

April 2009 Issue

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Tax Planning as You Age

While tax planning should be a consideration through all phases of life, the nature of that planning changes as you approach retirement age. During your working years, your primary tax-planning objectives are to reduce your current income taxes while saving for retirement. After decades of accumulating money, you now need to ensure you withdraw and manage that money properly. Here are some tips:

Rolling out of a 401(k) - If you don't want to leave your funds in your 401(k) plan, you should consider transferring your money to an individual retirement account (IRA). You can now transfer directly to a Roth IRA, provided your adjusted gross income does not exceed \$100,000 in 2008 or 2009. Starting in 2010, there is no income requirement. While there are no income tax ramifications if you roll over from a 401(k) plan to a traditional IRA, you do have to pay taxes on the amounts that would be taxable when withdrawn when converting to a Roth IRA (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs). However, if you pay the income taxes from funds outside the IRA, you have essentially increased the value of your IRA, since you won't have to pay income taxes on qualified withdrawals.

If you own stock in the company you work for in your 401(k) plan, consider those assets separately. There is a provision in the tax code that may save you a substantial amount of taxes. Instead of rolling over the company stock, have the shares distributed to you and put them in a taxable account. You will owe ordinary income taxes on the cost basis of those shares, which equals the price that was paid when the stock was purchased. (If you take the distribution prior to

age 59 1/2, you may also owe the 10% federal penalty on the cost basis.) At this point, you do not pay taxes on any appreciation in the stock's value. When you sell the stock, provided you have held it for over one year, you will owe capital gains taxes at a maximum rate of 15% on the net unrealized appreciation, rather than ordinary income taxes that would be paid on other traditional IRA distributions. If you have substantial appreciation in your company stock and are in a high marginal tax bracket, this strategy can save you a substantial amount of taxes.

Handling an inherited IRA - IRAs are becoming an increasingly significant asset for many people due to 401(k) rollovers and asset growth. Thus, it is becoming more likely that you will inherit an IRA. Don't immediately cash out an inherited IRA, which requires the payment of income taxes on the distribution. If you inherit a traditional IRA from a spouse, you can delay distributions to age 70 1/2 and then take distributions over your life expectancy. No distributions are required during your life if it is a Roth IRA. If you inherit the IRA from someone other than your spouse, you must start taking distributions in the year following the owner's death, but you can take those distributions over your life expectancy. Make sure to investigate whether you are entitled to an income in respect of decedent deduction, which is available when federal estate taxes are paid on IRA assets. This deduction can help offset income taxes due on distributions.

Dealing with a second home - If you plan on moving after retirement, you might want to acquire a home in that location before retirement. But first, be aware of the 1031 exchange rules. These rules allow you to sell one property and purchase another of like kind, deferring any gains. For instance, this tax rule can be used to help acquire a retirement home. Start out purchasing a small investment property. You can sell it at a later date and purchase a more expensive property, deferring the gains. You can continue this process until you eventually purchase your retirement home. However, before living in the home, you must first rent it out to defer the gain. While there are no clear-cut rules on how long the home must be rented, the Internal Revenue Service has validated a two-year period. After that, you can move into your retirement home and use it as your principal residence. Currently, as long as you live in the home for two of the last five years before selling, you could then sell the home and exclude up to \$250,000 of gain if you are single and up to \$500,000 of gain if you are married filing jointly. However, the Housing Assistance Tax Act of 2008 will affect sales and exchanges after December 31, 2008. The home sales exclusion won't apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use. Generally, nonqualified use is any period (other than the portion of any period before January 1, 2009) during which the property is not used as the principal residence of the taxpayer. The amount of gain allocated to periods of nonqualified use would reduce proportionately the home sale exclusion amount.

When purchasing the second home, be sure to get a mortgage on that property rather than a home-equity loan against your principal residence. Interest is only deductible on \$100,000 of a home-equity loan, while the entire mortgage interest up to a \$1,000,000 loan would be deductible.

Selling a business - Many business owners find that their business comprises a substantial portion of their net worth. Thus, when it comes time to sell that business, they naturally want to negotiate as large a selling price as possible. But keep in mind that there are many ways to structure a sale. You might want to consider an installment sale, so the gain is recognized over a period of years rather than a single year. You may want to consider including a consulting contract for a period of years. If you are selling the business to employees, an employee stock ownership plan may make sense.

Reviewing your estate plan - As you approach retirement, it's a good time to review your entire estate plan. While the estate tax exemption has increased (from \$2,000,000 in 2008 to \$3,500,000 in 2009) and the estate tax will be repealed in 2010, this amount will drop back to \$1,000,000 in 2011 unless further legislation is enacted. Thus, individuals with estates over \$1,000,000 still need to consider ways to use their exclusion amounts to minimize estate taxes. Those with large estates probably don't want to leave their entire estate to their spouse. While that will avoid estate taxes on the first spouse's death, estate taxes may be owed after the second spouse's death if the estate is larger than the estate tax exemption.

