protection under the Bankruptcy Code. The Bankruptcy Code exempts a tenancy by the entirety from a debtor's estate if the debtor's spouse has not filed for bankruptcy relief and if the property is exempt under the debtor's state law. This issue is discussed in more detail in Chapter 17. Generally, if a married couple wish to take title with rights of survivorship, they should do so under a tenancy by the entirety if it is available in their state.

VI. THE EFFECT OF EASEMENTS AND SERVITUDES ON THE PROPERTY

land subject to the easement, continues to have the right to full possession and enjoyment of his property subject only to the limitation that he cannot interfere with the special use of the property by the easement holder. There are a variety of easements, each of which have their own rights and term of existence.

Easements are terminated by the following:

1. The express terms of the easement can state under what conditions the easement will terminate.
2. Excessive use or misuse of the easement can terminate an easement.
3. The easement holder can terminate the easement by actions that manifest an intent to abandon the easement permanently and never use it again.
4. The parties may agree in writing to release the easement.
5. An easement may be terminated by adverse possession of the easement by the owner of the servient estate.
6. The easement owner can acquire the servient easement, an act which merges the interests and terminates the easement: an owner cannot have an easement on his own property.

The reason for this detailed discussion of easements is that a buyer must know about every easement that touches and concerns his land. Not all easements are of record (recorded in the county only way to determine the presence of unrecorded easements is to investigate the property for signs of use by other than the owner and by asking the seller if there are any unrecorded easements on the property.

VII. A BUYER SHOULD LOOK FOR ADVERSE POSSESSION

It rarely happens, but there are legal situations where the person with title as owner does not actually own the property and may not know it. In such an instance, a buyer may be buying property that cannot be sold. This strange result occurs as a result of a legal doctrine called adverse possession. For homes located in cities, the chances of being involved in adverse possession are slight. The chances, however, increase as the property becomes more remote.

Title to real property of another can be acquired by adverse possession if the possession of the land is all of the following:

1. Open and Notorious. The possession is sufficient to put the owner of the real property on notice.
2. Hostile. The possession must be without the owner's consent.
3. Claim of Right. The person seeking to acquire the property by adverse possession must assert his claim of

> holding the property for five years and paying the taxes on the property has acquired the property by adverse possession.

When all of the elements are met, title passes to the adverse possessor. Just as a person can acquire all of the title to real property by adverse possession, a person can acquire an easement (which is less than all of the title to real property) by adverse possession. A person who fulfills the requirements for adverse possession will acquire a prescriptive easement to continue using the property: use of the property for the required period of time in an open and notorious manner and without the consent of the owner. A prescriptive easement is personal to the holder unless it was acquired by the public under state law. Public use of the property may result in an implied dedication to public use. An easement acquired by prescription may be terminated in the same manner as ordinary easements.

The property becomes the possessor's if he occupies it long enough by adverse possession. This is called "squatter's rights." Once title is gained by adverse possession, the legal owner (the person whose name is on the deed) loses all right to the property;

to the property will defeat those of a person claiming title through adverse possession in accordance with the state's recording statutes.

VIII. COVENANTS AND EQUITABLE SERVITUDES

Before a purchase the buyer should check the title to determine if the property is subject to any special use restrictions. Such restrictions can be in one of two forms: covenants or equitable servitudes. These restrictions bar the uses for which a person can develop his property. In some cases these restrictions can increase the value of the property. In other instances they can limit its potential. In either event a buyer should be aware of their presence and impact before purchasing the property. Such restrictions must be recorded with the county recorder's office in order to be effective against a good faith purchaser.

A covenant is an agreement by the owner of the real property to do or refrain from doing some action. A covenant runs with the land: the burdens or benefits pertaining to the covenant pass to succeeding holders of the property. An enforceable covenant requires:

covenant must affect the parties as landowners, not just as members of the community.

4. There must be privity of estate between the parties: there must be a direct relationship connecting the parties to the covenant.

If the above conditions are not met, the covenant does not run with the land and will be unenforceable for successors of the parties. An example of a covenant running with the land is an agreement that all owners of a subdevelopment will only build single family homes. This covenant prevents commercial or apartment buildings in the development and maintains the residential quality of the area. If a buyer purchases the property with the intent of building an apartment complex, the covenant will legally prevent that occurring.

An equitable servitude is similar to a covenant. It is a restriction on the use of the land adopted by the owner of the land. The basis of the enforcement of an equitable servitude is that a person who takes property with notice that the property's use is restricted by the equitable servitude should be bound by the restriction. An equitable servitude requires:

The majority of states do not require privity of contract between the owner and the person seeking to enforce the servitude. Anyone can seek to enforce an equitable servitude in these states.

If the foregoing conditions are not met, the servitude will not run with the land and will be unenforceable after the original grantor dies or divests himself of the property. An example of an equitable servitude would be a statement in the deed that the property cannot be subdivided into less than five-acre parcels. Any buyer wishing to subdivide into smaller parcels is prevented by this equitable restriction in the deed.

Covenants and equitable servitudes are enforced by the courts. The party seeking enforcement asks for a court order, such as a mandamus or an injunction, to require the owner to perform the covenant or refrain from violating the servitude. Damages may also be awarded for injuries suffered as a result of any breach of the covenant or servitude by the owner.

IX. RECORDING A DEED

Most states require that all deeds, mortgages, powers of attorney and other instruments relating to the title of real property be recorded. The recordation is done in the recorder's chronological order according to the respective names of the grantor or grantee.

A few states use a tract index which lists all of the transactions involving particular pieces of property. Searches in tract indices are easiest to perform since all of the transactions affecting the title are listed in one document.

The purpose of recordation is to give notice to the world of the buyer's ownership interest in the real property. Recording gives constructive notice to the world of the person's claimed ownership from the date of recordation forward. Recording gives the court a basis to determine the conflicting claims of ownership where there are multiple sales or conveyances of the property.

All states have statutes (called recording acts) to determine the legal ownership of real property when two or more persons claim ownership of the same property. These acts vary from state to state but fall into three separate categories: notice, race and race-notice statutes. The rights of the parties in the real property is determined by who recorded their deed first and whether or not they knew of claims by the other parties.

A state's recording act may still deny title to a purchaser of

About half of the states have a pure notice recording act: a good faith purchaser will acquire the property free of all conflicting claims even if he is not the first to record. A good faith purchaser is also called a bona fide purchaser: a purchaser without notice of conflicting claims of others. The important issue under this statute: when did the purchaser acquire notice of the other conflicting claims, not when was the deed recorded. For example assume that A sells a farm to B and later sells it again to C, who had no knowledge of the earlier sale. C gets title to the farm, and B must sue A for his damages.

B. RACE RECORDING ACT

Two states, North Carolina and Louisiana, have this recording act. Under this act the first purchaser who records wins. Notice of conflicting claims is irrelevant. The purchaser that first records his deed shears all rights in the property of anyone recording later. For example, assume that C knows of the sale to B and still buys and records his deed first. C acquires title to the farm.

C. RACE-NOTICE RECORDING ACT

Most states have a race-notice recording act: the first good faith purchaser that records will be recognized as the owner of the sale, such as a gift, is not a purchaser. Therefore his interest in the property can be terminated by the subsequent recordation of a deed by a good faith purchaser.

Example: A gives the property first to B and then sells it to C and finally to D. D records first followed by B and then C. The property goes to D because he bought and recorded first in good faith without knowledge of the earlier gift to B and the earlier sale to C.

X. CONTRACT FOR SALE OF THE PROPERTY

All states have laws that require that any contract for the sale of land or that affects any interest that will touch and concern the land for over a year (such as a lease, easement, condition, covenant or restriction) must be in writing to be enforceable. A court may order specific performance of a contract involving real property that is not in writing if it can be proven that a contract did exist between the parties along with one or more of the following acts:

1. The purchaser has taken possession of the land,
2. The purchaser has made substantial improvements to the real property, or

from reasonable doubt either in law or fact regarding the title. The warranty of marketable title does nor require perfect title be delivered. It does require that the real property not have any clouds on the title that pose an unreasonable risk of litigation. Title is marketable if a reasonably prudent buyer would accept it after exercising ordinary diligence and prudence.

The remedies for breach of contract for sale of real property are:

1. Damages. The non-breaching party may sue the breaching party for the damages suffered as a result of the breach. The measure of the damages is the difference between the fair market value of the property and the sale price. In addition, consequential damages (damages reasonably foreseeable to be suffered from a breach) are also recoverable. Examples: replacement rents, costs of title searches, etc.

2. Specific Performance. Land is considered unique. Courts will always force the seller to honor the contract and complete the sale. Courts will sometimes force the buyer to purchase the property if the seller cannot reasonably sell it to someone else for the contract price. If the seller sells for less than the

property. Unless the contract states otherwise, the buyer must still pay for the property if it is destroyed after the contract of sale is executed. Exception: destruction is a result of the seller's negligence. Twelve states have adopted the Uniform Vendor and Purchaser Risk Act, which places the risk of loss on the buyer only after the buyer has taken possession of the property.

XI. TYPES OF DEEDS

There are two types of deeds with which a buyer should be concerned: a grant deed and a quitclaim deed. A buyer should, as a practical matter, insist on a grant deed, unless he has a specific reason for accepting a quitclaim deed.

A grant deed contains all the following covenants of title by implication:

1. Covenant of Seisin: the grantor has both title and possession of the property.
2. Right to Convey: the grantor has the right and authority to make a conveyance.
3. Encumbrances: the property is not encumbered by liens or mortgages not previously disclosed.
4. Quiet Enjoyment: the purchaser will not have his possession of the property interrupted by any lawful claim against title by a third party.

therefore required to pay all legal fees and damages incurred by a breach of any of these covenants.

A quitclaim deed is a written instrument that transfers all of a person's rights, title and interest to another. A quitclaim deed is not a statement that the seller actually owns the property: if the seller has an interest in the property, he has transferred it by the quitclaim deed. A quitclaim deed is usually used to perfect a person's title in real property by having persons holding potential conflicting claims release their contingent interest in the property. A person cannot be sued for issuing a quitclaim deed because there is no warranty that the person actually has an interest in the property.

XII. FINANCING THE PURCHASE

The three most common methods of financing the purchase of real property are a mortgage, a deed of trust and an installment sales contract. Of the three methods the deed of trust is the most common way of financing real property.

A. MORTGAGE

A mortgage is a security interest in real property given by the owner to guarantee payment of a loan. The borrower is called states allow the mortgagor to redeem the property within a year by paying the buyer the amount he paid at the judicial sale, not the amount originally owed.

If the sale proceeds do not satisfy the amount owed, a deficiency judgment for the balance may be obtained against the debtor if permitted under state law.

B. DEED OF TRUST

A deed of trust is a security interest in real property to secure payment of a loan or some other obligation. The borrower is called the trustor and the lender is the beneficiary. The trustor executes a promissory note for the amount of the loan. The payment of the loan is secured by a trust deed on the property for the benefit of the lender as the beneficiary. A trustee is appointed and is responsible for the fulfillment of the terms of the trust deed.

If the trustor defaults on payments on the promissory note, the beneficiary notifies the trustee of the breach. The trustee then gives the trustor (the borrower) notice that the property will be sold unless the default is cured within a statutorily mandated period of time. If the default is not cured (back payments made), delay of a judicial foreclosure.

A trustee usually has the option of selling the property at a private sale under the terms of the deed of trust or filing a lawsuit for judicial foreclosure. The only real advantage of filing a judicial foreclosure action (to sue in court) is that a deficiency judgment might be obtainable. Many states, however, have enacted anti-deficiency legislation which precludes a lender getting a deficiency judgment on any purchase money loan on residential real property.

A deed of trust is an interest in real property like any other. It can be sold, given away, attached or encumbered just like any other interest in real property. The method of transfer is the same for all purposes: the beneficiary of the deed of trust, who is also the holder of the promissory note on the property, executes an assignment of the deed of trust and has it recorded. Recordation of the assignment of the deed of trust transfers the deed of trust. It acts the same as a bill of sale for personal property or a grant deed for real estate.

C. DEED OF RECONVEYANCE

When a promissory note secured by a deed of trust is paid , a then record it.

The mechanics of this procedure are as follows:

1. The lender signs and marks the original promissory note "paid in full."
2. The note is then sent to the trustee. The trustee will prepare and execute a deed of reconveyance.
3. The deed of reconveyance is recorded.

Trustees tend to charge between $100 and $500 for signing and recording a deed of reconveyance. A trustee can always be replaced by the beneficiary of the deed of trust. The cheapest way for a buyer to get a deed of reconveyance is to have the beneficiary sign a "substitution of trustee" statement. The beneficiary appoints himself the new substituted trustee.

As the new trustee, the beneficiary executes and records the deed of reconveyance. Most stationary stores sell substitution of trustee and deeds of reconveyance forms. All that is needed is for it to be completed, notarized and recorded to remove the cloud of the deed of trust from the buyer's title on the property.

D. INSTALLMENT SALES CONTRACT

An installment sales contract is one where legal title stays with the seller until the contract is paid. In the event of the seller to foreclose on the property in court in order to clear his title on the land.

If the seller elects to treat the property as a forfeiture, he is prevented by law from suing for damages or specific performance. The seller cannot keep the property and still demand payment for it. Clearly, an installment sales contract does not protect the buyer as well as a deed of trust or a mortgage. Sometimes, however, that is the only way the property can be purchased, especially where the seller is being asked to "carry back" the loan (take payments rather than sell for cash).

E. "DUE ON SALE" CLAUSE IN A MORTGAGE OR DEED OF TRUST

Many mortgages and deeds of trust contain clauses that state the entire balance becomes immediately due and payable if the property is sold or conveyed in any manner. The purpose of these clauses is to protect the lender from risky sales or assignments. These clauses have the effect of preventing the sale of the property without the lender's approval unless the lender's loan has been paid.

Federal law will enforce a "due on sale" clause if the loan is from a federally insured lender. Some states, such as California, with the state's real estate law to determine if the provision is enforceable.

F. DEFICIENCY JUDGMENT

In the case of a mortgage debt, if the judicial sale does not completely pay the debt, the mortgagee can sue the mortgagor for the balance remaining (the deficiency). A number of states have limited the judgment in such cases to the difference between the debt and the foreclosure price. Some states, including California, have anti-deficiency legislation that prohibits deficiency judgments on purchase-money mortgages. A purchase-money mortgage is one used to buy the property rather than improve it.

Many states do not permit a deficiency judgment on a deed of trust where the property was sold under the trust deed's power of sale. If a deed of trust is foreclosed using a judicial foreclosure (suing in court for a judgment rather than selling the property under a power of sale in the trust deed), then a deficiency judgment may be possible provided there is no anti-deficiency legislation barring it.

An installment sale contract is treated like a mortgage in most states. In those states the seller is required to go through as damages under breach of contract.

Whether the foreclosure is judicial in nature or by sale of deed of trust, it voids all junior liens and encumbrances. It does not affect a superior lien or encumbrance. For example, assume that George purchases a piece of property at a foreclosure sale on a second mortgage. The property had a first mortgage of $100,000 and a third mortgage of $50,000.00. The first mortgage still stays on the property, but the third mortgage is void. The holder of the third mortgage can sue the mortgagee personally for the balance owed on the third mortgage but cannot go against the new buyer of the property.

XIII. CO-OPERATIVES AND CONDOMINIUMS

One form of common housing ownership is that of cooperatives. A cooperative is a corporation which owns the title to the land and buildings thereon. The cooperative leases apartments in its buildings to its shareholders. The residents in a cooperative are thus tenants (they lease apartments in which they live) and owners of the cooperative (they are shareholders in the corporate ownership of the apartments). The residents are not direct owners of their apartments. They are entitled to reside there only as long his unit plus an undivided interest in the exterior and common areas. Usually the condominium owners form an association or corporation to manage the condominium. Each owner finances the purchase of his unit by a separate mortgage on that unit. The condominium association has authority to levy assessments against the owners for maintenance, taxes and other proper purposes. Failure to pay these assessments gives the association the right to lien the property and to sue in court to collect payment.

XIV. HOMESTEAD

Most states permit an owner to claim a certain amount of equity in his primary residence, usually $40,000, as an exemption from attachment by creditors. In such states creditors cannot attach a debtor's home if a homestead declaration was recorded and the debtor's equity does not exceed the statutory amount. If the equity does exceed the statutory amount, the property is sold, and the statutory amount is returned to the debtor even if the debt is not paid totally. A declaration of homestead must be recorded in the county recorder's office of the county where the home is located prior to the filing of any lawsuit by a creditor. Recording the homestead declaration after the lawsuit is filed does use in the sale of real property. The major exception, at common law, existed for a building under construction or to be constructed based on the rationale that the buyer had no ability or opportunity to inspect the building. A majority of states now hold that there is an implied warranty for fitness in the sale of a new house by the builder. The warranty implied in these states is that the house is designed and constructed in a reasonably workmanlike manner and is suitable for human occupation.

If the seller knowingly makes false statements to the buyer on a fact that materially affects the value of the real estate and the buyer relies upon these statements in purchasing, the buyer has the following remedies:

1. The buyer may rescind the contract and demand return of the money purchase price plus damages incurred in performing the sale.
2. The buyer can affirm the contract and sue for damages. The damages are the difference in value between the purchase price and the true value of the property. Additional damages may be recovered for incidental expenses incurred because of the false statements and, if appropriate, punitive damages may be obtained.

The seller is just as liable for defects that he actually conceals buyer.

XVI. ZONING

Every buyer must be concerned with zoning in the area where the property to be purchased is located. Location determines price and the value of the location is itself determined by the zoning in the area. Every state has the authority to enact all laws reasonably necessary for the health, safety and welfare of its citizens. This is known as the state's police power.

Zoning is the term given to the laws enacted by a city, county or state that regulate the develop of land within its boundaries according to a general plan of development. The implementation of any zoning plan must comply with the constitutional provisions of due process and equal protection. If private property is taken for public use as a result of zoning, the owner must be paid the fair market value of the property. This is called eminent domain.

The government can so restrict the development of private property that no reasonable use of the property remains. In that event, the United States Supreme Court has held that inverse condemnation has occurred. Inverse condemnation is a violation of the U.S. Constitution's Fifth Amendment as a taking without just to be built. This is the hottest area of contention in zoning law. Regulatory agencies routinely demand unnecessary public easements across private property or dedications of land in conjunction with those necessary to grant building permits.

A buyer should inquire how the area is zoned. A home located in an area zoned for industrial use will be worth less than the same home in a residential area. The reason is that most people do not want to live next to steel mills, oil refineries or stock yards. Homes located in industrial or heavy commercial areas will appreciate at a slower rate than those homes located in residential areas. Since appreciation is one of the reasons for purchasing property, zoning is a factor that must be considered in any decision to purchase a home.

XVII. MINERAL RIGHTS AND WATER RIGHTS

Whenever a person buys property they should always buy the water and mineral rights of the property. All states permit water and mineral rights to be retained by a seller when property is sold: the seller will continue to own them even though the real property will be owned by the purchaser. In most states a person owning mineral and water rights has the right to go upon the however, can be limited by language in the deed that the seller retains the minerals but not the right to come on the surface to develop them (the right of entry). Where no right of entry is retained, the seller can only develop the property by subsurface access (digging a tunnel under the property or slant drilling a well).

Mineral rights are the ownership rights of all the minerals on a designated piece of real property. Mineral rights can be segregated from the land. Mineral rights carry with them a right to enter upon the real property surface or underground to search for and develop the minerals. This right of entry is called a "profit a prendre" and is a non-possessory interest in the land. A "profit a prendre" is an easement to enter upon and develop the minerals on the property. It can be terminated for the same reasons as an easement.

A riparian water right is the right of the owner of land bordering a stream to use all of the water necessary for his domestic purposes. The owner also has the right to use a reasonable amount of the water for non-domestic or business purposes provided he returns the water to the stream in an the surface. Many states, especially in the West, now hold that such use must be reasonable and that there may not be careless waste or pollution. Other states, such as Nevada, hold that all of the water belongs to the state and the owner of the land must perfect his rights to use the water on the property by application to the state.

The retention of mineral rights in homes located in cities usually is not a problem because zoning laws will usually prevent the seller from ever being able to mine for the minerals. In areas where mining is permitted, however, retention of rights could seriously affect the value of the property. Future buyers might not want to live under the threat of having their property invaded at any time. In the same vein water rights can be very important where water is obtained through wells rather than a water district. Buyers should be leery of purchasing property without access to water.

CHAPTER 3

REAL PROPERTY RENTAL

One of the most common forms of investment for individuals is the rental of real property. Most of the homes rented in the United States are not owned by huge real estate syndicates but by a husband and wife who are supplementing their income from the rental proceeds. There is no reason that individuals cannot invest and rent real property profitably.

The reason behind successful real estate rental is simple. Unless a person is living in a home he owns or is living with a relative, he is probably a tenant. For every tenant there is a landlord with superior ownership rights and control of the property. By renting property the landlord is supplying a basic need and should be amply rewarded for it. The degree to which the landlord is successful depends in large part on his management skill, the condition of the property, the location of the property, the investment in the property and the availability of other rental properties in the area. All of these matters must be given careful consideration before investing in real property.

regardless of the condition of the property. Over the years courts and state legislatures have greatly eroded the landlord's omnipotent rights in the property. Tenants today have significant rights in their rented properties, and the violation of them by the landlord can result in serious fines and penalties. In addition many cities have enacted rent control laws which seriously restrict the landlord's right to charge other than a fair market rent or less and impair the value of the property.

This chapter is designed to help people with their decision to invest in rental property. It is also intended to help those already in the business to understand their rights and obligations under the law. This chapter is designed to help the user operate a rental property profitably. After all, this is the reason the property was rented in the first place.

I. THE REASONS FOR RENTING REAL PROPERTY

There are only two real reasons for a person to rent real property, such as a home, to another person. The first reason is that the owner of the property wants to have someone on site to manage the property so that it will not be vandalized. This is an important reason. Any police officer will say that vacant buildings used by drug dealers have been condemned as nuisances and torn down. When that happens, the owner of the property is held responsible for the cost of the demolition.

The owner is doubly assaulted. In the first place the vandals destroy the building to such an extent that the owner cannot afford to repair it. In the second place the city destroys the building because of the damage caused by the vandals and bills the owner. The owner, though totally innocent, loses everything. It is clear why owners prefer to have tenants on the property to watch, even if they do not actually need the rental income.

The second and usual reason most people rent property is to make money. Real property is an asset and like any other asset can be used to make money. Real property can be sold and turned into cash, or it can be rented and generate a stream of income ad infinitum. Whether a person should get into the rental business depends whether he can make more money renting the property or investing elsewhere. In making that determination, several factors must be considered:

1. How much rental can be charged for the property.
2. How likely is the property to be rented.

Whether a person buys the rental property or inherits it, the property is an asset with value. The rental property should be sold if it does not generate a reasonable return on its value. In the 1970's and 1980's many real estate gurus touted negative investment in real estate. These experts advised people to invest in rental property even if the rental income would not make the payments. These experts believed that the owners should make up the difference because they reasoned that the unimpeded escalation of real estate prices in the major markets would continue forever. Their cry was, "The only thing they're not making any more is land." These experts believed that the owners would make a huge killing when the land was ultimately sold through astronomical appreciation occurring on real estate.

In all fairness that did happen for a few years and many people did make killings in real estate. Many investors, however, financially died by following that advice. When the savings and loan industry collapsed in the 1980's, real estate throughout the United States plummeted. The Federal Resolution Trust Corporation (FRTC) took over the failed savings-and-loan industry list of properties and sold them at bargain rates. As real estate prices meet their high mortgage payments or default on their loans and lose the property. Many of the owners lost their property to the Resolution Trust Corporation who then sold at depressed prices. This action by the FRTC drove the real estate prices ever lower. The savings-and-loan system collapse cost thousands of real estate investors their life savings.

The example of the savings-and-loan debacle shows that no one should ever invest in real estate in a financially negative fashion, nor should they rely on appreciation in the property for their profit. A real estate investor should expect a reasonable profit from the property immediately and should not expect an appreciation for sale but instead expect the property to retain the same value. If the property rises in value that should be viewed as a Godsend, but it should not be expected. The property should be sold if it drops in value so that it no longer generates a reasonable return.

As a rule of thumb, the property should generate a return of 5% to 8% greater than the real estate's loan rate at the bank. This would cover the mortgage payments and provide a reasonable amount of return. Example: If the rental property cost $100,000 and is on expenditure on property to about $1,100.

A landlord should figure that at least one month per year the property will be vacant. Statistics show that Americans tend to move frequently when they do not own their own homes. Therefore, a landlord should set aside a reserve to make the rent payments during the interim when an old tenant vacates and a new tenant enters. The mortgage payments must be made despite vacancies.

III. INVESTING IN RENT CONTROLLED PROPERTY

Investing in property that is covered by a rent control ordinance usually is not a good idea. Rent control prevents the owner from charging fair market value for the rental property. Rent control places a cap on the amount of rent an owner can charge and provides only a small yearly increase for the cost of living. In addition, the value of the property is reduced because the amount of rent is limited. It is hard to sell rent controlled property. In some cities it is impossible to take a rent controlled building out of the market without demolishing it and paying the tenants to move elsewhere. Most cities that have rent control forbid rental conversion to condominiums or co-operatives.

There is very little concerning rent control that is good from however, is shift that burden to landlords, who must bear the costs. In several cities where rent control has been implemented, it has been scaled back or removed because developers would not build new buildings there. As a result, those cities were able to grow and compete with other cities and, in the end, did not suffer in the recession as did those cities which had rent control.

In any event, the hassles of rent control are not for the individual lessor who has only a few rentals. The cost of complying with rent control laws is too onerous and the risk of loss too great for the average individual.

IV. LEASING THE PROPERTY

Once a person decides to rent property to another, the owner should execute a written lease with the potential tenant. By definition a lease is a transfer of real property for a period of time, called tenancy, by a person with a greater interest in the real property. The person granting the lease is called a landlord or lessor. The person receiving the lease is called a tenant or lessee. The consideration paid for the lease is called rent. The rights of the parties to a lease are governed by the specific type of lease that is used and the terms and conditions of the lease on real property be in writing to be enforceable.

There are exceptions to the requirement of a writing. The most important exception is that of a lease. In such a situation, the lease or contract will not have to be in writing in order for its terms to be enforced. Although not always required by the law, common sense dictates that all leases be in writing for the benefit of the landlord. All-purpose leases are sold in all stationary stores for approximately five dollars; so it makes sense to use them to avoid potential problems.

A. A PERIODIC TENANCY

A periodic tenancy is a lease that runs from period to period such as month to month or year to year. It is automatically renewed for another period until terminated. Termination of a periodic tenancy occurs by giving proper notice to the other party of the intent to terminate the lease prior to the end of the current term. In most states, unless the parties agree otherwise, the notice requirements for the termination of a periodic tenancy are:

1. For a month-to-month lease, 30 days notice.
2. For a quarter-to-quarter lease, one quarter's notice.
3. For a year-to-year lease, six months notice.

premises until a valid notice is given by the landlord.

B. A TENANCY-AT-WILL

A tenancy-at-will is a lease in which either party may terminate at any time. Unless the parties have expressly agreed that they intend the lease to be a tenancy-at-will, the court will treat it as a periodic tenancy. A tenancy-at-will terminates by operation of law when:

1. Either party to the lease dies.
2. The tenant commits waste to the property (damages it).
3. The tenant attempts to assign the lease.
4. The landlord sells the property.
5. The landlord executes a lease on the same property with another.

Many states, however, require 30 days notice to terminate a tenancy-at-will. A landlord should never use tenancy-at-will. A written lease protects the landlord by giving the landlord rights of inspection and repair and rights of termination that do not exist unless in writing.

V. RIGHT OF ENTRY UPON THE PROPERTY

Under common law a landlord has no right to come on property for inspection or repair unless that right is reserved in a lease.

restrict the use a tenant put to the property. If a landlord does enter the property without the consent of the tenant, he has committed a trespass.

Many leases contain clauses specifically giving the landlord the right to enter the property at reasonable times to make repairs. Likewise, many states give the landlord the right to enter the property under reasonable circumstances to make repairs even if the lease does not specifically give the landlord that right. A landlord who enters the property without a proper purpose may be violating the tenant's right of quiet enjoyment.

VI. LANDLORD'S OBLIGATIONS

In order to make money on the property, the property must be rented. Therefore, it must be in a condition that a prospective tenant would like to rent. By the same token the property must be minimally maintained so as to keep the tenant. In some instances the tenant may agree to perform certain maintenance, and in other areas the maintenance must be performed by the landlord. Failure to perform needed maintenance will affect the landlord's profits and may even expose the landlord to damages for injuries sustained by others. A landlord should understand the minimum standard the law

The modern trend in landlord tenant law is that landlords have a general duty to use reasonable care with respect to residential tenants. The landlord will be held liable for personal injuries suffered by the tenants and their guests as the result of the landlord's ordinary negligence. Liability will be imposed for such negligence only where the landlord had notice of the problem and failed to repair it after a reasonable opportunity to do so.

The California Supreme Court has gone so far as to hold landlords strictly liable for injuries caused by defective conditions without proof of negligence (knowledge) on their part.

Most states hold the landlord liable for all damages and injuries caused as the result of the landlord's failure to comply with housing codes regardless of what a lease may say. The courts of these states view the compliance with housing codes a non-delegable obligation of the landlord that cannot be waived or assumed by a tenant.

The fact that the landlord may have a duty to keep the premises in good repair does not relieve the tenant of his duty to keep the property in good repair. The tenant will be held liable for injuries suffered by third parties that the tenant could have warrants that his property is reasonably suited for use as a human residence. The remedies that a tenant has for a breach of the implied warranty of habitability are:

1. The tenant may vacate and terminate the lease.
2. The tenant may make the necessary repairs and offset the costs against future rent.
3. The tenant may abate the rent: reduce it to the fair market rental value of the property with the defects.
4. The tenant may pay the full rent and sue the landlord for damages caused by the defects.

The implied warranty of habitability is the wave of the future. Courts have held this warranty non-waiverable by a tenant. As a result, a landlord renting substandard property may find himself with tenants who are not paying rent and yet cannot be evicted until the property is brought up to code. The day of the slumlord is rapidly drawing to a close. With modern housing codes and the implied warranty of habitability, it is becoming dangerous, both civilly and criminally, for a landlord to allow his rental property to disintegrate into a hazardous condition for tenants.

B. MAINTENANCE OF COMMON AREAS

The common areas of multi-unit buildings are not part of a

Lessors have been found liable for negligence in maintaining the common areas when injuries occurred. The lessor must use ordinary care to make the area safe for tenants and invitees (business guests) to the property. The latest extension of liability for common areas occurred when courts found lessors liable for crimes committed by third parties. The California courts have held, for instance, that lessors were negligent when they failed to install locks on gates leading to the property. Criminals went through those gates and attacked a woman tenant. The courts held that the landlord knew the property was in a high crime area and should have taken the minimum precaution of installing locks on the gates.

C. QUIET ENJOYMENT AND CONSTRUCTIVE EVICTION

Every lease agreement contains an implied covenant of quiet enjoyment. The covenant implies that the landlord will do nothing to interfere with the possessory rights of the tenant. In other words, if there is something that affects the tenant's right to enjoy the property quietly, and it is within the landlord's reasonable power to correct the situation, the landlord's failure to correct is an interference with the covenant of quiet enjoyment.

1. The act or failure to act must be by the landlord or his agent, not third parties.
2. The results of the act are to render the property uninhabitable.
3. The tenant must vacate the premises as a direct result of the landlord's act. If the tenant does not vacate there is no constructive eviction.

A tenant may declare the lease terminated because of the constructive eviction and sue for damages suffered as the result of the eviction or sue for the return of possession of the property and damages suffered. The covenant of quiet enjoyment and constructive eviction go hand in hand. Simply, constructive eviction is such a serious violation of the tenant's right to quiet enjoyment that the tenant must move. The best example is the violation of housing codes which make the property uninhabitable. In such an event, the landlord may be sued by the tenant for the costs of having to vacate the premises.

