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The New Rules of Retirement

#7400

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NOTICE

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PREFACE: RETIREMENT HAS CHANGES…AGAIN

"Retirement and retirement planning are changing … In the future, there will be more changes to retirement, and the changes will occur much more rapidly."

That was the opening of the first edition of *The New Rules of Retirement*. That opening couldn't have been more accurate, and it still applies today.

Though the first baby boomers hadn't yet reached age 65 when the first edition published (that didn't happen until 2011), they already had an impact on retirement and would continue to transform the post-career years. Other forces and trends joined with the boomers' reaching the silver years to break the old retirement rules. In only 10 years we had to adjust to these and other changes:

- Life expectancy, and therefore the length of retirement, steadily increases.
- Employers and governments continue to reduce benefits to older Americans, leaving retirees more and more on their own.
- Higher-income older Americans are receiving even less support as the government programs become more means-tested.
- Income and estate tax laws changed significantly, requiring updates to plans.
- The nontax factors in estate planning became more prominent and were revised and updated.
- The Affordable Care Act of 2010 introduced many changes to medical insurance and benefit plans, including changes to Medicare.
- Long-term care insurance underwent a couple of revolutions, with both good and bad consequences for retirees.

Of course, few people expected the turmoil in the economy and investment markets and how they would affect retirement plans. The financial crisis of 2008 affected the economy more adversely than any event since the Great Depression of the 1930s. The downturn in the investment markets marked the second decline in the major stock market indexes of more than 50 percent in less than a decade. The Federal Reserve brought interest rates to near 0 percent in response to the crisis, changing the investment plans of many people who were in or near retirement.

The most important lesson from more than a decade of change is: Retirement has changed and will change again.

You need to expect change. Your plans need flexibility, and you need to be ready to adapt and adjust.

Yes, you need a plan for retirement. You also need to realize that it is only a plan. It isn't set in stone, and it isn't a blueprint for the future from which you shouldn't deviate. A plan is based on assumptions about the future. You'll estimate inflation, interest rates, investment markets, the tax law, medical insurance, and more. Reality rarely will match all the assumptions or even come close. Some assumptions will be on target. Others will be a little off the mark, while still others won't even be close.

Plans need to be reviewed and adjusted. When you are in or near retirement, plans need to be reviewed annually. You don't want to review and change plans too frequently, because then you'll be responding to each little change in the investment markets. Regular reviews, however, mean only minor changes in your retirement plan can keep you on track. When too much time passes between plan updates and reviews, then you're likely to need major upheavals to put a plan back on track.

NEW HELP FOR RETIREMENT

Perhaps the most important change in retirement planning in the last decade is the fresh focus of professionals and academics. When I prepared the first edition of this book, few financial professionals or academics addressed the issues of Americans in or nearing retirement. They were still concerned with helping younger people maximize the accumulation of wealth. They largely neglected the needs of those who were past the accumulation phase of life and were in that post-career spending, or decumulation, stage of life.

Most of those who did offer advice for retirees relied too often on rules of thumb, intuition, and shortcuts to make recommendations. Only a few of us spent the time to create and analyze data to make recommendations. When we did, as readers of the first edition learned, the best actions often were counterintuitive. The rules of thumb and short cuts often led to recommendations that either made sense only in the past or that didn't stand up to analysis.

All that has changed. Now, there is a fairly robust collection of academics and financial professionals vigorously addressing the needs and concerns of older Americans. They use detailed research, data, and analysis to demonstrate the results that would occur from taking different actions under different circumstances. That means retirees and their advisors can spend more time analyzing individual situations and less time constructing models and data. It also means that the problems of retirees benefit from the attention, experience, and intellectual capital of a large number of professionals instead of only a few.

A related change is a new focus on strategies for generating reliable streams of income and cash flow in retirement. Until a few years ago, almost all investment research was geared toward maximizing long-term total returns. With the aging of the baby boomers, there's a realization that a large number of people no longer are interested in total returns. They're interested in making their wealth last, keeping it safe, and generating reliable income to ensure they can pay their expenses for an indefinite period. "Keep my money safe and pay me income" is the new Holy Grail of investing. It is receiving attention from major financial firms, academics, and a range of financial professionals.

In short, those in or near retirement have a lot more intellectual support than they used to, and it will improve retirement advice and outcomes. This intellectual support wasn't available until only a few years ago. Your retirement will be better because of the ideas and research generated.

THE RETIREMENT PROCESS

For the first generation or two of American retirees, retirement was an event. A person reached a certain age, usually 65, and then stopped working. Retirement usually was filled with leisure pursuits: travel, recreation, spoiling the grandchildren, and similar activities.

While that model of retirement still exists, more and more Americans are shifting to different retirement models. The old model simply isn't appropriate for many of us.

Extending Careers

One emerging retirement model is to work past the age of 65. There are a number of reasons people do this.

German Chancellor Otto van Bismarck is said to have originated the practice of retiring at age 65 when he created the first old-age social insurance program in 1889. The U.S. Social Security Administration on its website disputes that this was the primary influence on the adoption of 65 as the first full retirement age in Social Security. The SSA points instead to an existing practice of designating age 65 in the U.S. private sector and state retirement systems, as well as actuarial data generated by the government, as the reasons age 65 was adopted.

Whatever the reasons for establishing 65 as the typical retirement age, they don't apply today. People live longer than they did in 1889 or 1935. Age 65 no longer is particularly old and people can live long beyond that, as we discuss later in this book. Many Americans at age 65 are relatively healthy and active. They don't want to stop working.

Research indicates there are many benefits to continuing employment. Mental and physical health often are maintained better with the regular social contact and structure that are part of steady employment. Work also gives a sense of purpose, which is essential at every age.

Of course, many people plan to continue working beyond 65 for financial reasons. The financial crisis of 2008 was a setback to many retirement plans, causing some retirees to seek to return to work while many preretirees began making plans to extend their careers. Since 2008, numerous surveys of Americans ages 40 and over found that many of them plan to continue working longer than they initially planned in order to increase their nest eggs.

Of course, work in retirement doesn't have to be compensated. Volunteer work provides many of the nonfinancial benefits of paid work. Volunteering also can provide psychic income and a sense of purpose because you are contributing to a cause that is important to you.

Keep in mind that retirement age isn't always a matter of choice. About half of retirees report in surveys that they didn't retire when they initially intended. A small percentage of them worked longer than planned, either because they liked what they were doing or needed the money. But most report that they retired earlier than they planned. Only a few retired early voluntarily and because they reached their financial goals. Most retired early involuntarily. Health reasons are a major reason for early retirement. People experience illnesses, injuries, or chronic conditions that make it difficult for them to continue their careers. Others retire early because they lost their jobs and couldn't find satisfactory new positions. After searching for a while, they left the labor force.

Retiring later is a model used by a growing number of people who still are planning and have a choice about when to retire.

Phased Retirement Is Here

A second retirement model growing in popularity is not to retire at all, at least not before health requires it. Leaving a long-time employer and settling down to a few years of travel, relaxation, or just sitting around isn't the game plan for many Americans any more.

Here is a more typical "retirement." A person in his or her late 50s or early sixties will leave an employer after working for that employer for 10 years or more. That employer will be one of four or five during the career. The next six months to one year will consist of relaxing and enjoying life, essentially taking a sabbatical or "career break." The period might include traveling, taking up a long-planned hobby, or spending more time on the activities that used to occupy only weekends and vacations. Then the person will search for a more meaningful way to spend some of his or her time.

The next phase of life has many possibilities. All of them are viable and in use today. It might consist of work in the same occupation the person previously had or in a related field. But it is just as likely to be something in a completely different field or industry. The new work might be full-time. In many cases, however, the work is in a lower-paid position with fewer responsibilities and fewer hours.

Some will keep this new job until it is time for a full-time retirement. Others will keep the job for a few years. Then, the person might shift to another position after deciding the current position is no longer fulfilling. The person might move to a completely unrelated position that involves learning new things. Over time, the hours worked might ratchet down. Even minimum-wage work might be sought at one point just to stay active and earn a little extra money. Eventually, the person might stop working altogether or decide to spend the time on volunteer activities for a charity or the community.

For some this is a planned process. Many others intend to retire and can afford to do so, but in their planning they neglected to consider how they would occupy their time in retirement. They return to the work force because they became bored and realized they had to "reboot" their retirement plans. They need to take some time to decide what would be a meaningful and successful retirement for them. Some people retire two or more times before getting it right.

There are many other scenarios. An executive who loves golfing might "retire" and take a job at his local course or club. Another executive might become a consultant, or take a job with a smaller business that needs an experienced hand, or even take a much lower-paying job to help run a charitable organization. Some hope to work at basically the same jobs for the same companies while working fewer hours, and some employers are trying to restructure positions to accommodate this.

Those who study retirement refer to all these possibilities as bridge jobs.

Starting a business in retirement is another course to take. One might start a small, part-time business that is not much more than an attempt to make money at a hobby. Another might have the ambition to build an operation with dozens or hundreds of employees.

These are just a few examples of possible phased retirements. There are likely to be as many retirements as there are retirees.

No longer is there a definite line between work and retirement, and there isn't a standard retirement age. People are more likely to retire in phases or stages, sometimes called downshifting.

RETIREMENT ACTIVITIES TO AVOID

This book focuses on actions you can take to make your retirement successful and better. For a few minutes, however, let's take a look at retirement advice from a negative perspective. Let's consider the actions you want to avoid if you can, those that have been proven to derail retirement plans.

Sometimes the best way to have good results is to avoid mistakes and losses. We have enough experience with retirement to know which actions and events are most likely to cause retirement to suffer a downward spiral. Avoid these and you're well on the way to a successful retirement. Of course, not all these events are within your control. Yet, you can be aware of their potential to upend retirement plans and plan for them by having flexibility in your plans and carrying insurance or other protections when appropriate.

We discuss each of these in more detail in the chapters noted.

Debt

Once it was rare for someone to retire with debt, even a home mortgage. Now, the number of retirement-age Americans with substantial debt is increasing. Some carry debt in retirement as a strategy. They believe leveraging their assets and income increases their standard of living without incurring much risk. Others are less strategic about their debt. They don't pay down their debt before retirement, and they aren't careful about incurring debt in retirement.

It's important to realize that in retirement your finances are less flexible. You have little or no potential for earning more income. Negative financial surprises are likely to occur, especially high medical or long-term care costs. If you're already carrying a fair amount of debt when these expenses arise, you'll have few options for dealing with them. For most people, it's better to eliminate debt before retirement and try to avoid it in retirement, except to deal with emergencies. Details about planning your spending are in Chapter 2.

Spending Too Rapidly

Surveys of retirees and preretirees indicate that many believe they can safely spend 7 percent or more of their assets each year without the risk of running out of money. Financial planners and academics who have studied retirement spending believe the safe spending rate is much lower. This issue is so important we discuss in detail in Chapter 4.

Uncovered Major Medical Expenses

Medicare doesn't cover all your medical expenses, which is something many people don't realize as they enter retirement. Of course, you can't really control when you need medical care. That's why medical expenses and long-term care expenses are the wild cards of retirement planning. We discuss how to plan for these expenses in Chapter 6 and 7.

Helping Others

People want to help their children and grandchildren. Since the financial crisis of 2008 and even before, there's been a trend of *boomerang* kids in the United States. These are adult children fully or partially supported by their parents, either while living on their own or in the parents' homes.

Retirees need to know there's a line of support they can't cross without endangering their own financial security. Too many are in danger of overextending themselves to help their younger loved ones. That's understandable, but it's dangerous. You're likely to spend down your nest egg too fast, and that will leave both you and the younger generation without any financial support.

