MONEY MATTERS — Tax and financial planning strategies

Considering a line of credit? Good idea

By Mike Slotopolsky

A LINE OF CREDIT IS ANY CREDIT source extended to a government, business, or individual by a bank or other financial institution and is a source of funds that can readily be tapped with interest paid only on money actually withdrawn. A line of credit doesn't give you one giant injection of funds like a traditional loan. Like a credit card, you draw on the credit when you need to pay for something that's financially out of reach. Unlike most credit cards, the interest rates on lines of credit are generally low, the limits tend to be high, and the rates can be fixed or floating.

Lines of credit can be unsecured or secured by collateral, usually with business or personal assets. The financial institution can require a personal guarantee, but this isn't always the case. A line of credit is usually renewed each year and there may be a cleanup provision. This means that during the year you or your business must repay the entire line and not reborrow for at least a month.

There are a few reasons to choose a line of credit over a traditional loan. With a traditional loan, you get a chunk of money and immediately begin paying it back, regardless of when you use the money. A line of credit lets you borrow the amount needed when you need it. With most lines of credit, you make payments only on the credit you've actually used. I encourage my clients to have a line of credit in place. It acts like an insurance policy that you're happy to have and thankful not to use. In order to secure a credit line, a financial institution may require financial data to determine if you or your business qualifies for the loan. This usually consists of business and personal financial statements, tax returns, forecast, and projections. The most important piece of the process is your credit score.

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The prime interest rate charged by the Federal Reserve affects the interest rate you get on a line of credit. The Truth in Lending Act gives you three days to change your mind after you set up a line of credit.

There are myriad reasons to have a line of credit, whether personal or business. For successful and profitable business clients who want to minimize their tax bill, we often utilize a line of credit to minimize their tax rate. There are times when a business is having a hard time collecting from customers and needs a line of credit to get through money-poor periods. Without a line of credit, companies may be forced to infuse their own funds into the business.

Business lines of credit do not differ much from personal lines of credit. A business line of credit can also be an equity line of credit, which means the credit is based on your ownership interest in something. Instead of using personal property for collateral, a business line of credit is secured by your business's assets. These assets might be business real estate, company vehicles, or even office furniture.

Regarding personal lines of credit, what happens if you lose your job? With unemployment still high, it may not be easy to get a job in a short period of time. If you don't have substantial savings and your home's value has dropped, a line of credit may be your only safety net and you'll be thankful to have secured it prior to any financial catastrophe. Another good reason to have a line of credit is if you have a high mortgage interest rate and you can't refinance because your house value has dropped, you can use a line of credit to reduce, or even eliminate, the mortgage. When your house value increases, you can refinance and pay off the line of credit.

The most common line of credit is the home equity line of credit (HELOC). This is not to be confused with a home equity loan, aka a second mortgage, which is a lump sum, not a line of credit. When you get a HELOC from your mortgage lender or other financial institution, you have a set period of time during which you can draw on it. This period is aptly named the draw term. During this term, you use checks, a special credit card, or another method to use the money in your line of credit. Since HELOCs are long-term lending agreements, draw terms tend to be around ten years.

There are other reasons to have a personal line of credit including financing a college education, major home repairs, or paying off medical bills. No matter the need, I can't stress the importance of applying for a line of credit well in advance of its use. Speak to your financial adviser about securing your own line of credit. ❑