Based upon the foregoing discussion, a landlord should make sure that the property is maintained in accordance with the appropriate housing codes and should exercise common sense. If the property is maintained in accordance with those minimum standards,

VII. TENANT'S OBLIGATION TO MAINTAIN THE PROPERTY

A tenant has no duty to make any substantial repairs to the property unless the lease agreement imposes an express duty to do so. The tenant does have the duty to make minor repairs and to take other steps necessary to prevent damage by the elements. If the tenant does not make the minor repairs, the tenant will be liable for the damages caused because the minor repairs were not made. He, however, will not be liable for the actual cost of making the repairs.

A small number of states have passed laws specifically requiring tenants to:

1. Refrain from violating any housing codes.
2. Keep the property free of vermin.
3. Use plumbing, utilities and appliances in a reasonable manner.

When the tenant covenants to keep the property in good repair, the condition of the property at the beginning of the lease and at the end of the lease must be compared to determine if there was a breach. If the covenant to repair does not contain any exceptions, the tenant may be liable for normal wear and tear to the property. If consideration (rent) is given for the use of the property, most

VIII. SUBLEASE OR ASSIGNMENT OF THE LEASE

An assignment is the transfer of all of the leasehold interest by the lessee, hereafter referred to as the assignor, in the real property to another, hereafter referred to as the assignee. In order for the transfer of the right to occupy the premises to be held to be an assignment, the following must be met:

1. The transfer must be for the entire remaining term of the lease. A transfer of six months on the remaining nine months of a lease is not an assignment.
2. The assignment must be on the same terms as the original lease. The original terms of the lease may not be varied.

The effects of an assignment are as follows:

1. The assignor stills remains liable to the lessor for performance of the conditions of the lease. If the assignee fails to pay the rent, the assignor can be sued for the unpaid rent.
2. By virtue of the assignment, the assignee has assumed obligations with the assignor to perform all lease conditions, such as the obligation to pay rent.
3. Both the assignee and assignor can be sued by the lessor for any breach of the lease.
4. The assignor can sue the assignee for indemnification (repayment) for any damages that the assignor has to pay the lessor due to the assignee's failure to perform the

performance on the lease even though most of the benefits have been transferred to the sublessee. To put it another way, a sublease does not transfer the tenant's rights or duties thereunder to the sublessee (subtenant): the subtenant becomes the tenant of the tenant, not of the landlord. There is no direct legal relationship between the sublessee and the landlord. For that reason the landlord cannot sue the sublessee for any breach of the lease. The sublessee can only be sued for any damages that he actually causes to the property under tort theory.

As a practical matter, every written lease should (all preprinted ones do) contain a clause whereby assignments or subleases without prior consent of the lessor are void. A transfer in violation of a clause in the lease that prohibits assignments or subleasing is either void or voidable depending on the language in the clause.

A lease that simply states that no assignment or sublease can occur makes a transfer voidable. The clause must be more specific. The landlord must take physical action to prevent the transfer: go to court or terminate the lease.

A clause in the lease may state that any assignment or immediately.

Most leases contain provisions that assignments or subleases cannot be made without the consent of the landlord. If the lease does not contain the provision that such consent shall not be unreasonably withheld, most courts will not add that provision. Some courts, however, will require that a denial be based on reasonable grounds. In addition, a landlord that refuses to consent to an assignment or sublease for discriminatory reasons such as race, religion or sexual preference, may be in violation of a state's anti-discrimination laws. The reason behind the inclusion of a restriction on assignments or subleases is to give the lessor the opportunity to check on the proposed assignee or sublessee. After all, it is the lessor's property that is being rented to this total stranger. The lessor should retain the right to stop any assignment or sublease to a person whom the lessor does not feel to be a qualified tenant. Without such a restriction the lessor cannot prevent his property being assigned to an irresponsible or incompetent tenant.

IX. TENANT ABANDONMENT OF THE LEASE

When a tenant abandons property with time still remaining on fact that the landlord enters the property to make repairs or offers to rent the property to another on behalf of the tenant does not constitute acceptance of the surrender.

2. The traditional option, still available in many states, allows the landlord to do nothing and simply sue the tenant each month for the rent as it becomes due or wait for the end of the term and sue for the whole amount.

Many states require a landlord to attempt to mitigate his damages and try to rent the premises and apply the rent received to the damages owed by the tenant. The tenant is then liable for the difference. If the property cannot be rented, the tenant will be liable in full for the remaining rent owed for the unexpired term of the lease.

X. "HOLDING OVER" BY A TENANT

"Holding over" occurs when a tenant continues to remain in possession of the real property after the termination of the tenant's right to possession. The landlord has two remedies against a tenant "holding over":

1. The landlord may evict the tenant under the state's unlawful detainer statutes, or
2. The landlord may in his sole discretion bind the tenant

lease, the tenant will be bound by those new terms if he "holds-over."

3. In some states the landlord is entitled to receive double the rent from a tenant that holds over.

The parties may agree in the lease to a stated sum, called liquidated damages, in the event of a breach by either party. In a liquidated damages clause the parties agree that the only remedy to either party for a breach of the lease is the payment of a fixed amount of money regardless of the amount of actual damages. Example: The liquidated damages clause may state damages as one month's rent of $500. A tenant that holds over one day is liable, not for one day's rent but for the liquidated damages amount of $500. Such clauses are enforceable if they represent a true attempt to limit damages before a breach has occurred and are entered in good faith by both parties.

XI. UNLAWFUL DETAINER

Unlawful detainer is the legal remedy available to a landlord against a tenant who:

1. Remains after the lease has terminated,
2. Continues in possession of the property without payment of rent when due,

lease merely because the tenant failed to perform the conditions of the lease. Today, both by statute and the terms of most leases, a landlord is permitted to terminate a lease for the failure of the tenant to perform conditions of the lease including failure to pay rent. After the breach has occurred, the landlord is required to give the tenant a short notice to perform the condition (usually pay rent) or quit the premises. If the tenant fails to do so, an unlawful detainer action to evict can be brought by the landlord against the tenant.

Unlawful detainer is a summary remedy where a "notice to quit" is served. It calls for the tenant to vacate the premises within a fixed period, usually three days. If the tenant does not leave, the landlord files a complaint in court and serves the tenant with it. The tenant will have a short period of time, usually five days, to answer the complaint. If the tenant fails to answer the allegations contained in the complaint, the court will enter a default judgment against the tenant.

If the tenant does answer, then case is set for preference on the calendar and usually heard within 30 days. An unlawful detainer action is one of the easiest legal actions to institute.

month of filing of proof of service of the complaint on the defendant. Forms for an unlawful detainer can usually be obtained from the clerk of the court where the complaint will be filed.

XII. RETALIATORY EVICTION

Retaliatory eviction is the eviction of a tenant for reporting housing codes violations to the proper authorities. Many states, such as California, make it illegal for a landlord to evict a tenant for reporting housing code violations. In many states a landlord may be fined for committing a retaliatory eviction. Many defendants in an unlawful detainer action allege retaliatory eviction as a defense even though it may not exist. A "retaliatory eviction" defense goes hand in hand with the "implied warranty of habitability." Tenants often claim that they refuse to pay rent because of the substandard condition of the property. If the claim is true, the landlord may be prevented by law from evicting the tenants and be precluded from collecting rent until the premises are improved to the standards of the housing code.

XIII. A TENANT'S DEFENSES TO AN UNLAWFUL DETAINER ACTION

A tenant in an unlawful detainer action may assert as a defense:

If the tenant prevails on either of the first two defenses, the complaint is dismissed for lack of jurisdiction by the court. If the tenant prevails on any of the other defenses, the court will allow the tenant to stay on the premises. In addition, the court would probably award damages to the tenant, even though the tenant may owe rent. The reason behind the award of damages to a tenant who is in arrears on his rent is to punish the landlord for being a slumlord and refusing to follow the housing code.

XIV. SELF-HELP BY THE LANDLORD AGAINST A HOLD-OVER TENANT

It used to be permitted for a landlord to lock a tenant from the premises after the lease expired. This form of self-help was widely used. A person need only to look at the movies of the 1940's and 1950's to see how hold-over tenants were then treated. It was a routine practice in the past to evict tenants behind in their rent.

Few states now permit a landlord unilaterally to evict a tenant. All states have unlawful detainer statutes to evict tenants wrongfully in possession. The unlawful detainer action is a summary procedure and is given preference on the court's calendar. Most states today recognize that unilateral eviction can result in whereby a person, usually the landlord, unlawfully evicts a tenant from the leased premises. States which do not permit unilateral eviction remedies to the landlord will find the landlord liable for damages if he forces a tenant to be evicted or interferes with his possession of the property. California, for example, makes it a crime for a landlord to shut off utilities to a tenant for any reason and fines a landlord $100 per day for any "forcible entry or detainer" act.

XV. A WRIT OF POSSESSION

If the landlord wins in an unlawful detainer action, the court will enter a judgment in the landlord's favor. The court will also issue an order that the tenant vacate the premises by a certain date. The clerk of the court will issue a certified order called a "writ of possession."

If the tenant fails to move out by the allotted time, the landlord takes the writ of possession to the local sheriff or Marshall's office. A police officer will be dispatched to oversee the removing of the tenant's possessions from the premises. The tenant's possessions are taken from the premises and either left on the street (if the tenant is present) or placed into storage and guarantee against damages to the premises. From this security deposit the landlord pays to repair any damages caused by the tenant. A security deposit is not rent. The purpose of the security deposit and its uses are clearly defined by statutes in most states. Many states require a security deposit to be kept segregated in an interest bearing account. A security deposit is refundable. The laws of many states, including California, impose penalties on the landlord that wrongly fails to return a security deposit which, in most states, must be refundable.

A landlord is required within a matter of days (usually 10) after termination of the lease to inform the tenant in writing as to how the security deposit was applied to satisfy the damages allegedly caused by the tenant. The landlord then must return the balance of the deposit. If the tenant feels that more of the security deposit should have been returned, the tenant should sue the landlord in small claims court for the amount in dispute plus any damages that the state law imposes on a landlord for misusing a security deposit.

XVII. FIXTURES

A fixture is personal property that is attached to the real cannot be taken by the tenant when the lease ends.

Most states have modified the common law on fixtures and now permit the tenant to remove fixtures provided they can be removed without damaging the real property. To address this problem, many leases contain clauses that state whether fixtures will be considered the property of the landlord or the tenant and if the fixtures can or must be removed upon termination of the lease. Some states give a landlord a lien on fixtures placed on the leased property. A building placed on the real property is a fixture and a lien could attach to it if permitted by the state law.

In the states allowing a fixture lien, the removal of the fixtures or improvements will not terminate the lien. Therefore, in the states that allow the lien, the removal of the fixtures by the tenant will still permit the lien to follow the fixtures. For example, if the landlord has a lien on a building which the tenant later moves off the leased land, the lien still follows the building. If the building is subsequently sold, the lien will still follow the building provided the buyer had actual or constructive notice of the landlord's lien on the building.

XVIII. STATUTORY LIEN

title to the property along with the right to possession, but a lien is attached to them.

The property to which the statutory lien of a landlord may attach depends on the statutes of each state. Most states that allow the lien permit it to attach all of the tenant's property on the leased premises. A few states limit the landlord's lien to certain types of property: growing crops on the leased land, fixtures used in a trade or business, or animals on the leased land. The statutory lien must be enforced in accordance with the laws of the state involved. A lawsuit must be filed for enforcement. In some states recording a notice or filing a UCC-1 form with the secretary of state will serve to give notice to the world of the lien. Such notice will prevent the property from being sold without the landlord being paid. The lien gives the landlord some preference as a secured creditor should the tenant file for bankruptcy.

A landlord may waive his statutory lien both intentionally by his express agreement or unintentionally by his conduct. In most of the states that permit the lien, if a landlord permits the tenant to remove the property without asserting the right of his lien, the lien is waived forever on that property. When the

CHAPTER 4

COLLECTING DEBTS IN SMALL CLAIMS COURT

Money is hard to get and even harder to keep. Therefore, everyone should always pay their just debts. Unfortunately, many people are professional deadbeats. These people deliberately run up debts for services or property and refuse to pay. Such people count on the fact that litigation through the normal court system is expensive and that it would usually cost more to collect the debt than it is worth. The cost for an attorney is usually at least $150 per hour. The normal debt collection runs at least $5,000 in attorney costs. Unless there is a written agreement that the prevailing party will get attorney fees, each side must pay their own attorney fees. It is this reality that the unscrupulous use to avoid paying their just debts.

In response to this situation, all states have adopted laws establishing small claims procedures. Under these laws, small claims, usually no more than $5,000, are heard before special judges, commissioners or attorneys serving as judges pro tem. The except for the occasional traffic ticket.

Small claims court exists as an alternative to the highly structured, complex and expensive traditional court system. Small claims courts are a cheap, fast and efficient means to settle disputes concerning small amounts of money.

There are many "How To" books on the market that instruct a person as to what he must do to file a small claims action. This chapter addresses most of the fundamental concerns people have concerning small claims court without having to buy expensive books that merely expand this information. Through this chapter the average person should be able to understand the small claims court procedure. The reader should be able to go to the clerk of the small claims court, get the forms and the local rules of court and intelligently start the action.

The reason this chapter is appearing in this book is to educate people on the advantages and simplicity of the small claims court. There is no reason that a person should forgive debts of hundreds or thousands of dollars because it is not cost effective to hire an attorney to sue for such money. Money represents a person's future and safety. Money's protection and its recovery

The small claims court is a specially created court in which most disputes can be tried inexpensively and quickly. The rules of the court are simple and court procedure is relatively informal. Lawyers are not permitted to present or try the case. Claims vary from state to state. In California, for instance, disputes of $5,000 or less can be heard in small claims court. The regular filing fee for most small claims courts is between $6 and $15.

A small claims case is usually heard within forty (40) to seventy (70) days from the filing of the claim. While most small claims cases involve money damages, most small claims courts have the power to grant other remedies. For example, most small claims courts have the authority to grant injunctive relief which means authority to order a person to do or not do something (mandamus or injunction) if the value of the act ordered or restrained is within the monetary limits of the court.

II. FILING A SUIT IN SMALL CLAIMS COURT

Nearly anyone can sue in small claims court. The person bringing the suit is called the plaintiff and the person being sued is the defendant. An individual can sue other individuals or businesses and vice versa. Most states deny collection agencies competent to file in small claims court. The plaintiff need not be a U.S. citizen to file a small claims complaint. The plaintiff does not have to speak English to file the complaint. Interpreters are permitted in court if a witness does not speak competent English.

It is imperative that a plaintiff file a small claims action in the proper court. Failure to file in the proper court may result in the action being transferred to proper court or dismissed altogether. Generally, a small claims action is filed in the court of the judicial district or area where the defendant lives or the business is located. Sometimes state laws permit the plaintiff to sue in the court district where an accident or tort (a civil wrong) occurred although it may not be where the defendant lives. Most states permit a small claims suit involving a breach of contract to be filed:

1. Where the defendant lives.
2. Where the defendant signed the contract.
3. Where the defendant lived when the contract was signed.
4. Where the contract was to be performed.

If it is possible to file in more than one judicial district, the plaintiff may choose the one most convenient for the plaintiff public.

III. ATTORNEYS USUALLY ARE NOT PERMITTED IN SMALL CLAIMS CASES

Most states preclude the appearance of an attorney in small claims court as an advocate of a party. In most states the attorney cannot give legal advice in court to either plaintiff or defendant, nor can an attorney comment in court as to the presentation of evidence. The fact that most states do not permit attorneys in small claims actions is unique. There are no other instances in American courts where the parties are denied the right to have an attorney speak for them in court.

Although an attorney cannot appear in many small claims courts, the parties are permitted to speak with attorneys outside court and ask for advice in preparing their cases. The reason attorneys are not allowed in court is they are not necessary under the abbreviated procedures of the court. Both sides merely tell the court what happened and produce evidence they have to support their explanation. The trial is informal, sometimes to the extent of becoming a community forum or pulpit for the expression of individual beliefs.

An attorney is permitted to testify as a witness. There is no

The court, however, may stand more on strict compliance with state procedure when an attorney is present, which is a benefit to the party with an attorney: evidentiary objections, particularly as to hearsay, are more likely to be upheld.

IV. ALL CLAIMS MUST COMPLY WITH THE STATE'S STATUTE OF LIMITATIONS

Every claim has a statute of limitations: a period of time in which a lawsuit must be filed or the right to bring the lawsuit will be lost. Statutes of limitation vary from state to state. The theory behind statutes of limitation is that no one should sit on their rights. The courts want to have claims decided as promptly as possible. Therefore, if a person waits too long to sue for damages, even though legitimately owed, the court will dismiss the complaint.

For example in California, the statute of limitations for various claims is as follows:

1. Claims for personal injury (physical injury to a person) have a one-year statute of limitation.
2. Breaches of a written contract have a four-year statute of limitation; while oral contracts have a two-year statute of limitation.

within a certain period of time following the injury or breach, normally around one hundred (100) days, but this varies. If the agency rejects the claim, the plaintiff must file his action within a very narrow time period, usually six months, or lose the right to sue altogether. Claims against government agencies should be pursued with all dispatch.

An agency is usually allowed 60 days after receipt to accept or reject. The claim is automatically rejected if the agency has not accepted within the allowed time.

V. THE DEFENDANT

The plaintiff must state the names and addresses of the defendants: the people or business being sued. Therefore, the plaintiff must know the identity of the defendant. If the defendant is a business or corporation, the business' legal name and address can be found with the city's licensing agency, the tax assessor's office, the fictitious business names files in the county clerk's office, or the office of the secretary of state's corporate division. All corporations incorporated in a state and foreign corporations doing business in a state are usually required to designate a person to receive process (service of complaints)

Because attorneys generally are not permitted in a small claims action, both parties must represent themselves. In the same vein a corporation may appear in small claims court only through an employee or an officer or director of the corporation. A corporation may not be represented in small claims court by someone whose job is to represent the corporation in small claims court. In other words, a corporation cannot use an attorney in court if the function of the attorney is to represent the corporation on small claims actions.

Certain businesses and entities other than corporations, such as partnerships or joint ventures, may appear in small claims court only through a regular employee of the entity. The representative may not be someone whose sole job is to represent the business entity in small claims court. A trust may be represented in small claims court by the trustee of the trust.

VII. THE MONETARY LIMITS OF A SMALL CLAIMS CASE

The most important consideration in a small claims case is the amount of the claim sought. A plaintiff cannot exceed the jurisdictional limit of the court. If a plaintiff asks for more than the court is allowed to award, the entire case may be could have sued in a regular court for the full $20,000, but he might have waited years to have the case heard and incurred large fees and costs preparing for the trial.

VIII. FILING FEES

There is always a filing fee for any complaint filed in any court. Courts are not free. In California the basic fee is $6 per case. Multiple filers, those with over 13 cases per year, $12 per case in California. In most states a person unable to pay the filing fee can request the court grant a waiver of fees. This waiver is called a "forma pauperis," Latin for "form for a pauper." If the plaintiff qualifies for the waiver, the fee is waived and subsequently recovered if the plaintiff wins. Put it another way: if the plaintiff wins the case, the defendant pays the filing fee as a court cost to the plaintiff.

IX. PLAINTIFF'S RECOVERY OF COURT COSTS

Most of the costs related to pursuing a small claims action are recoverable from the defendant if the plaintiff wins. Examples of court costs that are recoverable are filing fees, service of process fees, witness fees and mileage. There is usually no recovery for expert witness fees in small claims cases. Also plaintiff should always investigate to determine if it is awardable in his case.

After the trial the plaintiff presents a summary of his costs to the court for approval. Once approved, the costs are included in the court's judgment against the defendant.

X. SUBPOENAING WITNESSES FOR TRIAL

Some states permit statements by witnesses in small claims actions to be used instead of the witness actually appearing. In such states the statements must be in writing and signed under penalty of perjury. The statement should state, "Signed under penalty of perjury that the foregoing is true and correct." It is always best to have your witnesses available at trial. Since the other party cannot question a witness, judges do not have to accept the statement.

A plaintiff can subpoena a witness. A subpoena is a court order that the person appear at the court to testify or face charges of contempt of court. Likewise, a subpoena duces tecum can be issued for documents. A subpoena duces tecum requires the person served to bring specified documents to court on the day of trial. A subpoena can only be served in person. It cannot be

The proof of service is filed with the court. If it becomes necessary to compel attendance, the court will rely on the proof of service for jurisdiction over the witness.

Most states require the party issuing the subpoena to pay the witness a fair fee and mileage round trip. Example: In California this is presently $35 per day and $.20 per mile. Always bear in mind that a subpoenaed witness may be hostile to a case, and it might be better not to subpoena a witness who might "forget" key items.

XI. SERVICE OF THE COMPLAINT ON THE DEFENDANT

A defendant must be served (presented the small claims complaint) in such a manner that the court will know that it was done. The procedural requirement must be correctly followed or the action may not proceed and may be dismissed altogether.

A plaintiff cannot serve the small claims action on the defendant. In some states, such as California, the court clerk will mail the complaint to the defendant's address by certified mail. Service is complete if the defendant signs for it. The fee for this is $3 in California. If the defendant does not accept delivery of the certified mail, the plaintiff must serve the

$50. Once the complaint is filed, a proof of service is filed with the court stating the date and location of service. The case will not be dated for trial until proof of service is filed with the court.

In most states the defendant may be served by substitute service. Substitute service requires the process server to leave a copy of the complaint with an identified person at the business or residence of the defendant and to mail a copy of the complaint to the defendant at that address within 10 days. Proof of service must be filed by the process server stating the name of the person who accepted the complaint.

XII. FAILURE OF THE DEFENDANT TO APPEAR AT TRIAL

If the defendant does not appear at trial, the court first will determine if the defendant was properly served. The court will determine if service was valid. If service was procedurally invalid, the court will dismiss the case for want of jurisdiction over the defendant. If service was valid, meaning the complaint was properly served on the defendant, the case will continue.

Judgment is not automatic for the plaintiff just because the defendant fails to appear. The plaintiff must still put on evidence state or federal law.

If the plaintiff wins the action, the court will issue its judgment. Part of the judgment will be an award for the damages suffered by the plaintiff, the court costs in bringing the suit and the amount of interest permitted under state law.

XIII. DEFENDANT MAY FILE A COUNTERCLAIM AGAINST THE PLAINTIFF

The defendant may file a claim against the plaintiff in small claims court. The claim does not have to be over the same fact pattern as the plaintiff's claim. Example: The plaintiff may sue over a car accident, and the defendant may countersue over a broken refrigerator totally unrelated to the car accident.

The defendant's claim is subject to the same restrictions as the plaintiff's claim. The defendant may not sue for damages over the court's jurisdictional limit and must comply with the statute of limitations. Any amount exceeding the limit is forever waived, as with the plaintiff's claim.

The defendant may file his complaint in the regular courts, municipal court, superior court, district court or whatever that state calls its courts or even in federal court if appropriate. The plaintiff's small claim action will be transferred to the

The burden of proof is borne by the party seeking some form of relief from the other. The plaintiff has the burden of proof on his claim against the defendant. If the defendant files a claim against the plaintiff, the defendant has the burden of proof on his claim against the plaintiff. Most states have small claims cases tried only before a judge, but a minority of states permit jury trials of small claims cases.

The burden of proof is the standard of evidence needed to prevail in a case. In a small claims action the party having the burden of proof must convince the judge that it is more likely than not that he should win. In a fifty-fifty case of one person's word against another, the judgment should go to the defendant. Without this standard, anyone could sue and collect judgment without ever being damaged. The result would be unfair. Before anyone files in small claims, he should consider whether there is enough evidence to convince a total stranger to render judgment in his behalf.

Experience shows that the average small claims case takes each side between 10 and 15 minutes to present his case when tried by a judge. To accelerate speed of presentation, most judges require the parties to stand unless they are disabled. Standing causes the

After both sides have presented their case, the judge or jury will make a decision. When a jury is used, the decision is announced in open court before the parties. Occasionally, when the judge tries the case, the judge will take the case under submission and decide later. A case is taken under submission for several reasons. The judge may want to conduct research, conduct an investigation or simply not want to upset the parties while in court. When the case is taken under submission, the judge's decision will usually be mailed to the parties within a month. The judgment will state any monetary award along with any court costs that the judge finds should be recovered.

XV. THE SMALL CLAIMS JUDGE

Most small claims court judges are full judges of the local court. Many states permit private attorneys to sit as temporary small claims court judges called judges pro tem. In order to hear a small claims case as a judge pro tem, the attorney must have the written consent of both parties. If both parties agree to have a private attorney serve as the judge, the attorney will hear the case and render the decision in the same manner as a regular judge. The judgment of an attorney serving as a judge pro tem is treated parties that a regular judge is not available is on the date of trial, when the clerk asks the parties to stipulate to a private attorney.

XVI. THE APPEALABILITY OF A SMALL CLAIMS JUDGMENT

In most states, including California, a plaintiff may not appeal the judgment of a small claims action. If the plaintiff loses, the case is over and cannot be relitigated.

The defendant, however, can appeal the judgment of a small claims court. Usually in an appeal, the case is retried in a regular court and before a real judge. The new trial is called a "trial de novo", which means a completely new trial. In California, small claims appeals are heard in Superior Court. In California, when a small claims case is appealed, both parties may then use attorneys, but that is the exception to the general rule that attorneys may not appear in small claims cases.

In like manner, a plaintiff is entitled to appeal a judgment against him awarded to the defendant on the defendant's claim, and a defendant is not entitled to appeal a loss of his claim against the plaintiff: the defendant's counterclaim places him in the position of plaintiff. For example, assume that a plaintiff sues a defendant for filing a frivolous appeal. In California, if the court finds that the appeal was frivolous, it can award the plaintiff $250 as attorney fees. It is rare that the court will find the appeal was frivolous. "Frivolous" means the appeal was without merit and intended solely to harass, delay or encourage the other party to abandon the claim. If state law permits sanctions for filing a frivolous small claims appeal, there is no harm in asking for them.

XVII. COLLECTING THE JUDGMENT

Once the court issues a money judgment, the prevailing party, the person being awarded the money, becomes a judgment creditor of the losing party, who is now the judgment debtor.

The judgment may specify that the amount of money is to be paid in full to the judgment creditor or allow the judgment debtor to make periodic payments. Periodic payments are usually ordered in the judgment only if the parties entered a settlement agreement ordering them. Interest is usually computed on a judgment from the date of its award. The legal rate of interest varies from state to state but is around 10% per year.

Once the judgment is issued it is up to the judgment creditor award for the judgment creditor. It will supply orders and documents to help collect the judgment. Often an attorney or collection agency is hired to collect the judgment.

A. ATTACHMENT OF WAGES

The court issues its judgment in favor of the prevailing party. The prevailing party is the winner and can be the plaintiff winning on his complaint or the defendant winning a judgment against the plaintiff on the defendant's claim. The judgment is taken by the winner to the clerk of the court. The clerk of the court issues a writ of execution containing the information in the judgment.

A writ of execution is a court order directing the sheriff or marshal to take control of or levy upon the assets of the losing party to satisfy the judgment. It is the responsibility of the judgment creditor to tell the marshal or sheriff where the property is located so it can be seized.

Wages can be attached ("garnished") to pay the judgment. Most states have laws to prevent employees being fired because their wages have been attached.

All states provide debtors statutory exemptions from

Real property can be seized and sold by a marshal or sheriff executing a small claims judgment. Every state has its own procedure for execution on real property. The sheriff or marshall advertises in a newspaper of general circulation that on a certain date (usually after 30 to 60 days notice to the debtor) the real property will be sold to the highest bidder at a public auction at the sheriff or marshal's office.

At the sale, the highest bidder purchases whatever interest the debtor had in the property. If the debtor owes $100,000 on the real property, the purchaser will take the real property subject to that $100,000: the $100,000 debt still remains on the property. Several years ago in Florida a tenant sued his landlord, a large residential apartment owner, for return of a security deposit. The tenant won the case in small claims court. The tenant then executed against the real property and purchased it at the sheriff's sale for approximately $1,500. After the sale the landlord tried to set the sale aside, but the courts affirmed it. The tenant bought a $1 million dollar piece of property for $1,500.

In most states a person can file a homestead on the real property he owns and on which he resides in any amount not to amount because the creditor would not receive anything. A few states have no homestead exemption.

C. PLACING A JUDICIAL LIEN ON ALL OF THE DEFENDANT'S REAL PROPERTY

A judgment creditor can request that the clerk of the court issue an abstract of judgment. An abstract of judgment is an official recordable court document which states the amount owed to the plaintiff. When recorded in the county recorder's office, the abstract of judgment places an automatic lien on all of the real property of the debtor located in the county where the abstract is recorded. An abstract of judgment must be recorded in every county to cover all of the property that a defendant may own in a state.

Once a lien is placed on real property, it remains on all current and future property of the debtor until released by the creditor. No one will purchase any of the debtor's real property without having the lien removed. Once an abstract is recorded, it stays on the real property for a fixed number of years, for example 10 years in California, or until the judgment is paid. Both the abstract and the judgment, depending on state law, usually can be renewed for a fixed number of years, California permits renewals in increments of 10 years. When any of the debtor's real property is any real property. For this reason, recording an abstract of judgment makes good sense even if nothing else is done to collect the judgment.

D. EFFECT OF A DEFENDANT'S BANKRUPTCY

When a debtor files bankruptcy, there is an immediate "automatic stay" on any collection lawsuits being filed against the debtor. A person in bankruptcy cannot be sued in small claims court. Any judgment taken against a person while a bankruptcy proceeding is pending is void and unenforceable.

Furthermore, under the bankruptcy law, all judgments obtained within three months of a debtor's bankruptcy are set aside and must be relitigated again in the bankruptcy court. Older judgments are treated as unsecured claims in the bankruptcy proceeding except for judicial liens against real property. That means they are paid in a percent equal to the ratio of debts to assets in the estate after secured debts and allowable expenses have been paid. Assume, for example, that a creditor has an unsecured judgment of $4,000 against a bankrupt debtor. Assume the bankrupt debtor's estate is $20,000 after payment of all allowable debts and expenses and the unsecured debts are $80,000. The creditor's debt will be 5% of the judgment creditor, is paid in full or whatever lesser amount that might be agreed among the parties. The judgment creditor is required to file a form with the court after the judgment has been paid, called a "satisfaction of judgment." The recordation of satisfaction of judgment removes the liens placed on the debtor's property by the prior recording of an abstract of judgment.

Failure to record a satisfaction of judgment could expose the judgment creditor to a lawsuit for slander of title. Failure to file (record) the satisfaction of judgment would keep a lien on the debtor's property and thus prevent the defendant from obtaining loans or selling his property. Such would make the creditor liable for extensive damages.

F. EXAMINATION OF THE DEBTOR FOR ASSETS

It is the judgment creditor's responsibility to collect the award, and the creditor is given certain rights that help him. Many courts require the debtor to file a statement of assets once the judgment is entered. Using this statement of assets, the creditor is able to obtain the writ of execution from the court clerk. All states permit the creditor to apply for an "order to appear for a judgment debtor's examination." This is a court order assets he owns. A debtor is required to file it as a tool for the creditor in discovering property that can be seized and sold to pay the judgment.

XVIII. SMALL CLAIMS SUITS FOR BAD CHECKS

Small claims courts were established primarily to handle bad check complaints. These are complaints for bad checks of relatively small amounts. Most people have seen a list of bad checks in small restaurants to embarrass the writer. Every state has some type of bad check law that permits a business, and in some instances individuals, to sue for several times the amount of the bad check. In California, Civil Code Section 1719 permits a suit to be filed for value of the check plus three times the amount of the check. The additional amount will be, at least, $100 up to a maximum of $1,500.

Some states, like California, require that the debtor be given notice by certified mail of the bad check before the court will award the additional amount. Anyone given a bad check can always sue in small claims court for the amount and for the penalty also.

XIX. VALIDITY OF SMALL CLAIMS JUDGMENT

A small claims judgment is a valid judgment by a state court state as a sister state judgment. Doing so makes the creditor's small claims judgment enforceable under the other state's law and gives the debtor access to that state's collections procedures.

An out-of-state small claims judgment can serve as a lien on the real property of the out-of-state debtor if the prior steps have been taken to have it adopted as a sister state judgment. Once adopted as a sister state judgment, an abstract of judgment can be recorded, placing the lien on the real property of the debtor.