Help for younger generations must be affordable for you and shouldn't be open-ended or without expectations of results from the youngsters See Chapters 2 and 4 for discussions of how to plan spending and Chapter 11 for ways to help the younger generations.

Flying Solo

Married couples do better financially in retirement than singles. That's partly because divorce is expensive, requiring the same income to support two households. But it's also because too many retirement plans don't include the contingency that one spouse will pass away, costing the household Social Security and other income sources. A solid plan includes financial security for a surviving spouse. See Chapter 3 for some help on providing guaranteed income to the surviving spouse.

Fraud

Financial crooks generally target older Americans. Older Americans usually have enough money to entice the crooks, and they're more vulnerable than younger people. Studies show that people generally are more optimistic and trusting as they age, making them susceptible to fraudulent pitches. Others have reduced cognitive functions, so they don't make decisions as well as they used to. Realize you're more of a target for fraud and establish safeguards (see Chapter 13).

Second Homes

Classic retirement goals often include becoming a "snowbird" or having a vacation home. Too many people, however, don't understand the full financial burdens of these goals. A classic mistake is not to factor in the periodic repairs and maintenance required of the second home. These expenses mount as the home gets older and become significant in retirement when incomes are likely to be lower and finances are less flexible (see Chapter 14).

New Businesses

People with successful careers often consider starting businesses in retirement to stay busy. Before traveling this road, be aware of the high potential for failure and the loss of capital. A retirement business should use only capital that isn't needed to maintain the planned standard of living. Be sure to plan your spending carefully as discussed in Chapter 2 and establish a sustainable spending plan as discussed in Chapter 4.

THE NEW RETIREMENT AND YOU

You can have the retirement you desire. You can have financial independence and security. But you have to plan. Key issues must be carefully analyzed before decisions are made. The earlier you start planning, the better. But it's never too late to plan to improve retirement.

You can opt for the traditional retirement of living off your investments and other sources of income you have while filling your time with leisure or fulfilling activities. Or you can opt for the many other possibilities—or a combination of them. Regardless of the retirement you choose, you won't be alone if you don't participate in the traditional retirement that became common after World War II.

Keep in mind that retirement is a relatively new development. As recently as the turn of the twentieth century, few Americans lived past age 50. Only the very wealthy actually retired. We all are learning new things about retirement every day. Your plan needs to include flexibility, because many things will change. All retirement plans are educated guesswork. Regular adjustments are required as we learn more and facts and circumstances change. Even after you are retired, the plan will have to be modified to keep up with changes, so don't view yourself as being locked in to an inflexible retirement plan.

Now let's get to work. We know that the rules of retirement have changed and will continue to do so. We know every facet of retirement has been affected by change in the last decade or so, and each facet probably will be affected by change again. Let's look in detail at the key parts of retirement finances and the decisions that should be made now in order to enhance the retirement years.

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CHAPTER 1: THE NEW RULES OF RETIREMENT

Chapter Objective

After completing this chapter, you should be able to:

- Identify the issues facing retirees today.

Keep my principal secure.
Pay me income.
Protect me from inflation.

These are the goals of more and more Americans age 40 and above. As Americans enter or approach their post-career years, their focus shifts from earning higher income and investment returns to preserving their hard-earned nest eggs. They want to receive steady cash flow from their nest eggs and control their expenses. They want to ensure they'll have enough income and assets to meet their lifetime goals.

Steady, secure income means financial independence. That's why interest in developing a continuing, stable stream of cash is booming.

Unfortunately, your job is becoming harder than ever. Your job is to establish and maintain financial security and independence in those post-career years. Not too many years ago, it was fairly easy to establish and maintain financial independence in retirement. Retirees had assistance and support from former employers and the government. Most of them had pensions. It also was fairly easy to convert a preretirement portfolio into a reliable stream of cash flow that helped replace your working years' income. Things are different now.

Much has changed and continues to change in the economy, the markets, government policies, and employer practices. The Federal Reserve has kept interest rates dirt low since 2008, and it is likely to be years before rates return to historic average levels. The government is cutting programs and increasing fees and taxes. Employers are slashing benefits. Wall Street and the markets aren't helping much. The rules and choices are becoming more complex. All the factors of retirement finance are changed or changing.

Tough, complicated decisions need to be made about IRAs, 401(k)s, medical insurance, investments, taxes, estate planning, and more. Many of the decisions are irreversible. Make a bad decision or two, and the rest of your retirement plan might not matter.

In 1989, only 30 percent of Americans ages 30 and older were on track to be financially unprepared for retirement, according to the Center for Retirement Research. In 2015, 52 percent of Americans over 30 were considered unlikely to be able to maintain their living standards in retirement. About two-thirds of those aged 45 to 60 said in 2015 they will retire later than they had planned, according to the Conference Board. In 2011, that number was only 42 percent. Government data show that after many decades of declining, the average retirement age has been increasing.

Even those who think they're prepared for retirement often aren't. Almost half of all Americans die with financial assets of less than $10,000, according to recent research by James Poterba, an MIT economist. Many Americans enter retirement with what seemed to be substantial and adequate financial assets, but because of mistakes and unforeseen events they spend faster than they anticipated or should have. They end up with few assets.

It doesn't have to be that way for you.

You can be financially secure during your post-career years, free of the worries that will plague many others in the coming years.

But you can't rely on what worked in the past. Following tired "rules of thumb" and traditional cookie-cutter approaches is the road to income insecurity. Don't travel that road. The markets and economy, tax law, estate planning, health insurance, Medicare, Social Security, long-term care, annuities, and all the other financial aspects of your post-career life are being transformed. You need to use strategies and tools that are different from those that worked for previous generations of retirees.

SIX THREATS TO LIFETIME INCOME SECURITY

Most importantly, you need to know how to deal with today's six key threats to lifetime income security. Most of the threats aren't new, but they've been increasing, and so is the danger to your financial security.

Retirement Threat #1: The Foundations Are Crumbling

For decades, Social Security and Medicare provided the secure financial foundation of retirement. They still do. Today, however, those programs are in financial trouble, and they will have to change at some point.

You know about Social Security's problems. If changes aren't made by 2036, a 23 percent cut in benefits will be required to maintain the system, according to its chief actuary. The specifics of its financial condition and potential benefit cuts change annually as estimates are updated, but the general condition doesn't change.

Many people say they don't expect to receive anything from Social Security and aren't including it in their plans. Those are mistakes. Too many people underestimate the importance of Social Security to retirees. Even for many higher-income people who earned at least the maximum Social Security wage base for 35 years, the program replaces 28 percent of preretirement income. For low-income beneficiaries, it replaces 90 percent of preretirement income. On average, Social Security benefits are estimated to provide about 40 percent of the average retiree's income. Also, Social Security is the only income most retirees have that is indexed for inflation.

Most current retirees report depending more and more on Social Security as the years pass. They tend to spend down other assets or see the purchasing power of income and assets dwindle because of inflation. That's why it is important that you understand the role of Social Security and maximize your benefits.

If the program goes under or benefits are reduced substantially, many people will have to make major adjustments. I suspect most benefit reductions would be limited to those who aren't already retired or within 10 years of retirement, except for higher income people. Don't give up on Social Security. Instead, realize its importance to your retirement and plan to maximize and protect your benefits.

Medicare is in even worse shape and is closer to insolvency. Without change, Medicare will be bankrupt by 2022, according to the Congressional Budget Office. (Again, the specific estimate changes annually.) In recent years, there have been a few changes in the program, but more are likely. There are likely to be higher premiums, reduced benefits, more means-testing, and a later eligibility age.

Like it or not, Social Security and Medicare are the foundations of the American retirement, and you'll have a tough time replacing them.

In this book you'll learn how to shore up these foundations of your retirement plan. You'll learn to maximize the benefits you receive from these programs and avoid making the mistakes that thousands of retirees make every year. Learn the facts about Social Security and Medicare and they can be valuable assets, effectively adding many thousands of dollars to your nest egg.

Retirement Threat #2: You're on Your Own for Medical Care

Retirement medical and long-term care costs are prime worries of most Americans. About 67 percent of Americans ages 55 to 65 said medical expenses were the top retirement concern, according to a 2012 survey by Allianz. Many other surveys over the years reported similar results. And rightly so. Medical expenses are the retirement plan wild card.

Medical expenses and health care are among the most misunderstood and underestimated expense for retirees. Consider this:

- Many Americans believe that Medicare or their employer's insurance will cover most retirement medical expenses and long-term care expenses they need. That's not even close to the truth.

- Only 28 percent of employers with more than 200 employees provide retiree medical coverage (compared to 66 percent in 1968). Most of those that still offer retirement medical benefits are reducing benefits and moving retirees to privately run insurance exchanges. Smaller employers often don't provide any retirement medical benefits.

- Medicare pays only 80 percent of covered expenses, so you're on the hook for 20 percent of covered expenses with no limit. Plus, there are many medical expenses that aren't covered by Medicare. You need ways to pay for all of those.

- Medicare covers only about half of the average member's annual medical expenses. The average retiree will pay $6,000 to $8,000 out-of-pocket each year for medical care, depending on whose estimate is used. That's the average, so many pay more and some pay considerably more.

- A married couple age 65 today is estimated on average to need more than $270,000 over the next 20 years to pay for their medical expenses that aren't covered by Medicare. Of course, those with above-average needs or who live past age 85 will need more.
- Long-term care expenses generally aren't covered by Medicare. The truth is, Medicare pays for only 25 percent of total nursing home expenses in the United States, and those payments largely are for short-term rehabilitation after an illness or injury. Residents, their families, and Medicaid pay most nursing home expenses.
- Most prescription drugs aren't covered by basic Medicare Parts A and B.
- Medicare now is means-tested. The higher your income is, the higher your Medicare premiums will be for both traditional Medicare Part B and for prescription drug coverage under Part D.
- The Affordable Care Act shifts money away from Medicare, especially the popular Medicare Advantage program, reducing benefits and increasing costs for beneficiaries.

Medical expenses will be one of the three biggest post-career expenses for most people, and they'll only increase as the years go on.

Even many of those who understand they are largely on their own for medical care need to know more than they do. Many pay far too much for Medicare supplement, Part D prescription drug, and long-term care insurance. Recent surveys found that many owners of these policies pay up to twice what they need to.

It doesn't do much good to save and invest for a comfortable retirement and build a legacy for your loved ones only to spend most of your nest egg on medical care and overpriced insurance. You need to stay up to date about Medicare, Part D prescription drug coverage, long-term care, and every other aspect of paying for retirement medical care.

Retirement Threat #3: Avoid the #1 Retirement Planning Mistake

"We didn't realize how much everything would cost, Bob. That's the mistake we made."

Those were the words of a woman who shared, with her husband, a large lakefront house (with an indoor swimming pool) in a secured golf course community in central Virginia. They also owned a condo in Florida to be near one set of grandchildren in winter.

They weren't scrounging for money. But after five years of retirement, the couple were concerned that they had underestimated the cost of retirement. He took some part-time consulting work, and she also found part-time work.

This is not unusual. Ask many retirees what their biggest retirement planning mistake was, and a high percentage will say that they didn't do a good enough job of estimating retirement spending. Ask financial professionals, and they'll also say that most people don't have a good handle on how much retirement costs.

One-third of U.S. adults who haven't retired say they'll need 25 to 50 percent of their preretirement income in retirement, while another third say they'll need 50 to 75 percent, according to a TIAA-CREF survey.

The traditional rule of thumb used by financial advisors is your annual retirement spending will be about 80 percent of your preretirement income. That's far above the estimate many people use, and it still isn't a good way to estimate your retirement spending.

This simple rule of thumb, one of the great myths of retirement planning, gets many people into trouble.

