

Debt Settlement: Can You Really Get Out of Debt Paying Less Than You Owe?

by Gerri Detweiler for Credit.com

If you are struggling to pay off your [credit card debt](#), you may be wondering if the advertisements for debt settlement companies are real. Can they help you pay off your debts for “pennies on the dollar?” Will negotiation help you get out of debt fast? How will it affect your credit rating?

Let's walk through the pros and cons of debt settlement so you can decide whether it is the right option for you.

What Is Debt Settlement?

[Debt settlement](#) (also called “debt negotiation” and sometimes mistakenly referred to as “debt consolidation”) simply means that you negotiate a lump sum to pay off a debt that's too large for you to pay back otherwise. The ads that say you can “pay off debt for pennies on the dollar” are a bit misleading. You may be able to settle debts for anywhere from 10 to 75 cents on the dollar, but 50 – 60 cents is a more realistic settlement amount.

This approach may work if you have more unsecured debt than you can pay off in 3-5 years, or if you have fallen significantly behind on your bills. Creditors know that if you get to the point where you can't keep up with your payments, you may decide to declare bankruptcy. They may be willing to let you pay a smaller amount than risk getting nothing if you file.

Am I A Good Candidate for Debt Negotiation?

That depends. If you can afford to pay back your debts through a reputable credit counseling program's [Debt Management Program](#) (DMP), that's probably a better route. It will have less of an impact on your credit score, and it will likely be less stressful. Once your DMP is set up, you simply make one monthly payment to the counseling agency, which then pays each of your participating creditors. However, choosing credit counseling means that you have to pay back 100% of your debt, plus interest. If that's impossible, you should consider settlement.

Is Settlement Better Than Bankruptcy?

Bankruptcy allows you to either eliminate debts quickly (Chapter 7) or pay back a portion of your debts over five years (Chapter 13). It offers the legal protection of the court, so you don't have to worry about being sued or harassed about your debts while you are completing your bankruptcy. Debt settlement does not give you the legal protection bankruptcy does.

Chapter 7 bankruptcy is not an option for everyone; it has become more difficult to qualify to wipe out most of your debts. Chapter 13 bankruptcy requires five years of court-ordered payments, and may force you to surrender some assets. But there is no harm in talking with a bankruptcy attorney to learn about whether it might be the right move for you. Visit Nacba.org or ABI-world.org to find a local consumer bankruptcy attorney.

Can I Just Settle My Debts By Myself?

If you have one or two debts, or owe a small amount, you may want to try to negotiate with your creditors yourself. Our book, [Stop Debt Collectors: How to Protect Your Rights and Resolve Your Debts](#) will show you how. But if you owe a lot, or have several debts you need to settle, you may want to get professional advice.

That's because debt settlement is as much an art as a science. It's hard for the average person to know whether the settlement offers creditors are proposing are good. And it can be tough to handle the stress of creditor and collectors clamoring for payment. You might make poor decisions under that kind of pressure.

You can either hire a “full service” firm to help you settle your debts, or get coaching so you can do it yourself with guidance from an experienced expert.

How Will Debt Negotiation Affect My Credit?

You can't settle debts when you are current on payments. Creditors will want to see that you are in a hardship situation before they are willing to negotiate. That means you will have to stop paying your unsecured debts and let them go into collections before settling. In addition, you cannot settle some debts but pay others on time. Creditors and collectors can review your [credit reports](#), and they will not want to see they are getting less than the full balance when you are paying others on time. (This does not apply to secured debts such as car loans or a mortgage, both of which you must pay on time to avoid the risk of repossession or foreclosure.)

That means your credit report will be negatively affected by settlement. But that may be a small price to pay to avoid bankruptcy. You can begin rebuilding your credit as soon as you have settled the last bill.

What About Taxes?

A little about taxes: The IRS says that the forgiven debt is income. This means if you owe \$10,000 and settle for \$6,000, the \$4,000 difference is taxable "income." However, the IRS will often waive this tax if you can show that you were insolvent at the time of the settlement. Talk to an accountant or another financial professional to get more information.

Debt is never easy, and unfortunately, many consumers today are simply drowning in it. However, once you get it taken care of, you should be able to rest easier and move on with your life.

Where Can I Find A Good Debt Relief Company?

Be careful. Many companies offer this service and many of them are not legitimate. Not only are there a lot of debt settlement scams, but there are also companies offering "debt elimination" and other fraudulent programs. A good company will help you understand what your options are but will also be very realistic with you about the challenges you might face as they work to help you clear your debt. Often, the bad companies simply want to scam you by collecting a fee from you up front, but they won't help you resolve your debt.

Fourteen Questions to Ask a Settlement Company

If you are thinking about working with a debt settlement company to negotiate or settle your debts, there are some essential questions you should ask them before you sign up.

1. Are you a member of TASC?

TASC, The Association of Settlement Companies, is the largest trade association serving the debt settlement industry. TASC members voluntarily agree to comply with TASC's strict industry standards. Any company you choose should be a member. If not – Red Flag!

2. What are your fees?

The majority of fees should be based upon performance and results. Many companies charge a flat fee based upon a percentage of your debt amount. Their fees are collected in the beginning months of the program and are collected even if no settlements are completed. If fees are based upon a percentage of the debt and not tied to results – Red Flag!

3. Are you being paid a commission?

Salespeople may stretch the truth or leave out vital information if they are paid on commission. If they say yes – Red Flag!

4. Do you have a money back guarantee if I change my mind?

Don't accept anything less than a full 30 days. Don't be pressured into making a decision you can't reconsider. Anything less – Red Flag!

5. If I have faithfully made my payments for one year and you haven't settled any of my debt, how much money would I get back if I decided to quit?

Many companies charge excessive fees whether or not any of your accounts are settled. If fees are based upon a percentage of the debt and are not tied to results, the company will probably refuse to refund any of your fees – Red Flag!

6. How long have you been in the debt settlement business and how much debt have you settled?

Many companies don't settle much debt at all, and young companies have very little experience. If the company cannot provide proof of their experience – Red Flag!

7. Can you stop my creditors from calling me?

It is not possible to stop all creditor calls. If they say they can – Red Flag!

8. Will you be making monthly payments to my creditors?

Settlement companies do not make monthly payments to your creditors. If they claim to do so or if they give you the impression that they do – Red Flag!

9. Can I get sued?

The answer to this question is "yes;" it is a possibility. If they say anything to the contrary – Red Flag!

10. Will this have a negative effect on my credit report?

The correct answer to this question is "Yes." All debt management programs will have a negative impact on your credit report. If they say anything to the contrary – Red Flag!

11. When can I expect my first settlement?

Your first settlement should be made well within the first 12 months of your program. Any longer than 12 months – Red Flag!

12. Can you tell me exactly how long this will take and exactly how much this will cost?

Debt settlement is not an exact science, and there are too many variables to quote exact time frames and figures. Many companies will tell you anything to get you in the door. Any attempt to provide exact information would be a Red Flag!

13. Are there tax consequences I should be made aware of?

The correct is "Yes." The IRS considers forgiven debt to be taxable income, though you may be able to get the taxes waived if you can show the IRS you are insolvent. This should be explained. If not – Red Flag!

14. Who is holding my money while I'm waiting on a settlement?

Your funds should be held at a third party escrow company in a FDIC insured trust account. If the company tells you to save your own money or to send the funds to them – Red Flag!