PART II

INVESTMENTS

This section deals with the most common types of investments the average person might consider. Not every type of investment is discussed. This book is not directed toward wealthy individuals. Such will have financial advisors to render advice on investments far more complicated and expensive than the average person can afford. This book is aimed at the middle class person who cannot afford to pay $150 per hour to financial planners to invest $50 per week.

The only assured way to die wealthy is to save slowly. The investments discussed herein are not get-rich-quick schemes. There are a few sure means of getting rich but they are very hard to achieve with certainty such as winning a lottery or marrying a wealthy spouse. There is a line in an old Three Stooges movie where Curly opens a book entitled, "How to Make a Million." He reads, "How to make a million: find someone with two million and ask for half." If such advice works, it's great advice.

in this book. There are discussions on stocks, bonds, mutual funds, money market accounts, commodities, limited partnerships, annuities, and real estate investment trusts among others. Both benefits and risks attendant to each type of investment are discussed. There is no reason why a careful, prudent investor cannot develop a financial plan to accomplish steady, safe growth of an estate. It is toward that end that this book is directed.

CHAPTER 5

LIMITED PARTNERSHIPS

Limited partnerships are one of the most popular forms of investments. A limited partnership shares some of the characteristics of both a general partnership and a corporation. A limited partnership is neither a general partnership nor corporation. It also has certain investor drawbacks that neither of the above possess.

Investments in limited partnerships have resulted in a great deal of litigation over the propriety of the actions taken by the general partners. A true example of such was a California lawsuit for an accounting brought by some of the limited partners against the general partners concerning operation of a public golf course. The general partners had entered a special operating agreement with the golf course and received substantial benefits without disclosing that fact to the limited partners. After discovering the existence of the special operating agreement, the limited partners brought a lawsuit alleging that the arrangement violated the fiduciary duties of good faith and fair dealing which the

This chapter is dedicated to providing the basic information as to what limited partnerships are, how they operate and the role which a limited partner plays. People invest in limited partnerships to make money while not taking needless risks with their investments. This chapter is geared to explaining how limited partnerships operate so that the average person can understand the presentation of a person selling a limited partnership and be able to evaluate the true risks and rewards of the investment.

I. THE UNIFORM LIMITED PARTNERSHIP ACT

The National Conference of Commissioners on Uniform State Laws wrote the Uniform Limited Partnership Act (ULPA). Also created was the Revised Uniform Limited Partnership Act (RULPA). One of these acts has been adopted by every state except Louisiana. In addition, the Uniform Partnership Act applies to limited partnerships except where it is inconsistent with provisions of the ULPA or RULPA or state law.

The ULPA and RULPA provide the rules on how a limited partnership is to operate in situations not covered in the limited partnership agreement: the ULPA and RULPA fill the blanks of a limited partnership agreement. The partners can agree not to use

A partnership, whether general or limited, is two or more persons or entities working together as co-owners to run a business for profit. The Internal Revenue Code defines a partnership in Section 761(a) as:

> "A syndicate, pool, joint venture or other unincorporated organization through which...any business is carried on... and is not a corporation, trust, or an estate (meaning sole proprietorship)."

A partnership may be formed by either a written or an oral agreement. The determining factors as to whether a partnership exists are:

1. Whether the parties intended to form a partnership.
2. Whether the parties formed a de facto partnership without realizing it.
3. Whether they intended to make a profit from the activities.

Once the foundational elements of a partnership are met, the partnership is formed and governed by the terms of the written agreement and the state partnership acts.

Partnerships are treated for federal tax purposes as pass-

The effect of this pass through of profits and losses is that the partnership itself is not taxed. Partnership income is not subject to double taxation as is the income of a regular C corporation. To achieve this pass-through tax benefit for small corporations, Congress created the S corporation.

Under the 1986 Tax Reform Act profits and losses passing through to partners retain the same character they had in the partnership. A passive profit or loss to the partnership remains a passive profit or loss to the partner. The same treatment exists for an active profit or loss. A partner who materially participates in the partnership business will have all of the attributed profits and losses considered to be active. A partner who does not actively participate in the partnership business will have all of his share of profits and losses considered to be passive in nature.

A limited partnership is a legal entity which is a cross between a corporation and a regular partnership. A limited partnership has two types of partners: the general partners who run the partnership and the limited partners who are the investors. Unlike a regular partnership, the general partners are liable only for their agreed share of debts and liabilities of the limited specially created pursuant to each state's limited partnership laws.

A limited partnership must, at the least, have the following:

1. A written limited partnership agreement.
2. At least one general partner.
3. A provision in the written partnership agreement stating that the limited partners will have no management authority or control over operations of the partnership.
4. A Certificate of Limited Partnership or Registration Statement filed with the secretary of state or recorded in the county where the limited partnership does business in accordance with the requirements of state law.

It should be noted that operational losses pass thru to the limited partner just like profits do: dollar for dollar. This fact is what got many limited partners into trouble with the IRS. Limited partners were investing in tax shelters where they were able to deduct 2 to 5 times the losses of the amount they actually invested and had at risk. These are the requirements for all limited partnerships. Each state may have additional requirements that must be met in order for there to be a valid limited partnership.

ownership in the property. Likewise, property purchased with partnership funds is owned by the partnership.

The property held by a partnership can be legally sold, transferred or conveyed only by the partnership. Since partnership property is owned by the partnership, it cannot be directly attached to satisfy any court judgment taken against any partner, limited or general. A limited partner's ownership interest in a partnership can be attached and sold by a creditor but not the underlying property in the partnership. This is a very important aspect of partnership law.

An investor loses all individual rights in property contributed to a limited partnership. Assume a limited partner contributed a farm to the limited partnership worth $1,000,000 and is to receive $1,000,000 back upon termination. The limited partner has no legal right to request the return of the farm instead. In the same vein, creditors of the limited partner cannot sue the partnership for return of the farm. The rights of creditors of a limited partner against the partnership are limited to an attachment and sale of the partner's interest in the partnership, not a recovery of property contributed to the partnership. This

IV. POWERS OF A GENERAL PARTNER IN A LIMITED PARTNERSHIP

Under both the ULPA and the RULPA, a general partner of a limited partnership has all of the powers of a partner in a regular general partnership. All partners have certain basic rights in a general partnership. These rights are:

1. The right to insist on a partnership accounting and the right to have the books examined by an outside accountant.
2. The right to dissolve the partnership in accordance with the terms of the partnership agreement or, if none, the Uniform Partnership Act of the state.
3. The right to restrain the partnership from performing acts prohibited under the partnership agreement.
4. The right to bring a legal action for breach of the partnership agreement.

These are implied rights in any partnership agreement. Provisions in partnership agreements that waive such rights are usually found to be invalid and against public policy.

In addition to the regular partnership powers, a general partner is also held to hold a fiduciary duty to the limited

Likewise, a general partner is expected not to compete in business with the partnership. A general partner is expected not to do anything that a normal, reasonable person acting as a general partner would not do.

A general partner can be sued by limited partners for losses incurred by the general partner's breach of fiduciary duties. Limited partners can recover damages from a general partner whenever the partnership suffers losses because of the general partner's unreasonable actions.

V. ACTS REQUIRING CONSENT OF LIMITED PARTNERS

In a general partnership, each partner has full authority to act on the partnership's behalf in the normal course of its business. Each partner can bind both the partnership and the other partners to contracts even if the other partners never authorized or approved the contracts. This unlimited power on the part of one partner to bind the partnership and the other partners is the biggest concern of most investors. Partners may agree to limit their authority to bind the partnership or act on its behalf.

People dealing with a partnership are entitled to assume, unless informed otherwise, that any partner has the right and power lacked the authority to bind the partnership are binding on the partnership.

There are, however, some acts that a partner can never do unless the authority is specifically granted in a partnership agreement. Anyone is presumed to know that a valid contract cannot be executed unless the partnership agreement gives the partner specific authority to act in those areas. Unless the partnership agreement expressly states that a partner can do the following acts, the acts are invalid and not binding on the partnership under the Uniform Partnership Act:

1. Transfer a partner's interest to another.
2. Conveyance of partnership property.
3. Mortgaging of partnership property.
4. Confession of a judgment against the partnership.
5. Submission of a partnership claim to arbitration.
6. Any act that would make it impossible to carry on the business of the partnership.

Anyone dealing with a partnership should always ask to review the partnership agreement to assure himself that the partner executing the contract does indeed have the authority to do so.

is not permitted to participate in management and control of the partnership. To do so terminates the limited partner's protected status as a limited partner and turns the limited partnership interest into a general partnership interest.

Most states permit limited partners to participate in the following matters without losing their protected status:

1. Vote on the dissolution of the partnership.
2. Vote on the election or removal of general partners.
3. Vote on the admission of new limited partners.

A limited partner can, unlike a general partner, conduct a business in competition with the partnership unless prohibited by the partnership agreement.

VII. FIDUCIARY DUTY OF ALL PARTNERS

By law every partner, both general and limited, is an agent of the partnership. Each partner owes a fiduciary duty to the partnership and to the other partners to act in their best interests. Some of the important things that partners cannot do alone are:

1. A partner may not usurp a partnership benefit. This means that a partner must give the partnership the right of

bid on the job for himself without first informing the partnership of the job and giving the partnership the chance to take the job itself.

2. A partner may not divert partnership assets for the partner's own personal use. Such conduct is a breach of trust and may even expose the partner to criminal liability.

3. A partner must fully disclose all material facts of any business dealing affecting the partnership and its affairs to the other partners.

A partner who breaches any of these duties may be sued by the other partners for their lost profits or other damages suffered as a result of the partner's misconduct. Where the partner has usurped a partnership benefit (taken it for himself), the partner may be ordered to pay all of the profits realized from the transaction to the partnership on the theory that the partnership should have received those profits instead.

VIII. TERMINATION OF A LIMITED PARTNERSHIP

A limited partnership terminates when:

1. Its term of existence under the limited partnership

is used in the state). Such an act requires a new filing or recordation.

Unlike a general partnership, a limited partnership is not automatically dissolved upon the death, bankruptcy or withdrawal of a limited partner. On the other hand, the limited partnership is dissolved by operation of law upon the death, bankruptcy or withdrawal of a general partner unless the partnership agreement states otherwise.

After a partnership has been dissolved and its assets liquidated, the distribution of assets is made as follows to the extent of partnership assets:

1. All federal and state taxes are paid.
2. All employee wages and benefits are paid.
3. All secured liabilities are paid.
4. All unsecured liabilities are paid.
5. Remaining funds, if any, are divided among the partners in accordance with their percentage of ownership interest in the partnership.

The proceeds received by a partner in the dissolution of a partnership are a return of the partner's investment. Any gain or

The ULPA and RULPA require that a limited partnership file a registration statement with a governmental agency, usually the secretary of state. Connecticut requires that the registration statement be filed both with the secretary of state and the town clerk where the limited partnership does business. Some states, such as California, require a specific governmental form be used whereas other states permit the registration statement to be typed.

In addition to the filing requirement, some states require that the registration statement be published in a newspaper.

The purpose of filing a registration statement is to inform creditors of the existence of the limited partnership, thereby alerting the public. The filing requirement also makes it easier for governmental agencies to inspect a limited partnership for fraud or violations of state law. The information contained in it must be provided by the limited partnership in every state. All states require that most of the information below be provided in a registration statement for a limited partnership:

1. The partnership name.
2. The purpose of the partnership.
3. The location of the principal place of business.

9. The right to continue the partnership upon the death, withdrawal or bankruptcy of a general partner.

10. Whether new limited partners can be admitted.

Under both the ULPA and RULPA, a valid limited partnership will be found to exist "if there had been substantial compliance in good faith." If there are minor mistakes in the registration statement but it was filed in a good faith belief that it was accurate, the limited partnership is still valid. Every investor must verify that the registration statement is filed. If it is not filed, the limited partnership is not properly formed with the result that the investors will be treated as general partners for the purpose of sharing liability for the debts of the partnership. In other words, unless the registration is filed, the limited partnership does not legally exist and the limited partners have personal liability for the partnerships debts even though they may not be permitted to participate in the management of the partnership.

An amendment to the registration statement is required whenever any of the following acts occur:

1. The partnership name is changed.

2. The partnership business changes.

rights given do not terminate the limited partnership interest).

6. The amount changes or the character changes or limited partners' contributions change.

Any amendment to a registration must be signed by all the partners, not just the general partners.

X. LIMITED PARTNERS

Anyone can be a limited partner. Individuals, corporations, trusts, general partnerships, limited partnerships can all be limited partners in a limited partnership. Example: Abel Limited Partnership may be a limited partner along with Boxer Corporation and George Investor in the Ajax Limited Partnership.

Furthermore, a general partner may also be a limited partner in the same limited partnership. Although such a general partner is still liable for partnership debts, the limited partnership share of his investment is treated as a limited partnership contribution.

XI. TAXATION

A partnership is subject to its own peculiar tax treatment under federal tax law. Most unincorporated associations and trusts earns $1,000,000. It will pay no taxes. The partners will have to include the $1,000,000 on their tax returns. Assuming a 28% personal income federal tax rate, the partners will pay $280,000, not the total $519,200 that a C corporation and its shareholders must pay.

The partnership does not pay any taxes on the income from the partnership. All partnership profit or loss is passed through to the partners. The partnership files its Form 1165 partnership return and its K-1 to inform the IRS on the profit or loss allocation to each partner. Each partner is treated for tax purposes as a self-employed individual and is required to estimate his share of the partnership income and make estimated IRS quarterly payments.

Unless a limited partnership does business in a state which has no income tax (of which there are very few and getting fewer), it will have state tax laws with which it will have to comply. Limited partnerships are usually treated by the state tax codes in very nearly the same manner as they are treated by the Internal Revenue Code: as "pass-through vehicles" for the partnership. All profit or loss of the partnership "pass through" which mean that income). Individual state laws can vary from the federal tax law on specific items, but they are quite similar in concept.

XII. TAX DIFFERENCES BETWEEN A PARTNERSHIP AND A S CORPORATION

Partnerships provide more flexibility than S corporations in a few areas:

1. Partnerships may admit anyone as a partner and may have any number of partners. S corporations are limited to 35 members of special status.
2. Partnerships can divide profits and losses in a manner not related to the partners' ownership interest. S corporations must divide profits and losses among the shareholders in accordance with their percentage of stock ownership.

In most cases these differences are not important because the S corporation usually does not want additional shareholders and does want profit and loss allocated according to shareholder investment. The important difference between S corporations and partnerships is that there is no personal liability on the part of the shareholders for the corporation's debts. In comparison, general partners (but not the limited partners) are personally liable for the partnership

Securities and Exchange Commission (SEC). On the other hand, laws concerning sale of a limited partnership interest are quite different. The sale of a limited partnership interest, by contrast, is considered a security. Therefore before a limited partnership interest can be sold, it must be registered with the Securities and Exchange Commission unless the sale qualifies for an exemption from registration.

There are several exemptions from this Federal registration requirement which most small limited partnerships meet. The exemptions are:

1. An intra-state exemption under section 3(a)(1) of the Securities and Exchange Act. This is the most popular exemption for small companies. It is available where all the partners reside in the same state where the partnership is incorporated and doing business.
2. The sale of the partnership interest is a non-public offering under section 4(2) to sophisticated investors, and no advertisement or solicitation was done.
3. The sale complied with Regulation D requirements of the SEC. This exemption requires adherence to strict

interests in every state that it intends to sell or be exempt from registration under a state's law. No person should ever invest in a limited partnership without first being assured that the limited partnership has complied with all registration requirements or is exempt from registration. The potential investor should ask to see all information proving that a permit or exemption was issued for the sale of the interests. If an exemption is being claimed to avoid a registration, the investor should ask to see an opinion letter from an attorney that the exemption is truly available for the limited partnership.

XIV. COMPLIANCE WITH STATE SECURITY LAW

All states require that limited partnerships selling their interests in the state either have a permit to sell the partnership interest or that the sale fall into one of the state's statutory exemptions. Just as with the SEC, all states have some type of exemption for registration of securities. Usually, a partnership of less than 35 partners, as in California and Nevada, can simply sell the limited partnership interests and notify the secretary of state or record a certificate of limited partnership. The recordation gives notice that such limited partnership however, makes that determination on a case-by-case basis depending on the degree of control that the general partners actually exert over the partnership.

It is important that every investor verify that a state permit or that a valid exemption exists. If the state department of corporations or security department determines that the partnership does not qualify for an exemption, it will issue a cease and desist order. This is an immediate administrative order to stop selling the partnership interests and return all monies collected. Since most businesses, in such a situation, have already spent the money, they are forced to close and default on repaying the investors. Regulators do make mistakes, but they, unlike the poor citizens, have government immunity to protect them from the damages their results cause. In one of the most important security cases in California history, William Moreland vs. Department of Corporations, (1987) 194 Cal.App.3d.506, the plaintiff sold gold ore along with a contract to refine it once a refinery was built. The California Department of Corporations concluded the transaction was a security and issued a cease-and-desist order. There never was a question of fraud. In fact, the government's own assays showed months and was, eventually, forced to file for bankruptcy. Although he ultimately won the case, both the plaintiff and his investors had suffered millions of dollars in needless losses because of the agency's misinterpretation of the security laws. The plaintiff could not sue the state for his damages suffered as a result of the improperly issued cease and desist order because of state immunity. The irony is that the investors, whom the government was supposed to protect, also suffered because their investments were adversely affected by the client being wrongly forced out of business. The holding of this case has helped to develop California's security law and actually served as a basis for a CBS "60 MINUTES".

CHAPTER 6

STOCKS

Stocks are the title instruments of ownership of a corporation. A corporation issues a fixed number of shares in itself. These shares divide the ownership of a corporation among the shareholders. The shares are called stock. Control of the corporation is determined by the will of those who own a sufficient total number of the shares of stock which have been sold.

Stocks have always been a primary focus of investment. In exchange for purchasing their stock, investors become shareholders and get the right to share in the net profit of the corporation each year. The profit is paid in the form of dividends. Particularly successful companies may, in addition to a yearly dividend, see a steady increase in the value of their stock.

The price of a stock is governed by three important factors: yearly productivity of the company, net asset value and public perception of the company. Yearly productivity is the performance of the company itself. Net asset value of the company is the value of the company after all debts have been paid. By dividing net belief that the company will make more money in the future. Many companies pay excessive dividends rather than reinvest in the company. Consequently, yearly productivity is high but net asset value is low, and public perception is high because of the high dividends. On the other hand, many companies with low productivity but the possibility of great potential have high stock prices. For example, the company Genetech was the first company in the private sector to engage in genetic research. Genetech's stock prices have been very high despite relativity low productivity. However, given the recent accomplishments of the company, the patience of its investors is predicted to be amply rewarded.

I. STOCK EXCHANGES

The stock of public companies is sold through one of thirteen stock exchanges in the United States. The two largest and most recognized exchanges are the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). The stock exchanges have sold the right to use the exchange to purchase and sell stock to member stock brokerages such as Paine Webber, Prudential-Bache, Merrill Lynch, Sherson-Lehman and others. This right to trade on an exchange is called "having a seat." A stock exchange has

Besides the more traditional stock exchange, there is also the "over the counter" (OTC) market. Companies which cannot or do not want to be traded on the major stock exchanges can sell their stock over the counter (OTC). Many of the major corporations are traded over the counter. Over the counter trading is conducted through NASDAQ which is a computerized network system rather than the trading floor arrangement utilized by the exchanges. The stock of start-up companies will usually be sold on the OTC market because these companies do not qualify for the major exchanges.

II. CHOOSING A STOCK BROKERAGE

There are two types of stock brokerages: full-service brokerage and discount brokerage. Full-service brokerage provides investment advice while the discount broker merely buys and sells the stock as the client orders. There is a large difference in price. A full-service broker charges a fee of 6% of the value of the transaction on every purchase or sale for a client's account. On the other hand, the discount broker usually charges less than one-half percent. The difference in price is because the discount brokerage has reduced overhead: it does not have to maintain a research department.

investors, even though nearly 70% of all stock is purchased by small investors.

When stock is purchased, the buyer has two options available. The buyer can leave the stock in the brokerage's possession which is called "leaving the stock in its street's name." The brokerage holds the stock as trustee for the client. By holding the stock the broker can sell the stock quickly when requested, and the company does not have to print a new stock certificate with the purchaser's name on it. The other option available to a purchaser is to take possession of the actual stock certificate representing the number of shares which were purchased. The broker notifies the company to issue a new stock certificate in the owner's name.

These two types of brokerages offer a couple of interesting options to an investor. One option is to have both a full-service and a discount brokerage. When advice is required, purchase some stock from the full-service broker out of a sense of obligation but purchase the majority of stock from the discount broker. There is no requirement to purchase any stock from the full-service broker, but he will respond better if he is rewarded for his effort. Invest with the full-service broker just enough shares to the same time, a relationship will still exist with the broker from whom the stock was originally purchased.

Regardless of the type of brokerage house used, it should be guaranteed by the Securities Investor Protection Corporation (SIPC). This means that the accounts with the brokerage house are insured by a government-sponsored agency for $50,000 or less in the event the broker goes out of business. Given the fact that several brokerages have experienced financial troubles in the last few years, it makes no sense to keep any stock over the insured amount with a brokerage. The investor can split investments among several brokerages or take possession of the securities. If the investor intends to keep the stock for many years, it probably would be better to take possession of the stock. By the time the stock is actually sold the broker who originally purchased it may no longer with the company.

III. SOURCES OF INVESTMENT ADVICE

In the last ten years, there has been an explosion of easy-to-use investment advice regarding investments. Every major newspaper lists the daily trades of stock traded on the public exchanges. There are literally hundreds of advisory services available to the usually obtain sufficient information to determine whether to invest. Most public libraries and almost all college libraries have business sections containing such treatises.

There are hundreds of investment newsletters along with financial newspapers such as the "Wall Street Journal" and "Barron's." The most beneficial source of financial information is probably television. Public television carries the financial show "The Nightly Business Report" that is the finest financial show of its type. No serious investor should make a decision without first becoming familiar with the working of the financial world. "The Nightly Business Report" gives better long-term investment advice than probably any brokerage. Its guests are usually the top analysts for the major brokerages; so the viewing audience gets the best and most direct access to the best financial minds.

IV. TYPES OF STOCK

A company may issue two types of stock: common stock or preferred stock. Common stock is, as the name implies, ordinary stock with all the normal incidence of ownership such as the right to vote and the right to receive ordinary dividends. Preferred stock is stock with special rights. Preferred stock is usually fixed dividend regardless of whether the company makes money or not. On the other hand, a common shareholder will receive a dividend only if the company makes money, and the amount of the dividend is not guaranteed. If there is not enough profit to pay the preferred dividends, the obligation to pay remains in arrears until there is sufficient profit. No dividends will be paid common shareholders until all arrearages for the preferred dividends are paid. The dividend rate for preferred stock does not change. No matter how the company's earnings change, the preferred rate does not change. Sometimes, this works to the investor's disadvantage. In a very successful company the common shareholders will earn more in dividends than the preferred shareholders. Such is usually not the case. In most instances the preferred shareholders receive a greater return than the common shareholders.

In addition to a guaranteed dividend many preferred stocks carry with them the right to be converted into common stock at an agreed conversion rate. These preferred stocks have the best of both worlds. As long as the dividend rate is greater than the company common dividend rate, the shareholder will hold the stock as preferred. When the dividend rate for common stock is greater

A kissing cousin of a share of stock is a stock option. This "option" is the right to buy or sell stock at a certain price. Option trading is simple in concept but tricky in application. With the assistance of an exceptional broker an investor can make the proverbial killing. With a less than exceptional broker the investor will be killed, gutted, stuffed and mounted.

Options work by the investor purchasing from another person the right to buy or the right to sell a certain amount of a company's stock for a designated price, called the "strike price," on or before a specified date. If the option is not exercised by a specified date, it lapses. In the parlance of the industry an option to buy stock at a certain price is called a "call" option while an option to sell stock at a certain price is called a "put" option.

The following is an example of a call option. The stock of Gabriel Petroleum is selling for $10 per share. The investor thinks that the stock might go to $15 per share. The investor can buy a call option for $1 per share to purchase the stock at the price of $10 per share by December 31. The investor purchases 5,000 options for the price of $5,000. On October 13, the price of the stock has sufficient money to exercise the option, he can go to the bank and pledge the option as security for a loan. The bank will loan on such an option contract and be paid immediately from the proceeds from the exercise of the option. If the price of the stock does not rise, then the investor will lose his entire $5,000 investment in the options.

A sell option, called a "put," is the reverse of a call option: a person agrees to purchase stock from the investor at a certain price before the exercise date. A put option works when the investor believes that the stock will go down in value. The investor will make money on the difference between the strike price and the actual drop in value. The following is an example of a put option. Gabriel Petroleum stock is selling for $10 per share. The investor believes that the stock will go down in value. The investor buys a put for $1 per share for 10,000 shares at the price of $8 per share by December 31. The stock drops to $6 per share. At $6 per share, the investor buys 10,000 shares for $60,000. The investor then exercises the option and forces the person bound by the put to purchase the 10,000 shares at $80,000 ($8 per share). The profit is $10,000 ($20,000 difference in price minus the option appropriate option. Options can also be used to insure stock from an excessive drop in price. For example, an investor owns 10,000 shares of Gabriel Petroleum at $10. The value of the stock is $100,000 (10,000 shares times $10 per share). The investor buys an $8 per share put for $1 per share. The price falls to $6 per share. The stock is now only worth $60,000 (a loss of $40,000 in value). The investor can exercise the put and force the sale of the stock for $80,000. In such an event the true loss would be $30,000 ($20,000 loss in value plus $10,000 put cost). A put option to cover stock already owned is called a "covered option." In contrast a put option covering stock which is not owned is called a "naked option."

Options can exist for any length of time up to nine months. The majority of options are written for three, six or nine months to correspond to the quarters of a fiscal year. Every option is required to contain a specific expiration date and a specific price upon which a fixed quantity of shares of stock can be purchased. The real advantage of options as investment vehicles is that they offer persons without sufficient resources the ability to speculate to a much greater degree. By purchasing options investors can a gamble concerning the market price direction a stock will take. A wrong guess or a move not as sufficient as anticipated will result in loss of the option payment. A correct guess, on the other hand, means profit.

VI. MARGIN TRADING

To make huge profits in the stock market, a person must own a large number of shares. As mentioned before, one way to obtain those shares is through an option. An option, however, must be renewed, or it terminates on the expiration date. An investor may have to renew an option as often as four times per year. This could result in a large outlay of cash just to maintain the option, reducing the profit of the transaction. One alternative to the use of an option is for the investor to control stock which he cannot afford: through margin trading.

Margin trading is basically the purchase of stock on credit through a stock broker. As with most purchases on credit, an investor pays some money and borrows the remainder from the brokerage house. The Federal Reserve Board regulates the amount of money which a person must place on a margin account. The amount required to be placed on margin accounts has been as high as 65%.

millionaires. When the crash hit, margin calls (demands for additional payments on the loans) were made. When the demands were not satisfied, the stocks in the margin accounts were sold and the accounts liquidated. Millions of people were suddenly rendered destitute. The Federal Reserve Board has been charged with implementing procedures to ensure that such unrestricted margin trading does not occur again.

Margin trading works by increasing the number of shares which an investor controls. As long as the stock increases in value there is no problem. The investor borrows the amount needed to cover the loan. The broker waits until redemption of the stock in order to get paid. If the stock falls below an agreed value, the broker is authorized to make an immediate demand for additional payment or to sell the stock to cover its loan.

As an example of margin trading, assume that an investor wishes to purchase 10,000 shares of Gabriel Petroleum at $10 per share. The investor may have only $62,000. The Federal Reserve set the margin figure at 50%. The broker will lend the investor $40,000 on the condition that the investor's equity in the stock will always be $50,000. The stock later drops to $8 per share. The commission, and the remainder will be paid to the investor: a substantial loss for the investor.

The advantage is just the opposite. Because the stock is purchased on margin, the investor can purchase more shares and thus realize greater profits when the stock moves higher in value. For example, if the margin requirements are 50%, the investor can purchase twice as much stock on margin and realize twice as much profit when the stock increases in value.

VII. SHORT SELLING

Another means of trading in stock which a person doesn't own is through the technique of short selling. As with a put, short selling is based on an educated gamble that the stock price will go down. When stock is sold short, the seller sells stock which he does not own, a neat trick only permitted in security sales through a broker. It works because the stock is borrowed from the broker. When the price goes down, the investor purchases replacement stock and gives it to the broker. The investor realizes a profit between the price of the stock at sale and the price of the replacement.

An example of short selling: An investor sells 10,000 shares of Gabriel Petroleum through a broker for $10 per share. The and gives them to the broker. The investor then takes the $20,000 profit minus the broker's commission.

The downside is obvious. If the stock does not fall or, heaven forbid, actually rises, the investor will suffer severe economic hardship. In the above example, if the stock rose $2 per share instead of falling, the investor would have to pay $20,000 more plus commissions to cover the short sale.

CHAPTER 7

BONDS AND GOVERNMENT SECURITIES

Two related types of investments are bonds and government securities. This chapter will focus on the similarities and the differences of these types of investments. Such investments should only be undertaken after careful consideration of many factors. No one should ever assume that a bond is safe because it is from a major corporation or guaranteed by a state. Nothing in life is guaranteed except death and taxes. A prudent investor never forgets this truism.

I. BONDS

A bond is an instrument of debt. It is a debt instrument wherein the buyer of the bond lends money to the issuer of the bond in an amount equal to the face value of the bond. The bond issuer is usually a corporation or a government entity. The issuer makes payments equal to the interest rate specified in the bond for the period of time covered by the bond. Upon reaching the maturity date of the bond, the issuer pays the entire principal (face value) of the bond. The payments of the interest are sometimes called

Bonds are issued primarily by the government and large corporations. Bonds offer a greater sense of security than a private loan with individuals. The only situation where a bond holder is not paid occurs when the issuer becomes insolvent or bankrupt. This highlights the need to be ever vigilant when investing money. In recent years there have been few failures of large companies. Even fewer have failed who had good credit ratings. Furthermore, it is often possible to check a corporation's financial circumstances prior to investing.

Many bonds have a "call-back" feature that permits the issuer to repurchase them prior to maturity if the interest rates fall. The reason for this is that the issuer would not want to have to pay higher interest rates than necessary for the loan. The call-back feature is similar to a person's right to refinance a house if interest rates fall.

Bonds are bought and sold on the market like any other security. The individual market for bonds price rises and falls as their value rises and falls. Their value is determined by their worth to an investor compared to other securities. Simply speaking, an investor with $50,000 cash will buy what he believes to capital gains tax. If a bond is sold for a profit, the amount of the profit is subject to capital gains tax. On the other hand, if the bond is sold at a loss, the amount of the loss is subject to capital loss provisions of the Internal Revenue Code.

III. FEDERAL BONDS

The federal government, in order to operate with its ever-increasing federal deficit, must sell bonds to supplement the shortfall from taxes. Congressmen never consider reducing pork barrel handouts to lessen dependency on federal bonds. A few years back, there was trade tension with Japan. The U.S. wanted Japan to open its markets to American manufacturers. When members of Congress suggested trade sanctions, Japan announced that no American federal bonds would be sold in Japan. When Japan stopped purchasing federal bonds, a minor financial crisis ensued. Japan and the U.S. government quickly reached an agreement. American financial policy revolves around the U.S. being able to sell its bonds. The primary customers for American bonds besides Japan are the large institutional investors, such as pension plans and mutual funds.

The federal bonds with which most are familiar are the famous

Federal bonds have a long term: between 10 and 30 years. Only federal bonds with terms of 30 years have a call-back option, and that option can be exercised only after the bond is 25 years old. This means that the government cannot issue an early call-back of the bond if interest rates fall. When the T-Bond is purchased in a period of high inflation, the government is locked into that rate even though the general interest may subsequently fall.

Interest on T-Bonds is paid every six months. The interest on T-Bonds is not exempt from federal taxes, but it is exempt from state and local taxes. The exemption from state taxes is an important benefit when the purchaser resides in a high tax state such as California. T-Bonds can be purchased in various blocks of $1,000, $5,000, $100,000 and $1 million dollars.