You will spend less (or nothing) in retirement on expenses such as commuting, new work clothes, payroll taxes, 401(k) contributions, and a few other items. It sounds very logical.

But since you aren't working, you have time to fill. That time might be filled by activities that cost money, such as golf, travel, entertaining, eating out more frequently, going to more shows and movies, hobbies, spoiling the grandchildren, or a host of other possibilities. Over time, you also are likely to incur higher medical expenses.

With parents living longer and children needing more financial help, you could end up helping both your parents and your children. That situation has become more and more common.

The truth is that for many people, expenses stay the same or increase in the first years of retirement. The money goes to different expenses. A rule of thumb that actually works is that the higher your income, the less likely your expenses are to decline in the first years of retirement.

If you don't want to wake up in a cold sweat worrying about money a few years into retirement, ignore the general rule. The question is: How much are you likely to spend in retirement? Many people learn to their regret that the general rules of thumb don't apply to them. We discuss how to estimate retirement spending in Chapter 2.

Even those who correctly estimate their retirement spending often make a different mistake. They fail to consider how inflation affects the purchasing power of income and assets over time. In fact, the most common retirement planning mistake is failing to consider the effects of inflation in retirement plans. Many people develop a spending plan for the first year or two of retirement that matches their income. But they forget that prices and costs change over time.

Inflation is one of the great enemies of retirees. The average three percent annual inflation of the last few decades cuts your purchasing power in half over 24 years and by close to 20 percent after five years. A more modest 2 percent inflation cuts your standard of living by 20 percent after 10 years. It doesn't happen overnight, but it is painful over time.

And don't use the Consumer Price Index to measure inflation. It measures inflation for a basket of goods purchased by a hypothetical American family. Your household spending is different, and so is its inflation rate. In retirement, for example, you'll probably spend less on housing and more on medical care. There are other differences.

You learn in this book the right way to estimate your retirement expenses, the true effects of inflation, and more.

Retirement Threat #4: Most Retirement Investment Advice Is Wrong and Dangerous

Retirees and those close to retirement traditionally receive the worst investment advice. There've been some improvements in recent years as demand from the Baby Boomers forced changes. Yet, many still receive poor investment advice for the years just before retirement and during retirement.

That's not surprising. Most financial advisors and brokers still concentrate on investors who are going to increase their investment accounts each year. That's a growth business. There's not much growth when clients plan to spend their investment funds and draw down their accounts.

The investment advice for retirees used to be simple. As you age, move most of your portfolio into safe, income-producing investments such as short-term bonds, certificates of deposit, and money market funds. Then, live off the income.

That made sense when retirement lasted about five years, interest rates were higher, and you didn't have to worry about wide changes in the cost of living. Now, this advice could be the most dangerous thing you can do in retirement.

More recently, retirees and preretirees were told to invest like everyone else, using diversified portfolios developed using historic returns and computer programs. They were told to buy-and-hold these portfolios and to count on the long-term trends of ever-rising stock prices to fund their retirements. That's a shame, because the results since 2000 have been awful.

The strategy can work over the very long run. Unfortunately, it often produces poor results in the short run. People in or near retirement can't invest based on 80 years of history. What happens in the next 10 years or so is what matters to them, and the results over the next 10 years often vary greatly from the last 10 years and the historic averages. Investment returns in the five years immediately before and after retirement will make or break your retirement plan.

Another problem with most investment advice is that people are told they have diversified portfolios when they really don't. The truth is that when a portfolio is 60 percent stocks and 40 percent bonds, about 90 percent of your total returns and volatility are tied to the stock indexes. Your retirement security rises and falls with the stock indexes.

When the bulls are running, that's a great thing. But the volatility and poor performance of stocks since 2000 have hurt many retirees and put future retirees in uncomfortable positions.

These days, investing conservatively and for safety isn't rewarding, either, thanks to the Federal Reserve board's zero-interest-rate policy and market manipulation. The Fed is saving the economy by punishing savers and those who simply want a comfortable, safe retirement income. Savers are losing money after inflation and taxes.

You have more choices than the traditional safe, low interest investments and investing for the long term while hoping for the best in the short-term. You don't have to bounce up and down with the stock indexes or sit in cash, losing money to inflation and taxes.

Retirement Threat #5: Retirement Lasts Longer Than Most Think

For the first generation of post-World War II retirees, retirement generally lasted five years or so. Today, many people still believe they have to plan only for 5 to 10 years of retirement. The fact is, a 20-year retirement is common, and 30-year retirements aren't unusual.

People on average still retire before age 65. Though many people now say they plan to work longer and the average retirement age has been increasing, about half of people retire involuntarily and before they expected. The fact is that retirement could last a long time, even if you plan to continue working, because you might not retire when you thought. Even for those who retire at age 65 or later, retirement can last a long time. People simply are living longer than they used to.

Here's a sample of what you need to know about longevity. In a married couple in which each spouse is age 65 today, there's about a 20 percent chance either spouse will live to 95. When both spouses are 55, there's a 43 percent chance at least one will live past 95, according to annuity mortality tables. In about 15 years, the odds will increase by about 50 percent, according to the insurance actuaries.

Many people born in 1946 and later can expect to spend more than 30 years in retirement. Some will spend more time in retirement than they did in their careers.

There's another twist to consider. Life expectancy increases with wealth and education. The wealthier and better educated a person, the greater on average is the life expectancy. Such a person has access to better medical care and is more likely to make smart lifestyle choices. The person's career probably wasn't physically demanding and was unlikely to result in injuries or disability. These factors make an above-average life expectancy more likely, probably about four years longer than the average for his or her age.

Life spans are likely to increase in coming years as science discovers new treatments and cures.

There are many benefits to longevity and longer life spans. But there's one giant negative. The nest egg needed to pay for all those years of retirement can be substantial. You have to save enough money and keep that nest egg growing to pay for all those years of retirement and protect the purchasing power from decades of inflation.

Retirement Threat #6: Your Taxes Won't Go Down in Retirement

It used to be a truism that taxes and tax rates would decline in retirement. That's no longer the case.

These days, someone's taxes and tax rate are less likely to decline after retiring. Even if they do, they're likely to creep up during retirement. In many cases, a person's marginal income tax rate actually increases in retirement, and retirees face some of the highest marginal tax rates in history. Average tax rates are likely to stay the same or increase.

You have to be on constant guard against politicians devising new and creative ways to get their hands on your nest egg. It's only going to get worse as the population ages.

The bottom line is that for most retirees, taxes are one of the three largest items in their budgets. The situation is likely to get worse. Congress and state and local governments are far more likely to increase your taxes than to cut them.

You'll learn effective tax reduction strategies throughout the book, but we focus on ways to plan for lower taxes in Chapter 9.

YOU CAN CREATE SAFE, SECURE, SUSTAINABLE LIFETIME INCOME

You don't have to stand there meekly and let these risks destroy your nest egg. You can fight and win. You can build a fortress around your assets and generate reliable cash flow.

I believe today is a great opportunity for those who prepare for retirement and adapt to the recent changes and those to come. Be clear that there isn't a magic formula, silver bullet, or single ideal investment. You'll have to look elsewhere for gimmicks and fads. You can create a successful retirement by using a toolbox of strategies and a solid plan. You'll also need to ignore the status quo, conventional rules of thumb, and standard Wall Street advice.

I find that simple solutions often are the best. You need to push past the complexity so beloved by Wall Street and Washington and find strategies that will maximize your cash flow.

Most importantly, remember a retirement plan is a process, not an event. As you've seen, the rules and circumstances keep changing. You can't set-it-and-forget-it. Be sure you're aware of changes, carefully analyze how they affect you, and choose a course of action that will work for you.

We know that retirement in the future will be as different from the retirement of the past as night is from day. Those who planned for retirement only 15 or 20 years ago would be shocked by the task faced by their counterparts today. Many of the issues and questions to be addressed today weren't even on the radar screen not long ago.

The first real generation of American retirees, those who retired in the 1960s and 1970s, developed the image of retirement that many Americans still hold today. For most of the second, third, and fourth retirement generations, things will be different. Sometimes they will be shockingly different.

Many observers paint a gloomy picture of retirement in the coming years. Yet there is no reason for the majority of people to experience a retirement that is less satisfying than was experienced by the first generation of retirees. Most of us should be able to create the retirement we desire.

Retirement is an opportunity. It is an opportunity to do things you never could find the time for. It is a chance to plan how to spend your next 50 years. But to take advantage of the retirement opportunity, you have to plan and prepare. Most of all, you need to know the new rules of retirement planning.

In the coming chapters, we'll explore the financial concerns of retirees and preretirees and how they are affected by the trends I've identified. We'll look at how to estimate retirement spending and how much money you should accumulate for retirement. I'll explain the medical expense options and how to pay for long-term care. You'll learn how to invest before and during retirement. I'll show you how to plan an estate, cut taxes, and provide for loved ones. We'll cover these topics and much more. I'm not going to give you the obvious advice, such as start early, invest the maximum in a 401(k) account, and invest for the long term. Think of this book as your instruction manual for the new world of retirement.

You can have the retirement you desire, but you must act now to stay ahead of the dramatic, rapid changes that are taking place. Even those who already are retired are affected and must act. Those who don't learn about and understand the shifting world of retirement will have retirement years filled with worry and anxiety. Those who understand the new rules of retirement will make decisions with confidence and be able to take advantage of all their retirement opportunities.

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CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**In 2015, what percentage of Americans aged 45 to 60 said that they would retire later than they had planned:** **A.** 30% **B.** 42% **C.** 52% **D.** 66%
2.	**Which of the following accounts for roughly 40 percent of the average retiree's income:** **A.** Social Security **B.** pensions **C.** stocks **D.** bonds

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CHAPTER 1: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The percentage of Americans that say they are planning to retire later than originally planned is significantly higher than 30%. **B.** Incorrect. The number of people that are reporting postponing their originally planned retirement date was 42% in 2011, but has since increased dramatically. **C.** Incorrect. The percentage of Americans planning on postponing their retirement is higher than 52%. **D.** CORRECT. About two-thirds of Americans aged 45 to 60 said they will retire later than they had planned. *(See page 9 of the course material.)*
2.	**A.** CORRECT. On average, Social Security benefits are estimated to provide about 40 percent of the average retiree's income. **B.** Incorrect. Pensions are not a major source of retirement income for most Americans. **C.** Incorrect. Stocks do not account for 40 percent of the average retiree's income. **D.** Incorrect. Forty percent of the average retiree's income does not come from bonds. *(See page 10 of the course material.)*

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CHAPTER 2: START WITH SPENDING

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the realities of spending after retirement.

The main goal of a retirement plan is to be sure you have enough income or cash flow to maintain the retirement standard of living you want. To meet that goal, first, you need to estimate how much a year of your retirement standard of living will cost. Second, you need to generate income to pay those expenses.

In this chapter we focus on estimating your retirement spending. In the next chapter we'll begin looking at ways to generate the income needed to fund that spending.

It is difficult to make retirement plans, even something as simple as setting a retirement date, without estimating the cost of your retirement. Every other part of a retirement plan hinges on how much you plan to spend. If that estimate is way off the mark, the rest of your plan will be way off. Some people overestimate how much they'll spend in retirement, and that causes them to reduce their preretirement standard of living so they can save enough for retirement. Others underestimate retirement spending and find they need to make substantial adjustments after retiring.

Even if you already are retired or very close to it, estimating future spending now is important. The steps we discuss in this chapter will give you a good handle on how long your money is likely to last under current practices and let you know if adjustments need to be made. Those who carefully estimated spending before retirement should repeat the exercise every year or so to see how accurate the estimates are and whether the plan needs to be adjusted.