While increasing estate tax exemption amounts can make it more difficult to plan, you should still consider leaving part of your estate to other heirs. If you don't want to make outright distributions in case your spouse needs the assets, you can set up a trust (commonly referred to as a credit shelter or bypass trust) to hold those assets. Your spouse can then use the income and even some of the principal, with the remaining assets distributed to your heirs after his/her death. This preserves the use of your exclusion amount. You may also want to add a disclaimer provision to your estate planning documents, detailing what happens if one of your heirs disclaims his/her inheritance. With the estate tax exemption amount fluctuating over the next several years, this provides a way for heirs to decide after your death how much should be placed in various trusts.

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A Review of Your Portfolio

With the recent market declines, it may be painful to reevaluate your portfolio in depth, especially if your portfolio contains large losses. But this review is necessary to see if changes are needed to your portfolio. Some factors to consider include:

- **Measure the performance of each investment in your portfolio.** Many investments and investment managers will provide you with periodic performance information. If you invest in individual stocks and bonds, you may need to calculate those returns yourself. Your total return equals the change in market value plus any dividends, interest, or capital gains, divided by the beginning market value. Total return can be difficult to calculate, especially if you make additional investments or withdrawals during the year.
- **Compare each component of your portfolio to an appropriate benchmark.** A wide variety of market indexes now exist, covering many different segments of the market. You should be able to find ones that track investments similar to each component of your portfolio. Making comparisons to a benchmark should help identify portions of your portfolio that may need changing or that you want to start monitoring more closely.
- **Calculate your overall rate of return, comparing it to your estimated return.** When designing your investment program, you probably assumed a certain rate of return that determined how much you needed to invest to achieve your financial goals. Calculating your actual return will determine if you are on track. With the recent market declines, you are likely to find you have not made that much progress or may have lost ground over the past couple of years. In that case, you need to take a fresh look at your financial goals and your current investments, and then recalculate how much you should be saving on an annual basis to reach your goals.
- **Review your overall allocation to determine whether changes are needed.** This annual review is a good time to compare your actual allocation to your desired allocation. You may find you need to make changes for a variety of reasons. Over time, you will find your allocation shifts due to varying returns on different assets. You may also need to sell certain investments that are not performing well. Your asset allocation is likely to need refinement, since your strategy will change over time.

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Encourage Your Children to Fund IRAs

Once your children start working, help them develop good savings habits by encouraging them to fund an individual retirement account (IRA). Even if your child only contributes for a few years, an IRA can provide significant funds for retirement.

Your child must have earned income to contribute to an IRA and may only contribute the lesser of earned income or the maximum IRA contribution. The maximum limit is \$5,000 in 2009 and 2010. Due to tax law provisions, the limit will be reduced to \$2,000 in 2011 unless further legislation is enacted.

Assume your 16-year-old daughter starts working part-time. If she contributes \$2,000 to an IRA from the ages of 16 to 22, she will contribute \$14,000 over seven years. With no further contributions, the IRA could potentially grow to \$527,437 on a tax-deferred or tax-free basis by age 65. That assumes earnings of 8% compounded annually but does not include any income taxes that might be due.

If your child continues \$2,000 IRA contributions until age 65, she would make total contributions of \$98,000 and could accumulate investments of \$1,145,540. (These examples are provided for illustrative purposes only and are not intended to project the performance of a specific investment vehicle.)

Although most children will be eligible to contribute to both a traditional deductible IRA and a Roth IRA, you should probably encourage your child to fund a Roth IRA, which has several advantages:

- **Roth IRAs are more flexible.** Your child can withdraw all or part of his/her contributions at any time, without paying federal income taxes or penalties. Thus, if your child later decides to use contributions for college, a car, a down payment on a home, or for some other purpose, contributions can be withdrawn with no tax consequences.
- **Earnings accumulate tax free, plus qualified distributions can be withdrawn tax free.** A qualified distribution is one made at least five years after the first contribution and after age 59 1/2. There are also certain circumstances where earnings can be withdrawn without paying income taxes and/or the 10% federal income tax penalty. If your child allows the funds to grow until at least age 59 1/2, all contributions and earnings can be withdrawn without paying any federal income taxes.
- **A traditional deductible IRA offers little tax benefit to a child.** When your child first starts working, he/she will typically pay a low marginal tax rate on his/her income. So even though the Roth IRA contribution is not tax deductible, your child typically receives little or no tax benefit from deducting the traditional IRA contribution anyway.

