

Is Debt Settlement Right For You?

by Michael G. Peterson

These days debt settlement is looking like an increasingly good option for many people. But before you take the plunge, there are some important things to know about how it works and how it affects your credit.



Some debt settlement companies guarantee debt relief in a year. Others promise to slash your debt, in some cases reducing the amount you owe by up to 60 percent or more, all while keeping the creditors at bay. And, almost all of them pledge to help you regain control of your finances.

If you're drowning in debt, debt settlement programs sound like a dream come true. But, are they *too* good to be true? Are debt settlement companies legit, or are they a scam to be avoided at all costs? Is it smarter to tackle your debt on your own, or is it worth it to hire someone to do it for you? Before we can answer that question, let's take a closer look at how debt settlement works.

Debt Settlement in Theory

Once you enroll in a debt settlement program, most settlement companies will tell you to stop making your monthly credit card payments and save that money. Once you've got a sizeable amount (usually several thousand dollars), the debt settlement company will negotiate with your credit card company, offering them a large, one-time payment to settle your debt.

Most debt settlement companies claim that this one-time payment is usually significantly less than the original amount you owed. They also tell you that they'll put an end to the endless phone calls from creditors or collections agencies.

It's an attractive idea. Unfortunately, most people who sign on with a debt settlement company end up deeper in debt than they were before.

Debt Settlement in Reality

Here's what really happens if you follow the typical debt settlement plan:

The minute you stop paying your credit card bills, you'll start to rack up high-interest, late fees and over-limit fees. Imagine that you have a \$10,000 debt. If it takes you, say, three years to save enough for a settlement (which is usually about half of the amount you owe), your total debt will have doubled.

So, in the time that it takes you to save up half of your original debt -- around \$5,000 in this case -- your debt will now be around \$20,000. To settle now, you'll need about half of that new amount -- or \$10,000.

See the problem?

Of course, after you stop paying your credit card bills, the calls will start coming in from creditors and collections agencies. Your phone will be ringing off the hook. But your debt settlement company handles that, right?

Wrong.

Debt settlement companies can't stop collections calls.

The only way you can stop collections calls is by making your monthly payments. If you don't pay, the calls will continue. If your debt is large enough, your credit card company may even take legal action to force you to pay -- in many cases, your wages may be garnished until the debt is taken care of.

Even if you don't get sued, there are still some serious drawbacks to debt settlement:

- **You'll pay a hefty fee:** Debt settlement companies usually charge a substantial fee (typically a percentage of your total debt) for their services. Ultimately, the money you pay the debt settlement company is just money you could have used to pay down your debt.
- **You'll pay taxes:** One thing that debt settlement companies don't tell you is that you'll have to pay income taxes if your credit company forgives some of your debt. So, if a debt settlement company gets, say, \$5,000 knocked off of your total debt, you'll pay income taxes on that money. By law, the creditor has to send a client a 1099 tax form indicating the amount written off in a settlement situation. You are responsible for taxes on that amount.
- **Your credit score will hit rock bottom:** If you're working with a debt settlement company, your credit score is probably on the low side to begin with. But, you should be aware that settling your debt will effectively ruin your credit, making it more difficult to buy a house, a car, rent an apartment, or even get a job.
- **Creditors are refusing to do business with settlement companies:** Recently, more and more creditors are sending notices to their clients who have signed up with settlement companies letting them know that they will not work with these organizations.

Debt Settlement vs. Debt Management: What's the Difference?

While a debt settlement company typically advises you to stop paying your monthly credit card bills, debt management (also known as credit counseling) takes a different approach.

When you sign up with a debt management company, your credit counselor will negotiate with your credit companies for lower monthly payments.

You send your monthly payments to your debt management company, and they distribute the payments among your credit card lenders. You make one payment a month, regardless of how many credit card bills you have.

And, credit counseling services don't hurt your credit score -- although you won't be able to get additional unsecured credit until you complete the program.

Keep in mind that there's typically a fee involved for debt management services, but it's generally a lot more affordable than a debt settlement company. Credit counseling fees are typically included in the amount of your new lower monthly payment, and average around the \$30 range.

Debt Management Checklist

Remember, as with anything, you need to do your homework. Debt management companies may be nonprofit, but nonprofit status is essentially a tax designation, not a government endorsement of a group's mission. There are plenty of near-fraudulent credit counseling agencies that are registered nonprofits.

Check with the Better Business Bureau, verify the agency's accreditation by an independent nonprofit (such as the National Institute for Financial Counseling Education), and look for positive reviews from real people. Fees for debt management companies should be reasonable--between \$30 and \$50 per month--and the company should give you reasonable promises (they cannot "wipe out" your debt; they can only help you pay it off).

What's Right for Me?

Only you can decide the best way to handle your debt. Debt settlement sounds like a simple solution, but in most cases, the costs outweigh the benefits. Before you make a decision, do some research, check on the companies BBB listing, or ask friends or family members for referrals. Whatever you do, remember that if something seems too good to be true, it probably is.

Joel Walsh contributed to this article.

Michael G. Peterson co-founded American Credit Foundation, a non-profit credit counseling organization. Visit debtguru.com for more information and financial resources.