How important is this step?

The greatest fear of most Americans approaching or in retirement is not having enough income and assets to last through retirement.

Survey after survey confirms that. (Some surveys peg medical expenses or the cost of long-term care as the major concerns, but that's another way of saying people are worried about not having enough money to meet these expenses.) Even surveys of wealthy Americans reveal they worry about their standards of living eroding in retirement. I've met multimillionaires who were genuinely concerned that they wouldn't be able to maintain their preferred lifestyles after retiring.

Ask retirees what their biggest retirement planning mistake was, and a high percentage will say that they didn't do a good enough job of estimating retirement spending. Ask financial professionals, and they'll say that most people don't have a good handle on how much the retirement they desire will cost or even how much they are spending today. Another reason to estimate retirement spending is that surveys show that people who estimate their expenses and capital needs, even if they make poor estimates, save more and are better prepared for retirement than those who do not make estimates.

Unfortunately, most of the advice on how much to save for retirement is nothing more than very simple rules of thumb. Longer retirements and greater self-reliance mean that we must dispense with rules of thumb and devise a more accurate estimate of retirement spending and capital needs. Even when a rule of thumb is generally accurate, you shouldn't use it. It might reflect what people do on average, but almost no one is the average. You need to estimate your likely spending.

A number of methods are used to estimate retirement spending. There is no one right way to estimate retirement capital needs or spending, but some ways are better than others. As we've collectively developed more experience with extended retirements, we've learned more about which methods work best.

In this chapter, we'll look at different ways to estimate the amount of money that should be accumulated for retirement. We'll review a couple of widely cited rules of thumb or short cuts. I'll explain why you should avoid those methods. Then I'll point you to some better ways to estimate retirement spending.

THE 80 PERCENT RULE

If you've been exposed to any retirement planning advice, you probably heard the classic and most common formula: Assume that retirement spending will be less than 100 percent of the income of your last preretirement year. The recommended percentage varies. I've heard from 65 percent to 85 percent, but most of the recommendations I've seen are around 80 percent.

The advice is quick, easy, and has a reasonable theory behind it. The theory is that not as much money will be spent in retirement as was spent during the working years. In retirement there won't be Social Security taxes or commuting expenses. There also isn't likely to be the need for as many new suits or other work clothes. Of course, 401(k) contributions won't be made. Perhaps lunches will be eaten at restaurants less often. Other expenses also might decline or disappear.

Some research supports this general rule. Since 1988, every few years Georgia State University, in a project funded by Aon Consulting, has used government data and other sources to determine the percentage of preretirement income that people actually spend in retirement. This percentage is known as the replacement ratio. It is the percentage of your preretirement income that your retirement income and assets have to replace to meet retirement spending needs. The study adjusts preretirement income for postretirement changes such as income taxes, savings, and expenditures related to age and work. The latest study I've seen was done in 2008 and can be found on the Aon website.

One result of the Aon/Georgia State study that often isn't mentioned is that it regularly finds that the replacement ratio depends on income. The lower one's preretirement income, the higher will be the replacement ratio until annual pre-retirement income reaches $60,000. Above that level, the replacement ratio plateaus. But the 2008 study caps preretirement income at $90,000. Some of the earlier studies estimated the replacement ratio for incomes up to $150,000 and found that after the plateau replacement ratios rose steadily as preretirement incomes rose above $90,000.

In the first edition of this book I wrote that on average, a couple with preretirement income of $150,000 would need about 85 percent of that income in retirement. A couple with $50,000 in preretirement income would need only 74 percent of that income in retirement. The replacement ratio, however, rose again for even lower incomes. A couple with $30,000 of preretirement income, for example, needed 78 percent of that income in retirement.

More importantly, the studies over the years have found that the replacement ratio rises steadily over time. For example, in 2001, a preretirement income of $50,000 required a replacement ratio of 74 percent. The replacement ratio rose to 77 percent in 2004 and 81 percent in 2008. At higher incomes, however, the replacement ratio remained fairly steady over time. For a preretirement income of $90,000, the ratio was 76 percent, 78 percent, and 78 percent, respectively.

The Aon-Georgia State studies are interesting and provide useful information for those planning retirement. It would be a mistake, however, to simply take the study results and apply them to your own retirement plan. Using the replacement ratio to help establish a target amount to accumulate is acceptable for someone years away from retirement. As retirement approaches, a more individualized estimate should be made.

While certain expenses will be eliminated after retirement, other expenses might take their place. After retirement, the time that used to be spent working has to be filled. It might be filled with no-cost activities such as watching television, playing cards, walking, visiting nearby friends, or sitting in the park. It also might be filled with hobbies or activities that cost money. These include golf, travel, eating out more often, or going to more movies and shows. The retiree might become a volunteer, which might require employment-type expenses such as commuting, lunches, and clothing. Another popular retirement activity is spoiling the grandchildren.

It’s also important to consider some spending wildcards. Medical expenses could rise substantially over time. The amount of medical expenses will depend on personal health, insurance coverage, and where one lives. With parents living longer and children needing more financial help, more retirees end up helping both parents and children at the same time.

The point is that retirement spending is unique for each person or household. Studies and rules of thumb provide averages and estimates. Anecdotal evidence indicates that many retirees find that, contrary to the traditional assumption, their expenses don’t decline in retirement, at least not in the first years of retirement. They spend the same and even more after retiring as they did just before retiring. The higher your pre-retirement income, the more likely it is that you’ll be in that group. On the other hand, I’ve known people who said they spend considerably less in retirement than they did before retiring.

THE DOUBLE TROUBLE METHOD

Here is a widely recommended method for estimating retirement financial needs that uses two simple rules of thumb. It’s very simple, which explains a lot of its appeal. I sometimes call it the *ballpark method*, because it gives an answer that’s “in the ballpark.” But the simplicity and the generality of the rules leave a lot of room for error. This method can be helpful to a young person who is looking for some benchmark of how much to save and accumulate for retirement. As one is closer to retirement, the imprecision can make the method dangerous. For some people, the method will greatly overestimate spending, leaving retirees to live far more frugally than they need to. For others, the method underestimates spending and raises the probability of running out of money.

Here's how the method works.

Suppose our friend Max Profits uses the 80 percent rule to estimate his spending in the first year of retirement to be $40,000. He estimates he'll earn a total annual return of 7 percent on his investments. He'll need a $571,429 portfolio in order to draw $40,000 annually to spend ($40,000 divided by .07). That's a simple calculation that produces a retirement savings goal in a few minutes. It gives, however, a very incomplete answer. Someone less than five years away from retirement definitely needs a more accurate estimate. Even people within 10 years of retirement should be focused on a better estimate.

One factor not considered in this estimate is inflation. The cost of living is likely to rise each year, and Max needs to factor this into his plan. Max will need to spend more than $40,000 each year after the first year to maintain that standard of living. That means Max must reinvest a portion of the investment return each year to ensure that the portfolio and its income will maintain their purchasing power. If Max expects 3 percent annual inflation, then he needs to reinvest 3 percentage points of the annual investment return. Max can spend only 4 percent of that 7 percent annual return. That brings the annual spendable income from the portfolio down to only $22,857. To meet his goals, Max needs to either increase the investment return to 10 percent or increase the retirement fund to $1,000,000. If Max's investments will earn less than 7 percent, he will need an even bigger nest egg.

Even after adjusting the method for inflation, there still are key elements missing from the estimate. The method assumes Max receives nothing from Social Security. Although Social Security has its problems and changes are likely to be made, Max is still likely to get $10,000 or more annually from Social Security, perhaps much more, for many years. Factor in Social Security and Max will need to save less than this simple method indicates. Max also should be sure not to overlook any other income sources.

The ballpark method also assumes the investment principal never is touched. Most retirees don't want to dip into their initial capital in the early years of retirement. But there's no reason to assume that the principal won't be touched for life unless the primary goal is to pass the entire principal intact to a spouse, the next generation, or to charity. Otherwise, the method sets the savings goal too high. I think the results should be viewed as a high estimate of the amount that should be saved to meet retirement needs.

There are other simple rules to estimate retirement spending, and they suffer from some or all of those shortcomings.

YOUR STARTING POINT

The real question is: How much are *you* likely to spend each year in retirement? I recommend throwing out the general rules. Don't use a rule of thumb about replacement ratios. Don't look at annual retirement spending as a lump sum. Instead, develop a spending estimate that reflects the lifestyle you want.

Retirement planning is about much more than finances. Most people focus on the finances, but successful retirement doesn't start or end with the finances. You need to give some thought about how you want to live in retirement. What will you do with those hours that no longer will be spent working?

Your retirement plan should start with a thoughtful consideration of the lifestyle you anticipate in retirement and then be followed by an estimate of what that would cost today. You'll have daily activities, as well as weekly, monthly, and less frequent activities. You'll have regular necessary expenses for food, shelter, utilities, and medical care. There will be periodic necessary expenses such as replacing cars and things around the house.

Some people refer to this approach as life planning or holistic financial planning. Call it whatever you want. What's important is that the activities you engage in will drive your spending to a large extent. If your lifestyle in retirement isn't much different than your preretirement lifestyle, then your spending estimate will be very similar to your preretirement spending. But if you plan a different lifestyle for at least the first few years of retirement, then your spending might differ greatly from the preretirement years.

Develop a detailed list of possible monthly categories of expenses and decide how much money is likely to be spent on each item in today's dollars. How much do you want to travel? Play golf? Give to the grandchildren? Dine in restaurants? These are all retirement expenses that for more people are higher than before retirement. Don't forget to include taxes—all kinds of taxes.

Medical expenses are the wild card in any retirement budget. The average retiree spends anywhere from $6,000 to $10,000 annually on out-of-pocket medical expenses, depending on whose estimates are used. The estimates include all costs, such as Medicare and insurance premiums, deductibles, copayments, and noncovered expenses. But it is just an average. A particular retiree might spend more or less, depending on health, family history, and insurance coverage. The amount also is likely to increase above the average as the retiree ages. We discuss medical expenses and how to plan for them in detail in Chapter 6. Study the medical expense coverage options carefully before estimating retirement expenditures.

Don't overlook infrequent expenses. These include home maintenance and improvements, appliance replacement, automobiles, travel, and help for family members. For these expenses, divide an estimated annual spending by 12 and put a monthly amount in the spending estimate. This is what accountants call a sinking fund. Suppose you plan to buy a new car every four years at a cost of $40,000. At 3 percent inflation, the cost after the first four years is about $45,000. You could list about $940 per month in the budget to ensure the cost of a new car will be accounted for in your spending plan. A more sophisticated approach is to assume some interest will be earned on the sinking fund. At 3 percent annual interest, the monthly amount to set aside would be about $884.

Once all the amounts are determined, add them to get monthly and annual estimates of the cost of the first year of retirement.

This exercise has several important benefits. Of course, it makes your estimates of retirement spending more accurate. That reduces the probability that you'll run out of money in retirement by spending your nest egg too rapidly. Studies of retirees often show that those who are most satisfied and financially secure are those who engaged in some financial planning before retiring.

The exercise also requires you to spend time thinking about what you will do in retirement. Too many people enter retirement without giving much thought to how they'll spend their time. Through school and their careers, decisions about how to spend most of their time were made by others or by circumstances. In retirement, most of the decisions often are yours. Failure to give careful thought to daily and weekly lifestyles is why a high percentage of people retire more than once. They retire, and then after a while become bored and realize they are wasting a lot of time. They return to work, resolving to retire a few years later and more successfully. The nonfinancial aspects of retirement determine the success of retirement more than the finances. By making this exercise part of your planning, you increase the probability retirement will be a success from both the financial and nonfinancial perspectives.