T-Bonds are issued in one of two ways, as either registered or bearer bonds. A registered T-Bond has the buyer's name on the T-Bond. To sell a registered T-Bond the buyer must send the old bond to the Treasury to have it canceled and a new one issued. A bearer T-Bond has no name on it and is treated like cash. Any person having possession of a bearer T-Bond is presumed to be the owner.

reimbursement. When a bond is registered, the owner can also elect to have the interest registered. The check for interest is sent directly to the registered owner of the T-Bond. This is usually what is done with registered T-Bonds. If the owner of registered T-Bonds does not elect to have the interest payments registered, the bond will be issued with coupons, and the interest payments will be paid the same as interest with bearer bonds.

Savings bonds are the type of bond most familiar to the small investor. Savings bonds are sold in denominations ranging from $50 to $10,000. Such bonds first appeared during World War II and have been sold ever since. In the 1970's a new version of savings bond, the series EE, was introduced. Unlike other federal bonds, the interest rate on the series EE bond has a variable yield. The yield is adjusted every six months to equal the current yield on five-year Treasury notes. The Treasury also guarantees that the interest on series EE bonds will never drop below 6% provided the bonds are held for at least 5 years.

The interest of EE bonds is not paid to the buyer by installments. Instead, the interest accumulates until the bond matures. Upon maturity the principal is paid with the accumulated of the interest on the bonds will be taxed to the child and not the parents. The child will usually pay taxes at the lowest tax rate, rather than at the parent's rate which could reach 33%. This would be a substantial savings. Persons holding EE bonds can exchange them in increments of $500 for class HH savings bonds. Class HH bonds pay annual interest at a rate of 6% per year payable semiannually.

IV. MUNICIPAL BONDS

As does the federal government, state and local governments also issue bonds to raise operating capital. The appeal of municipal bonds is that the interest on state and local government obligations is generally tax exempt. This includes obligations of a state or one of its political subdivisions, the District of Columbia, a possession of the United States, or one of its political subdivisions used to finance governmental operations. This includes interest on certain obligations issued after 1982 by Indian tribal governments recognized by the Secretary of the Treasury as having the right to exercise such sovereign powers.

Interest on arbitrage bonds issued by state and local governments after October 9, 1969 and interest on private activity must be reported on the taxpayer's return: this is an information reporting requirement.

Tax-exempt bonds are one of the few tax avoidance vehicles still available. A tax-exempt bond is a special bond issued by a federal, state or municipal agency that is free of federal and in some cases state income tax. Because the bonds are issued by the government, they are secure: a stable investment.

Before anyone invests in tax-free bonds, however, he should determine the amount of any alternative minimum tax. Municipal bonds interest is a tax preference item for federal tax purposes. This means that a person who shelters income may still have to pay an alternative minimum tax on a portion of the municipal bond interest. Most investors need not be concerned with the alternative minimum tax. The exemption for the tax is $40,000 for a joint return, $30,000 for single returns and $20,000 for married persons filing separately.

Tax-exempt bonds pay less interest than regular bonds. The advantage of the tax-free bonds over most regular bonds is that the amount of total income after taxes is greater. The following is a chart of the interest a taxpayer would have to be paid on a regular

15%	4.74%	5.88%	7.06%	8.24%	9.41%	10.59%	11.77%
28%	5.56%	6.94%	8.33%	9.72%	11.11%	12.59%	13.89%
31%	5.80%	7.25%	8.70%	10.14%	11.59%	13.04%	14.49%

Municipal bonds are a major source of revenue for state and local governments. As shown above, corporate bonds have to pay a higher interest than municipal bonds for an investor to obtain the same after-tax benefit. The Tax Reform Act of 1986 reduced the types of municipal bonds that can be federally tax exempt. Prior to the 1986 Act all municipal bonds were tax exempt. Now as a result of the 1986 act, the following municipal bonds are taxable or exempt according to their uses.

1. Those municipal bonds issued for government construction purposes (roads, schools, dams, etc.) and that finance regular government operations are exempt.

2. Those municipal bonds that are issued to pay for a particular municipal project or program (such as student loans or industrial development) are exempt for regular tax purposes, but the income is included in calculating any alternative tax liability.

3. Those municipal bonds issued to pay for non-governmental

attraction in that no premature call is allowed for at least 10 years. This means that the investor can still receive the higher interest even in a time of falling interest rates.

V. PURCHASING MUNICIPAL BONDS

There are 6 different ways a person can invest in municipal bonds. Each method has its own advantages and disadvantages:

1. Individual Bonds
2. Open End Municipal Funds
3. Closed End Municipal Funds
4. Unit Investment Trusts
5. Single State Municipal Funds
6. National Exempt Funds

A. PURCHASE OF INDIVIDUAL BONDS

The simplest means of investing in municipal bonds is simply to purchase the individual bonds. By holding the bonds until maturity the investor will not have to be concerned with interest rate changes and will always know what is owned. There is no management fee to be assessed against the bond as there is when a share in a mutual fund which invests in municipal bonds is purchased. Bonds can be purchased with remaining times on their sold in units of $5,000 each. In addition to the large cash outlay the investor must still be concerned with the selection of the bond. The investor should determine if and at what price the bond can be redeemed before maturity. The investor should know the annual yield.

Most important! The investor should ascertain if the bond will be repaid from the general revenue of the government (i.e. taxes) or from revenue from a specific project, such as income from a nuclear power plant. The source of payment is important. If repayment is not from the general revenue but is directly from a project's income, the bond may not be repaid if a project fails.

B. OPEN-END MUNICIPAL FUNDS

Municipal funds are mutual funds which invest solely in municipal and government bonds. The municipal funds may invest in both taxable and tax-free bonds or may limit themselves to just taxable or tax-free bonds. Mutual funds are discussed in detail in another chapter. Briefly, a municipal fund is a pooled investment. New shares are issued as money is invested in the fund. The fund can continue to receive investment throughout its existence, and for that reason it is called an open-end fund. The investor

Municipal funds permit investors to purchase interests in municipal bonds with small investments. Initial investment in a municipal fund may be as low as $250. An investor wishing to build capital rather than receive income can elect to reinvest dividends and capital gains into new additional shares automatically. Municipal funds have a professional management staff and charge an average of .86% of the fund's assets each year as a management fee. Municipal funds may be sold on a load basis (with a commission fee) or on a no-load basis (without a commission).

C. CLOSED-END MUNICIPAL FUNDS

Closed-end municipal funds are like any other closed-end mutual fund: they initially offer only a fixed number of shares, and thereafter these shares are traded like any other stock. Like any municipal funds, they invest in municipal and government obligations. Closed-end funds trade either at a discount to their net asset value or at a premium (higher than their NAV). No investor should purchase the initial offering of a closed-end fund: as much as 8% of the purchase will go to the underwriting fee and not into the purchase of assets.

Usually closed-end municipal funds are not the best way to

The first bond funds were the Unit Investment Trusts (UITs) that appeared in 1961. UITs, as with closed end funds, have a fixed number of shares. Units in the UITs are purchased from brokers for about $1,000 per unit. The fund uses the investment to buy municipal and government bonds. Investors in UITs collect regular interest payments until the bonds in the UIT mature and members are paid off.

The main advantage of UITs is that there is no active management; therefore no annual management fee. In addition, the investors know with certainty when their investment will be returned (the maturity date of the bonds). For that reason UITs tend to perform better than single-state funds by .6% annually. UITs have a sales charge of 2% to 5%. The units can be resold to the issuer at any time for net asset value. Prospecti for UITs can be obtained from brokers. The largest UITs are managed by Nuveen and Van Kampen Merritt.

E. SINGLE STATE MUNICIPAL FUNDS

Some municipal funds limit themselves to the municipal and governmental obligations of one state. The purpose for having a municipal fund limited to one state's obligations is to give the

The advantage of the state tax exemption has a downside: its diversification is limited to bonds in the state. Many single state funds invest primarily in long-term bonds, which are a good investment in times of steady or dropping interest rates. If interest rates rise, however, as is feared with the Clinton economic plan, long-term bond prices will fall. A hedge against rising interest rates is to invest in intermediate single-state funds. These generally offer only about 80% of the return of the long-term bond funds. On the other hand they carry only about 60% of the risk of loss should interest rates rise sharply because they have few or no long-term obligations. Single-state bonds can be purchased as open-end funds, closed-end funds, UITs and individual bonds. The number of single-state muni funds has grown dramatically. In 1991 there were 400 such funds with $67 Billion in assets. In June 1993 the number had grown to 655 with $81 Billion in assets.

F. NATIONAL EXEMPT FUNDS

The alternative to single-state funds is multi-state funds. Many investors will find they fare just as well or even better with a top- performing national muni fund. Many investors so hate just one state whereas the national muni-fund can choose from throughout the United States.

TOP PERFORMING MUNICIPAL FUNDS

The following table lists some of the top performing no-load municipal funds through 1992:

Single State Municipal Funds

FUND	TOTAL RETURN Jan 1, 1987 to Jan 1, 1992	AVERAGE 1992 YIELD
Vanguard New York Insured	62.50%	5.95%
Scudder California Tax Free	61.80%	5.34%
Safeco California Tax Free	61.19%	5.70%
Scudder New York Tax Free	60.32%	5.33%
Dreyfus New York Intermediate		5.48%
Boston Co. Tax-Free California		5.28%

National Municipal Bonds

FUND	TOTAL RETURN Jan 1, 1987 to Jan 1, 1992	AVERAGE 1992 YIELD
Dreyfus General Municipal Bond	70.13%	6.55%
Financial Tax-Free Income	68.53%	5.60%
United Municipal High Income	59.50%	6.36%
Vanguard Municipal Bond	58.35%	5.65%
Intermediate-Term Portfolio		
USAA Tax-Exempt Intermediate Term	52.77%	5.92%
Eaton Vance National Muni	51.50%	6.57%
Putnam Tax-Free High Yield	53.51%	5.97%

VI. BOND INSURANCE

than 1% of all municipal funds. Recently, however, many local and state governments have experienced economic hardship. In fact, Standard and Poor's down-graded more municipal funds than it upgraded in 1993.

Purchasers of an insured bond will give up between 15 and 35 basis points (.15% to .35% of the yield) depending on the quality of the bond. The result of this is that an investor purchasing a high-quality, 10-year insured bond would accept a yield of 5% rather than 5.15% for an uninsured bond.

The investor is not, in fact, giving up much interest when purchasing insured bonds. Insured bonds are of the highest grade: they have the least risk of default. More than one-third of municipal bonds issued in 1992 were insured. Insured bonds are most popular with investors who choose their own purchases without the aid of brokers or financial planners. Another advantage that insured bonds have over uninsured bonds is greater liquidity: an investor wishing to sell a municipal bond prior to maturity will find a better market for an insured bond than an uninsured bond.

Insurance doesn't protect the investor from a decline in value of the bond due to rising interest rates. As interest rates rise, investor from an early recall of its bond by the issuer if interest rates decline.

VII. CORPORATE BOND

Corporate bonds are similar to government bonds except they are issued by corporations. They are not in any way, shape or form tax-exempt. Because corporate bonds are not tax-exempt, they must pay more interest than tax-free bonds in order to generate the same after-tax return for the investor. Moreover, they are not insured against a risk of loss. Some bonds, however, are collateralized by hard assets, thereby being more secure than bonds that depend only on the financial success of the company.

A corporation, no matter how large, may fail because of a downturn in the economy or a sudden surge of lawsuits for some past activity. A case in point could be the tobacco industry. If people suddenly begin succeeding in their lawsuits against cigarette companies for causing cancer, the companies will be rendered bankrupt virtually overnight. Such a scenario, of course, has not happened yet.

Since the value of corporate bonds is directly related to the strength of the company, it is an absolute requirement for the on a bond, the risk of the company defaulting on the interest payment rises considerably: the lower the rating, the greater the risk. The average investor should not invest in bonds below AA unless he is gambling. Bonds with ratings lower than A are often called "Junk Bonds."

Corporate bonds also carry with them the real threat of a premature call. Unlike government bonds, corporate bonds usually do not have a restriction preventing their recall for a certain period of time. In prolonged periods of low interest companies routinely recall their high interest bonds and refinance with lower yielding bonds. Corporate bonds are more volatile and more actively traded than government bonds. Their higher interest (than government bonds) engenders in corporate bonds a chance of greater capital gain, which is the reason for the investment in the first place.

VIII. ADVICE

Bonds are not ownership interests in the company issuing the bonds. Bonds are best described as loans: the holders of the bonds are creditors of the company. Bondholders therefore will be paid before shareholders in the event that the company is ever

An investor must balance the two needs of profit and security when deciding to invest. Generally, municipal bonds are a better investment than corporate bonds for a working person. A working person normally is in a middle or high tax bracket and his income from corporate bonds is subject to substantial taxes. A retired person, however, with little earned income, usually is in a low tax bracket. For him, corporate-bond-interest taxes may be of negligible impact and, as such, it might make better financial sense to invest in taxable bonds rather than tax-free bonds.

IX. T-BILLS

Besides T-Bonds, the U.S. Treasury raises money for the federal government through the sales of T-Notes and the more common T-Bill. Treasury Bills, known as T-Bills, are short-term obligations of the federal government. They are bought as follows: $10,000 for the first T-Bill and increments of $5,000 thereafter. T-Bills mature in varying lengths of time from three months to a year. The attraction of T-Bills lies in the fact that they are safe, exempt from state taxes and totally liquid: they can be sold easily and quickly. T-Bills do not pay interest through coupons; they are treated similarly to savings bonds. The face value of the

Treasury will sell newly issued three- or six-month T-Bills at a weekly auction. T-Bills maturing in one year are sold at auction once per month. An investor can purchase T-Bills by directly bidding at the auction, an unlikely prospect, or purchasing it through a broker or a bank. When purchasing a T-Bill through a broker, the investor places a "noncompetitive" bid: the average market rate for the T-Bills at that auction. The noncompetitive bid price is no discount or bargain. At the same time the buyer is not gouged by the sales price.

In addition to new T-Bills, there is a market for the purchase and sale of unmatured T-Bills. The price for the purchase of such outstanding T-Bills depends both on their interest rate and time of maturity. A person can submit a noncompetitive bid for any amount less than $500,000 as long as it is in increments of $5,000 and the minimum bid is $10,000. The price paid for the T-Bill will be the average of all the successful bidders at the auction. To submit a noncompetitive bid, a person submits Treasury form "Tender for Treasury Bills" and a cashier's or certified check in the amount of the Treasury Bill sought to be purchased. The Federal Reserve Bank will return the unused balance of the check to the purchaser, request that the proceeds of a matured T-Bill automatically be rolled into new T-Bills through noncompetitive bidding on the tender form. The Treasury will honor this automatic rollover feature only on the first maturity. Each subsequent rollover will require the filing of a specific request which can be obtained from a Federal Reserve Bank. A person requesting a "Tender for Treasury Bills" can get one from the Federal Reserve Bank in Washington, D.C. 20551, (202) 452-3000 or Columbus, Ohio 43216, (614) 846-7050.

T-Bills are not for the average investor. The $10,000 minimum investment is rather high. In addition, T-Bills have a restriction on them that the seller may not resell the T-Bills within 20 days of purchase or 20 days of maturity. On a 90-day T-Bill, this means that the investor has only 50 days to sell the T-Bill in the event his personal or financial circumstances change. Moreover, if the T-Bill is purchased through a broker or bank, the commission fee further decreases the profit of the T-Bill.

X. T-NOTES

The last major investment option of the Treasury Department is the Treasury Note known as the "T-Note." Unlike T-Bills, which mature in terms of a year or less , T-Notes are federal obligations

T-Notes have a significant advantage over T-Bills in that they are sold in smaller lots. T-Notes maturing in less than five years are sold in $5,000 increments. T-Notes maturing more than five years are sold in lots of $1,000. The interest that is paid on T-Notes is usually a little higher than for T-Bills and is paid every six months to the owner until maturity. Interest on T-Notes and T-Bills is subject to federal taxation but exempt from state taxes. T-Notes do not have a call feature: Treasury cannot force a redemption when interest rates fall.

XI. OTHER GOVERNMENT SECURITIES

Besides the U.S. Treasury, there are other federal agencies which issue securities and notes. Some of these agencies are the Federal Home Loan Bank, the Federal National Mortgage Association (FNMA, called "Fanny Mae"), and the Government National Mortgage Association (GNMA, called "Ginny Mae"), among others. A list of such bond issuers can usually be found in the Wall Street Journal or another financial source.

These other government agencies usually offer about 1/2% to 1% higher interest rates than the Treasury. The big difference is that not all of these agencies have the backing (insurance

CHAPTER 8

ANNUITIES

I. INTRODUCTION

Avoidance or deferral of taxes should be the cornerstone of estate and financial plans. The Government, both state and federal, have announced sweeping new taxes in order to pay for their projects. The money to finance the ever-widening sphere of government involvement can only come from the taxpayers. The only people who receive government benefits for free are the poor. Everyone else subsidizes those benefits through their taxes.

There is nothing wrong in a person wishing to keep as much income as he can as long as he does so in a legal manner. It has always been the tenet of American taxation that no person can be forced to pay any more taxes than he is legally required to pay. A person can legally reduce his tax obligations and provide for a better retirement by financial planning. This chapter deals with one method of retirement planning: tax deferred annuities.

A tax-deferred annuity, also called a deferred annuity and often just an annuity, acts substantially like a pension plan. Actually, it is an insurance policy. The general concept of an for the rest of his life. In some annuities the payments are continued for the life of the surviving spouse. Upon the death of the insured, or in some cases also the insured's spouse, the annuity terminates. No payments under an annuity are made to the family of the insured upon the death of the insured person or spouse.

A company's rate for an annuity is based on the life expectancy of the insured. All insurance companies have actuarial tables which compute the average life expectancy for a variety of individuals. These tables have proven so accurate that the IRS has used them to develop their own tables for valuing gifts with retained interests. Using these tables, insurance companies have set their rates based on the probability of having to make payments and the likelihood of making a profit from the policy. Simply, an insurance company charges the lowest premiums for those it feels are most likely to die before or soon after payoff starts. Premiums rise in a sliding scale to keep pace with greater likelihood that the insurance company will have to pay more in benefits. In short, the insurance company makes money if the insured dies early, and the insured makes money if he lives a long time.

which will pay a fixed and certain amount upon maturity is not influenced by changes in the rate of inflation; it is called a fixed annuity. The payments of a fixed annuity will not be increased by inflation during the period prior to maturity. Consequently, the payments received upon maturity may not be adequate to meet the insured's needs.

A variable annuity is an annuity in which the benefits paid to the insured are based on an interest rate which will vary throughout the term of growth of the annuity, thereby responding to changes in the rate of inflation: as inflation rises so does the interest rate on the annuity. There is a chance with a variable annuity that the economy would enter a period of severe deflation and the interest rate used in the annuity would go down. That is a risk, but given the past six decades since the Great Depression, such a period of deflation would appear unlikely.

Variable annuities give the insured the right to cash the annuity at any time, subject only to an early withdrawal fee in the first few years of the annuity. The value of this right cannot be understated. It forces the insurance company to maintain competitiveness or risk losing its clientele. Thus annuity rates one of two ways either as a lump sum (all at one time and never again) or in payments according to the terms of the annuity contract.

Insurance companies do not charge a sales fee for an annuity. Most annuity contracts charge an early withdrawal fee for withdrawals made prior to maturity. This fee cannot exceed a fixed percentage of the annuity, usually 5%. Most insurance companies do not charge a fee for early withdrawal after the policy has been in place for five years. An annuity which carries the withdrawal penalty past five years should not be purchased: the insured would be excessively punished if the annuity were canceled because the insured could no longer meet payments yet still was not allowed to withdraw.

When a variable annuity is purchased, the insurance company guarantees a minimum below which the annuity's interest rate will never fall. This rate is usually guaranteed for the first six months of the annuity. The minimum interest rate is usually less than the commercial rates of banks or mutual funds. When compared against the after-tax return of bank and mutual fund accounts, however, variable annuities are usually higher.

annuity. The costs involved in the sales are borne by the insurance company: added pressure on it to make a profit.

IV. TAXES

Annuities are purchased by an individual with after-tax money. There is no tax deduction available for the purchase of an annuity. The tax advantage comes when the annuity starts to pay. When the insurance company starts to pay on the annuity, the percentage of the payment which relates to the purchase price is not taxed. What is taxed is the growth of the value of the annuity: the interest income.

Here is an example of how an annuity is taxed: Upon maturity, the insured had paid $55,000 for the annuity. The contract calls for payments of $5,000 per year. The insured will not have to pay taxes on the annuity for 11 years, at which time the entire purchase price will be recovered. If the annuitant, the insured, does not survive the 11 years the insurance company gets a windfall: the annuity terminates without invading the income generated from the insured's investment. If the annuitant survives more than eleven years, the additional payments come from the

Insurance companies offer annuity contracts with a variety of payment options. The most common payment options are:

A. A Lump-Sum Settlement. Under this option, the insured may, upon maturity, elect to receive all of the principal and accrued interest at one time. The insured then pays taxes on the amount over the purchase price as ordinary income. The annuitant may be able to use special lump-sum tax rules on the distribution. This is essentially the same as receiving the cash surrender value on a whole life policy.

B. Installment Payments. This is the option most often chosen by an insured who is married. Under this option, payments are made to the insured over a fixed period of time. They do not correspond to the life of the insured. Upon the death of the insured, if the payment period has not expired, the payments are continued to the designated beneficiary. Any payments which continue after the death of the insured will be included in the estate of the insured and may be subject to estate taxes. Since the payments are spread over a finite set of years and not the life expectancy of the person, the tax burden may be more or less depending on the number of years involved.

in which the insurance company guarantees that a fixed amount of payments will be made for life. The payment benefit is based on the premium paid and the actuarial life expectancy of the person. There is no adjustment for inflation under this option.

D. Interest Only. The fourth option is an election to receive, after maturity, only the yearly interest from the policy. The benefits which the insured receives are interest income and are fully taxable. The principal, the insured's payments for the annuity, are paid to the insured's designated beneficiary upon the insured's death. This principal is included in the insured's estate for the calculation of estate taxes.

Many insurance companies give the insured the option of combining two or more of these alternatives. Example: The annuitant might take a lump sum payment at maturity of a fixed amount and leave the remaining value of the annuity in the account to generate monthly payments for life. Before an annuitant makes the election to receive the payments under the matured annuity, he should consult with a tax and estate planning professional to determine what method or combination of methods would be best.

VI. CONVERTING ORDINARY INSURANCE

on any cash that he receives which represents interest on the cash value of the policy. Such interest would probably be very slight given the low cash values of most insurance policies in the early years of their existence.

There is no requirement that a person buy whole life insurance in order to invest in an annuity. Some unscrupulous salesmen attempt to foster that belief so that they can sell both the annuity and the whole life policy to the insured. Generally, an annuity is a better buy than whole life insurance.

CHAPTER 9

COMMODITIES

One of the most lucrative and by far the most dangerous type of investment is commodity trading. In commodity trading a person is buying an actual item: gold ore, silver bars or even grapes. The investor gambles that the price of the item will rise enough in the future to offset the storage fees of the commodity and the lost interest.

Commodity trading has three downsides. The first is that the price may not rise and might fall. The second is that investment in the commodity is not generating income while waiting to be sold. Example: Buying gold that rises from $400 an ounce to $440 per ounce is a 10% capital gain, but the actual return was less than 2½% per year if it took four years to do it. Third, storage must be deducted from the profit.

This chapter will discuss the major commodity investments available to an investor. Generally, the average investor should avoid commodity investments unless he brings a degree of specialized skill to the transaction.

and is readily tradeable. Gold is no longer the standard upon which the money supply of nations is based. The actual supply of gold in the world is immense. Over 600 million ounces of gold is mined every year. There will never be a gold shortage.

Fluctuations in the value of gold are man-made by inflation and uncertainty of world events. Gold prices climb in response to fear of world-wide financial panic or war because these occurrences dramatically affect the stability of the financial world. The Gulf War is an excellent example. During the beginning three months of the war, gold experienced a slight growth in prices. As the world realized that Iraq would not destroy the middle East oil fields, the price of gold dropped to its pre-war state. Those persons investing in gold in the hope of a prolonged rise in price lost big. On April 28 1993, the price of gold closed at $353.60 per ounce: an increase of $0.60 per ounce. The February 1995 future price for gold closed at $370.70, an increase of $1.40 over a 21-month period: a very low predicted increase in value. This indicated the financial community expected the economy not to experience great growth or inflation in the next few years.

Gold has an advantage. In a deflation it tends to drop in

Gold is the easiest commodity to purchase. It is sold in bars and gold coins which can be purchased outright by most coin stores for a slight premium. In addition, gold stocks and gold mutual funds exist. The investor can purchase stock in gold mining companies rather than the gold ore. For small amounts of gold, the investor should purchase gold coin even though a premium is charged for it by the coin store. For larger amounts of gold, he should purchase the gold in bullion form: in bars. The bars must have the assay mark of purity from a major assayer. The gold must then be safely stored, usually in a safety deposit box. Banks may also agree to insure the gold kept in their safety deposit boxes, but the fee may be high and further erode the profit margin of the gold.

II. SILVER

The day of the silver barons is past. Silver was once called the poor man's gold because of its many uses and the great demand for it. Once silver backed our economy and Williams Jennings Bryan won the Democratic nomination for President based upon a speech predicting the nation being crucified on a cross of silver when the silver standard was abolished. Today there is a glut on the market, a billion dollars, Mr. Hunt was fined by the government for both buying and selling silver. The price of silver is now only a fraction of what it was in the 1970's. On April 28, 1993, the price of silver closed at $4.18 per ounce. During the Hunt era, silver approached $50 per ounce.

Silver investing was once a financial consideration for us, but it is no longer. In the 1970's, a lady bought a hoard of silver coins and held them believing the price was going to go through the roof. At one time that hoard was worth nearly $50,000. Now it is worth about $2,000. The lady is still adamant that silver will rise again. She refuses to divest herself of her hoard even though it is worth only what she originally paid for it nearly 20 years ago.

The main use of silver is in photography. New means of making films, however, use less silver than before, and more silver is recovered in the development process. Moreover, there has been a steady increase of silver production on the world market, primarily from the former communist countries. All of this has depressed the price of silver. Today, silver can be purchased the same as gold in both coins and bullion form. In addition, silver stocks and silver as great as gold. South Africa, which produces most of the world's platinum, maintains an annual production of 3.5 million ounces. World-wide gold production is over 600 million ounces. The relatively small amount of new platinum on the market each year explains why a marginal increase in its world-wide availability causes dramatic swings in prices.

The main use of platinum is in catalytic converters for automobiles. These converters, however, have been steadily improved: less platinum is needed. In addition, since 1987, Russia has entered the platinum world market. Platinum prices have stabilized. In 1987, platinum reached an all-time high of almost $600 per ounce for a few months. Much of that price was pure speculation. The price quickly dropped over 23% in the October 1987 crash. By comparison gold prices remained relatively stable.

A small amount of platinum is used in jewelry and some high tech defense applications. Decreases in defense spending, including research and development, will reduce the demand for platinum and lower the price.

Platinum can be purchased in coin or bullion forms. Platinum stocks can also be purchased. Generally, this is not a good able to work with a discount broker to avoid all the profits going to commissions. If coins and bullion are used, the investor must include the premium charged in purchasing and the less- than-quoted value that the dealer pays when the platinum is sold.

IV. PERISHABLE COMMODITIES

Brokerages sell future contracts for all types of food crops. A "future" is a term of art in the investment commodity: a contract to receive a certain amount of a commodity in the future. The price paid for the future is based upon when in the future the commodity is to be delivered. Future prices can either climb or descend depending on the financial community's perception of the commodity: will there be a surplus or shortage on the delivery date.

The system works in the following manner. Farmers sell some or all of their crop before it is planted with an obligation to harvest and deliver on a certain date. The company which buys the crops then stores them and sells contracts to investors for each month of a year. The market determines the price of the future by speculation as to whether there will be a shortage of the crop on each delivery month.

For example, on April 28, 1993 the future price of March 1994

Most investors simply sell the contract on delivery date for the current price. The purchaser then takes delivery and puts the soybeans to use.

A great deal of money can be made in perishables. The market is created new each year. The major drawback to commodity investment is the weather. A disastrous year climatically, such as drought, floods or freezes, will drive the price high. In the same vein, a good growing year will yield bumper crops which will depress the prices. Some brokerages may offer mutual funds for the investment in commodities, permitting the risk to be spread among various investors. They may also offer a diversification among various commodities. Such an investment in perishable commodities could be quite lucrative. As with all investments involving a mutual fund, the broker is a key factor. He must be diligent to detail. Such a fund should be chosen with care. Consideration should be paid to past performance by the broker as an indication of the degree of care he spends in managing the fund.

V. FINANCIAL FUTURES

Another type of investment is in financial futures. This is the purchase of money for delivery in the future. An investor buys investor will make a profit. Otherwise, a loss will be sustained. Such trading is not an investment for the timid or the trusting.

In 1987, a friend was contacted by a company trading in financial futures. The deal seemed good. He invested $10,000. In the space of a few months, due to uncertainty in the market, he made a profit on paper of $7,000. He refused to take his original principal and trade only on the gain. In the space of a month, the financial market started to drop steadily. With the contract delivery date approaching, he was calling his broker daily. He was repeatedly assured that the drop was temporary, that it would turn. Finally, the broker's supervisor called in an attempt to calm his fears. He was told that the market would turn and, if by chance it did not by delivery date, he could make up any losses on the next contract. At this point his wife called. He was told to sell now. This time, he listened. While he lost $4,000 on the sale, had he not sold out he would have lost it all: the exchange rate on the delivery date was less than he paid for the contract.

It is a shame that brokers are not held to the same standard of care as an attorney. If an attorney had given such bad investment advice, he could and would be sued for malpractice:

inflating their successes. Most brokers are little more than salesmen. Remember, the investor should choose a broker carefully unless he is using a discount broker. If he is, the investor alone will be responsible for choosing the investments. The average investor should not have anything to do with this type of investment. It is too risky.

VI. LEVERAGED ACCOUNTS

Another source of investments that has appeared in the last few years is the leveraged account. It is usually offered only by questionable brokerages. These accounts work by the brokerage arranging a package deal with the investor for the purchase of a commodity. The brokerage has an arrangement with a bank whereby the investor borrows money from the bank to buy the commodity. The bank takes a substantial down payment and holds the commodity, which is usually gold, silver or platinum. The bank also charges a storage fee for holding the security. The contract is only for a short period of time, usually a maximum of six months. The bank has the right to make margin calls when the price of the commodity drops below a certain amount. The broker takes a substantial fee for arranging this transaction.

with Safra Bank to purchase platinum. After the price dropped considerably, the client contacted the broker. On that day, however, there was a slight increase. He was convinced to invest more by additional false information. Immediately after the purchase, the platinum continued its slide. The client lost almost his entire investment. In 1990 Morgan Whitney was placed into receivership by the Federal Trade Commission; it was found to have employed high-pressure "boiler-room" sales tactics. A class action suit was filed against Morgan Whitney and Safra Bank alleging violations of federal anti-racketeering and securities laws. The suit was certified in March 1991. Roughly $20,000,000 are claimed to have been lost by thousands of investors. The attorneys handling the case are Lief, Cabrasser & Heimann, 275 Battery Street, 30th Floor, San Francisco, CA. 94111. Any person who was involved with Morgan Whitney should contact this firm to determine if they have any interest in the lawsuit.

No person should get in a leveraged account. Buy the commodity outright or buy a future through a reputable brokerage but never consider entering into a leveraged account. Such investments are not for the average investor.

CHAPTER 10

MUTUAL FUNDS

I. INTRODUCTION

Mutual funds are the most common form of security investment. Mutual funds are investment pools formed and managed by large brokerages. The manager of the fund sells interests in the fund based upon the daily value of the fund. The fund then takes the money from the investors and purchases securities such as stocks, bonds and commercial paper. The investors in the mutual fund share the collective profits and losses of the fund based upon their percentage of ownership in the fund. The managers of mutual funds charge between ½% to 2% of the net assets of the fund as a managerial fee each year.

