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TAX MATTERS

Advice for young graduates on how to best manage debt

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Our youngest son is graduating from high school today. The other morning, I asked him: “What are the most important things you’ve learned in high school?”

“Well, Dad, in history I learned that Sotheby’s auction house sold a 200-year-old piece of Tibetan cheese for $1,513 in 1993. And I learned that the wooden letters in a game of Scrabble are made of Vermont maple.”

“That’s it?” I asked. “That’s all I can remember,” he explained.

My daughter then chimed in: “Dad, wait until he gets to university. He’ll learn that over 14 cubic metres of air pass through the average person’s nose every day.”

“I’m looking forward to paying for that education,” I said.

Postsecondary education is expensive, and many students graduate with thousands of dollars in debt. Today, I want to share some thoughts for students who are heading to postsecondary school or have recently graduated and may not understand how to handle debt.

1. Borrow prudently. If you’re borrowing for your education, base the total you borrow on your ability to pay it off after you graduate. Follow the “Rule of Tens”: For every $10,000 in student debt, you should be able to earn $10,000 over a base of $10,000 annually to be able to pay off that debt in 10 years. For example, if you graduate with $50,000 of debt, you should be able to earn $50,000 over a base of $10,000, for a total of $60,000 annually to pay off that debt over 10 years.

2. Create a budget. During school and after graduation make sure you understand where your income is coming from, how much, and where it’s going. Track your spending for at least three months. Using an online service such as mint.com will make this easy. Then make sure your disbursements, including debt payments, are less than your income. If you go to canada.ca and type “budget planner” in the search field, there's a great planner there that makes it easy to create a budget.

3. Choose a time frame. When you have student debt, or any debt for that matter, make sure you have a goal for when you'd like it paid off. In the end, you have to keep up with the regular payments, so your time horizon will depend on your income level. For student loans, I think 10 years or less is an ideal time frame. For a home mortgage, chances are good it's going to take 20-plus years to pay that off, but you can speed it up by making biweekly rather than monthly payments, and by making periodic lump-sum payments against the mortgage if you have some extra cash and the terms of your mortgage allow this.

4. Pay certain debts first. Your student loans generally provide some tax relief in the form of a tax credit for interest, so you'll typically want to pay off other debt sooner. Loans with the highest interest costs make the most sense (credit cards or payday loans come to mind), but don't underestimate the value of paying off smaller loans quickly since that can provide a feeling of accomplishment and keep you motivated to pay off your other debts faster.

5. Work with your creditors. If you're getting to the point where your debts are becoming a real burden financially and causing you stress, reach out to your bank or other creditors and talk to them. Ask them to consider lowering your rate of interest, or to extend your payments over a longer period to reduce your monthly payments if necessary. For student loans, consider applying under the Repayment Assistance Plan (RAP), which can reduce or eliminate your monthly payments.

6. Consolidate your debts. It can make sense to pay off a number of high-interest loans all at once through a single debt-consolidation loan at a lower rate of interest. You may be able to move from several payments each month to just one and may be able to reduce your overall monthly debt payments. This could allow you to put the extra money toward paying down other debts, or to savings. When it comes to student loans that are eligible for the student loan interest tax credit, you should avoid consolidating these loans or you'll lose the ability to claim the credit.

7. Avoid more debt. If accumulating debt is a problem for you, consider closing certain revolving credit accounts once they're paid off (credit cards, for example). If you ever hope to borrow for a home or business, having a good credit rating will be important, and while having some credit history is important, avoid the temptation to apply for too many credit cards or loans. The more applications you fill out, the more desperate you appear for credit, and the worse your credit score becomes.

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