HOW MUCH WILL YOU REALLY NEED?

At this point you have completed the most important step in retirement planning. You've given careful thought to the retirement lifestyle you want and estimated how much that would cost, at least in the first year.

As you go through the rest of the steps in this chapter and this book, don't be alarmed if at first it appears your income and assets don't match well with your spending estimate. That's not a bad thing, since you start a retirement plan by thinking about what you really want to do in retirement and how much that will cost. Your spending plan likely has expenses you could put into several broad categories. There are the essentials or "must haves": food, housing, medical insurance, and the like. Then there are the "nice-to-haves," which could be a range of activities and even upgrades to the essentials, such as a larger home. The final category is aspirational spending, the activities you'd do in an ideal world.

Most people at the first attempt at a retirement plan find that all these expenses are too much for their resources. Then, they go back to their spending plans and make adjustments. Don't be concerned if adjustments need to be made in your first plan after going through the next steps.

After estimating your first year of retirement spending, you need to estimate the length of retirement. Younger people should simply assume an extended period of at least 30 years, though 40 years or more looks like it will be more appropriate as life expectancy increases. For people retiring soon or already retired, we discuss longevity more in Chapter 4.

Next, use the spending and longevity estimates to make a reasonable estimate of how much money you need to fund retirement. That's what the rest of this chapter explains. You'll learn to customize and modify the information to make more reliable estimates of your retirement needs. Keep in mind that there are a lot of tools and technology available today to make calculations much easier. We'll discuss some of the options in this chapter.

The basic next step to determining how much money you'll really need is to adjust the spending estimate for inflation over your working years and retirement. Then, you'll use an assumed investment return to estimate how much money should be accumulated at the start of retirement or for the rest of retirement.

An easy step is to use the many calculators that are available, mostly free, from various financial services firms and websites. Once you've estimated retirement spending, these tools walk you through steps to estimate how much money you'll need for retirement and how much needs to be saved each month. These calculators are available free from most mutual funds, brokers, and other financial services firms. While some still are available in printed format as worksheets, most now are available free through websites. Even many news sites have financial calculators, including retirement planning calculators. Employers that sponsor 401(k) plans also usually have these available on the plan website.

I used to list software packages and websites that I believed were the best to use for retirement planning. Unfortunately, the offerings and their availability change too frequently. Some of the financial services also reserve their better tools to clients instead of making them available to the public. Therefore, I can't offer a list of retirement tools to consider. Instead, I suggest you visit the websites of the major financial services firms, especially mutual funds and discount brokers. You also should find tools on many financial news and strategy websites.

The standalone software available to nonprofessionals has declined significantly. Quicken from Intuit still has a retirement planning function. You also might want to visit the website of Money Tree Software, which has for years offered a software program called Silver Financial Planner. At times, a version of this has been available to consumers, while at other times it was available only in conjunction with financial planners who have the professional version. Of course, a reader also can purchase the professional version, which was less than $500 in 2015.

Obviously some of the calculators try to be more accurate, while others try to keep things simple so that people won't fail to complete the process. The calculators are kept simple by limiting the variables the user can change, such as inflation rates, life expectancy, and some of the details of spending. Some, for example, have you enter an annual lump sum for spending that is constant over time. Others allow more flexibility or detail in the spending estimates. The simplest calculator I'm familiar with is the Ballpark Estimate from the American Savings Education Council. An online version is on its website, www.asec.org, along with links to several other retirement calculators from other organizations. (Like other websites, this one changes over time. This description was accurate when this book was written.)

The basic data used to complete one calculator often can be easily transferred to another calculator. Most people who are planning their retirement would benefit from completing several different calculators and comparing the results. Most of these calculators will estimate how large the investment portfolio should be on the first day of retirement (or today, if you're already retired) to meet the spending goals. For those not already retired, most also will compute how much money should be saved and invested each month to accumulate that sum by the estimated retirement age.

Using multiple calculators is helpful, because you'll see the different results. That tells you how important the different assumptions are and how difficult it is to make an estimate. That should tell you that it is in your interest to revise the estimates regularly and change assumptions as needed.

The web calculators will do all or most of the computations. The best web calculators are those that are more robust, allowing you to change many assumptions. Of course, it takes more time to use these calculators than simpler ones. Members of *Retirement Watch* can download from the members' section of the website a spreadsheet, which allows substantial customization of spending details, especially of the issues discussed next.

Better Planning with Technology

A major reason the simple methods of estimating retirement spending and capital needs were developed was that it was too difficult to make a proper, detailed estimate. A large number of calculations had to be done by hand. Since technology now is widely available and relatively inexpensive, detailed estimates are relatively easy to make. Here are examples of the issues that can be addressed and make estimates more accurate than the simple methods when technology is used to develop a retirement plan.

Customized Inflation

One of the biggest mistakes in retirement planning is failing to fully factor inflation into the plan. Over 20 or more years of retirement, inflation can make a comfortable income uncomfortably tight or even inadequate. A good retirement planning model, whether it is a simple one or a sophisticated tool using technology, will take inflation into account.

The most common approach is to apply a flat inflation rate to estimated annual spending. Prices of different goods and services, however, do not increase at the same rate. More importantly, your spending probably doesn't match the basket of consumer goods and services that the government uses to compile its inflation numbers. Education expenses have increased faster than overall inflation and are a meaningful portion of the Consumer Price Index, but those expenses don't affect many retirees. On the other hand, medical and long-term expenses also have increased faster than the CPI, and retirees often incur a larger amount of these than is represented in the CPI.

That's why a better approach to estimating inflation is to assign a separate inflation rate to each budget item or at least to groups of similar items. That gives a much better estimate of the inflation the individual is likely to experience during retirement. The recent inflation rates for different items and other information about inflation can be obtained from the Bureau of Labor Statistics of the U.S. Department of Labor website, www.bls.gov/cpi/home.htm.

Some of the web calculators allow different inflation rates to be assigned to each item in the retirement budget or at least general categories of items. Software available to professional financial planners often allows customized estimates of inflation. The difference between this approach and using one inflation rate for the entire annual expenditure won't mean much in the first few years of retirement. After 10 or more years of retirement, however, the compounded difference could be significant.

Irregular Expenses

Earlier, I explained how to use a sinking fund to factor into the monthly budget expenses that are not incurred each month or even each year. A more precise alternative to the sinking fund is available in some calculators and software. These programs ask for an estimate of the year when these expenses are likely to be incurred. For example, a program might ask how often a car will be purchased and what the cost in today's dollars is likely to be. This information is included in the estimated income and spending for that year. The same can be done for home repairs and replacement of major appliances.

Unlike the simple methods, the more sophisticated software calculates the spending of each year separately instead of assuming uniform spending each year. This can make for a more accurate projection of total retirement spending. It also shows the bumps and fluctuations in spending that are more realistic than the simple models' uniform annual changes in spending.

Mature-Years Spending

Simple retirement models assume the same amount is spent each year all through retirement. The truth is that most people slow down as they age. Sometime between ages 70 and 75 many people choose to travel less, play golf less, and dine out less. In general, they spend less in many areas than when they were younger. Activities and spending might ratchet down again from 75 to 80. We'll discuss this lifetime spending cycle more in Chapter 4.

The simple models don't adjust for this, but some software is written to handle these changes. Without factoring the mature-years spending change into a retirement plan, estimated spending could significantly exceed actual spending. In addition, for married couples, spending usually is reduced after one spouse passes away. Again, failure to adjust for this could lead to an overestimate of retirement capital needs or an underestimate of how much could be spent in the early years of retirement.

Changing Assumptions

Ideally, more than one estimate of retirement spending and capital needs is made. A number of assumptions go into the calculations. Estimates include inflation, investment returns, tax rates, the retirement date, the actual spending on each item, and more. Because of the number of assumptions, it is a good idea to do several projections, changing one or two of the assumptions each time. What happens to the plan if investment returns are less than expected? What happens if inflation is higher? A really good calculator or program allows you to change the investment returns each year. That way you can see what happens if you have poor investment returns the first few years of retirement.

Very small changes in these assumptions can significantly change the results, especially if there still are years to go before retirement and two decades or more to spend in retirement.

Those who don't want to work with the numbers or technology themselves of course should consider working with a financial planner or similar professional. For those readers, this chapter gives you a good idea of what to look for in a plan and the questions to ask.

UNCERTAINTY AND MONTE CARLO

For years, retirement planning models would assume a steady rate of return is earned on the investments. If a 7 percent investment return is estimated, the method will assume that exactly 7 percent is earned each and every year.

Anyone who has been in or watched the markets for a while knows that isn't the way markets work. Investment returns are likely to be variable. A 15 percent gain one year might be followed by a 5 percent gain the following year, a 12 percent loss the third year, a 20 percent gain the fourth year, and so on. Over time, these variable returns might amount to a 7 percent average annual return. The major stock market indexes, for example, rarely have a year that matches their long-term average annual returns.

Often, the difference between the assumption of steady returns and the reality of variable returns won't make a meaningful difference. That's especially true when a younger person is planning for a retirement several decades in the future. There are times, however, when it can make a big difference. It is most likely to make a meaningful difference when the markets enter a strong bearish phase at the start of retirement. (The periods from 2000 to 2002 and following 2007 were such times. So was 1966 to 1982.) A portfolio's value could fall dramatically during those years. Instead of spending income the first few years, the new retiree would be spending principal. That also leaves less principal to generate gains and income when the markets eventually resume a bullish phase. The result often is that the wealth won't last as long as initially forecast unless spending is reduced.

To deal with this potential problem, the financial community developed a new method to make estimates in retirement plans. The traditional method of assuming a constant rate of return is known as a linear or deterministic model. The alternative is a probabilistic model. The plan produced by a deterministic model shows the specific amount of money projected to be available each year of retirement. The probabilistic method concludes by showing the probability or likelihood that a particular plan of spending, saving, and investing will lead to a successful retirement. Probabilistic models weren't readily available until the late 1990s or early 2000s. The computing power available was too expensive and slow. The declining cost and increased power of technology made this newer approach available to anyone with a newer personal computer or access to a website.

The most common probabilistic model is known as the Monte Carlo simulation. It actually was developed by nuclear scientists at the Los Alamos Laboratory to design atom bombs. Instead of assuming one average annual return, the Monte Carlo simulation calculates the results of a plan under a wide range of possible investment scenarios or outcomes. Some Monte Carlo simulations use many combinations of actual historic returns from the investment markets. Other simulations use random, computer-generated returns (within parameters set by the programmer). The Monte Carlo simulations for financial plans usually calculate 500 or more possible outcomes. That means for a 30-year retirement plan, the program will calculate investment returns over 500 different 30-year periods. The program determines the percentage of times that the investment capital lasts the entire 30-year period or longer, and that is the probability that the plan will be successful. For example, the report might say that there is an 85 percent probability that the nest egg will last through the retirement period under the assumptions used. Most financial advisers recommend changing a plan until there is a 90 percent or greater probability of success.

The Financial Engines website at www.financialengines.com (and available through many 401(k) plans) probably was the first vehicle to make Monte Carlo simulation generally available. Now simulations are on the websites of most financial services firms and financial news and strategy firms.

While the Monte Carlo simulation can be more informative than a simple deterministic model, it has its own drawbacks. A number of assumptions are built into each program. These assumptions include the average annual returns for each investment asset over time and the correlations among the different investments. Correlation is the extent to which the investments rise and fall together. Sometimes these assumptions are explicitly revealed; sometimes the program documentation is not clear about the assumptions. These assumptions could be unrealistic, wrong, or ones with which the user simply disagrees. An incorrect assumption would make the Monte Carlo simulation as unrealistic as the traditional deterministic method.