Mutual funds, through the ability to pool investments, permit a wider degree of diversification (thus safety), than that which is available to the lone investor. By virtue of ownership of shares in a mutual fund, an investor has an interest in hundreds of companies through the stocks and bonds of those companies held by the mutual fund. Because of this diversification, failure of one or two companies will not devastate the fund.

drawback. The variety of mutual funds on the market, however, and the competition they generate for invested dollars assure no mutual fund will stay in business long with a history of poor management and poor returns.

Mutual funds only invest in securities. Mutual funds do not loan money nor do they invest directly in real estate or commodities. Because their investments are in securities, mutual funds live or die by the fluctuations of the stock and bond market. Mutual funds are easily traded, just like stock. In addition, most mutual funds offer phone and wire redemptions.

The stock and bond market is volatile. Having an able, astute mutual fund manager is critical. The manager of the fund provides the professional decisiveness and technical expertise necessary to further the fund's stated objective. The return from any particular mutual fund is dependent on the fund's portfolio. Mutual funds vary their portfolio in accordance with their stated investment objectives. Mutual funds that seek high income (called "income funds") purchase stocks and bonds which pay high yields. Such stocks and bonds tend to have a trade-off: they usually have slow appreciation in price and low growth for future capital gain. Some

The newest type of mutual fund is called an "index fund." This type of fund invests in all of the funds which make up the Standard and Poor's 500 or the Wilshire Index. Such funds are not high performers but are very stable. To illustrate, the S&P index for the last five years had an average return of 15.9%; the S&P 500 index mutual funds had an annual return of 14.4%.

There are more than 4,000 mutual funds in the United States. It is possible to purchase foreign mutual funds as well. The growth in mutual funds has been extraordinary. Now mutual funds are also being created by bank and insurance companies. In 1992 alone, 434 new mutual funds were formed. The investments in stock and bond mutual funds for 1992 was $196 billion dollars, the highest amount ever.

Besides safety, the other reason for investment in mutual funds is profit. In 1990, the bank CD rate was 8%. Today the bank CD rate is less than 4%. By comparison, stocks and bonds have traditionally had a return 4% to 5% higher than bank CDS and T-Bills. The returns for the top 20 mutual funds for the last three years have averaged 12%. By comparison the average return for the Standard and Poor's 500 was 10.8% for the last three years.

With over 4,000 mutual funds on the market the first problem to be faced in investing in a mutual fund is the most critical. How does a person choose a mutual fund? As stated above, there are mutual funds for every type of investor. First and foremost every investor should have a set of investment objectives before entering into an investment. An investor should first decide whether the objective is to achieve long-term growth or an immediate income flow. If the objective is to achieve steady, secure, long-term growth, the investor will want to invest in growth funds. Otherwise, the investor should concentrate on an income fund. Generally, the closer a person is to retirement, the more interest he has in receiving income rather than capital growth. A retiree not working probably wants additional immediate income. On the other hand, a young person generally is more concerned with capital appreciation because he usually is able to support himself without dipping into savings while the investment in the fund is left to appreciate for retirement purposes.

Once a person has defined his financial objectives, the next step is to study the type of mutual funds of interest. There are several good annual surveys that rate the performance of the major funds should be compared both on a long-term basis (over the last 10 years) and on a short-term basis (over the last two years). This will give the investor reasonable insight into the ability of the fund's management to predict problems and opportunities and make successful decisions. It is an old adage in the financial community: "Anyone can make money in good years; it takes a good businessman to make money in bad years." By comparing the various funds over a period of time, both in good and bad economic years, the true strength and performance of a fund can be judged.

After narrowing the list of potential mutual funds down to a workable three or four, the potential investor should write to the mutual fund for a copy of the fund's prospectus. Before any mutual fund can take money from an investor, it is required by law to give him a prospectus. A prospectus is also called an "offering circular." It is a complete statement that contains the fund financial goals, the list of managers of the funds and the types of investments each fund makes. Many mutual funds include copies of their balance sheets. The mutual fund also is required to list any contingent liabilities or litigation that it has which may adversely affect its operations. The three things that an investor to maintain peak performance. A smaller fund might be a better investment.

2. Redemptions versus sales. Another concern is whether the fund's latest redemptions are higher than its sales of new shares: are current investors in the fund jumping ship. If so, that means that either the fund's returns are not high enough or investors are seeing risk in the fund. The fund must sell assets to cover these redemptions, which means dipping into the fund's principal. This hurts the remaining investors in the fund. This information is usually contained under a section of the prospectus entitled "Changes in Net Assets": a table or statement of the number of shares sold versus the number of shares redeemed.

3. The management fee. An investor also should verify the reasonableness of the management fee. In many funds the annual fee is between ½% and 1% of the mutual fund's total assets, not just the income of the fund. Many mutual funds, because of competition, waive their management fee on a quarterly basis. This makes the

should probably divest himself of a fund that falls upon a prolonged losing streak.

III. OPEN-END VS. CLOSED-END MUTUAL FUNDS

Mutual funds are divided into two categories: "open-end" mutual funds and "closed-end" mutual funds. There are differences between the two which affect the profits to be realized.

An open-end fund is one in which the mutual fund can issue and sell any number of shares to the public. Most mutual funds are open-end funds. By being able to sell continually, an open-end fund has the opportunity to grow to an immense size. There can be a drawback in investing in an open-end fund: it can grow to such a size that it experiences management problems. A large fund dedicated to investing in small companies may find it difficult to place all of its funds. The result could be that the company has large amounts of unused cash in its treasury. These cash reserves reduce the fund's returns.

Investors in an open-end fund buy and sell shares through the fund itself. The number of shares changes daily as investors enter and leave the fund. The market value per share of an open-end fund always equals the net asset value (NAV) of the fund: the value per forth in a manner similar to stock. A closed-end fund will never issue more shares in itself, nor will it "buy back" or redeem any existing shares. Because the fund cannot sell new shares, it does not have the ability to raise funds to expand investment diversification. On the other hand, because the fund is closed, the investors do not worry about an influx of investors causing the fund management to invest in riskier stocks and bonds to maintain the yield for the new investors. There are not many closed-end mutual funds: probably less than a couple of hundred of the 4,000 mutual funds. Of the 251 companies which began trading on the NYSE in 1992 only 87 were closed-end funds. The number of closed-end municipal bond funds increased from 103 in 1992 to 189 in 1993.

Contrary to an open-end fund, a closed-end fund can sell its shares at a price higher (at a premium) or lower (at a discount) than its NAV depending on the desirability of the fund to investors. Buying a closed-end fund at a premium is risky because the NAV must rise above the premium before the investor realizes a profit. On the other side, a closed-end fund can be purchased at a discount when the fund's NAV rises and discounts. When the NAV falls, this stock then becomes a premium.

closed-end funds will trade at an average premium of 2% of their initial offering.

Unlike open-end funds, closed-end funds can borrow money on short-term rates and use the funds to invest in long-term bonds. This maneuver boosts their yields. Although investing borrowed funds can be a benefit, there is risk in that the funds become vulnerable to large price declines if interest rates fall. The average closed-end municipal fund yielded 6.6% in 1992. The average open-end fund earned 5.6%.

It is not wise to purchase the initial offering of a closed-end fund. While there may not be a commission charged, there is usually an underwriting fee of 8%: $8 will be used to pay the underwriter for each $100 invested in a new closed-end fund. Only $92 of the investment will be available to purchase assets. On the other hand, closed-end funds purchased after the initial offering will have no underwriting fee, and any commission (on a loaded fund) will still be less than the underwriting fee.

The following table lists a few of the major performing closed-end funds for the first five months of 1993 and over a three-year period ending on June 1, 1993. Such performance is only

Anchor Gold and Currency	27.0%
Cohen and Steers Realty Income	16.1%
Petroleum and Resources	14.8%

FUND NAME	NAV ANNUAL INCREASE THREE YEARS ENDING JUNE 1, 1993
First Financial	39.4%
Southeastern Thrift & Bank	31.6%
Cohen & Steers Realty Income	22.1%

MUNICIPAL BOND FUNDS

FUND NAME	NAV INCREASE JANUARY 1 THROUGH JUNE 1, 1993	
Van Kampen Merritt,	Invst. Grade N.J.	12.1%
Van Kampen Merritt	Insured Municipal	11.7%
Van Kampen Merritt,	Cal Quality Municipal	10.9%

FUND NAME	NAV ANNUAL INCREASE THREE YEARS ENDING JUNE 1, 1993
Nuveen N.Y. Performance Plus	14.8%
Van Kampen Merritt Muni Income Trust	14.7%
Putnam Investment Grade Municipal	14.6%

TAXABLE BOND FUNDS

FUND NAME	NAV ANNUAL INCREASE THREE YEARS ENDING JUNE 1, 1993
Alliance World Dollar Income	28.1%
Emerging Markets Income	21.5%

In addition to domestic closed-end funds, there are international closed-end funds as well. Investment in such funds should be carefully evaluated. Since 1990 the market values of the European closed-end funds have fallen an average of 5.1%: the worst of all closed-end funds. Some forecasters believe, however, that European utility stocks will experience a great run when European interest rates go down. These forecasters favor such diverse closed-end funds as GT Greater Europe, which sold in June 1993 at a 10.2% discount, the New Germany Fund which sold at a 10.3% discount and Global Health Sciences at an 11.6% discount.

FOREIGN CLOSED-END FUNDS

FUND NAME	NAV INCREASE JANUARY 1 THROUGH JUNE 1, 1993
Turkish Investment	71.0%
ASA Ltd	68.4%
Japan Equity	61.8%

FUND NAME	NAV ANNUAL INCREASE THREE YEARS ENDING JUNE 1, 1993
New World Investment	35.0%
Chile Fund	34.5%
Mexico Fund	29.2%

IV. LOAD VERSUS NO-LOAD FUNDS

the investor to get the money back that he invested. Stockbrokers are paid commissions for selling these shares: a major incentive to sell load funds.

In contrast to the load fund is the no-load fund. In simplest terms, a no-load fund is a mutual fund which does not have a sales fee tacked onto the price of the shares. Many brokers are not interested in helping potential investors purchase shares in a no-load fund: there is no sales commission.

While a no-load fund does not charge a sales fee, it charges a higher management fee. A good no-load fund will make more money for the investor than a good load fund. Of course a badly invested or mismanaged no-load fund will not do as well as a well-managed load fund. No-load funds are identified in most financial newspapers with the abbreviation N.L. across from their name. A list of no-load funds can be obtained by writing to the No-Load Mutual Fund Association at 475 Park Avenue South, New York, NY 10016.

V. B SHARES IN A LOAD FUND

A cross between a load and no-load fund is a fund which offers what is known as "B shares." The holder of a B share does not pay

$47,500 in the fund while an investment in B shares would result in shares worth $50,000. Dividends are paid based upon the amount of shares a person owns; so a person investing in B shares would own more shares and receive a greater dividend.

An attractive feature of B shares: the load which will be paid upon sale is reduced by usually one point per year. If B shares are held for a period of time (six years in some cases) the load will be reduced to zero. At that point the B shares will be converted without a charge to normal A shares (shares on which the load has been paid). As of October 1993 there were 42 mutual funds which offered B shares. One of the largest funds offering B shares is Oppenheimer Management Corporation that offers B shares with 13 of its funds.

A downside exists for B shares: persons investing more than $100,000 do not do as well in B shares as smaller investors. Big investors get break points (a reduction in load points) and load is usually waived completely on million dollar investments in A shares. In contrast, there are no break points for B shares. As such, a big investor who sells early pays the full sales charge. Some brokers recommend and push B shares just to avoid having to fund's assets. B shares often carry 12b-1 fees of 1%, the maximum permitted to be charged by NASD (National Association of Securities Dealers). NASD sets a time limit that a fund may charge the maximum 12b-1 fees. The funds charge the maximum fees for B shares as long as possible. B shares carry this higher charge because the fund has to pay the broker his commission for having sold the bond even though there was no sales charge when the bond was sold. In conclusion, according to the Chicago newsletter Morningstar Mutual Funds, B shares have performed as well as ordinary no-load funds for the small investor.

According to Morningstar, however, some people confuse no-load shares with B shares because there are no sales charges on the initial purchase. An alternative to front loads, B shares are experiencing a growth in demand. This growth is being met by an increase in the number of funds offering them.

VI. CLOSURE OF A FUND

In April 1993, the Small-Cap Value Fund, the Strong Common Stock Fund and 14 of the 75 top performing stock funds listed by the Morningstar Mutual Funds advisory service temporarily stopped selling interests to new investors; they continued selling new

Occasionally a fund is closed because the management feels that it is getting too big to manage properly. This concern occurs most often in funds which invest in small growth companies. The stocks of small growth companies have fewer shares outstanding than the major corporations. With only small quantities of stock available for purchase, small growth companies are tougher to manage for funds with large dollar amounts to invest.

Another reason to close new sales of a fund temporarily is that the fund has no place to invest all the money investors want to place with it. Investors want to invest in successful funds and can overload a dramatic fund. In the face of such a demand, the funds face the prospect of reducing their standards for investment so as to retain their successful rate of return. Such an action increases the risk for all investors. By the same token money not invested by the fund will dilute return to investors because fund earnings will not be as high.

Even though a fund may be closed to direct sales to new investors, it is still possible to purchase interests in it. Investors can seek interests in the funds through discount brokers who trade in fund shares or through a current investor in the fund.

Many companies, for management convenience, offer several mutual funds which invest in the same types of stocks. The closure of one fund does not mean that its clone will also be closed. By forming several clones to invest in the same securities, the fund companies are able to keep the overall management within a tolerable level. Consider investing in one of these clones.

VII. TAX TREATMENT

Mutual funds pay their investors the profits earned from trading in the securities held in the funds' portfolios. Investors desiring an income stream have the dividends paid directly to them. Investors desiring capital growth have the distributions reinvested into additional shares. Reinvesting the profits, however, does not mean the investor does not have to pay taxes on the distributions.

Tax treatment of these mutual fund capital gains is tricky. Most mutual funds make capital gain distributions in December. A person purchasing shares in a mutual fund prior to the distribution will have part of the purchase price returned when the capital gain distribution is made. The investor then has to pay taxes on fund profits which he never realized (the profits were realized by those holding the shares during the time of the profit-making activity).

There is no like-kind exchange treatment for mutual funds: switching investment from one mutual fund to another is a taxable event. In like manner, redeeming shares in the mutual fund is a taxable event. The difference of the purchase price and sales price is income. An investor can control capital gain by directing which shares are to be sold. Each share of a mutual fund is sold for its net asset value on the day of sale. An investor who purchased 100 shares at $13.92 on April 14 and 100 shares at $13.98 on May 1 has 200 shares with an average price of $13.95 per share. For tax purposes, however, gain or loss will be calculated on which shares are sold. If on May 3, the 100 shares of April 14 stock are sold for $13.92, then the investor will have no gain per share. By contrast, if the May 1 shares are sold, there is a loss of $.06 per share ($13.98 per share purchase price minus $13.92 sales price). Unless an investor directs which shares are to be sold, the I.R.S. will determine that the shares with the lowest cost were sold which means that the investor will pay the highest tax. Information on the tax treatment of mutual fund distributions is covered in I.R.S. Publication 564. Telephone 800-829-3676.

VIII. RATINGS

their investors in 1990. The Standard and Poor's stock index finished down by 3% for 1990. Stock mutual funds as a whole did far worse. Given that background, it can be seen why ratings of stock funds are taken as an average over five years to equalize the fluctuations of good and bad years.

IX. INCOME FUNDS

Income funds invest in dividend-paying stocks. The fund then pays those dividends to the investor rather than reinvesting them into more fund shares. Several top performers from the period of 1988 through 1992 were:

1. Vista Growth & Income. A load fund with an annual return of 31%. Its phone number is 800-348-4782.
2. AIM Value. A load fund with an annual yield of 21%. Its phone number is 800-347-1919.
3. Neuberger & Berman Guardian. A no-load fund with an annual yield of 19%. Its phone number is 800-877-9700.
4. Financial Industrial Income. No-load with an annual yield of 18%. Its phone number is 800-525-8085.
5. Dean Witter Equity Income. A no-load fund with an annual yield of 15%. Its phone number is 800-869-3863.

production from their investments. Several top performers from the years 1988 through 1992 were:

1. Kaufman. A load fund with an annual yield of 34%. Its phone number is 800-237-0132.
2. Alger Small Capitalization. A load fund with an annual yield of 27%. Its phone number is 800-992-3863.
3. Robertson Stephens Emerging. A no-load fund with an annual yield of 23%. Its phone number is 800-766-3863.
4. Fidelity Blue Chip Growth. A load fund with an annual yield of 19%. Its phone number is 800-544-8888.
5. CGM Mutual. A no-load which has an annual return of 14%. Its phone number is 800-345-4048.

These high returns are usually the product of risky investments by the funds. In fact, most of the above funds suffered extreme losses in 1990 which were offset by prior and subsequent better years. The only way to know a fund's true potential is to view its performance over several years.

XI. BANK MUTUAL FUNDS

The popularity of mutual funds has greatly eroded investment in certificates of deposit (CDs). Banks have traditionally relied funds aggressively: even calling their CD investors prior to maturity of the CD and informing them of the bank's mutual funds. Wells Fargo Stagecoach Funds has increased from $650 million in January 1992 to over $3 billion dollars by May 1993, a nearly five-fold growth.

By tradition banks have also been known as conservative investors. Bank mutual funds reflect this tradition. Bank mutual funds tend to lag slightly behind non-bank managed mutual funds in their performance. Usually bank mutual funds are loaded funds at about 4%, which means an investment of $5,000 carries a fee of $200. In addition, banks tend to charge about 1%, which is $50 per $5,000 investment, as a yearly management fee.

A mutual fund sold by a bank carries with it the same risks and advantages of any other mutual fund: the potential of high return and the risk of loss. A bank's mutual fund is not insured; a certificate of deposit is. An investor can lose money if the stock the mutual fund bought decreases in value. A mutual fund does not guarantee a fixed rate of return; the certificate of deposit does. With no fixed rate of return, a mutual fund return fluctuates in response to market forces. Bank mutual funds, as

It is important that an investor considering investing in a bank mutual fund compare the performance of that fund before investing. The investor should read carefully the prospectus of the fund he is considering. The following are some of the top bank mutual funds from 1989 through 1992:

1. Chase Manhattan's Vista Growth Fund has had a 25.06% annual return over three years.
2. First Interstate's Westcore Midco Growth has had a 22.20% annual return over three years.
3. Bank of America's Pacific Horizon Capital has had a 20.47% annual return over three years.
4. Premier Bancorp's Paragon Value Growth has had a 18.94% annual return over three years.
5. Mellon Bank's Laurel Stock Portfolios has had a 15.75% annual return over three years.

XII. BOND FUNDS

1. First Interstate's Westcore Long-term Bond has had a 15.87% annual return over three years.
2. Chase Manhattan's Vista Tax-Free Income has had a 14.50% annual return over three years.

5. First National Bank of Chicago's First Prairie Tax-Exempt Insured has had a 11.76% annual return over three years.

XIII. RECOMMENDATIONS

Investment in mutual funds is at an all-time high. The reason for this is clear. Mutual funds make money. Stock mutual funds have outperformed most other investments over the past 10 years. As with any investment, however, there is a risk associated with mutual funds.

The main consideration in any investment strategy is that of inflation. It makes no sense to make an investment which will give the investor less purchasing power in the future than the present value of his money. A proper investment will have a rate of return equaling or exceeding the rate of inflation. For the last 10 years the rate of inflation has averaged 3.8% per year. By comparison the money market accounts of banks paid an average interest rate of 7.1%: investors in bank money market accounts could have earned 3.3% over the inflation rate. In other words, the purchasing power of the money in the bank account increased by 3.3% each year (an investor could buy 3.3% more goods for the money in the account than in the previous year).

the purchasing power of money invested in stocks, as a whole, has more than doubled since 1983.

The best way to buy stocks for the average investor is through a mutual fund. The best type of mutual fund for the average person is a no-load mutual fund. The investor should choose a mutual fund based upon the factors discussed in this chapter.

It is better to make a series of purchases in a mutual fund. Several investments will equalize the costs of the shares by reducing the risk of purchasing all of the shares on a date when share prices are unusually high. It is a good idea to invest with a company which manages several mutual funds. This makes it easier to transfer money between any member of the family of funds. Moreover, many companies that manage several funds send consolidated statements listing the performance of all funds in the investor's portfolio rather than sending separate statements for each fund.

The key is to make money. The investor should choose a mutual fund that satisfies his personal requirements for safety, growth and income.

CHAPTER 11

MONEY MARKET VEHICLES

I. INTRODUCTION

There are three types of similarly named investments that are in fact very different in their operation, safety and return.

1. Money market accounts.
2. Money market certificates.
3. Money market mutual funds.

Money market accounts and money market certificates are operated and sold by banks. Money market mutual funds are offered by brokerages and mutual fund families.

The common name of the accounts, "money market," defines the type of investment vehicle: safe, short term items such as T-Bills, T-Bonds, T-Notes, and stable corporate bonds. The investments of a money market fund are intended to earn higher interest than the average short-term interest rate.

Money market funds appeared in the financial community in the early 1980's. They were an immediate success, and investors withdrew their low-paying savings and CD accounts by the billions

The history between the Money Market Account and the Money Market Fund is one motivated and exacerbated by competition and agreed. Money market funds first hit the financial community in the early 1980's and were an immediate success. As a result, investors withdrew, by the billions, their low paying savings and CD accounts and invested in the far more lucrative money market fund. Yo compete, banks created a new checking account called the money market account. The bank's money market accounts share a similar name but there the similarity ends.

II. MONEY MARKET FUND

Money market funds are huge investment accounts run by brokerages. The price of the shares of the fund are calculated by dividing the daily asset value of the fund by the number of shares outstanding. The fund uses its liquidity to purchase high-yielding short-term investments. Because of the huge amount of money invested in the money market fund, the fund is able to purchase large amounts of diversified securities. This pooling of investor funds permits the acquisition of a diverse portfolio of securities with an emphasis on safe governmental securities.

Money market funds generally invest in the following types of

Federal National Mortgage Association, Federal Intermediate Credit Bank, Export-Import Bank. Federal Home Loan Bank, Governmental National Mortgage Association, etc.

2. State Securities. Another source of investment is state bonds. Some of these bonds have full faith and credit of the state behind them and may also be exempt from state and federal taxes.

3. Corporate commercial paper. Corporations issue promissory notes which mature in less than nine months. The notes are rated in the same manner as corporate bonds are by Moody or Standard and Poor's. Money market funds seldom invest in commercial paper without high ratings.

4. Bank Certificates of Deposit. Money market funds can invest in large certificates of deposits issued by both domestic and foreign banks. Such CDs are usually sold in amounts of $1,000,000 or more. The CDs are only guaranteed to a certain amount ($100,000 for U.S. bank CDs). Thus the risk for such investment depends directly upon the financial strength of the bank.

of dollars in low-yield bank savings and CD accounts when the same money could be placed in a money market fund for more interest and still have immediate access to the money through service-free checking. People swarmed from the banks to the money market with their investments.

The money market fund makes its profits solely from the interest that is paid on the securities held in its portfolio. The fund calculates its investors' current market return on a daily or weekly basis. This frequent calculation of the investors' interest in the fund exposes the investors to market swings. The money placed in a money market fund, unlike a bank account, is usually not insured. This means that the value of those securities may go down, like any stock. Because the purchased securities can decrease in value, money market accounts usually invest deeply in safe government securities and diversify extensively. The interest that a money market fund pays to its investors is the profit made from its operation and is directly related to conditions of the financial market. In 1981 money market funds paid as high as 17% while in 1989 the average money market fund paid 9%.

The interest on money market funds is usually subject to

The main alternative to money market funds that offers liquidity and investment is direct investment in T-Bills. Money Market Funds offer the following advantages and disadvantages as compared to direct T-Bill purchases:

1. The amount needed to invest. T-Bills are sold in increments of $10,000. The average investor does not have $10,000 to invest solely in T-Bills. The money market fund combines the investments of several persons in order to purchase the T-Bills.
2. Liquidity. Money market funds are extremely liquid. A person can close a money market account simply by writing a check. A T-Bill must be sold prior to maturity, usually by going through a broker, which takes at least a week or two.
3. Costs. Money market funds carry a 1% operating fee. A T-Bill can be purchased directly from the Treasury without a fee.
4. Taxes. Treasury bills are exempt from state taxes whereas most money market funds are not exempt. This can be a significant factor if the investor resides in a high tax

by simply writing a check. Withdrawals can be made just as easily. Since money market funds pay a higher interest than a bank money market account (the difference was 3% in 1989) the average person desiring liquidity should consider opening an account with a money market fund. In addition, the person should open a bank checking account with just enough money to avoid a monthly check fee and cover monthly expenses. He should invest all funds above normal expenses in the money market fund where he is also liquid and will earn a higher rate of interest. If he suddenly needs additional money in the bank account, cash from the money market fund can be transferred; or the person can simply write a check from the money market fund for deposit into the bank account. It is just that simple to transfer funds from a money market fund to a bank account while enjoying the higher interest rates of money market funds.

One situation where a money market account should be used is in conjunction with a business bank account. Most banks do not pay interest on business bank accounts. Any successful business needs a bank account in which to place its money temporarily. A money market fund is obviously the best answer. Cash from the money market fund can be easily transferred into the normal, non-interest

There is an abundance of literature available to help assist in the choice of a money market fund. Consumer Reports, Standard and Poor's, Moody's, Wall Street Journal and Barron's are among sources of information regarding performance. For the average investor, safety, stability and return are the most important factors. By comparing one fund's characteristics with another the best one can be chosen. It is not difficult to identify mutual funds. The business section of the Sunday edition of every major newspaper will carry the Friday closings for all the mutual funds. The immediate earnings of all the funds can be compared. The information on how to invest the funds is not given. More detailed information can be obtained by consulting the authorities already listed in any large public or college library or by calling a broker, who will send a prospectus (offering history) for the fund.

III. MONEY MARKET ACCOUNT

A bank's money market account is promoted as the equivalent of a money market mutual fund. The bank's money market account does permit smaller investors to invest in higher interest bearing accounts. It also permits the investor to write a limited number of checks each month (usually between seven and 10). Because of the

One advantage of the bank money market account is that it is insured by the FDIC for $100,000: the account cannot suffer capital losses like a money market mutual fund.

The difference between the bank's money market account and the money market fund is in how the money is invested. In the fund the money is invested in the purchase of short term securities. The fund investor realizes profits or losses from the interest derived from the securities purchased by the money market fund. In comparison, the bank uses the money invested in its money market account as part of its regular loan operations: a bank simply uses the cash in its money market account to reloan at higher interest rates. Money market accounts do not pay as much interest as money market funds. In 1989, for example, money market accounts paid an average of 6% whereas money market funds paid an average of 9%:a difference of 3%.

IV. MONEY MARKET CERTIFICATE

Banks and savings and loans offer what is known as money market certificates or T-Bill accounts. These accounts exist just to invest into T-Bills. The money market certificates pay an interest rate equal to the 26- week Treasury Bill. The T-Bill is

($100 minus the 6% discount). The real rate of interest is not 6% on the face value but 6% on the purchase price of $94 which is a real interest rate of 6.38%. As the interest rate increases the difference between the discounts and the real interest rate increases: the investor makes more money.

One drawback with the purchase of a money market certificate is a reduced degree of liquidity. The smallest T-Bill is $10,000 with a total broker fee of about $50 for its purchase and sale. The larger the T-Bill being bought and sold, the lower the broker fee paid on the purchase.

When a T-Bill is sold prior to maturity, the investor receives all the interest earned prior to the sale. By contrast, the money market certificate is more expensive to close. Closing a money market certificate within 60 days after purchase exposes the investor to significant penalties, which actually cut into the principal. If a money market certificate is closed after ninety days, the investor loses all of the interest for the first ninety days and will only receive regular passbook interest for the remaining term up to the cancellation date. It is easy to see that T-Bills are much more liquid than money market certificates.

or FSLIC. As with the Savings and Loan crisis, we have seen financial institutions fall and the government cover the insured accounts. Investment in money market certificates should never exceed the amount guaranteed by the Federal Government.

The final comparison between money market certificates and that of T-Bills is in taxes. T-Bills, as obligations of the federal government, are totally exempt from all state and local taxes. On the other hand, the interest from money market certificates, even though based on T-Bills, is totally subject to federal, state and local taxes. The exempt status of T-Bills is especially attractive when the investor resides in a high-tax state such as New York or California. In high-tax states nearly 1.5 percent of the interest paid on money market certificates is taken as taxes.

Generally, the little bit of convenience of being able to purchase the money market certificate is greatly outweighed by the greater risk, the slightly lower interest rate and the reduced liquidity. As a rule, the average investor should not get involved with money market certificates. Instead, an investor should purchase T-Bills directly or invest in a quality money market fund.

CHAPTER 12

REAL ESTATE INVESTMENT TRUSTS

I. DEFINITION

One of the most interesting investments available to small investors is the REIT (Real Estate Investment Trust). A REIT is not heavily taxed: the profits are passed through the trust to the investors, similar to a partnership or S corporation. Another advantage is that a REIT permits many persons to invest, pooling their funds to participate in larger, more lucrative projects.

A REIT is defined under section 865 of the Internal Revenue Code as being a corporation, trust or association which meets the following requirements:

A. INCOME SOURCE REQUIREMENTS

In order to qualify as a REIT, three income-source tests must be met, in addition to the other requirements:

1. The first test: 95% of the trust's gross income must come from investment.
2. The second test: 75% of the gross income must come from

In order to be treated as a REIT, at the end of each quarter of a tax year the trust must have:

1. At least 75% of the trust's total assets invested in real estate, cash, cash items and government securities.
2. No more than 25% of the total assets can be in non-government securities. No more than 5% of the gross assets can be invested in any issuer's securities, and no more than 10% of any issuer's securities can be held.

C. GENERAL REQUIREMENTS

In addition to income source and investment diversification requirements a REIT must meet the following general requirements:

1. The trust must be managed by trustees or directors.
2. Transferable shares or certificates must be issued to represent the beneficial interests of the investors.
3. The REIT must be taxable as a domestic corporation.
4. The REIT must not be a financial institution or an insurance company.
5. The trust (REIT) must be owned by at least 100 people for at least 335 days of a 12-month tax year.
6. No group of five or less investors can own more than 50% of the beneficial interest of the REIT.

D. ELECTION

REIT status is not automatically granted under the Internal Revenue Code. Corporations, trusts or associations wishing to

II. TAXATION

A. TRUST

Once a corporation, trust or association qualifies as a REIT, it will be taxed only on the taxable income that it retains. This fact is the most important aspect of a REIT: it does not pay taxes on the distributions made to the investors. In this instance, a REIT is similar to a S corporation. The REIT is taxed at ordinary corporate tax rates only on the income that the trust retains and does not distribute. A special federal tax code section holds that when a REIT retains more than 5% of its ordinary taxable income and foreclosure property, then all of its income will be taxed unless special deficiency dividend rules apply. The tax on these undistributed capital gains is determined by using whichever of the two following tests produces the lower tax:

1. The first test: excess of long-term capital gain over net short-term capital loss taxed with REIT's other taxable income at regular corporate rate.
2. The second test: undistributed capital gains taxed at the alternative tax rate.

Capital gains which are distributed are taxed to the investors who are the REIT's beneficial owners or shareholders. The REIT cannot held longer than four years. A REIT is taxed 100% on net income derived from prohibited transactions: the government takes all the profit.

The IRS Code contains a "Safe Harbor" provision that avoids the 100% penalty. The REIT must meet the following conditions to remain in the Safe Harbor:

1. The property being sold must have been held by the REIT for at least four years before the sale. If the property sold was property upon which the REIT foreclosed pursuant to a loan, the length of time that the REIT held the loan before foreclosure is counted as part of the four year holding period.
2. The REIT cannot increase the basis of the property by more than 30% of the selling price during the four years before the sale. Special rules apply to foreclosed property: any expenditures made after default are treated as being made by the REIT. Such post-default expenditures are not counted in the 30% limitation if they relate to the foreclosure. In addition, expenditures made to restore property damaged by fire, storm or other casualty are not included in the 30% limitation.
3. A REIT may make no more than seven Safe Harbor sales and the adjusted bases of all sales may not be more than 10% of the adjusted bases of all REIT assets as of the

The 100% penalty provision is not automatic in the event the Safe Harbor provisions are not met by the REIT. Under section 857(b)(6) of the Internal Revenue Code, determinations for penalty taxes are to be made case-by-case based on the facts.