If you can't convince your child to use his/her own money to fund the IRA, consider reimbursing him/her, as part of your annual gift tax exclusion, for any

IRA contributions. Hopefully, you will also teach your child some important lessons about saving at an early age.

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How Much Do You Need in Retirement?

One of the most critical factors in determining how much you need to accumulate by retirement age is how much annual income you'll need in retirement. But if that retirement date is years or decades away, it may be difficult to come up with a reasonable estimate of your income needs. Most people will want a standard of living similar to the one they're living before retirement; so simple rules of thumb, like 70% of preretirement income, may not give you an accurate estimate. Follow these tips to estimate how much you'll need:

- **Add up your current expenses.** Make sure the list is as complete as possible, including regular monthly expenses as well as irregular, periodic expenses, such as insurance premiums, tuition, and gifts. If you've prepared a detailed budget, much of the work will already be done. If you don't have a budget, most of the information can be found by examining cancelled checks, credit card bills, and tax returns. If you can't account for more than 5% of your income, you may need to take a closer look at your cash purchases.
- **Estimate which expenses won't be incurred in retirement.** Once you retire, you won't need to save for retirement anymore. Other expenses that are likely to go away include commuting costs, some clothing expenditures, and meals while working.
- **Determine what additional expenses to expect after retirement.** This will depend in large part on how you plan to spend your retirement years and will typically include items like travel and entertainment. At this point, you want to plan for your ideal retirement lifestyle. Don't forget to consider health-care costs. Even if you qualify for Medicare, most people incur substantial out-of-pocket costs.
- **Decide which expenses you can cut back on.** This analysis will become critical if you can't afford your ideal retirement. Break down your expenses between essential and discretionary. Essentials will include food, utilities, health care, transportation, and housing. Discretionary could include travel, entertainment, and purchases of luxury items. Cutting back on discretionary items is not your only alternative. Perhaps you can move to a smaller home or pay off your mortgage, both of which could dramatically

lower your expenses. Or, you might only need one car instead of two after retirement.

Once you decide how much retirement income you need, you can calculate how large a nest egg you'll need at retirement. Be as accurate as possible, since overlooking just one or two items can significantly change the income you'll need.

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What's Your Score?

How is it that you can apply for a mortgage, credit card, or car loan over the phone and be approved or declined in a matter of seconds? For speedy access to credit - and the mountain of credit card "preapprovals" you get in the mail each month - you can thank an invention called the FICO score.

Your FICO score is the most common type of personal credit score, used in some form by most lending institutions. The FICO score tells lenders in a very simple way how likely you are to repay your debts on time. Ranging from 300 to 850, your FICO score is calculated according to a formula developed by the Fair Isaac Corporation (hence the acronym "FICO").

What everybody wants, of course, is a high score - the higher the better. With higher scores come lower interest rates. How do you get a higher FICO score? First, you need to know the factors that influence your score. In order, they are:

- **How you pay your bills (35 percent of your score).** How consistently have you made your payments on time? If you've paid bills late, how many times were you late? How late were you? How much money did you owe? Have you ever had a debt in collection? What was the size of the debt? Have you ever filed for bankruptcy?
- **Your total outstanding debt (30 percent).** Outstanding debt is debt of all kinds, including mortgages, car loans, credit cards, home-equity lines of credit, and any other loans that are reported to a credit agency. Another important factor here is how much unused but available credit you have on your credit cards. The absolute amount of available credit you have is less important than how close you are to maxing out the credit you've been granted. The highest scores go to people who use credit sparingly and keep their balances low.
- **The length of your credit history (15 percent).** The longer you've had and used credit, the higher your score. You get even more points if you have established long-term credit with the same lenders - a reason why

- you might not want to close long-term credit cards, even if you don't use them very much.
- **Mix of credit types (10 percent).** Your score is higher if you have a variety of fixed-payment loans and revolving credit.
 - **Recent applications for credit (10 percent).** A number of applications for credit over a short period of time raises a red flag for lenders, as it is often a sign that a person is in a cash flow problem. The FICO formula takes points away for this. Multiple applications for a specific type of credit in a concentrated time frame - when you're rate shopping for a mortgage, for example - don't count against your credit score.

What doesn't have an effect on your credit score? Demographic data like your age, sex, race, education, marital status, and how long you've held your job or lived in your current home. Perhaps surprisingly, your income and whether you've ever been turned down for credit also have no bearing on your credit score.

How to Raise Your Score

Just as there are things you can do that will lower your credit score, there are also things you can do to raise it, including:

- Pay your bills on time.
- Make more than the minimum payments, especially toward credit card accounts with balances close to your credit limit.
- Transfer a portion of the balances you have on cards that are nearly maxed out to cards where you are well below the limit.
- Challenge any inaccuracies on your credit reports. You're entitled to a free credit report every year. Check it at least that often to guard against mistakes.

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