A large number of iterations are necessary for the simulation to be useful. A program or website that doesn't want to incur the cost of a high number of simulations does a disservice to its users. In a public opinion poll, the number of people questioned determines the probability of error. Likewise, the number of simulations determines the probability of error in the program. Unfortunately, Monte Carlo simulation programs typically don't reveal their probability of error.

Of course, the probabilities are a lot like insurance. Suppose you look at the statistics and decide that there is a low probability of your house burning down this year. So, you don't buy homeowner's insurance. That probability doesn't do you much good if in fact your home does catch fire this year. Likewise, a 98 percent probability of success from a Monte Carlo simulation looks good. But the plan is not a good one if your actual results fall into the 2 percent of outcomes when the plan fails.

More important than the probability of failure is the extent of the failure. If a plan falls short of the goal by a few dollars and a few months, that's not a real problem. Small adjustments in spending can turn the plan into a successful one. But if the plan falls short of success by years and tens of thousands of dollars, that's a different story. Likewise, if a plan is successful and actually will fund the retirement for 60 years, then the plan might be restricting spending too much. The extent of success or failure can matter as much as the probability.

The Monte Carlo simulation also assumes that the retirement plan will be followed. In the real world, however, an investment bear market or some other unexpected and negative event often causes people to change their investment portfolios or other parts of their plans. Reducing stock holdings in a bear market, for example, would reduce a person's ability to participate in a succeeding bull market. But that possible change in behavior is not factored into the probability of success calculated by the simulation program.

Of course, the simulation is only as good as the data on which it is based. That is why the most important part of retirement planning is to develop a realistic estimate of retirement spending, saving, inflation, and other factors. Nothing else matters if those estimates aren't done well.

The Monte Carlo simulation is a useful tool in the retirement planning toolbox. Don't think, however, that because it uses high-level mathematics and computer power that the result is hard science. There are many assumptions and variables in the simulation. Solid judgment and key decisions are at least as important as computer power. You need to realize the limits of the tool.

A SUCCESSFUL RETIREMENT

The key to successful retirement planning is a good estimate of retirement spending. Everything else relies on it. Whichever method is used to estimate retirement finances, keep the following principles in mind.

How to Forecast Spending Successfully

Use Your Own Spending

Don't use rules of thumb or rely on surveys of other retirees. Decide what you want to do in retirement. Then, estimate how much that lifestyle would cost today. As we discussed earlier, this estimate of annual retirement spending might equal or exceed spending during the working years. It depends on your plans for retirement.

Count on Inflation

Even low inflation has a strong effect over 10 years or more. A 3 percent annual inflation rate cuts purchasing power in half over 24 years and by close to 20 percent after five years. Even a low 2 percent inflation rate cuts the standard of living by 20 percent after 10 years. For example, after 10 years of only 2 percent inflation, almost $12,200 is needed to buy what $10,000 used to buy (a 22 percent increase). After 15 years, almost $13,500 is needed. If inflation doubles to 4 percent, almost $15,000 is needed after 10 years and $18,000 after 15 years. Here's another way to look at it. A dollar in 1982 had the purchasing power of about 59 cents in 2002. A 1967 dollar equaled about 19 cents in 2002. It won't happen overnight, but it is painful over time. See Table 2.1.

TABLE 2.1 DOLLARS NEEDED TO RETAIN PURCHASING POWER

	Inflation Rate		
Years	**3%**	**4%**	**5%**
1	1.0	1.0	1.1
2	1.1	1.1	1.1
3	1.1	1.1	1.2
4	1.1	1.2	1.2
5	1.2	1.2	1.3
6	1.2	1.3	1.3
7	1.2	1.3	1.4
8	1.3	1.4	1.5
9	1.3	1.4	1.6
10	1.3	1.5	1.6
11	1.4	1.5	1.7
12	1.4	1.6	1.8
13	1.5	1.7	1.9
14	1.5	1.7	2.0
15	1.6	1.8	2.1
16	1.6	1.9	2.2
17	1.7	1.9	2.3
18	1.7	2.0	2.4

	Inflation Rate		
Years	**3%**	**4%**	**5%**
19	1.8	2.1	2.5
20	1.8	2.2	2.7
21	1.9	2.3	2.8
22	1.9	2.4	2.9
23	2.0	2.5	3.1
24	2.0	2.6	3.1
25	2.1	2.7	3.4
26	2.2	2.8	3.6
27	2.2	2.9	3.7
28	2.3	3.0	3.9
29	2.4	3.1	4.1
30	2.4	3.2	4.3

A Key Issue Is Which Inflation Rate to Use

People who were planning retirement in the early 1980s would use a 4 percent to 5 percent annual inflation rate. The average annual inflation rate from 1962 to 1982 was 5.9 percent. That turned out to be much too high for the following 20 years, when inflation rose only 3.2 percent annually. Overestimating inflation causes a preretiree to save more money than required and reduces their working years' standard of living. Those planning retirement today might be tempted to use a 1 percent to 2 percent rate, based on recent history, but this would be risky. If inflation rates rise in the future, they won't have saved enough for retirement. For the long term, the inflation rate in the United States has been around 3 percent. Ideally, as we discussed, a separate inflation rate is assigned to each item of proposed retirement spending. The usefulness of that method, however, still depends on being able to estimate future inflation accurately.

Don't Underestimate Longevity

People who retire today have life expectancies that were only dreamed of during their youth. A common retirement planning mistake is to underestimate life expectancy and spend money accordingly. To be safe, most people should count on a retirement of at least 30 years. Married couples should assume at least one spouse will live into his or her 90s, unless there are medical or family reasons that likely limit life expectancy. Many advisors say that the safest advice is to assume that at least one spouse will live at least 15 percent longer than the current life expectancy for his or her age or that at least one spouse will live to 100. That means that many people should plan on 30 or more years of retirement. We'll discuss longevity in more detail in Chapter 4.

Don't Overlook All Possible Income Sources

The tools available from the financial services companies often tend to overstate the amount of investment assets needed. Don't forget other income sources such as Social Security, home equity, a reverse mortgage, and so forth. Inheritances also might be part of the equation. Remember that in the later years, retirees should feel free to spend principal and not rely solely on income and capital gains, unless leaving money to loved ones or charity is the primary goal.

Make More than One Estimate

The primary projection will depend on the best estimates of inflation, investment returns, and other factors. Additional projections also should be made that will show the results if one or more of those assumptions change. Consider making alternate projections with higher and lower inflation and investment returns and some changes in spending. The point is to see how long-term changes in the assumptions change the results. That makes it easier to adjust the plan over the years when it looks as if actual results will differ from the original assumptions.

Stress Testing

Medical expenses and long-term care expenses are the most uncertain spending in most retirement plans. You can make annual estimates of those expenses and assume an inflation increase, but unlike other expenses these expenses have the potential to balloon in one or more years. You might have routine medical treatment and exams for years and then require a major surgery or other treatments in one or more years. You might develop a chronic condition that requires additional expenses every year. Or at some point you might need long-term care.

The best way to deal with such uncertainties is stress testing. Assume that at some point in retirement you are faced with large expenses for medical care or long-term care. How much of those expenses would be covered by insurance or government programs? How would the expenses not covered by insurance or programs affect your retirement plan?

After looking at stress test results, you might modify your plan. You might decide to increase insurance coverage. The trade off is that more insurance increases your annual costs but reduces the uncertainty by covering more of the catastrophic or large expenses. Or you might decide to build more flexibility into your plan. Don't spend as much money annually as your plan seems to allow. That will give you more of a reserve to cover any large medical or long-term care expenses.

Review and Revise Regularly

No matter your age, remember that the plan is only a plan. It is based on assumptions, and real events are going to differ from at least some of your assumptions. Younger people should review their plans every five years, or more often if significant life changes occur. People in or within five years of retirement should make annual reviews comparing their plans to actual results. Annual reviews enable you to make relatively small adjustments to stay on course. Waiting too long to compare results to the plan might require significant and jarring adjustments to spending or other parts of your plan. Think of a retirement plan as a process that has to be fine-tuned regularly.

HOW MUCH IS ENOUGH?

"How much is enough?" is partly a practical question and partly a philosophical one. So far, I've addressed it as a practical question. But let's look at it philosophically for a moment. How much do you really need to reach your goals? If you can’t reach all the goals, which goals are the important ones?

Surveys regularly indicate that people could be very happy if they had more money than they actually do have. People at every level of wealth believe they need more money to be happy and to fulfill their goals—it’s a natural, very human response. It also is consistent among countries and cultures. As income grows, things that once were luxuries become necessities and are taken for granted. Then we train our sights on what might be available if we had even more money, and shoot for those things. But life is full of choices, and there are precious few of us who can afford everything we would like.

True wealth produces freedom. I’ve seen too many people who let their things own them, rather than owning their things. A big house or multiple houses, nice cars, club memberships, entertaining, and travel all cost money. They’re great as long as the money to support them is available. But not everyone is comfortable with that much overhead or with the investment risks needed to support this kind of spending. In those cases, the people don’t own the things, the things own the people. Nice things shouldn’t increase one’s level of stress. If the pressure of paying for things causes someone to be unhappy or to snap at loved ones, that person probably can’t afford those things.

In later chapters, I will demonstrate how to invest to increase returns, reduce taxes and other expenses, and take other steps to make wealth last longer. These steps will enhance retirement. The first step, however, is to make a good estimate of retirement spending and capital needs and develop a plan to accumulate that amount. Spending amounts should be adjusted when it appears that income and assets won’t be sufficient to fund the spending.

Not many people begin retirement with all the money they need to pay for their desired retirement. However, that doesn’t mean they will outlive their assets or end up living with their children. It just means they have to make some adjustments as they go along. A key to successful retirement is knowing when adjustments need to be made and making adjustments that you can live with. Unsuccessful retirements generally occur when no early planning is done, the retiree lives however he or she desires, and later adjustments are forced by circumstances.

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CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **All of the following are correct regarding expenses after retirement <u>except</u>:**

A. many retirees find that expenses don't decline immediately after retiring

B. medical spending is a retirement planning wildcard

C. other expenses may fill in the place of obsolete work-related expenses

D. using averages and estimates are the best way to plan your retirement expenses

2. **Which of the following is the best way to estimate inflation when retirement planning:**

A. assign a separate inflation rate to each budget item

B. apply an estimated inflation rate to estimated annual spending

C. base the inflation rate off of the Consumer Price Index

D. the rate of inflation is not a factor in retirement planning

3. **Which of the following is correct regarding probabilistic models used to make estimates in retirement plans:**

A. probabilistic models assume a constant rate of return

B. probabilistic models have been commonly used since the late 1960s

C. the most common probabilistic model is the Monte Carlo simulation

D. probabilistic models typically calculate 10 to 20 possible outcomes for a particular scenario

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CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Many retirees find that their expenses actually increase in the early years of retirement. **B.** Incorrect. Medical spending is a retirement planning wildcard. Medical expenses can rise substantially over time and vary wildly depending on personal health, insurance coverage, and where one lives. **C.** Incorrect. Many retirees look forward to cutting out work-related expenses like meals and work clothing. They may not realize that their new found free time is filled with activities that have their own expenses. **D.** CORRECT. Averages and estimates are not the best way for someone to plan their retirement expenses. Retirement spending is unique for each person and should be planned accordingly. *(See page 25 of the course material.)*
2.	**A.** CORRECT. The best approach to estimating inflation is to assign a separate inflation rate to each budget item. **B.** Incorrect. Applying a flat inflation rate is the most common way of factoring in inflation, but it is not the best way. Different goods and services do not increase at the same rate. **C.** Incorrect. The Consumer Price Index will show inflation but, because most retirees' expenses differ from the generic basket of goods and services that the government uses to compile its inflation numbers, it's not very useful. **D.** Incorrect. One of the biggest mistakes in retirement planning is failing to fully factor inflation into the plan. *(See page 30 of the course material.)*
3.	**A.** Incorrect. Linear, or deterministic models, assume a constant rate of return. **B.** Incorrect. Due to the high cost and low computing power, probabilistic models did not become readily available to the public until the late 1990s and early 2000s. **C.** CORRECT. The most common probabilistic model is known as the Monte Carlo simulation. **D.** Incorrect. Probabilistic models, like the Monte Carlo simulation, usually calculate 500 or more possible outcomes for an investment scenario. *(See page 32 of the course material.)*

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CHAPTER 3: SECURING AND MAXIMIZING GUARANTEED LIFETIME INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Identify the issues revolving around Social Security benefits.