Given the terrible effect the 100% penalty can have , it is important that a REIT be continually solvent: continually be able to meet its debt obligations without being forced to sell assets early. If there is prohibited property (property on which the REIT held loans for less than four years), the REIT will be denied a profit. Investors should ask to see a profit and loss statement and a balance sheet before investing to assure themselves they are not buying into a shaky REIT.

B. INVESTOR

The income an investor receives from a trust is taxed. Ordinary income of the trust is taxed as ordinary income, even if the investor is a corporation. Corporate investors are denied a "dividend received" deduction for the distributions they receive from the REIT.

A capital gains distribution from the REIT is a long-term capital gain for the investor: sale of assets held over one year.

December or January are considered paid and received by shareholders on December 31 of the tax year.

An investor loss on sale or exchange of a beneficial interest in a REIT owned less than six months is a long-term capital loss to the extent of any long-term capital gain distribution from the beneficial interest.

III. INVESTING IN A REIT

A REIT offers several significant advantages to an investor. The first is that it provides for more money for investment: a pooled situation. Larger real estate projects can be undertaken. The larger the real estate project, the greater the return on investment for the investor. Secondly, a REIT usually is managed by a professional real estate expert who should have greater expertise in real estate management than the investors, offering a better potential to protect and increase the investor's assets.

In some ways a REIT is similar to a mutual fund: in both situations the investors pool their assets, and a professional manages them. The major difference is that a REIT invests in real estate and the mutual fund invests in securities. Because of the practical advantages of REIT, there are telemarketers who attempt and swindle those who trusted them. The practice is illegal. If caught, these crooks are prosecuted. The investor, however, never sees his money again.

The safe way is to invest in a REIT that is operated by a major real estate company or financial institution. The sale of a REIT is a security. Therefore it must be registered with the department of corporations in the state where the REIT is located. If the REITs are being sold through advertisement they will also be registered with the Securities and Exchange Commission. Security brokerages also handle the sale of beneficial interests in bonds. Major real estate brokerages also offer REITs.

The best advice concerning any investment is that if the deal appears too good to be true, then it is too good to be true. An investor should not attempt to save money by investing with unknown people. An investor must rely on the manager and the money invested by other people in order to make a profit. Therefore, the company running the REIT and the manager of the REIT must be able to attract more investors and be able to manage the assets ably. To make that determination, the investor must probe the background of both. Most investors do not have the time or the knowledge to stable investment with steady but gradual increases in value with its REIT is where most investors in REITs should settle.

Any investor seeking a quick killing in real estate should remember that for everyone who makes a killing someone is killed; that person who is killed thought that he was would be the one making the quick killing. A person investing in a REIT should limit himself to one of the 142 "equity" REITs followed by the National Association of REITs. Investment in these REITs has risen more than 32% in previous years. Investment in equity REITS is recommended: they own the properties in which they invest and distribute at least 95% of their income. Currently, equity trusts pay dividends between 5% and 7%.

One of the main attractions of equity REITs is they are still able to acquire good income-producing properties at good prices because of the recession. The cash flow from these properties is higher than costs: a good profit is maintained. The recession in real property, however, may finally be ending, due to both decreased construction and a slow growth in demand. The properties currently owned by REITs will begin experiencing appreciation. REIT owned apartment properties will experience the first wave of in March 1993. New investment in the fund was 33.5%. Mutual funds are leading the drive for investment in REITs. Cohen & Steers Realty Shares is a no-load mutual fund which invests in REITs. They have experienced a 42.5% growth and a 5% dividend yield for the near ending March 31, 1993. Investment in the fund required a $100,000 minimum investment. It was reduced to $2,000 through May 1993 and the reduction may continue thereafter. Charles Schwab also reduced the minimum investment in its PRA REAL ESTATE FUND from $100,000 to $2,000 in order to make its investments in REITs more affordable.

Financial forecasters predict rents will continue to rise and fuel the above-average growth of REIT dividends. On the other hand, some forecasters feel that the REIT market has reached its max for the near term and feel that rents and cash flows are too high now to grow again. Such forecasters recommend investing in real estate stocks abroad, where the market for such is relativity new.

The best advice for a person wishing to invest in REITs: do all of the homework attendant to investing in a security. Review the prospectus; calculate returns on investment. Decide whether investment through a mutual fund or directly through purchase from a broker is best. A point to remember: a REIT sold through a broker will have a commission fee attached to it; purchase of a no-load mutual fund which invests in REITs will not have a commission

PART THREE

INDIVIDUALS IN DEBT

Living with debt is a fact of life for many. Most people live their lives of quiet desperation from paycheck to paycheck with never more than enough savings to last a few months in the event of a personal calamity: loss of a job, a court judgment or extraordinary medical bills.

Bankruptcy is one option for people who have a mountain of debts. Bankruptcy is discussed in detail in its own chapter. In the Living with Debts chapter, the discussion is devoted to educating people about their rights as debtors. On the other hand, it is not written in stone that the person will lose everything he owns or that bankruptcy is the only alternative.

This Part Three discusses both living with debts and the alternative of starting over again through the use of bankruptcy. Financial planning always involves a personal debt relationship. It is impossible for the average person to manage his finances without having a good grasp on debt. When a person does not have a good grip on his debt, he must adopt a strategy to handle that

CHAPTER 13

LIVING WITH DEBTS

Our society survives on debt. Nearly everything purchased in this country is done on credit. The major credit card companies are everywhere. Just about every store accepts one or more credit cards: Visa, MasterCard, Discover, American Express, Diner's Card. If everyone had to pay cash for their purchases, the economy would stagnate. Our economy is one of conspicuous consumption. Fashions change every year, and women must purchase a new wardrobe to stay in fashion. Cars are designed to be functionally obsolete every five years. We are conditioned to buy new and replace the old even if it isn't necessary. Progress is purchased at the expense of debt.

Because a person owes money does not mean he is a deadbeat. Once it did but it does no longer. There are few people who are not in debt to someone for something. A medical doctor will owe up to $100,000 in student loans for his education. Nearly everyone buying a new car must finance the car. There are few home purchases for cash. Nearly everyone uses a credit card, and few are paid modern society. Few people are immune from it. Even Donald Trump, a multi-millionaire, has debt obligations which he must satisfy. There is nothing wrong in owing money as long as the debtor meets his financial obligations on time. The problems arise when he can no longer make the payments. At that time he is apt to make his worst mistakes in financial planning. This chapter is devoted to helping a person understand and manage his debts and live with peace of mind.

I. SECURED VERSUS UNSECURED DEBTS

There are two types of debt: secured debt and unsecured debt. Secured debt is a debt whose payment is backed by collateral. When a secured debt is not paid, the creditor (person to whom the debt is owed) may employ the state's legal procedure, repossess (take possession of) the collateral and sell it. The proceeds from the sale of the collateral are applied to the amount of the secured debt. To the extent that the proceeds do not cover the amount of the secured debt, the creditor becomes an unsecured creditor. A secured debt is created by a written security agreement or clause in the purchase contract which specifically identifies the property that is collateral for the debt.

failure to make a payment. Subsequently, the buyer misses several payments; the furniture store repossesses the furniture and sells it at a public sale. The buyer owed $3,700 and the sale brought in $2,300. The buyer therefore owes the furniture store $1,400. Since all of the collateral has been sold, the store must get a judgment before it can collect the remaining $1,400. To the extent of $1,400, the furniture store is an unsecured creditor.

The opposite of a secured creditor is an unsecured creditor. An unsecured creditor is a creditor with no collateral for the debt. The creditor must sue the debtor and obtain a court judgment before he can collect the debt. Most debts are unsecured: medical bills, credit card bills, debts resulting from accidents, food bills, student loans, etc. Any debt which is not backed by collateral is an unsecured debt.

The major credit purchases in a person's life are usually secured. The most commonly secured debts are home loans, car loans, boat loans and furniture loans. Understanding the differences between secured and unsecured loans is necessary so the debtor can know how a creditor can collect a judgment legally.

Unscrupulous collection agencies harass debtors by claiming

The fact is creditors cannot take property that is not pledged as collateral for a debt without first having sued and collected a judgment. Without a court judgment a secured creditor may repossess only that specific property pledged as collateral for a debt.

Most states will permit repossession of property under a security agreement only if it can be done without a breach of the peace. This means that the secured creditors usually cannot break doors in order to get to the property. There is a remedy for the secured creditor in the event that the debtor will not permit the property to be repossessed peaceably. The secured creditor can get a writ of possession from the court requiring the debtor to release the property. Established procedures permit a secured creditor to obtain a writ of possession quickly. Once the writ is issued, the creditor can get a sheriff or marshal to accompany him to ensure that repossession is peaceable.

II. EXEMPTIONS

Regardless of the amount of money that a person may owe, no state will permit all of the unsecured property of a debtor to be taken to pay his debts and obligations. States will not interfere with the repossession and sale of secured property because the

Each state places limits on the amount of unsecured property which can be taken by unsecured creditors. The property that cannot be attached or seized as payment for unsecured debts is called exempt property. These specific limitations on property attachment are known as exemptions. An exemption is the right of a debtor to keep a certain amount and type of unsecured property even though he has obligations in excess of the value of the exempt property.

English common law did not provide for exempting any property from creditor seizure. Both America and Australia were settled in part by indentured servants or persons sent to debtor's prison because of their failure to pay debts. The idea of letting people start again in the face of overwhelming debt is really a relatively new idea under the law. The Bankruptcy Code is amended roughly every five years to keep it abreast of our modern society's attitude toward debts and debtors.

Exemptions exist to help the debtor and the debtor's family at the expense of the creditors. Exemptions are created by specific state law and are determined solely by the language in the exemption statutes. Exemptions are usually divided into three exempt property: less unsecured property can be taken from a debtor with family than from a single debtor or a head of household. The reason for the higher family exemption: someone has to support the family of the debtor. No state will permit all of the unsecured property to be taken and the debtor's children to be rendered destitute.

B. HEAD-OF-HOUSEHOLD EXEMPTIONS

A head of household is a person, married or not, who has a legal or moral obligation to support the people living with him. The head-of- household definition is similar to the federal tax exemption definition for head of household: the household must consist of family relatives, and the head of household must provide more than half of the support of at least one member of the household.

Under most state laws a head of household has more exempt property than a single person for the same reason that a family debtor has higher exemptions. The state wants to minimize the harmful effect on innocents of the attachment of a debtor's unsecured property.

C. EXEMPT PROPERTY

All states grant some degree of exemption for personal property. Usually, the value of the exempt unsecured personal property is $3,000 to $15,000. As part of the personal property which is exempt, most states include the value of food needed for reasonable support. A debtor cannot buy a supermarket of food and claim that all is exempt. The value of insurance policies usually is exempt as are welfare, social security and disability benefits. The most commonly exempted form of personal property is household goods, including furniture. Household goods are determined to be ordinary household items of ordinary value (not antiques) that are needed for ordinary use and comfort. Most states also permit one unsecured motor vehicle with a value of less than $1,500 to be exempted. In addition, all states permit personal clothing of ordinary value to be exempted.

2. WAGES AND EARNINGS

An unsecured creditor must file a lawsuit against the debtor in order to get paid. At trial the creditor will present his case, and the court will enter a judgment against the debtor if he has no defense. The judgment orders the debtor to pay a certain amount of money to the creditor. The creditor can then begin to garnish week. No creditor can attach a debtor's wages unless the earnings, after taxes, are more than the exemption: only the excess can be seized.

3. PROPERTY USED IN TRADE OR BUSINESS

Most states permit unsecured property used in a trade or business to be exempt. The purpose is to leave the debtor with the ability to earn a living to support his family. The value of this property varies from state to state but is usually around $1,500. By "trade or business" most states mean vocational occupations such as mechanics, plumbers, etc. Most states do not consider professions such as lawyers, doctors, architects to be trades, and the unsecured property used in their businesses is not exempt in those states. Some states, however, do permit the professional library and instruments of a professional to be exempt for the same reason as property used in a trade or business.

4. TENANCY-BY-THE-ENTIRETY PROPERTY

Only about 20 states recognize tenancy by the entirety. It is a special joint tenancy estate between a husband and wife. Neither spouse can obtain a partition of the estate or defeat the right of survivorship of the other spouse. It cannot be terminated by the

2. Mutual agreement, whereby they agree to terminate the tenancy.
3. Execution against the property by a joint creditor of both spouses. A creditor of just one spouse cannot execute against in a tenancy by the entirety.

The following states permit a debtor to exempt tenancy-by-the-entirety property from seizure by creditors for debts in which the debtor's spouse is not liable (both spouses had not incurred the debt on the property, only one spouse put the debt on the property) or the debt was not for necessities for the couple:

DELAWARE	DISTRICT OF COLUMBIA	FLORIDA
HAWAII	MARYLAND	MASSACHUSETTS
MICHIGAN	MISSOURI	NORTH CAROLINA
OHIO	PENNSYLVANIA	TENNESSEE
VERMONT	VIRGINIA	WYOMING

Most states treat tenancy-by-the-entirety property as ordinary joint tenancy property. In most states a debtor's interest in joint tenancy property can be seized and sold to pay his obligations. On the other hand, those states recognizing tenancy-by-the-entirety property do not permit creditors of just one spouse to take the debtor's interest in the tenancy-by-the-entirety property because the interest of the non-debtor spouse would be affected.

the full amount of the homestead. Most states do not permit this "doubling" of the homestead.

It is up to the debtor to prove that the property on which a homestead exemption is claimed is the debtor's residence. This can be accomplished quite easily by the recordation of homestead declaration. In fact, some states actually require the filing of a homestead declaration prior to filing the bankruptcy petition. Even if recording is not required, as a practical matter, a debtor should record a homestead declaration prior to filing the bankruptcy petition if a homestead exemption is sought. Filing the homestead declaration strengthens the homestead exemption and is proof that the property was the debtor's residence: important evidence if a creditor contests the appropriateness of the homestead exemption.

A homestead declaration form can be purchased at most stationary stores, notarized and recorded for a total cost of $20. Given the fact that the declaration may save thousands in exemption, it is a cheap insurance policy. The amount of the debtor's homestead available to creditors is calculated by taking the fair market value of the property, subtracting the higher priority liens on the how the homestead exemption is employed: the debtor's home is worth $40,000, the loan on the property is $19,000, the cost of the sale is $2,000 and the homestead exemption is $7,500.

Sale price	$40,000
minus debts on home	($19,000)
minus costs of sale	($2,000)
minus homestead exemption	($7,500)

Remainder Trustee keeps for unsecured creditors	$11,500

The above example is a worst case scenario. The debtor has equity that will be lost in the sale. There are two alternatives. The first is to sell the house before the seizure and then invest the proceeds in new exempt property. The other is to borrow against the equity and invest those proceeds in exempt property. Caution should be exercised in doing either of the above. Some courts might consider such actions an abuse of the exemption law.

A second example more common and beneficial to the debtor exists where the debtor does not have enough equity to cover the homestead exemption. In such a situation, the debtor should sell non-exempt assets and apply the proceeds to the loan on the home.

just $500. The bank account will be lost to creditors in any collection action if the debtor uses the bank account to reduce the $37,500, the debtor's equity and homestead exemption will increase to $2,500.

The following is a list of homestead exemptions by state. Exemption amounts occasionally are raised so a person in debt should always be aware of not just the homestead exemption but all of the other ones as well.

ALABAMA Under Alabama Code statute 6-10-2 there is a $5,000 homestead exemption on real property or a mobile home. The property cannot exceed 160 acres. A homestead declaration must be recorded before any sale of the property. A husband and wife may double this exemption (each take the full amount).

ALASKA Under Alaska Code statute 9.38.010 there is a $54,000 homestead exemption. If joint owners file for bankruptcy, the total exemption is still only $54,000. It can't be doubled.

ARIZONA Under Arizona Code statute 33-1101 there is a $100,000 homestead exemption. A married couple may homestead. For a homestead no greater than one quarter acre in a city, town or village or 80 acres elsewhere, the entire homestead is exempt. If the homestead is more than one quarter acre but less than one acre in a city, town or village, or between 80 to 160 acres elsewhere, the maximum exemption is $2,500. Above one acre in a city, town or village, or more than 160 acres elsewhere, there is no exemption. A married couple may not double a homestead exemption. For a single person the homestead exemption is $800, and for a married person, not head of household, the exemption is $1,250 under statute 16-66-218.

CALIFORNIA Under C.C.P. sections 704.710 and 704.730 there is a homestead exemption of:

1. $50,000 if single and not disabled.
2. $75,000 for married couple filing jointly: $37,500 each.
3. $100,000 if the debtor is 65 or older or mentally or physically disabled.

The debtor must live on the property. The proceeds from a sale are exempt for six months after received under C.C.P. 704.720. A homestead exemption may be filed under C.C.P. 704.920.

COLORADO There is a homestead exemption for real property occupied by the debtor of $30,000 under statute 38-41-201. A house trailer or coach used as a residence is exempt to $3,500 under statute 13-54-102. A mobile home can be used as a residence under statute 13-54-102. Sale proceeds are exempt for one year under statute 3841-207.

CONNECTICUT Under Connecticut law, there is no homestead exemption.

DELAWARE Under Delaware law, there is no homestead exemption. The courts, however, In Re Hovatter 25 B.R. 123 and Citizen's Bank Inc. vs. Astrin 44 Del 451, have permitted a married debtor to exempt his half interest in tenancy by the entirety (joint tenancy with the debtor's spouse) unless both spouses are liable on the debt.

debtor's half interest in a tenancy in the entirety (joint tenancy with a spouse) is exempt unless both spouses are jointly liable on the debt which the creditor is collecting.

FLORIDA	Under statute 222.05 and the Florida Constitution Article X Section 4 there is an unlimited homestead exemption for ½ acre in a municipality or 160 acres elsewhere, includes mobile or modular home. The Bankruptcy Court in the cases In Re Blum 39 B.R. 897 and In Re Hohler 19 B.R. 308 (1987) has ruled that a debtor's half interest in a tenancy by the entirety (joint tenancy with a spouse) is exempt unless the debt being collected is a joint obligation.
GEORGIA	The homestead exemption is $50,000 and any unused portion can be applied to any other property under statute 4413-100.
HAWAII	Under statutes 36-651-91 and 36-651-92 there is a homestead exemption of $30,000 to a head-of household debtor over 65 years of age. For all other

entirety (joint tenancy with a spouse) is exempt unless both spouses are liable on the debt being collected.

IDAHO Under statute 55-1003 the homestead exemption is $30,000. Sale proceeds are exempt for six months.

ILLINOIS Under statute 110-12-901 the homestead exemption is $7,500. Sale proceeds are exempt for one year. A married couple may double this exemption. A spouse or child of a deceased owner may claim a homestead exemption under statute 110-12-902.

INDIANA Under statute 34-2-28-1 the homestead exemption is $7,500. The homestead exemption plus the personal property exemption cannot exceed $10,000. Tenancies by the entirety (a form of joint tenancy with a spouse) are exempt unless the debts being collected are joint obligations. In re Jeffers 1 C.B.C. 559 and In the Matter of Haynes 4 C.B.C. 181 (1981).

IOWA Under statutes 499A-18, 561.2, 561.16, the homestead exemption is unlimited for a home on one half acre in a town or city or 40 acres elsewhere.

	$5,000.
LOUISIANA	Under statute 20:1 the homestead exemption is $15,000 for a home on no more than 160 acres. The spouse or child of a deceased owner may claim the exemption. The debtor must occupy the property when the exemption is claimed. A married couple may not double this exemption.
MAINE	Under statute 14-4422 the homestead exemption is $7,500 increasing to $60,000 for a person over age 60 or physically or mentally disabled. A married couple may double this exemption.
MARYLAND	None but tenancies by the entirety were held exempt in In re Ford, 1 C.B.C.2d 840 (1980) and Sumy vs. Schlossberg 777 F.2d 921 (1985) unless both spouses are liable on the debt.
MASSACHUSETTS	Under statutes 188-1 and 188-1A the homestead is $100,000 increasing to $200,000 for a person over age 65 or physically or mentally disabled. A married couple may not double. In addition under statute 209-1, a debtor's interest in a tenancy by

	Nat'l Bank vs. Chrystler 5 C.B.C. 85, the court held that a debtor's interest in a tenancy by the entirety (a special form of joint tenancy with a spouse) is exempt unless it is a joint debt.
MINNESOTA	Under statutes 510.01, 510.01 and 550.37 there is an unlimited exemption for a home on one half acre in a city or 160 acres elsewhere.
MISSISSIPPI	Under statute 85-3-21 the homestead exemption is $75,000 on property of 160 acres or less. The debtor must occupy the property prior to the filing of bankruptcy unless over age 60 and either married or widowed.
MISSOURI	Under statute 513.430 and 513.475 the homestead exemption is $8,000 for real property and $1,000 for a mobile home. A married couple may not double this exemption. Tenancies by the entirety were held exempt in the case In re Anderson 12 B.R. 483 (1981) unless the debts of both spouses are a joint liability.
MONTANA	Under statute 70-32-101 and 70-32-104 the homestead

	$10,000 on property that cannot exceed two lots in a city or 160 acres elsewhere. Sale proceeds are exempt for six months after a sale.
NEVADA	Under statutes 21.090 and 115.010 the homestead exemption is $95,000 on property. A married couple may not double this exemption. A homestead declaration must be filed before a creditor begins a collection action in order to get the exemption.
NEW HAMPSHIRE	Under statute 480:1 the homestead exemption is $30,000.
NEW JERSEY	NONE
NEW MEXICO	Under statute 42-10-9 there is a homestead exemption of $20,000 for a person who is married, widowed or supporting another person. A married person may double this exemption.
NEW YORK	Under statute C.P.L. section 5206 the homestead exemption is $10,000. A married couple may double this exemption.
NORTH CAROLINA	Under statute 1C-1601 there is a homestead exemption

	interest in a tenancy-by-the-entirety property except where both spouses are liable for the debts.
NORTH DAKOTA	Under statutes 28-22-02 and 47-18-01 the homestead exemption is $80,000 on real property, house trailer or mobile home used as a residence.
OHIO	Under statute 2329.66 the homestead exemption is $5,000 for real property, mobile home, house trailer or house boat used as a residence. In the cases In re Thomas 14 B.R. 423 and In re Hicks 1 C.B.C. 963 (1980), the court held that a debtor could exempt property held in tenancy by the entirety unless a discharge is sought for the debts of both spouses.
OKLAHOMA	Under statute 31-2 the homestead exemption is unlimited on real property or manufactured home provided the property does not exceed ¼ acre. If the property exceeds ¼ acre, the exemption is $5,000 on one acre in a city, town or village and 160 acres elsewhere.
OREGON	Under statutes 23.164 and 23.240 the homestead exemption for real property, mobile home or

or village or 160 acres elsewhere. Sale proceeds are exempt for one year if the debtor intends to roll the proceeds into the purchase of another home.

PENNSYLVANIA There is no homestead exemption. On the other hand, court decisions In re Thacker 5 B.R. 592 and In re Barsotti 3 C.B.C.2d 306 (1980) permit a debtor to exempt a tenancy by the entirety unless both spouses are jointly liable for the debts.

RHODE ISLAND There is no homestead exemption. Tenancy by the entirety may be exempt if it is not liable for a joint debt of both spouses: Cull vs. Vadnais (1979) A.2d 1241.

SOUTH CAROLINA Under statute 15-41-30. the homestead exemption for real property, mobile home or houseboat used as a residence is $5,000. A married couple may double this exemption.

SOUTH DAKOTA Under statutes 43-31-1 through 43-31-4 there is an unlimited homestead exemption on real property not exceeding one acre in town or 160 acres elsewhere. The exemption also applies to a mobile home larger

TENNESSEE	Under statute 26-2-301 the homestead exemption is $5,000, but a married couple may claim $7,500. Under court decision Ray vs. Dawson 5 C.B.C. 404 (1981) a debtor is permitted to exempt a tenancy by the entirety provided the debt is not owed by both spouses.
TEXAS	Under Property Statutes sections 41.001 and 41.002 there is an unlimited homestead exemption on real property that cannot exceed one acre in a town, city or village or 100 acres elsewhere (increasing to 200 acres for a family). Sale proceeds are exempt for six months after sale.
UTAH	Under statute 78-23-3 the homestead exemption is $8,000 but increases to $10,000 if married and adds an additional $500 for each dependent. A homestead exemption must be filed before any sale of the home in order to protect the proceeds.
VERMONT	Under statute 27-101 the homestead exemption is $30,000, which may also apply to rents, profits and out buildings. The spouse of a deceased owner may

VIRGINIA	Under statutes 34-4 and 34-18 the homestead exemption is $5,000 plus $500 per dependent, which may also apply to rents and profits. A married couple may double this exemption. Under court decisions In re Costley 39 B.R. 585 (1984) and Ragsdale vs. Genesco 674 F.2d 277 (1982) a debtor is permitted to exempt a tenancy by the entirety provided both spouses are not liable for the debts. The debtor must file a homestead declaration prior to a creditor's collection action in order to get this exemption.
WASHINGTON	Under statutes 6.13.010 and 6.13.030 the homestead exemption is $30,000.
WEST VIRGINIA	Under statute 38-10-4 the homestead exemption for real property, mobile home or houseboat used as a residence is $7,500. Any unused portion of the homestead exemption may be used for any other property.
WISCONSIN	Under statute 815.20 the homestead exemption is $40,000. Sale proceeds are exempt for two years if

this exemption. The property must be occupied by the debtor at the time of filing for the exemption in order to get this exemption. A spouse or child of a deceased owner may claim this exemption. Under court decision In re Anselmi 52 B.R. 479 a debtor is permitted to exempt a tenancy by the entirety provided a discharge is not being sought for the debts of both spouses.

III. ADVICE

A person who is head-over-heels in debt with "no way out" has two options: do nothing or file for bankruptcy protection. The debtor should ask two questions to determine which is best for him. How much unsecured property do I have which is exempt from creditors? Is it likely that I will acquire more exempt property before I die?

If the answers to the above questions are "none" and "no" respectively, the debtor is judgment proof. A judgment-proof debtor is one from whom, even if he does not file for bankruptcy, the creditor will never be able to collect any judgment. A debtor who is judgment proof will never have any unsecured property which is dead-end minimum-wage-paying job and owes hundreds of thousands of dollars in debts. Al knows that his creditors cannot take away what little he has, so he is totally contemptuous of bill collectors or threats of lawsuits. It is not suggested anyone adopt Al Bundy's life style. Nonetheless, he has the correct attitude. If all a debtor's property is exempt and the debtor is getting enough exempt income to live on, there is nothing a creditor can do to harm him. The only reason for filing bankruptcy would be the unlikely possibility that fortunes might change and non-exempt property would be received which a creditor could take.

A judgment-proof debtor usually has nothing to fear from creditors. All the debtor tells the collection agency is, "I'm judgment proof. I can't pay; so I guess you'll have to sue." The collector very seldom sues a truly judgment-proof debtor because it is unlikely there will ever be a payment. A collection suit costs the agency between $2,000 and $5,000. To spend that money without a likelihood of recovery is poor business. For that reason the Al Bundys of the world get a free ride.

If the answer to the above questions is "some" and "yes," then the debtor must consider filing for bankruptcy protection.

satisfy the judgment. Filing for bankruptcy protection settles all claims against the debtor by freezing the debtor's estate as it existed on the date of filing the bankruptcy petition. Therefore, subsequently acquired property after a bankruptcy filing will not be subject to attachment by creditors.

The cost for bankruptcy filings is high. The filing fee is $175, and the cost of hiring an attorney is between $750 and $1,000, depending on the problems arising in each case. There are, however, several do-it-yourself bankruptcy books on the market. These books contain forms and filled-in examples which the average person can purchase for around $20. A person wishing to file his own bankruptcy petition can do so with relative ease and certainty that it is being handled correctly. The next chapter addresses some of the general considerations by a person who does file for bankruptcy protection.

CHAPTER 14

FILING BANKRUPTCY

No discussion regarding financial planning would be complete without touching upon bankruptcy. A Chapter 7 bankruptcy petition is the most common type of bankruptcy petition which is filed. Chapter 7 bankruptcies are known as liquidations because the entire property, less exemptions, is taken and sold by the Trustee. The proceeds are divided among the debtor's creditors. To the extent the creditors remain unpaid, the debts are discharged. The debtor can start with a clean slate.

It is this fact that a debtor can start over with a clean slate which makes bankruptcy a significant tool to consider in financial planning. A person deeply in debt but with a potential of receiving money in the future can declare bankruptcy and discharge all of the debts. Then when the anticipated money is received in the future, the debtor's old creditors cannot attach it. For example, once came into a law office seeking advice. She explained that she was co-liable with her ex-husband for over $100,000 in debts. Having no way of paying off the debts, it was clear that she declaring bankruptcy, her creditors received nothing because she was judgment proof. Upon her father death two years later, she inherited the house free of any creditor claims. She subsequently sold the house and then used the proceeds to start a small cafe.

Many wealthy businessmen have gone through bankruptcy during their climb to wealth. The discharge of their debts gave them the opportunity to start again and continue their ascent. While it might be evidence of a person's strength of character to strive to pay off all of their obligations and die broke, it is often foolish and unnecessary. The bankruptcy law exists to permit people to start again when facing an insurmountable pile of debt. Not to take advantage of the right to discharge such debts legally is poor financial planning.

2005 BANKRUPTCY REFORM ACT

On October 19, 2005, the 2005 Bankruptcy Reform Act became effective. This was the most sweeping change in Bankruptcy Law ever undertaken. It changed the rights of debtors that were in place from virtually the founding of this country. Below is a systemic paramount to understanding how the bankruptcy law will for the foreseeable operate.

I. CREDIT COUNSELING REQUIREMENT

For the first time, debtors are now required to seek credit counseling as a precondition for filing a bankruptcy petition be it chapter 7 or Chapter 13. Before filing a bankruptcy petition, the potential debtors are now required within 180 days preceding the filing to have received an individual or group “briefing” for credit counseling that assists the individual in performing a budget analysis. §109(h) The credit counseling may be by telephone and Internet briefings.

To prove that the counseling had occurred, the debtor must file with the Court a certificate from an approved nonprofit budget and credit counseling agency describing the services provided to the debtor along with a copy of the debt repayment plan, if any. §521(b). The Bankruptcy law now requires that the Credit Counseling Agency provide adequate counseling with respect to a client's

Only certificates from those credit counseling agencies approved by the US Attorney and listed by the clerk of the Bankruptcy Court will be accepted by the Bankruptcy Courts. §109(h) § 111.

The official standard for the approval of the credit reporting agency is that provides qualified counselors, safeguards client funds (audits and bonding), provides adequate counseling for credit problems, and “deals responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides.” The agency must have an independent board of directors, charge a reasonable fee and provide services “without regard to ability to pay the fee.”

In the event that after the credit counseling a proposed debtor decides not to file for bankruptcy relief, then the credit counseling agency is specifically barred from reporting to a credit reporting agency that a debtor has received or sought instruction. This is to protect the person’s privacy and seek more use of credit counseling services.

representing consumer Debtors for pay would fall in the category of "Debt Relief Agencies" as contrasted with "Credit Counseling Agencies" discussed above. Debt relief Agencies include anyone other than a credit counseling agency who provides "bankruptcy assistance to assisted persons" by definition assisted persons are consumer debtors having less than $150,000 in nonexempt property.