The most important financial goal of retirement planning is to establish a secure stream of income or cash flow that will meet your spending needs for the rest of your life. Too often, people lose track of this goal amid all the talk about how much to save, how to invest, and other topics. The ultimate goal is to generate reliable income to pay your expenses for life, what I call establishing your *retirement paycheck*. The more income that can be guaranteed for life, the more financially secure and independent you'll be.

Establishing a lifetime stream of income in retirement was easy for the first post–World War II generation of retirees. Most of them had Social Security and pensions from their employers providing a floor of guaranteed income. With their own savings, they invested in a collection of safe income investments, such as certificates of deposit, treasury bonds, and tax-exempt bonds. They might have taken a little risk with utility stocks, high-dividend yield stocks, and corporate bonds. Such portfolios generated a lot of income, and the principal value didn't fluctuate much. The income and portfolio didn't have to last too long, because most people were retired only 5 to 10 years.

Things are different today. The foremost difference is that yields on most investments have been at or near historic lows for most of the time since 2000. A very valuable portfolio is needed to generate a high income from the investments used by previous generations of retirees. Also, life expectancy has increased to the point that many people should plan on retirement lasting 30 years and perhaps longer. We discuss longevity in more detail in Chapter 5. Inflation is likely to degrade the purchasing power of income over that time. Even modest inflation of 2 percent annually reduces purchasing power by over 30 percent over 20 years. Taxes, all kinds of taxes, are likely to rise steadily and reduce the income available for other expenses. Expenses can be higher, because retirees now pay more of the expenses that in the past were borne primarily by former employers or the government. That trend is likely to continue. There are other obstacles to securing guaranteed lifetime income.

Fortunately, there are many tools available to create your retirement paycheck. There's no silver bullet or single financial product you should use to secure your lifetime income stream. Instead, you need to take full advantage of all the tools available for establishing post-career cash flow, and you need to optimize those tools for your situation.

Today those entering or nearing their post-career years have a number of tools available to them:

- Social Security

- Employer pensions
- Annuities
- Nest egg distribution or spending strategies
- Nest egg investment strategies
- Tax strategies

In Chapter 2, we discussed the importance of estimating lifetime spending reasonably accurately, so you'll know approximately how much income you'll need. In this chapter we discuss how to use Social Security and annuities to establish and maximize a base level of income that's guaranteed for life, no matter how long you live. In Chapter 4, you'll learn how to extend the life of your other investment assets by developing a strategy for spending your nest egg, and in Chapter 5 we review investment strategies that can make your nest egg last longer. In Chapter 10, we discuss issues involving employer retirement plans, so you can maximize the benefits of those plans.

There's a key point to keep in mind regardless of the recommendations you adopt from these chapters. Remember: It's only a plan. Many factors are considered and assumptions are made when developing a financial roadmap for retirement. The real results will differ from the assumptions. You won't forecast everything correctly. Some of the differences will be more favorable than those used in your plan; others will be less favorable.

That's why you can't consider a plan to be set in stone. The plan will have to be revised. Remember to monitor and review your situation, compare it to your plan, and make adjustments when necessary. When circumstances aren't monitored and a plan doesn't have flexibility, a solid lifetime paycheck can shrink or disappear when reality doesn't match the plan. Review the plan at least annually once you're in retirement and even in the five years before retirement. Regular reviews mean you can stay on track with modest changes. Let too much time pass between reviews of and updates to your plan, and you might have to make major, uncomfortable adjustments to get back on track. Regular reviews mean modest changes, and you'll have more confidence.

Retirement income security is a process, not a fixed plan.

Despite the obstacles and challenges put in your path, you can convert accumulated assets and resources into a stream of cash flow that will last the rest of your life and your spouse's. It could even last longer, so you can leave a legacy for your children, grandchildren, and causes that interest you.

SECURING BASIC EXPENSES WITH GUARANTEED INCOME

Before consider strategies to lock in guaranteed lifetime income, you want to prioritize your spending.

In Chapter 2 we discussed how to estimate retirement spending. Within that spending estimate, you'll have several levels of spending. The first level consists of your basic or required expenses. This level includes food, shelter, utilities, insurance, transportation, clothing, and regular medical care. You might have other categories of spending in this level.

The next level of spending is the “nice to have” or preferred spending. These are the expenditures that maintain or somewhat increase your standard of living. This level might include travel, dining out, recreation, entertainment, and a wide range of expenses that are part of your expected retirement lifestyle but that can be reduced or deferred when money is tight.

The third level is what I call aspirational spending. These expenses are for activities and items that you’d like to be part of your retirement, but that you know are “extras.” They include “bucket list” types of activities and purchases that you’ve always wanted but never had the time or money. In retirement, you’ll have the time.

The final level is what I call legacy spending. The most common legacy spending is spoiling the grandchildren and providing some financial help to your children. There’s also long-term legacy spending. This legacy spending involves conserving part of your estate so it can be left to either family members or charities or both. Your first priority, of course, is to maintain your standard of living in retirement. Many people, however, prefer restricting some of their levels of spending in order to have some legacy spending.

Some spending might be split between two or more levels. For example, you need some clothing, but you probably don’t need designer clothes or a large volume of clothes. So, if you’re inclined to want a large volume of clothes or expensive clothes that exceed basic need, some clothing expenses will be basic spending and some will be at a higher level. The choice of retirement housing is similar. There’s a basic housing cost, and then there is nice-to-have and aspirational housing. Likewise, you might want to play a lot of golf. The cost will vary, however, depending on whether you play on public courses or join a private club. Playing on public courses probably is nice-to-have spending while a private club could be aspirational spending.

After estimating and prioritizing your spending, the next step is to decide how much of the spending you’d like to be supported by guaranteed lifetime income, which includes Social Security, employer pensions, and annuities.

I think it’s a good idea for most people to match their basic or required living expenses with guaranteed income. You don’t want to worry about being able to pay for food, utilities, and the like. When you don’t have guaranteed income paying for those basic expenses, there’s a tendency to worry and reevaluate spending and investments each time the investment markets take a tumble. When there are large, sustained market declines, many retirees wonder if their nest eggs will last the rest of their retirement years and often make emotional or panic decisions to change their spending or investments or both.

When basic expenses are covered by guaranteed lifetime income, people are able to take a little more risk with the rest of their nest eggs than they otherwise would. Taking more risk intelligently creates the potential to earn higher investment returns. Higher returns can lead to a higher standard of living in retirement or more legacy spending for family or charities.

The amount of guaranteed income you desire can vary, depending on your financial situation. Someone who hasn’t quite saved enough money for a secure retirement might want to increase the amount of guaranteed income. The less financially secure a person is, the lower is the allowable margin of error from low investment returns or other surprises. That's why someone on the edge of a secure retirement might prefer a high level of guaranteed income to ensure the income doesn't fall short for either basic expenses or spending beyond that. Someone who is more financially secure might be comfortable with less guaranteed income. This person's investment portfolio might be large enough that basic expenses and beyond would be covered even after major surprises, such as investment losses and unexpected expenses. A financially secure person might be willing to take more risk in exchange for the potential of earning higher income and having more for the aspirational and legacy spending.

The greatest fear for those in or approaching retirement is running out of money during their lifetimes. Whatever income doesn't come from guaranteed sources must come from working, savings, and investment returns. Those income sources have risk and uncertainty. Maximizing guaranteed income sources reduces risk and uncertainty, and with it, the potential for running out of money.

There are two sources of guaranteed lifetime income for almost everyone: Social Security and annuities. We're going to discuss those in the rest of this chapter. You'll learn how to maximize the benefits of these tools to enhance your financial security.

SECRETS TO BOOSTING SOCIAL SECURITY BENEFITS

There's a lot of confusion about Social Security. Of course, there's discussion and uncertainty about the financial condition of Social Security and how long the program will last. More importantly, there's confusion among Americans age 50 and older about the role of Social Security benefits in their retirement plans, the rules of Social Security, and which decisions to make about taking benefits.

The confusion is unfortunate, because decisions need to be made about Social Security benefits. Those decisions generally are irreversible, and the choices can change your lifetime benefits by tens of thousands of dollars, sometimes substantially more than that. The effects of the decisions also can ripple through to your spouse and even to your children. You need to carefully consider Social Security decisions. Ideally, planning for Social Security benefits begins years before you plan to retire. You don't have to begin Social Security benefits when you retire from work. The benefits can begin before or after formal retirement, and the optimum decision for you might be for benefits to commence at a time other than your retirement.

Before retirement, most people don't give Social Security much consideration and think Social Security won't be an important part of their retirement cash flow. Yet, 34 percent of current retirees estimate that Social Security provides 90 percent or more of their retirement income. For most American retirees, Social Security provides a meaningful portion of their retirement income, and it is the only guaranteed lifetime income received by many. It is among the very few available guaranteed and inflation-indexed sources of income. Also, the importance of Social Security to regular cash flow usually increases as one ages. Other assets are spent, and inflation reduces their purchasing power.

Most people have little idea of the level of their retirement benefits. The Social Security Administration (SSA) mailed annual statements of estimated benefits to everyone for years, and then suspended the mailings for a few years. In 2015, SSA reinstated mailing estimated benefit statements to some people, but that policy probably will change again. You don't have to wait for Social Security to mail you a statement of estimated benefits. Estimates are available over the telephone or through the Social Security website any time.

When you receive a benefits estimate, it is likely to be misleading unless you understand how the estimates are developed.

Social Security retirement benefits are based on your highest 35 years of earnings. The younger you are, the more likely the estimate won't be reliable. The estimate assumes earnings will increase at the estimated wage inflation rate from now through retirement age. Your history of promotions, raises, changing jobs for higher salaries, and being laid off is likely to be very different from the steady path assumed in the estimate. If you avoid extended layoffs, you're likely to have several points in your career when your earnings increase significantly because of promotions or job changes. Some people believe the SSA deliberately understates likely benefits in these estimates to encourage people to save more. On the other hand, one or more extended periods of unemployment or stagnant salaries could cause your earnings history to lag the estimates.

As you age, however, the statements generally should be more accurate, but errors at that point are likely to overstate eventual benefits. The estimate assumes you work until the age at which benefits begin and that earnings increase each year at the estimated wage inflation rate. Many people in their 50s and beyond "hit the wall" as far as salary increases go, have periods of unemployment, retire earlier than expected, or take jobs that pay less than their previous positions. In these cases, your 35 highest earnings years could be less than the estimate.

Yet, for some people the estimates still will tend to underestimate benefits. Keep in mind only the 35 highest years of earnings are used. As you work longer, you likely are knocking off low-earnings years from your youth. Even if you suffer a setback and don't earn as much the rest of your career as originally anticipated, you could earn more than in the early years and increase your final benefits.

The online Social Security benefits estimator is more accurate than the mailed estimates. After you register online, the calculator uses your real earnings history. You also have the flexibility online to estimate benefits using different scenarios. The paper statements mailed to people are limited to a fixed set of assumptions and have a higher margin of error.