The Debt Relief Agency which includes the debtor's attorney would be subject to sanctions if it:

1. fails to meet new disclosure and record keeping requirements for Debt Relief Agencies;
2. fails to comply with advertising requirements;
3. fails to perform any service that it contracted to perform;
4. files a document that with the exercise of reasonable care it should have known was untrue and misleading; or
5. directly or indirectly misrepresents to a client or prospective client the services it provides OR the benefits and risks of bankruptcy. §526

The Act requires that the Debt Relief Agency and Debtor's Attorney execute a written contract with the debtor within five (5)

B. NEW REQUIREMENT FOR VERIFICATION OF FACTS

Debtor’s Attorney will now under the Reform Act face personal liability on a number of new factual situations such as:

1. If the trustee files a 707(b) motion for dismissal or conversion which is then granted, and the Court finds that the attorney for the debtor violated rule FRBP 9011 by filing the petition, then the Court may order the attorney to reimburse the trustee for all reasonable costs in prosecuting the motion. §707(b)(4)(A)

2. If the court on its own motion finds that the attorney for the debtor violated FRBP rule 9011, the Court, may assess an appropriate civil penalty against the attorney. §707(b)(4)(B)

Under FRBP 9011, the signature of an attorney on a petition, pleading, or written motion is now taken to mean that the attorney has performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion and determined that the petition, pleading, or written motion beyond that of simply relying on the statements of the debtor. Now the conclusive certification that the attorney has no knowledge after an inquiry that the information contained in the schedules is incorrect. §707(b)(4)(D)

As such it the attorney the attorney becomes personally liable for damages and sanctions when he has been misled by his client to the extent that he could have discovered the falsehoods had he investigated. There is no longer a good faith defense for a false petition rather the attorney must now actively prove that he could not have discovered the falsehood with normal diligence as set by the court.

C. PROHIBITED ADVICE

The Reform Act prohibits the debtor’s attorney among others from going out and incurring more debt before filing bankruptcy. This has been a running sore point with credit card agencies for decades where shortly before filing a debtor went on a spending spree. The question to be determined in future case law is the extent which this prohibition can be enforced.

It has been asserted that the provision may be car which would be paid 100% under the new Ch 13 provisions. This advice though totally legal and beneficial to both the creditors and debtor would be in technical violation of the Act § 526(a)(4)

Common sense would seem to dictate that legal advice intended to marshall and streamline an estate rather than to create new debts will continue to be protected. Care, however, must be taken to assure when property or debts are transmuted from unprotected to protected that the proper holding periods are maintained before the filing of the petition. These periods have been extended, in some cases, years longer.

III. MULTIPLE FILINGS NO LONGER PERMITTED

The Reform Act has increased the number of years after a Ch 7 case that an individual must wait before filing another Ch 7 case has been increased from six years to eight years. § 727(A)(8). This was a major victory for credit card companies which sought a longer period before debtors could again file another bankruptcy petition. Credit Card companies, in reality, view a person who filed for bankruptcy a better risk in many situations than a person who had

Another change in the act is that a debtor may no longer receive a discharge in a Ch 13 case if they received a discharge in a case filed under chapters 7, 11, or 12 during the 4-year period preceding the date of the order for relief in the Ch 13 case. This was once known fallaciously as a Chapter 20 petition or s SUPER DISCHARGE. In the same view, a debtor may no longer receive a discharge in a Ch 13 case if they received a discharge in a case filed under chapter 13 during the 2-year period preceding the date of the order for relief in the Chapter 13 case. §1328(f) These changes are important because they prevent a debtor from using a Chapter 7 filed after a Chapter 13 case has closed to eliminate unsecured debt not discharged in the Chapter 13 case. This was once a very popular means to avoid such debts and was on its face contrary to the intent of the bankruptcy code. It was a testament to the slowness of Congress that it took decades of debate before the Chapter 20 was abolished.

IV. NEW NOTICE TO CREDITORS REQUIREMENT

To help assure that creditors get their proper notice, the Act requires that if within 90 days before the filing date, a creditor address along with the account number. This helps define where a notice is to be sent for the purpose of starting a valid creditor claim period to run §342(c)(2)

When a creditor files with the bankruptcy court a notice of address, then any notice required to be provided by the court to the creditor shall be sent to that address unless the creditor files with the court and serves on a Ch 7 or Ch 13 debtor notice of a different address. §342(e)&(f)

If a notice is not sent to the designated address, it is not effective notice until brought to the attention of such creditor. If a creditor designates a person or division to be responsible for receiving bankruptcy notices, and establishes reasonable procedures so that notices are delivered to them, then a notice has been brought to the attention of the creditor when it is received by the designated person or division. §342(g)(1)

V. AUTOMATIC STAY RULES

A. AUTOMATIC STAY LIFTING

The Reform Act made several changes in how the automatic stay for good cause. This imposes an affirmative duty on the court to timely process the such petitions or the debtor loses the protection of the stay. This raises the constitutional argument of due process if a stay is lifted simply because the court did not get around to hearing the merits of the motion. In such an event, an appellate court could find the lifting of the stay under that circumstance was a denial of due process and thus unconstitutional

2. Under §362(c)(3) & §362(c)(4), absent clear and convincing evidence to the contrary, a new bankruptcy petition is presumptively not filed in good faith as to all creditors if:

   (A) the debtor had filed a Ch 7, 11, or 13 case is filed within one year of the dismissal of a prior case, other than a case refiled under 707(b) – the median income bankruptcy “abuse” section. In which case, the stay will be automatically lifted on the 30th day after the filing date. On the motion of a party in interest, the court may extend the stay as to any or all creditors, subject to conditions or limitations, if the party demonstrates that the current filing is in good faith as to the creditors to be stayed. §362(c)(3)

   (B) the debtor had two or more Ch 7, 11, or 13 cases had been pending within one year of the filing date of the current case, except for a case refiled under 707(b) – the median income bankruptcy “abuse” section. In which case, the automatic stay does not go into effect when the current case is filed. Within 30 days after filing the court may order the stay to take effect as to any or all creditors, subject to conditions or limitations, if the party demonstrates that the current filing is in good faith as to the creditors to be stayed. § 362(c)(4)

The purpose of these sections is to prevent a debtor from

B. AUTOMATIC STAY ON REAL PROPERTY

A debtor attempting to use the automatic stay to defraud creditors may be barred from receiving protection under an automatic stay for up to two years. Under the Reform Act, if the court finds that a Debtor filed a petition to delay, hinder, and defraud creditors through a scheme to transfer real property without the consent of a secured creditor or court approval, or through filing multiple bankruptcy cases affecting the same real property, then the Court may Order that the Relief from Stay remain binding in any case filed by the Debtor over the next two years. A debtor may, within 30 days of filing a subsequent case, move for relief from such order based upon changed circumstances or for good cause shown. §362(d)(4)

If such an Order is in effect, the Act provides that in a subsequent case filed during the 2-year period there is no stay to prevent enforcement of any lien against, or security interest in, the real property. §362(b)(20)

Similarly, the Act provides that there is no stay to prevent voluntary dismissal of the case following the filing of a motion for relief from stay, or the subsequent case was filed in violation of an order prohibiting the petitioner from being a debtor in the case. §362(b)(21)

C. AUTOMATIC STAY ON SUPPORT OBLIGATIONS

The Reform Act did not change the automatic stay for voluntary and involuntary wage and other income deductions for domestic support obligations. Likewise, the automatic stay will not stay the commencement or continuation of a proceeding to

1. establish paternity; to order or modify domestic support obligations;
2. concerning child custody or visitation;
3. for the dissolution of a marriage, except determination of division of property of the estate; regarding domestic violence;
4. to collect a domestic support obligation from property that is not property of the estate;
5. to withhold income, under a nonbankruptcy order or statute, that is property of the estate or the debtor for payment of a domestic support obligation;

8. to intercept a tax refund; or to enforce a medical obligation under the SSA. §362(b)(2)

The bankruptcy law defines Domestic Support Obligations as debts under non bankruptcy law owed to a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, responsible relative, or governmental unit in the nature of alimony, maintenance, or support without regard to whether such debt is expressly so designated, and not assigned to a non governmental entity, unless assigned voluntarily for the purpose of collecting the debt. §101(14A)

VI. MEANS TESTING FOR CHAPTER 7 ELIGIBILITY

The feature of the Reform Act is the “means test.” For the time in history, a debtor can only file a Chapter 7 bankruptcy petition if the debtor passes a means test. The test is designed to prove to the court that the debtor is so poor that it is unlikely that the debtor could make even marginal payments to the creditors. If the means test shows that the debtor is able to make some payments to the creditors then the debtor’s petition for chapter 7 relief would be denied and only relief under a Chapter 13 petition court before dismissing a petition, that standard has now been reduced to a mere finding of abuse. This makes more likely a dismissal irrespective of a filing of the means test. Now a bankruptcy court could dismiss a Chapter 7 petition or convert it to a Chapter 13 petition under Section 707 upon a finding that granting relief would be an “abuse” of the provisions of Chapter 7 by an individual consumer debtor. What constitutes an abuse is on a case by case basis. Essentially a court would have to find based o the totality of evidence that the debtor filed the petition in bad faith. Abuse can be found without applying an income and expense “test” and may be based on non-economic factors. §707(b)(3).

There are really two tests which together determine if the Debtor is qualified to be permitted to seek Chapter 7 relief and thus may file a petition

A. MEDIAN INCOME TEST

The First test is simply to see if the Debtor’s Current Monthly Income exceeds the State Median Income for a family of the more than one half of the people min the state. If the debtor’s family earns less than one half of the families of the same size then the test is met. For example if there are 50,000 families of four (4) in the state and 25,000 earn more than $6,000 per month and one half (25,000) earn less than $6,000 per month then if the debtor’s family earns $4,500 per month, the debtor qualifies under this test. This is really a quite easy test to apply as the monthly income is et for each state for each family size and the debtor will either meet it or not.

Essentially if the excess income of monthly income remaining after deducting reasonable expenses leaves enough money to be able to give a meaningful dividend to unsecured creditors, then the test is not met.

B. MEANS TEST

After passing the first test, then the second test must be passed to be permitted to file a Chapter 7 petition. This is a means test to determine whether the Debtor’s Current Monthly Income once reduced by allowed expenses would exceed a statutorily

The essential rules for the test are as follows;

1. If the Debtor’s Current Monthly Income is less than the State Median Income, then there is NO presumption of abuse exists on which a dismissal can be based.

2. If the Debtor’s Current Monthly Income is more than the State Median Income, but the Debtor’s excess income is LESS than the amount allowed under the Means Test, NO Presumption of abuse exists on which a dismissal can be based. This situation would apply in a high income state where one half of the people earn lots of money and one half of people earn very little. In such an instance it would be possible for someone to earn more than one half of the people in the state and still be below the base line earning figure of the state.

Under the test, should the Debtor’s Current Monthly Income is more than the State Median Income, AND the Debtor’s excess income is MORE than the amount allowed under the Means Test, then a presumption of abuse exists on which a Motion to Dismiss can be based.

A motion to dismiss for abuse can be brought based upon a belief of abuse can be brought at any time by the Court or the U.S.

The first step in applying the means test is to calculate the Debtor’s “current monthly income.” This is the average monthly taxable and non-taxable income from all sources, including income attributable to a non-filing spouse unless they are separated, except Social Security payments and certain payments to victims of war crimes or terrorism, including amounts paid on a regular basis by other entities for the household expenses of the debtor or the debtor's dependents, that the debtor receives during the 6-month period ending on the last day of the calendar month immediately preceding the date of filing. If the debtor does not file the required schedule of current income then the dates for the 6-month period are determined by the Court. §101(10a)

2. State Median Income –

The next step in applying the test is to determine if the Current Monthly Income for the Debtor’s family exceeds the State Median Income for a family of the same size. The Administrative Office of the U.S. Trustee will develop and maintain tables based on U.S. Census data showing median income for each state for households with up to four family members. For example, as of

Act, households with more than four members will receive an additional $525 per month per individual.

WHERE THE DEBTOR’S CURRENT MONTHLY INCOME DOES NOR EXCEED THE STATE MEDIAN INCOME, THERE IS NO NEED TO APPLY THE MEANS TEST AS IT IS AUTOMATICALLY SATISFIED.

WHERE THE DEBTOR’S CURRENT MONTHLY INCOME THEN THE MEANS TEST MUST BE APPLIED WHICH REQUIRES CALCULATING MONTHLY EXPENSES. The means test is based upon disposable income. Such disposable income must be below the state median income to avoid the presumption of abuse. To determine the disposable income monthly expense must be deducted from the gross income to see if it still remains higher than the state median income.

Monthly expenses are defined in section 707 of the Reform Act. For 2005, the IRS National Standards for food, clothing, personal care and entertainment were:

One Person National Standard
Based on Gross Monthly Income

Item	**less than**	**$833 to**	**$1,250**	**$1,667**	**$2,500 to**	**$3,334 to**	**$4,167 to**	**$5,834**

Apparel & services	60	61	70	75	100	124	134	207
Personal care products & services	19	24	26	27	40	42	43	44
Miscellaneous	108	108	108	108	108	108	108	108
Total	$403	$428	$460	$494	$577	$649	$691	$953

Two Persons National Standards
Based on Gross Monthly Income

Item	less than $833	$833 to $1,249	$1,250 to $1,666	$1,667 to $2,499	$2,500 to $3,333	$3,334 to $4,166	$4,167 to $5,833	$5,834 and over
Food	336	337	338	424	439	487	559	691
Housekeeping supplies	36	37	38	48	52	53	107	108
Apparel & services	81	88	91	95	125	132	164	276
Personal care products & services	33	34	35	43	44	51	56	71
Miscellaneous	134	134	134	134	134	134	134	134
Total	$620	$630	$636	$744	$794	$857	$1,020	$1,280

Three Persons National Standards
Based on Gross Monthly Income

Item	less	$833	$1,250	$1,667	$2,500	$3,334	$4,167	$5,834

Personal care products & services	**34**	**36**	**37**	**44**	**45**	**52**	**61**	**79**
Miscellaneous	**161**	**161**	**161**	**161**	**161**	**161**	**161**	**161**
Total	**$835**	**$851**	**$867**	**$882**	**$908**	**$1,002**	**$1,156**	**$1,430**

Four Persons National Standards
Based on Gross Monthly Income

Item	**less than $833**	**$833 to $1,249**	**$1,250 to $1,666**	**$1,667 to $2,499**	**$2,500 to $3,333**	**$3,334 to $4,166**	**$4,167 to $5,833**	**$5,834 and over**
Food	**468**	**525**	**526**	**527**	**528**	**640**	**722**	**868**
Housekeeping supplies	**42**	**43**	**44**	**50**	**54**	**61**	**109**	**110**
Apparel & services	**146**	**169**	**170**	**171**	**174**	**189**	**217**	**317**
Personal care products & services	**37**	**42**	**43**	**45**	**46**	**53**	**62**	**81**
Miscellaneous	**188**	**188**	**188**	**188**	**188**	**188**	**188**	**188**
Total	**$881**	**$967**	**$971**	**$981**	**$990**	**$1,131**	**$1,298**	**$1,564**

More than Four Persons National Standards
Based on Gross Monthly Income

Item	**less than $833**	**$833 to $1,249**	**$1,250 to $1,666**	**$1,667 to $2,499**	**$2,500 to $3,333**	**$3,334 to $4,166**	**$4,167 to $5,833**	**$5,834 and over**

ADDITIONALLY:: If demonstrated to be reasonable and necessary, the monthly expenses may include an additional allowance for food and clothing of up to 5 percent of the food and clothing categories above.

In addition the Debtor can deduct expenses determined by the IRS Local Standards for transportation and housing ‘ Here are some of the New York state housing allowances which show the wide variance among the counties.

New York - Housing and Utilities Allowable Living Expenses

Collection Financial Standards
Financial Analysis - Local Standards: Housing and Utilities (effective 1/1/2005)

Maximum Monthly Allowance

County	**Family of 2 or less**	**Family of 3**	**Family of 4 or more**
Albany County	**1,217**	**1,432**	**1,647**
Allegheny County	**794**	**934**	**1,074**
Bronx County	**1,609**	**1,892**	**2,176**
Broome County	**947**	**1,114**	**1,281**
Cattaraugus County	**826**	**972**	**1,117**
Cayuga County	**971**	**1,143**	**1,314**
Chautauqua County	**858**	**1,010**	**1,161**
New York County	**3,547**	**4,173**	**4,799**

ADDITIONALLY: The debtor's monthly expense allowance for housing and utilities may be increased based on the Debtor’s actual reasonable and necessary expenses for home energy.

ADDITIONALLY: the IRS Transportation allowance:

Allowable Living Expenses for Transportation

Step by step:

(A) Multiply monthly income less deductions _____________ X 60 = ___________ (A)

(B) If the Amt on Line A IS GREATER THAN OR EQUAL TO $10,000 **THE PRESUMPTION EXISTS**

(C) If the Amount on Line A IS LESS THAN $10,000 CONTINUE

(D) Multiply the unsecured debt _____________ X .25 = ___________ (D)

(E) Write the GREATER of Line D or $6000 here = ___________ (E)

(F) If the Amt on Line A IS GREATER THAN OR EQUAL TO Line E **THE PRESUMPTION EXISTS**

(G) If the Amt on Line A IS LESS THAN the Amount on Line E **THE PRESUMPTION DOES NOT EXIST** § 707(b)

3. DOCUMENTS REQUIRED TO BE INCLUDED IN A PETITION

Debtors must make sure that the following information is provided to the court in their petition or within 45 days following the filing.

a. A certificate of the attorney or petition preparer or pro se debtor regarding the 342(b) notice;

B.. Copies of all “pay stubs” received within 60 days before the filing date;

f. A certificate from the approved credit counseling agency;

g. A copy of the debt repayment plan, if any;

h. A record of any interest that the debtor has in an IRC 529(b)(1) or 530(b)(1) education individual retirement account or qualified State tuition program;

§521(a)(b)&(c)

Failure by the debtor to file all of the required information within 45 days (plus up to an additional 45 days if granted by the Court) after the date of the filing of the petition, would result in the case being automatically dismissed on the 46th day.

In addition to the above, the Debtor is required to file tax returns as well as follows:

1. Seven (7) days before the meeting of creditors, a Debtor in a Ch 7 case is required to provide the trustee, and any creditor who requests one, with a copy or a "transcript" of their Federal income tax return for the most recent tax year ending before the filing date for which a Federal income tax return was filed. If the Debtor fails to provide the return the court must dismiss the case unless the debtor demonstrates that the failure was due to circumstances beyond their control. §521(e)(1)&(2)

have not been filed by the meeting date, the trustee may continue the meeting to allow the debtor to file the returns. The Debtor may then be required to file and provide all three years of the prepetition returns. If a missing return(s) was past due on the filing date the meeting can be continued for no more than 120 days. If the missing return(s) was not past due, the meeting can be continued for 120 days or to the date on which the return is due under the last automatic extension for filing the return, whichever is later. If the debtor demonstrates by a_preponderance of the evidence that failure to file is due to circumstances beyond their control, the court may extend the filing period for a short additional period.§1308

If a post-petition return is not timely filed, or filed within 90 days of a request to file, a Tax Authority can move for dismissal or conversion of the case. § 521(I)

3. WHO CAN FILE A MOTION TO DISMISS

(A) WHEN DEBTOR’S INCOME IS LESS THAN STATE MEDIAN

The Act provides that where the Debtor’s Current Monthly Income is LESS than the State Median Income, ONLY the Court or the U.S. Trustee not the Chapter 7 panel Trustee may file a Motion to

(B) WHEN DEBTOR’S INCOME EXCEEDS STATE MEDIAN

1. When the Debtor’s income is LESS than the State Median Income, OR Debtor’s income is MORE than the State Median Income and the Debtor’s excess income is LESS than the amount allowed under the Means Test, NO presumption of abuse exists, and a Motion to Dismiss for abuse cannot be filed by anyone under the presumption of abuse provisions (Note that it can still be filed based on bad faith or totality of circumstances). §707(b)(7)

2. Where the Debtor’s Current Monthly Income is MORE than the State Median Income, presumably the U.S. Trustee, Trustee, Court, or any party in interest may file a Motion to Dismiss for abuse on grounds of bad faith or based on the totality of the circumstances of the debtor's financial situation. §707(b)(1)

3. Where the Debtor’s Current Monthly income is MORE than the State Median Income and the Debtor’s excess income is MORE than the amount allowed under the Means Test, a presumption of abuse exists, and a Motion to Dismiss CAN be brought by the U.S. Trustee, Trustee, Court, or any party in interest under the presumption of

The clerk of the bankruptcy court is required to notify all creditors if the presumption of abuse exists. §342(d) In addition, the U.S. Trustee is required to conduct a review of the case and file within ten (10) days following the meeting of creditors a determination as to whether the presumption of abuse exists. If the Trustee believes such a presumption of abuse exists then the Trustee, must file a motion to dismiss or an explanation why none is being filed. §704(b)(1)

A Debtor may successfully prevent a dismissal even under a presumption of abuse to the extent established establishes by a preponderance of the evidence that the case is necessary to satisfy a domestic support obligation. §707(c)(3)

VII. DOMICILE RULES FOR FILING

To avoid the past practice of forum shopping in bankruptcy by moving to another state and then filing, the Reform Act increased from 180 days to 730 (two years), the residency period for changing a domicile. So to qualify for using a State’s bankruptcy Exemptions a Debtor must now live in a state for two years prior to least 730 days after moving to a new state to qualify to use that State’s exemptions. § 522(b)(3) so the advantage of moving to take advantage of another state’s more favorable exemption schedule such as in the homestead exemption is significantly reduced.

VIII NEW RULES ON HOMESTEAD EXEMPTION.

Next to the means test, the most important changes in the Reform Act are the changes to the homestead exemption. Since a home is the largest asset in most debtors’ estates, the issue of changing the homestead exemption was a major sticking point in the amendment of the Bankruptcy Act for decades. Even now the changes, while significant were still not the wide sweeping changes originally foreseen: There are three major changes in how the homestead exception works:

1 There is a limitation on the increase of value in a debtor’s homestead prior to filing bankruptcy. Under the old law, there was no prohibition to selling nonexempt assets and adding the proceeds toward improvements or paying off the debts on the homestead to the extent of the exempt homestead amount under state law.

Now under the Reform Act, any addition to the value of a made with the intent to defraud or delay creditors will still be counted toward the homestead amount. Ten years seems entirely too long a period to be workable. It seems very unlikely that creditors could succeed in claiming that improvements made more than three years before filing a petition were part of a plan to defraud creditors. Improvements made closer to the filing period will start to carry such a presumption under the Act

2. The second change to the homestead act prevents adding additional value to a homestead exemption which would raise it more than $125,000 within 1215 days (three years and four months) prior to the filing. For example, if a debtor’s state exemption is $250,000 but the debtor only has $50,000 equity in the homestead, the debtor can only add an additional $75,000 in value to raise the exemption amount within 1215 days of filing anything more than that will not count. However if the debtor waits more than 1215 after last adding value to the homestead, he can increase it by $200,000

   Not included in the addition to value is an interest transferred from a debtor's previous principal residence acquired prior to the beginning of the 1215-day period into the debtor's current principal residence in the same state, or the homestead is the principal residence of a family farmer. § 522(p)

(a) had been convicted of a felony which demonstrates bankruptcy abuse,

(b) owes a debt arising from violation of Federal or State securities laws; or any RICO civil remedy;

(c) committed any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual during the last five years. An exception to this $125,000 limitation is allowed to the extent reasonably necessary for the support of the debtor and any dependent. § 522(q)

IX. LIEN AVOIDANCE ON HOUSEHOLD GOODS.

Under the Reform Act, a nonpossessory, nonpurchase-money security interest in household goods may be avoided only on clothing; furniture; appliances; 1 radio; 1 television; 1 VCR; linens; china; crockery; kitchenware; educational materials and equipment for minor dependents; medical equipment and supplies; furniture for children and elderly or disabled dependents; personal effects (including toys and hobby equipment of dependent children and_wedding rings) of the debtor and the dependents of the debtor; and 1 personal computer and related equipment.

recreational device, conveyance, vehicle, watercraft, or aircraft.' § 522(f)(4)

X. PROPERTY NOT PART OF A DEBTOR’S ESTATE

A. Contributions to Educational Accounts

Contributions made to an education individual retirement account (IRC 530(b)(1)) or a qualified State tuition program (IRC 529(b)(1)(A)) are not part of the debtor’s estate and thus not lost in a bankruptcy when

(a) made at least 365 days before the date of filing, and

(b) the beneficiary is a child (including an adopted or foster child), stepchild, grandchild, or step-grandchild.

The exemption is only available to the extent that the funds are not security for a loan and are not excess contributions (IRC 4973(e)). In addition, only $5,000 of contributed funds placed in accounts between 720 days and 365 days before the filing date are exempt for a beneficiary § 541(b)(5)&(6)

B. Contributions to Employee Plans

employees for payment to a qualified employee benefit plan (IRC 414(d)); a deferred compensation plan (IRC 457); or a tax-deferred annuity (IRC 403(b)) (does not constitute 1325(b)(2) disposable income); or to a health insurance plan regulated by State law. § 541(b)(7) This is nothing new as it has been the case law for over a decade but now it is codified.

C. Pension and Profit Sharing Plans - 401K Loans

Retirement funds are subject to special attention under Act. There is a codification and extension of the Patterson vs. Shumate decision of the Supreme Court to the effect that tax exempt retirement funds, are not property of the estate subject to payment of debts. Likewise,

1. transfers and roll-overs, are not part of the estate up to $1,000,000 per individual. §522(b)(4)
2. loans from these plans are specifically exempted from discharge §523(a)(18)
3. wage deductions for funding tax-deferred plans and repayment of such loans are not subject to the Automatic Stay which means the deductions can continue §362(b)(19)

The effect of this favored treatment of these types of retirement loans may be that to some extent debtors may borrow money from their own account prior to the bankruptcy and then repay it to their retirement accounts during the Ch 13 case thus reducing the amounts available for repayment of creditors.

C. Transfers to Asset Protection Trusts

A few states permit self settled grantor trusts wherein a grantor can create an irrevocable spendthrift trust for the grantor. After a certain period of time under state law, the self settled spendthrift trust cannot be attached by the creditors of the grantor. Under the Reform Act, the Trustee may avoid any transfer into a self settled grantor trust within 10 years of filing where the debtor is a beneficiary and the debtor made the transfer with actual intent to hinder, delay, or defraud a current or future creditor. § 548(e) The operative provision therein is a finding that the transfer was made to hinder delay or defraud creditors. Since the purpose of such a trust is to protect the estate form creditors, it seems that nearly every such trust could be invalidated by a Trustee.

and the debtor's dependents, which is very difficult to prove absent a severe disability, all student loans are now nondischargeable. Under the Reform Act, it does not matter who makes the student loan to the debtor all such loans whether governmental, non-governmental, commercial entity are nondischargeable asset extreme hardship § 523(a)(8).

B. Taxes

Under the Reform Act, Taxes are now treated the same in a chapter 13 and they are in a Chapter 7 case. In addition, interest will continue to run on unsecured nondischargeable, taxes throughout the life of the Chapter 13 plan and continue to be subject to payment.

Priority will be given to taxes assessed within 240 days before the filing date – calculated by not counting the time which an offer in compromise was pending during the 240 days plus 30 days, and any time during which the collection of the tax debt was stayed during the 240 days plus 90 days. For example, if an offer in compromise had been pending from March 1 to May 31 for a Debtor who filed on July 1, any income tax assessed within 422 (240 + 90 with respect to a tax period and tax liability that ended before the date of filing, unless the set off of an income tax refund was not permitted because of a pending action, in which case the governmental unit may hold the refund pending the resolution of the action unless the Bankruptcy grants the taxing authority adequate protection. § 362(b)(26)

C. Debts for Luxury Goods & Cash Advances

To further prevent debtors from taking out last minute loans or going on a buying binge prior to filing, the Act makes nondischargeable the following debts:

1. Consumer debts incurred within 90 days before filing, totaling more than $500, and owed to a single creditor for "luxury goods or services" which are not goods or services reasonably necessary for the support or maintenance of a debtor or dependent

2. Cash advances from a single creditor totaling more than $750 obtained within 70 days, which are now presumed to be nondischargeable. § 523(a)(2)(C)

D. Debts Subject to Property Settlements with Former Spouses -

nondischargeable. §523(a)(5) Under the previous law, such debts were dischargeable if the debtor did not have the ability to pay the debts or if discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor.

Often in the past, under a property settlement agreement or divorce one spouse agreed or was ordered to pay joint debts. Then in the future that person filed for bankruptcy, and discharged those debts despite the agreed property agreement or court order leaving the other ex-spouse to pay the debts alone. That is now changed in that the non-filing co-debtor ex-spouse may be able to effectively block any meaningful Ch 7 bankruptcy by having a State Court order the Debtor to pay the spouse directly so they can in turn pay the Creditors. § 523(a)(5) § 523(a)(15)

XII. PREFERENCES

The Act attempts to clarify when payments on existing accounts are to be considered preferences and when they are not.

1. A transfer is not a preference to the extent it was a

4. A transfer is not a preference if it totals less than $5,000. § 547(c)(9)

5. A bona fide payment made on a domestic support obligation is not avoidable. § 547(c)(7)

If the trustee avoids a transfer, made between 90 days and 1 year before the date of filing, from the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, the transfer is avoidable only with respect to the insider. For example, if payment is made between 90 and 365 days to a third-party creditor that favors an insider by reducing the amount owed by the insider on a debt, the transfer is not recoverable from the third-party, but may be recoverable from the insider. § 547(I)

A new feature under the Act is that the trustee cannot avoid transfers made as part of a repayment schedule created by an approved credit counseling agency. § 547(h) The time allowed for a creditor to perfect a lien is increased from 10 to 30 days. § 547(e)(2)

XIII. REAFFIRMATIONS

Under the Act, a debtor may not retain possession of personal the property would no longer be part of the property of the estate, and the creditor may take action under nonbankruptcy law to recover such property.§ 521(a)(6)

Reaffirmations which are agreements by a debtor to pay for property rather than lose it in a Chapter 7 proceeding (under §524(c)) must now have, where appropriate,

1. a disclosure statement;
2. the reaffirmation agreement;
3. a statement of intent to reaffirm;
4. a declaration of the attorney (if any);
5. a Debtor's statement of support showing income and expenses and amount available to pay reaffirmed debt;
6. and an order.

The disclosure must include the "Amount Reaffirmed," which is the total amount of debt reaffirmed plus fees, and the "Annual Percentage Rate," using a Truth in Lending Act formula when available. §524(k)(1)

The Act presumes that if the amount of monthly income available to pay a reaffirmed debt is less than the payments on the statement that identifies additional sources of funds to make the payments. If the court is not satisfied with the explanation, then it may disapprove the agreement after a noticed hearing before entry of a discharge.

XIV REDEMPTIONS

Redemption are agreements in which the debtor, in essence, agrees to back secured property which was otherwise to be returned to the secure creditor under the bankruptcy. Under the Act, a debtor in a redemption must make payment in full of an allowed secured claim at the time of redemption. §722 Under the previous law, a creditor was entitled to receive the amount that the creditor would have received if the secured property had been repossessed and sold minus the costs of sale. The Reform Act now holds that the value of personal property securing an allowed claim is the replacement value as of the date of filing without deduction for costs of sale or marketing. If the property is property that was acquired for personal, family, or household purposes, “replacement value” means the price a retail merchant would charge for property of that kind considering the age and condition of the benefit to the estate, and the court may order adequate protection and delivery of the collateral to the trustee. § 521(a)(6) § 362(h)

The Act the debtor must file a statement of intention to redeem or reaffirm a debt within strict time periods. If the statement of intention is not timely filed, , then the automatic stay is lifted as to such secured personal property for purchase money or non-purchase money debts. Such secured property would no longer be property of the estate, or subject to an unexpired lease. If the debtor wishes to reaffirm or redeem property, then a statement of intention must be filed within 30 days of the petition filing date or as extended b y the Court (or as extended by the Court for cause) after the Meeting of Creditors to file a statement of intention with respect to such personal property or within 30 days to take the action specified in such statement, unless the debtor's intention is to reaffirm and the creditor refuses to agree to the reaffirmation. § 362(h)

If the debtor fails to timely act and redeem property with debtor continues making payments. The creditor could always do it later if payments are missed.

XV. EFFECT OF BANKRUPTCY ON DEBTOR’S LEASES

The Act governs how addresses, in part, leases for both real and personal property are handled along with when and how evictions from real property are handled

The trustee may not assume a breached executory contract of unexpired lease unless the trustee cures or provides adequate assurance that the trustee will promptly cure such default or provides adequate assurance that the trustee will promptly cure such default; other than a default arising from failure to perform nonmonetary obligations under an unexpired lease of real property that cannot be cured by the trustee, except from failure to operate in accordance with a nonresidential real property lease, such default shall be cured by performance at and after the time of assumption in accordance with such lease, and with pecuniary losses being compensated. §365(b)

An unexpired nonresidential lease of real property shall be

Should a lease of personal property be rejected or not timely assumed by the trustee, the leased property is no longer property of the estate and the stay is automatically terminated. For such unassumed leases, the debtor in a case under chapter 7 may contact the creditor in writing and offer to assume the lease. A creditor is not required to accept a debtor proposed assumption of a rejected lease. §365(p)(1).

Whether an automatic stay exists to stop eviction proceedings depends on whether there as obtained by the landlord a judgment of possession prior tot he debtor’s filing for bankruptcy relief

A. JUDGMENT OF POSSESSION OBTAINED BEFORE DEBTOR’S FILING

The automatic stay will not stop evictions under state judgments received prior to the filing of the petition. Where a landlord has obtained a judgment against the debtor for possession of the Debtor’s residence prior to the filing date, the Landlord can, without obtaining relief from stay, continue with the eviction proceeding.

However an exception exists staying a judgment for possession

2. the debtor has deposited with the clerk of the Bankruptcy Court any rent that would become due during the 30-day period after the filing of the bankruptcy petition.

Should the debtor within the 30 day period then file and serve on the lessor a second certification that they have under nonbankruptcy law cured the entire monetary default then the eviction would be stayed permanently as long as rent is paid. The landlord may file an objection to any certification and then the court must hold a hearing within 10 days to determine if the certification is true. If the landlord’s objection is upheld then the stay is lifted and the landlord may immediately proceed to recover full possession of the property. § 362(b)(22)

B. NO JUDGMENT OF POSSESSION OBTAINED BEFORE DEBTOR’S FILING

Even when a landlord has not obtained a writ of possession, the landlord can still proceed with an eviction action based on

1. endangerment of the residential property or

2. the illegal use of controlled substances on the premises,

The lessor must provide the debtor with a certification that

1. an eviction action has been filed, or

The landlord after waiting 15 days, can then, without obtaining relief from stay, move forward with an eviction proceeding. § 362(b)(23). However an eviction proceeding may be stayed if within the 15 day period the debtor files and serves on the lessor objections to the truth or legal sufficiency of the Landlord’s certification. In which case, the court must hold a hearing within 10 days to determine the truth of the certification. If the debtor satisfies the court that the situation did not exist or has been remedied, then the stay would remain in effect. If the debtor cannot disprove the certification, then the landlord may immediately proceed to recover full possession of the property.

A debtor is required to disclose on the Petition if a judgment for possession has been obtained and provide the name and address of the lessor so the Bankruptcy Clerk can provide required notices to them. § 362(l) § 362(m)

XVI. DEBT PRIORITY

A. Priority for Support Payments and Discharge of Property Settlements

2 child of the debtor, or such child's parent, legal guardian, or responsible relative, or

3 are assigned, or owed directly to or recoverable by, a governmental unit under applicable nonbankruptcy law. § 507(a)

B. Priority Claims

Under the Act the Priority Period for wages, salaries, and commissions that are owed is extended back to 180 days prior to filing and is allowed in an amount up to $10,000 per claim. In addition, business cases, claims for contributions owed to Employee Benefit Plans are given priority up to $10,000 multiplied by the number of employees. A new tenth priority class of claim was created for drunk driving death or personal injuries. § 507

XVII AUDITS

The Act imposes a duty on the Attorney General and on the Judicial Conference to perform IRS like audits on not less than 1 out of every 250 randomly selected individual Chapter 7 and 13 cases, AND audits of schedules in all cases with greater than average statistical variances for the district by reason of higher to the U.S. Attorney and take further appropriate action, including but not limited to commencing an adversary proceeding to revoke the debtor's discharge.

Audit standards must be established within 24 months after enactment, with the audit provisions taking effect 18 months after enactment. The Act provides for revocation of Discharge if a debtor fails to satisfactorily explain a material misstatement in an audit or to make available for inspection all necessary accounts, papers, documents, financial records, files, and all other papers, things, or property belonging to the debtor that are requested for an audit. Presumably a Debtor is required to keep all records relating in any way to their bankruptcy for an indefinite period after their Discharge? § 727(d)(4)

XVIII. CHAPTER 13 PLAN

A. PAYMENT OF UNSECURED DEBTS UNDER A CHAPTER 13 PLAN

The Reform Act has adopted what is called a “best efforts test” to assure that a debtor makes a good faith attempt to pay the unsecured creditors. In essence, an unsecured creditor or the debtor’s disposable income is determined to be the debtor’s current monthly income minus the following

1. child support payments, foster care payments, or disability payments for a dependent child reasonably necessary to be expended for such child minus amounts reasonably necessary to be expended for the maintenance or support of the debtor or a dependent, or for a domestic support obligation first payable after the filing date,
2. minus IRS deductible charitable contributions in an amount not to exceed 15 percent of gross income for the year the contributions are actually made.
3. If the debtor has a business, disposable income is reduced by expenditures necessary for the continuation, preservation, and operation of the business. §1325(b)
4. The charitable contributions exclusion made by the debtor. Proposed contributions are deducted from the current monthly income but the contributions must be made. Failure to do so might result in both fraud being charged the debtor and the attorney himself being liable for the misrepresentation for not watching over the debtor.

Health insurance premiums are deducted from the current

If a Debtor’s income meets or exceeds the mean’s test, then any Ch 13 Plan must be for five years unless the plan provides that all allowed unsecured claims are to be paid in full which apparently would be without interest over a shorter term. §1325(b)

C. ADEQUATE PROTECTION FOR CREDITORS

An important goal of the Act is to provide Adequate Protection for the creditors of Chapter 13 cases. In that vein, the Act provides:

1. that payments on allowed secured claims made through the Plan must be in equal monthly amounts in an amount not less than sufficient to provide “adequate protection” as determined by the Court during the term of the plan. §1325(a)(5)(B)(iii).

2. that for lease obligations that become due after the order for relief, the debtor must make the adequate protection payments directly to secured creditors. This has the effect of reducing the proposed lease payments under the plan by the amount of the direct payments, and providing the trustee with proof of payment showing the

> debtor must make adequate protection payments directly to the secured creditors and providing the trustee with proof of payment showing the amount and date. §1326(a)(1)

Under these provisions, a debtor must continue to make payments directly to creditors on leases and on installment purchases, pending confirmation of a chapter 13 plan. While the approval of the proposed plan is pending, the court could modify, increase, or reduce the payments until approval.

Thirty days after filing the proposed Plan, , the debtor must be making regular payments to the Trustee of the payments required under the proposed Plan. However, if the Plan is not approved then the Trustee must return those payments.

These provisions may have a significant impact in many jurisdictions. It would seem that if Creditors actively seek adequate protection, Debtors will be required to make sufficient pre and post confirmation payments to keep the balance owed to each creditor less than the depreciating value of the security. While this may have been a general requirement in the past, under the Act it is given new emphasis that the Court and Trustee will need to

Valuation of security has always been an important aspect of a bankruptcy because it determines both how much a secured creditor is paid and how much a debtor must pay for the secured property. The Act has settled this area a little by holding that both in a Chapter 13 case and a Chapter 7 Redemption, the value of property securing a debt is the replacement value as of the date of filing without deduction for costs of sale or marketing. If the security is property that was acquired for personal, family, or household purposes, "replacement value" means the price a retail merchant would charge for property of that kind considering the age and condition of the property. § 506(a)(2)

E. LIEN RETENTION AND EFFECT OF CONVERSION

A secured creditor does not lose his protection or security in a Chapter 13. The plan is required to protect the Secured Creditor by

1. retaining the creditor's lien until the underlying debt is paid in full the amount that would be paid to the Creditor under nonbankruptcy law , or

2 the debtor receive a Ch 13 Discharge.

a reduction in principal and interest owed to a secured creditor. Under the Act, a debtor may no longer file a chapter 7 petition after completing a chapter 13 the option of conversion to Ch 7 where secured debts have been stripped down. Now under the Act:

1. If a case is converted from Ch 13 to Ch 7 any secured property will continue to be secured until the amount which the creditor would be entitled under nonbankruptcy law for that property has been paid in full, as set by the date of conversion. This means the amount that the debtor is paid the same amount that would have been received if no bankruptcy had been filed.
2. Unless a prepetition default has been cured in full under the plan, the default shall have the effect it would have under nonbankruptcy law.

Another quirk of the Act is that valuations of property in the Ch 13 case do not carry over to a Ch 7 case. Thus a Chapter 7 trustee is free to redetermine the asset values of a Chapter 13 case as of the date of filing.§348

F. SECURED CLAIMS- NO CRAM DOWNS

In Chapter 13 cases – a Debtor MUST pay the secured and unsecured portions of a claim in full but possibly not at the at was incurred within 1 year preceding the filing date [some suggest that in the 1 year situation the language can be interpreted to include non-purchase money security interests]. §1325(a)(9)

G. CONFIRMATION OF PLAN

1. Hearing Date

The Plan confirmation hearing is to be held between 20 days and 45 days following the date of the meeting of creditors. The court can decide to hold the conformation hearing earlier if it finds that earlier hearing would be in the best interests of both the creditors and the estate and there is no objection. §1324(b)

Under the Act, the Court will not confirm a plan where the debtor until the debtor has become current with all post-petition domestic support obligations §1325(a). In addition, a final discharge will not be granted at the conclusion of the Plan until a certificate is filed with the Court stating that all post-petition domestic support obligations and pre-petition domestic support obligations under the plan have been paid. §1328(a)

If during the Plan period the court finds that a debtor is not obligations are owed to a governmental unit, then the plan can provide for less than 100% payment in the situation where the debtor proposes to pay all of his projected disposable income in a five year plan. §1307(c)(11) §1322(a)(4)

2. Annual Reports and Privacy

Under the Act, a debtor will be required to file an annual financial statement with the court if any party in interest along or the Court requests it. Such a statement must disclose the amount and sources of the income of the debtor; the identity of any other person responsible for the support of a dependent; and the identity of and the amount contributed by any person to the debtor’s household. This provision opens up the debtor’s home life to the public. §521(f)(4) §521(g)(1)

3. Interest on Non-Dischargeable Debt

If a debt is non-dischargeable interest and penalties continue to accrue. If interest is payable on a tax claim or administrative tax expense, or to enable a creditor to receive the present value of a tax claim, the rate of interest is the rate under nondischargeable unsecured claims IF the plan provides for full payment of all allowed claims. §1322(b)(10)

This provision would be advantageous where creditors do not file significant amounts of dischargeable unsecured claims. In which case, the debtor's attorney should be alert to filing claims for them with interest and penalties when amounts otherwise paid to general unsecured creditors would be paid on nondischargeable debt. A debtor may file claims for a Creditor up through 90 days after the 341 meeting for general creditors and 180 days for governmental units with the exception that in a Ch 13 case a claim with respect to a prepetition tax return must be filed on or before 60 days after the date the return was filed. §502

4. Insurance

The Act extended the time for a debtor to get required rental insurance to 60 days. Now debtors must provide a lessor or secured creditor reasonable evidence of required insurance coverage no later than 60 days after the date of filing, and continue to provide proof of insurance for so long as the debtor retains

Under the Act for all Chapter 13 cases, there is to be held, at least 10 days before the discharge order is issued, a pre-discharge hearing to determine that:

1. that there is no reason to believe that the Debtor owes a debt for - violation of Federal or state securities laws and regulations;
2. that there is no reason to believe that the debtor engaged in fraud, deceit, or manipulation in a fiduciary capacity in connection with registered securities; a civil remedy for securities violations; any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death in the preceding 5 years, and
3. there is no pending proceeding where the Debtor may be found guilty of a felony or liable for a debt based on those acts. A pre-discharge hearing is to be held in all Chapter 13 cases.§1328(h)

2. DEBTS NOT DISCHARGEABLE UNDER CHAPTER 13

Under the Reform Act a Chapter 13 discharge can no longer discharge claims which were nondischargeable under a Chapter 7 proceeding such as resulting from:

3. Credit received under false pretenses or representations or actual fraud other than a financial statement;

4 Credit received under a written financial statement that the Debtor made with intent to deceive that was materially false and reasonably relied on by the creditor;

5. Debts that were neither properly listed nor scheduled in the petition to permit timely filing of a proof of claim (and in the case of claims regarding luxury goods, fraud by a fiduciary, and willful injury, sufficient time to challenge dischargeability), unless the creditor had notice or actual knowledge of the case so as to permit a timely filed proof of claim;

6. fraud by a fiduciary, embezzlement, or larceny;

7. a domestic support obligation;

8. educational loans (as expanded by the Act - absent undue hardship);

9. death or personal injury caused by unlawfully operating a motor vehicle, vessel, or aircraft under the influence of intoxicants;

10. criminal restitution or a fine included in a sentence on the debtor's conviction of a crime; and

Under the Act a Ch 13 Plan can still discharge three types of debt that cannot be discharged in a Ch 7 case, claims resulting from:

1. property settlements [not support obligations] (§523(a)(15) debts);
2. willful and malicious injury to property (§523(a)(6)); and
3. debts incurred to pay nondischargeable tax obligations (§523(a) §1328(a)

The Reform Act defines the nondischargeable debts using references to §§ 507 and 1322, however §1328 denies a Ch 13 discharge of civil restitution or damages resulting from “willful OR malicious” acts, while under §507 a discharge is denied when the acts are both “willful AND malicious.” This language would make the Ch 13 discharge more restrictive than the Ch 7

The Act increases the time period under which a Trustee may go back and seize certain transfers are deemed to be fraudulent and recoverable by the Trustee under the Bankruptcy Code from one to two years State fraudulent conveyance laws often allow the trustee to go back even further. § 548

CHAPTER 14

ASSET PRESERVATION THROUGH THE USE OF SELF-SETTLED SPENDTHRIFT TRUSTS

Probably the most interesting and controversial changes to estate planning to occur within the last 50 years have been the adoption in a minority of states of spendthrift trusts for the asset protection of the trust grantor and not just the beneficiaries' interests in the trust. This is such a major departure from the asset protection law of the majority of states that it may have, in the future, a profound effect as to how people hold title to their property in the United States.

A spendthrift trust has always been a special type of trust, the assets of which, by its own terms, could not be attached by creditors of the trust beneficiary. The history behind the spendthrift trust extends far back into English common law under which assets, primarily land, were kept intact for passage down through a family line.

By definition under the **RESTATEMENT (SECOND) OF TRUST SECTION** sell or alienate their interest in the trust. Likewise, creditors of a beneficiary of a spendthrift trust, which in the past did not include a grantor if also a trust beneficiary, could not force the trustee to pay the debts of a beneficiary from the beneficiary's interest in the trust.

HISTORY OF SPENDTHRIFT TRUSTS

The validity of a spendthrift trust as a shield from a beneficiary's creditors was recognized by the United Supreme Court in its decision ***NICHOLS VS. EATON*** 91 U.S. 716 (1875). The case involved a trust provision calling for the termination of a trust beneficiary's right to require the trustee to pay income to the beneficiary upon the beneficiary's bankruptcy followed by the beneficiary's income interest being replaced by a purely discretionary trust. Under the terms of the newly created discretionary trust, the trustee would not be under any requirement to make any payments to or for the benefit of the beneficiary. Such payments would be at the sole unfettered discretion of the beneficiary. Since such payments were discretionary and not mandatory, the Court held that the creditors of the beneficiary trust would be used for the benefit of a beneficiary and not be taken first by the creditors of the beneficiary. The Court stated:

> “[T]he doctrine that the owner of property cannot dispose of [that property], but that [the beneficiaries sought to be benefitted by the gifts in trust]....must hold [the property given into the trust for their benefit] subject to the debts due his creditors...is one which we are not prepared to announce as a doctrine of this court.”

Following the United State Supreme Court’s decision all of the states subsequently adopted the rationale set forth in ***Nichols*** and have held that spendthrift trusts are valid and protect the trust assets from attachment by the creditors of the trust beneficiary.

So complete has been this judicially created bar from a spendthrift trust’s attachment by the creditors of a trust beneficiary, that when attachment has been permitted, it has only been by legislative act. The most important and pervasive exception to rule that creditors of a spendthrift trust may not attach the trust is for claims of child or spousal support against a debtor parent or spouse who is the beneficiary of a spendthrift trust. Virtually all states have by legislation enacted laws permitting such creditor claims against a spendthrift trust for which the exceptions to the general rule which remains firmly entrenched that absent a legislative acts stating otherwise, the assets of a spendthrift trust are not attachable by the creditors of a trust beneficiary.

By trust beneficiary, it had always been taken to mean someone other than the Grantor. It was always understood that while a grantor could be one of the beneficiaries or even the sole beneficiary of a spendthrift trust, the assets attributed to the Grantor in the Trust would remain attachable by the Grantor's creditors. To do otherwise, the courts have always believed would give the Grantor a means to avoid paying his or her lawful debts by simply transferring his or her assets into a trust for himself or herself. The law in virtually all states permits creditors of a trust grantor to attach the assets of the trust when the trustee has the authority to transfer the assets of the trust back to the grantor. As such, when the grantor is a beneficiary the trustee has authority to transfer some or all of the trust assets to the grantor and thus the grantor's creditors can attach the trust assets which can be transferred to the Grantor whether the Grantor wants those assets or not.

of the grantor. This is why living trusts also known as revocable trusts are not protected from the grantor’s creditors while the grantor is alive. As long as the grantor of a typical revocable trust is alive, he or she may revoke the trust and reacquire the assets. For that reason, the grantor’s creditors may attach the trust assets.

The majority rationale against recognition of self-settled spendthrift trusts as a means of a grantor to avoid his or her creditors arise squarely from the belief that no one should be permitted to shield his or her property from existing creditors and yet have, at the same time, effective control and use of that property.

USE OF THE SELF-SETTLED SPENDTHRIFT TRUSTS TODAY

Until 1997, it was impossible for a person to shield his or assets from existing creditors through the use of a self-settled spendthrift trust. That has changed to an extent. As of April 2000, four states, have enacted legislation which permits self-settled spendthrift trusts in one form or another. These states are:

4. Nevada (See Nev Rev Stat. 166 (1999)

For a grantor to qualify for asset protection under a self-settled spendthrift trust in any of the above jurisdictions, he must strictly comply with the statutory requirements for the state involved.

NEVADA’S ACT

The self-settled spendthrift trust law of Nevada will be discussed as an example as how the concept works. Prior to implementing its self-settled spendthrift trust legislation, Nevada followed the majority of states wherein a spendthrift would only protect someone other than the grantor of the trust. If a grantor was among the beneficiaries of a spendthrift trust, the creditors of the other beneficiaries could not attach the trust but the creditors of the grantor were permitted to attach the trust for claims against the grantor.

As of April 2000, a person can create a self-settled spendthrift trust in one of the above four states in which a grantor is also a beneficiary and which will be safe from attachment by creditors of the grantor except under very specific

(b) a qualified bank trust department with an office in Nevada, or

(c) a qualified trust company with an office in Nevada

2. The Trust must be in writing

3. The trust must be irrevocable

4. The Trust must have a spendthrift provision wherein the trustee is not required to distribute any of the income or principal to the grantor, and

5. The Trust may not be formed with the intent to hinder, delay or defraud ***known*** creditors of the grantor.

Once the trust is properly created, the grantor may be the primary beneficiary of the trust and receive virtually all of the distributions of income and principal while at the same time having the trust assets shielded from his or her creditors. For this to work, care must be taken to assure that all statutory requirements are met. While the trust must be irrevocable, the grantor can still retain some operative rights such as the right to order the trustee not to make a distribution. The grantor cannot order a distribution to be made but can order one not to be made. A Trustee other than the grantor can have discretion to make distributions of income and principal to the grantor Nev.Rev Stat. Sec. 166.040(2)(b) (Supp.

(a) all or a part of the land, rents, issues or profits in the trust are located in Nevada, or

(b) all or part of the personal property, money, dividends upon stock, and other intangible personal property in the trust are in Nevada, or the declared domicile of the creator of a spendthrift trust affecting personal property is in Nevada, or

(d) at least one qualified trustee has powers that include maintaining records and preparing income tax returns for the trust, and all or part of the administration of the trust is performed in Nevada.

In addition to the above, a trust will be governed by Nevada if the trust document itself states that it is to be governed by Nevada law.

If the self-settled spendthrift trust has been properly drafted then attachments for the creditor claims of the grantor are strictly limited. Under Nevada Revised Statute 166.170, creditors of a grantor in existence at the time property is transferred into a self-settled spendthrift trust must commence action within two years after the property transfer or six months after they discovered or should have discovered the transfer which ever occurs first. Creditors of the grantor arising after the transfer of the of tax liens or claims for child or spousal support as discussed above.

ALASKA'S ACT

Alaska was the first state to enact a self-settled spendthrift trust act. Alaska's legislation is effective only for spendthrift trusts created after April 2, 1997. For trusts created prior to that date the settlor's interest may still be attached for payment of claims against the settlor.

The pertinent part of legislation as it relates to a grantor's interest in a trust, Alaska Stat. 34.40.110 states that the "transfer restriction prevents a creditor existing when the trust is created, a person who subsequently becomes a creditor or another person from satisfying a claim out of the beneficiary's interest, unless the

(1) transfer was intended in whole or part to hinder, delay, or defraud creditors under AS 34.40.010;

(2) trust provides that settlor may revoke or terminate all or part of the trust without consent of a person who has a substantial beneficial interest in the trust and the interest would be adversely affected by the exercise of the power held by the settlor to revoke or terminate all or part of the trust; in this paragraph "revoke or

(3) trust requires that all or a part of the trust’s income or principal, or both, must be distributed to the settlor”

The above Alaskan law is quite similar to Nevada in several important respects as it relates to creditor of the grantor’s attachment of the grantor’s beneficiary interest in the trust. As in Nevada, a grantor’s interest in the trust can not be attached if:

(1) the trust is irrevocable but the grantor can maintain a veto power over distributions

(2) the grantor cannot terminate all or part of the trust without the consent of the other affected beneficiaries.

(3) the trust does not mandate or order distributions be made to the grantor of income and/or principal, and

(4) the settlor if acting as trustee cannot have the discretion of making distributions of income or principal to himself as beneficiary.

As these issues are the same as Nevada, the Nevada discussion on them above would apply here as well.

Where Alaska law and Nevada law differ is in what is referred to as the period of contestability. This is the period of time set transferred into the trust or one year after discovery of the transfer or when he should have discovered it, whichever is later, to bring an action against the trust as a fraudulent transfer. Likewise a creditor of the grantor who becomes one after the trust is created must bring an action within four years of the transfer of property into the trust in order to attach it. Once property is in the property for more than four years, subsequent creditors of the grantor cannot attach it.

DELAWARE’S ACT

Delaware’s law regarding spendthrift trusts and their applicability is in essence the same as Alaska’s. Under Del. Code.Ann.tit 12, Sec 3570, a spendthrift trust is valid as to a grantor if the trust instrument:

“a. Expressly incorporates the law of this State to govern the validity, construction and administration of the trust;

b. Is irrevocable, but a trust instrument shall not be deemed revocable on account of its inclusion of 1 or more of the following:

1. A transferor’s power to veto a distribution from the trust.

> principal is either in the sole discretion of a qualified trustee or qualified trustees or is pursuant to an ascertainable standard in the trust instrument.”

As discussed in Nevada and Alaska above, a spendthrift trust for a grantor must be irrevocable. In addition to giving a trustee sole discretion to make distributions to a grantor, Delaware permits the trust agreement to specify a specific formula for distributions to a grantor and still have the trust be a spendthrift one. Use of a specific formula, however, defeats the purpose of a spendthrift clause because even if the assets cannot be attached directly, creditors will know how much and when such distributions will be made pursuant to the formula and thereby prepare for their attachment once the distributions are paid. While the grantor may retain the right to veto a distribution of the trust, it is unclear that the veto would actually be permitted in a situation where the distribution is mandated by the trust instrument and the only reason the grantor has for vetoing it is to prevent the grantor’s creditors from seizing it.

The period of contestability of a transfer of property into form attaching the property. The Delaware Act applies to spendthrift trusts created after July 1, 1997.

MISSOURI'S ACT

The Missouri spendthrift law is the broadest of any of the states. Mo.Rev Stat. Sec 456/080(3) states as follows:

"(3) A provision restraining the voluntary or involuntary transfer of beneficial interests in a trust will prevent the settlor's creditors from satisfying claims from the trust assets, except:

(1) Where the conveyance if assets to the trust was intended to hinder, delay, or defraud creditors or purchasers,

(2) To the extent of the settlor's beneficial interest in the trust assets, is at the time the trust was established or amended;

(A) The settlor was the sole beneficiary of either the income or principal of the trust or retained the power to revoke or amend the trust, or

(B) The settlor was one of a class of beneficiaries and retained the right to receive a specific portion of the income or principal of the trust done at a time when the settlor was insolvent and unable to pay his obligations and for inadequate consideration. It is a tenuous concept and requires affirmative proof by the creditor of the financial distress of the grantor at the time the trust was created or that the transfer was part of a pre-designed scheme to defraud creditors. Transferring property to a trust and then subsequently developing a plan to defraud creditors shields the assets from subsequent judgments by defrauded creditors so timing is important as to when a suit is made.

Missouri like Delaware permits a specific formula to be used for determining distributions to the grantor in addition to the option of giving sole discretion to the trustee. As in the Delaware discussion, the use of specific formula assures the creditors of the grantor that the fixed determined amount of distributions will be available for attachment once made to the grantor. There is no provision under Missouri law for the grantor to veto the distribution and therefore the amount could possibly be attached by the grantor’s creditors once it has been actually paid.

CONSTITUTIONAL QUESTIONS AND CONFLICTS

of Columbia do not recognize self-settled spendthrift trusts as protecting the assets of the grantor who is also a beneficiary of such a trust. The question then arises what will happen if a grantor of such trust is sued in such a state.

Because the concept of using a self-settled spendthrift trust to protect the assets of the settlor is new, no case law has developed yet to see how non-self-settling states would view suits against the grantor. However, it is extremely likely that in such an event that the non-self-settling jurisdiction (one of the 46 states and the District of Columbia majority) would disregard the trust and order payment of any judgment from the trust assets. This is consistent with the long established treatment of spendthrift trusts and was in fact how the minority states handled the issue prior to their enactment of their self-settled spendthrift trusts legislation.

The Constitutional argument is very complicated. If a non-self settling jurisdiction were to give full faith and credit to a self-settled spendthrift trust created in another state, it would be giving rights to a trust not permitted to trusts formed under its own laws. There would be an immediate conflict between the rights

It would seem very unlikely that the majority of states would accept a self-settled spendthrift trust as protecting the grantor's assets in the trust from judgments in that state against the grantor.

However, even if a non self-settling spendthrift trust jurisdiction disregarded the trust, it still could only enforce a judgment against the trust if either the trustee or trust assets were in the state. The only person or entity who could transfer assets in the trust to pay any judgment is the trustee. If the trustee is not subject to state jurisdiction because the trustee is not in the state, then there is no way to obtain jurisdiction over the trustee so as to order the trustee to pay the judgment. Likewise, if no trust assets are in the non-self-settling state, the court of such a state could not assume in-rem jurisdiction over such property to and apply it to satisfying the judgment.

All of this assumes that under the terms of the trust document that the grantor does not have the power to replace the trustee. As long as the Grantor cannot replace the trustee, he would not be able to order the trustee to make a distribution to the grantor. Therefore, the court would not be able to order the grantor to

American courts have no jurisdiction. In such instances, American courts have held the trusts invalid and punished the creators as violating American law.

In ***FTC V. AFFORDABLE MEDIA, LLC.*** 179 F.3D 1228 (9th Cir. 1999) the grantors of self-settled offshore APT were jailed for contempt pending repatriation of the assets. In the case of ***IN RE PORTNOY***, 201 B.R. 685 (1996) a transfer to an APT was found in violation of public policy when a foreign trust was created to shield the grantor’s assets from a personal guarantee that was to be called. Both of these APT cases were prior to the enactment of the self-settled spendthrift acts of Alaska, Delaware, Missouri or Nevada but there is no reason to believe given the reasoning of those court’s that their outcome would be different today. Generally it is better to assume that federal courts, state courts and federal agencies are more apt to regard a self-settled spendthrift formed under a valid state law as more legitimate and enforceable than one established under the laws of foreign country and thereby exempt from review under American law.

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spendthrift trust in a state that allows them, then after a certain period of time, the trust will become exempt from attachment for any judgment against the grantor. The time limit for this period varies among the states from two years in Nevada to four years in Delaware and Alaska and immediately in Missouri but it will happen in time. What this means is that a person can transfer assets into the trust and if no lawsuit or liability against the grantor arises during this period of contestability that at its conclusion the assets are automatically free from attachment at a later date.

The rights of the creditors under self-settled spendthrift trusts in states permitting them are different depending on status. The creditors are separated into two classes: those in existence when the trust was created and those arising after the trust was created.

1. For the second class of the creditors the treatment is rather straightforward if the creditors become so after the period of contestability has run, then they cannot bring suit to attach the trust assets. State law will determine if they can seize the trust assets by attachment during the period of contestability which they usually can if they can show an intent to avoid

default in order avoid the period of contestability from running. In Nevada for instance, such a suit must be brought within two years of the transfer into the trust or six months after discovering the trust of facts that would leading a person to discovering the existence of the transfer to the trust which ever occurs later. If the suit is not timely brought, the assets in the trust cannot be attached for payment of the grantor's debts.

In short, assets transferred into a self-settled spendthrift trust will be totally exempt from subsequent creditors after the contestability has run whatever it is for the state being used. There is no other provision in American law which permit people to create such a complete shield for their assets.

In order to create a self-settled spendthrift trust, the revocable trusts in the Estate Planning Two book published by ***LAWYER AT LARGE LLC.*** and ***ATTORNEY ET AL, LLC***. can be used with the following simple changes:

1. Delete the Article making the trust revocable. Instead insert a new article stating something to the effect:

   "THIS TRUST SHALL BE IRREVOCABLE. THE GRANTOR HAS THE INTENT OF MAKING CREATING AN IRREVOCABLE SELF-SETTLED SPENDTHRIFT TRUST UNDER THE LAWS OF THE STATE OF

3. Designate a trustee other than the grantor and it would be best to even state that the grantor cannot be the trustee. It is best that the trustee be a resident of the state named in number 1 and 2 above. In fact Nevada requires it.

4. You must state that the trustee has absolute discretion to make distributions of income and principal to the grantor as beneficiary but the beneficiary may not require or force the beneficiary to do make such distributions.

5. You may also insert language limiting the grantor’s power to remove a trustee, but there is no guarantee that it will work as it has never been tested, something to the effect that:

   "The grantor may not replace a trustee pursuant to a court order from a court outside of the state whose governing law is used if such replacement is done solely with the intent to have the new trustee make a distribution of assets of the trust for payment of the debts of the grantor if the current trustee could not be ordered by the such court to make the distribution directly under the governing state’s laws. In such an event, it should be left to a court of the governing state to determine if the trustee replacement is proper or if it violates the law or public policy of the governing state."

grantor's debts wherever located if the attachment would violate the law of the governing state.

You might circumvent this issue entirely by stating that the grantor cannot replace the replacement the trustee and that replacement can only be a court of the governing state. As such only assets located the state, which does not have governing authority over the trust could be attached by one of its courts.

The use of self-settled spendthrift trusts will afford almost complete protection for a grantor’s assets if the assets are transferred into a state which permit such trusts and the trustee is a resident of such a state and the grantor cannot replace the trustee or order the trustee to make a distribution. If any of these elements are missing, then it becomes problematical whether a judgment obtained against a grantor in a state which does not permit self-settled spendthrift trusts can be enforced against the trust.

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