Another way to look at Social Security retirement benefits is the replacement ratio. This is the amount of your final income that Social Security will replace in the first year of retirement. Social Security benefits are calculated so that the replacement ratio depends on your income level throughout your career. The lower your income, the higher the Social Security replacement ratio is. A low-income worker could have Social Security retirement benefits replace 90 percent of final income. A very-high-income worker could receive closer to 10 percent or less of final income in Social Security benefits.

In 2015, someone who made the minimum wage (about $14,500 annually) would receive Social Security retirement benefits on average of 76.5 percent of final wages. For the median income of $33,120, the replacement ratio declined to 58.4 percent of final income. Someone whose earnings were the maximum wage for Social Security withholding had a replacement ratio of only 28.2 percent, and someone earning $165,150 had retirement benefits of only 18.8 percent of final earnings. The replacement ratio will decline further as income rises, because there is a maximum first-year retirement benefit. No matter how much you earn and pay in Social Security taxes, you won't be paid more in retirement benefits than the year's maximum. (In 2014, the monthly maximum payment for someone at full retirement age was $2,642.) To receive the maximum benefit, a worker would have to earn the maximum Social Security wage base (the maximum salary amount on which Social Security taxes are collected) every year for the 35 highest years of earnings. The maximum payment applies only to someone starting benefits that year. Once benefits begin, they rise with increases (but don't fall with decreases) in the Consumer Price Index each year.

The average U.S. worker receives about 40 percent of final salary income in Social Security retirement benefits.

With the poor performance of the stock market indexes since 2000, low interest rates on bonds, and high volatility in all investments, Social Security is becoming a more important source of income for many Americans, and more are starting to realize how important that guaranteed income and stability is.

Within a wide range of options, you decide when to begin Social Security retirement benefits. Many people don't realize just how much flexibility they have and how much the choices change the amount of benefits. A retiree can substantially increase lifetime cash flow by making the optimum decisions about Social Security.

It is critical for a near-retiree to spend time carefully analyzing the Social Security benefit options. The best choices often are not intuitive or even well-known. Also, the choices that will maximize income have changed over time. Rules of thumb from the past are not ideal for today's retirees.

For married couples, there can be a series of decisions instead of one decision. These decisions have long-term effects on the retiree's income. Just a few of the decisions are: At what age should benefits begin? When should a spouse begin benefits? Should benefits be based on one's own work record or one's spouse's record? Should you change the choice? Contrary to what many people believe, Social Security benefits can be changed under certain circumstances. Beginning Social Security benefits often is referred to as claiming benefits. Choices about when to begin benefits often are called claiming strategies.

Maximizing Social Security benefits can greatly enhance retirement financial security. You could lose opportunities and substantial income by treating Social Security benefits as an afterthought and "bonus income" or by not realizing that you have choices. Social Security is for many people the only part of retirement income that is both guaranteed for life and inflation-protected. These are two qualities many people appreciate only after they've been retired a few years. Social Security benefits also act as a form of life insurance for married couples, since a surviving spouse can receive benefits based on the deceased spouse's earnings history.

There are two other aspects of Social Security benefits that often are misunderstood. For more and more retirees, a portion of the benefits is subject to income taxes. Originally, benefits were tax free. But beginning with the 1986 law, a portion of benefits became taxable. For higher-income beneficiaries, the portion taxed was increased in 1993. There are ways at least some people can reduce the income taxes on their benefits.

The other misunderstood feature of Social Security benefits is how earning income from work after benefits begin affects the benefits paid. The law on that also changed over the years, generating much confusion.

These issues are covered in Chapter 10 on taxes in retirement.

WHEN TO BEGIN BENEFITS—THE BASIC CHOICES

The amount of benefits received depends partly on the age you choose for the benefits to begin. Each person can choose to begin receiving Social Security retirement benefits at age 62 or any time thereafter. (You might be eligible for disability or survivor's benefits at younger ages.) The earlier the benefits start, the lower the initial payment is.

A key concept of Social Security is full retirement age (FRA). If you choose to begin benefits at this age, you receive the full or normal benefits under the program's formulas. Begin benefits earlier, and your monthly checks will be reduced. Begin benefits later, and your monthly checks are increased for each month you wait after FRA to begin benefits until you reach age 70. There's no increase for delaying benefits after 70.

The FRA at the inception of Social Security was 65, but the 1983 reform changed FRA for anyone who was born after 1937, which means for anyone who turns 65 after 2002. The FRA rises roughly two months for each year you were born after 1937, with a break from 1943–1954, until the FRA becomes 67 for those born in 1960 or later. The schedule is in Table 3.1.

TABLE 3.1 FULL RETIREMENT AGE SCHEDULE

Year of Birth	Full Retirement Age (FRA)	% of FRA Benefits at Age 62	Annual Credit for Delayed Retirement	% of FRA Benefits at Age 70
1936 and before	65	80%	6%	130%
1937	65	80%	6.5%	132.5%
1938	65 & 2 mos.	79⅙%	6.5%	131.42%
1939	65 & 4 mos.	78⅓%	7%	132.66%
1940	65 & 6 mos.	77½%	7%	131.5%
1941	65 & 8 mos.	76⅔%	7.5%	132.5%
1942	65 & 10 mos.	75⅚%	7.5%	131.25%
1943–1954	66	75%	8%	132%
1955	66 & 2 mos.	74⅙%	8%	130.66%
1956	66 & 4 mos.	73⅓%	8%	129.33%
1957	66 & 6 mos.	72½%	8%	128%
1958	66 & 8 mos.	71⅔%	8%	126.66%
1959	66 & 10 mos.	70⅚%	8%	125.33%
1960 and later	67	70%	8%	124%

Other changes made in the 1983 reform were adjustments to the formulas for computing benefits that begin before or after FRA. There is a bigger reduction for taking benefits before FRA than under the previous law, and the bonus for delaying benefits after FRA was increased.

Of course, if you're not working or simply need the income, you might not care about optimizing the lifetime Social Security benefits. You'll need to begin retirement benefits, because you need the income. Also, when there's a personal or family history that indicates living to life expectancy or much beyond is unlikely, waiting to receive benefits might not be the best strategy.

For many other people, however, there is a choice and a reasonable chance of outliving life expectancy. For them, a careful analysis of when to begin Social Security benefits can significantly affect both lifetime income and the benefits available to survivors.

The easiest way to decide when to begin benefits is to compute the simple break-even point. Start with your estimated benefits, which you can find on the Social Security website. Suppose your normal benefit at FRA would be $1,400 per month. Waiting until age 70 would entitle you to $1,820 monthly or 130 percent of the normal benefit, an additional $420 monthly. For this example, we'll say your FRA is 66, which means taking benefits at FRA gives you benefits 48 months earlier than at 70.

To find the break-even point, multiply the normal retirement benefit at age 66 by the number of extra months you'll receive it before age 70. In this example that is $1,400 times 48 for a cumulative early payment of $67,200. Divide that total by the increased monthly benefit for waiting until age 70 ($420). The result is 160. That is the number of months it will take for the total lifetime payments received after waiting until age 70 to catch up with the lifetime payments you would receive by starting benefits at 66. That comes to 13⅓ years. That means after age 79 the decision to delay benefits will pay off. If you die before age 79 and four months, you lost money by waiting to take benefits.

The benefit formula is set up so that the benefit for waiting to receive benefits closely follows the actuarial tables available in 1983. Those who outlive the 1983 life expectancy will come out ahead, and those who do not will lose money by delaying benefits. The system should come out even.

Here's another example. Suppose you turned 62 this year. Your benefits payable at 62 would be 77.5 percent of normal retirement, meaning you'll receive $1,085 monthly at 62 if your FRA benefit were $1,400. FRA for you, however, was 65 and six months. By taking benefits at 62, you will receive the benefits for an extra 42 months. That means total benefits received by FRA would be $45,570. Divide that amount by the $315 additional benefit you would receive by waiting until FRA. You'll find that it will take 144⅔ months for lifetime benefits to make up for waiting until normal retirement age to begin taking benefits instead of starting them at age 62. That means you will have to live until about age 78 to break even for waiting until normal retirement age. Live longer than that, and you benefit by waiting until normal retirement age instead of starting benefits are 62.

As in the other example, the break-even point is designed to be around normal life expectancy as of 1983 for the age group. The system breaks even on average, and those who live beyond life expectancy come out ahead.

This simple break-even calculation does not include all possible factors and can oversimplify the decision.

The monthly increases for delaying benefits aren't steady and equal, points out William Meyer of Social Security Solutions in an article in *The Wall Street Journal*, so the break-even age changes. From age 62 to 63, benefits increase 0.42 percent of the benefit per month of delay. From 63 through 66, they increase at 0.56 percent. From 66 through 70, benefits increase 0.67 percent for each month of delay.

Because of this unevenness, the break-even age changes. There are good times and bad times for singles to begin retirement benefits, and most singles are making the wrong choice.

The worst times for singles to begin benefits, says Meyer, are between 62 years, one month and 63 years, 11 months and from 65 years, five months and 66 years, seven months. Many people take benefits either when they're first eligible or at normal retirement age, and those are among the worst times. He says the break-even age is 78 years when benefits are begun from 62 to 63 but falls to 76 years at ages 63 to 64. The break-even point from then is on a roller coaster through age 70.

There are additional factors to consider before making a decision under the simple break-even analysis.

Once benefits begin, they increase with inflation each year that the Consumer Price Index is greater than 0 percent. That should push the break-even point of waiting a little further into the future. But there's another factor that could act in favor of waiting. When Social Security computes your benefits, it uses your wage history but also increases past wages for general wage inflation. Wage inflation usually is higher than Consumer Price Inflation, so you could benefit more by delaying benefits than is demonstrated by the simple break-even analysis in these examples.

Also, if you're considering delaying benefits, that means you don't need the money at 62 to pay expenses. You have other resources available. You could begin benefits at 62 and invest the money as it is received. Investment returns could increase the advantage of early benefits, and that would push the break-even point of waiting farther into the future. This is the time value of money. Receiving money now is more valuable than receiving the same amount later. Of course, there's risk in this approach. If your investments lose money or earn less than the 8 percent annually that benefits increase by delaying them, you've taken a gamble that didn't pay off. In recent years, earning 8 percent or higher has been a very ambitious goal.

The simple break-even method also doesn't take into account potential changes in inflation, investment returns, and taxes. For example, instead of delaying Social Security benefits you could begin the benefits and draw less money from your investment portfolio. Investment returns could offset the reduction in benefits. When you move beyond the simple break-even method, the calculations become potentially more accurate but also far more complicated. Fortunately, New York Life Insurance Company published a paper in 2015 that did these calculations. The paper concluded that using the additional factors made delaying benefits even more attractive in most cases.

Most Americans begin receiving their Social Security benefits early, though the percentage delaying benefits has increased. About 37.5 percent of men and 42.4 percent of women claimed their retirement benefits at age 62, according to the 2013 Social Security Administration's Annual Statistical Supplement.

Even so, more people are delaying benefits than used to, because 10 years ago about 50 percent claimed benefits at 62. About 31.5 percent of men and 25.2 percent of women now wait until their FRA to claim benefits. Far fewer than 10 percent wait until age 70, when benefits are maximized, and that number's held steady for decades.

For those who retired before the changes started in 2002 and took early benefits, they probably made the right decision. But taking early benefits might not be the right decision for those who come after them.

Don't Leave Money on the Table

The key is that the rules for increasing or decreasing benefits are set so that anyone who lives to life expectancy receives the same lifetime payouts regardless of the age benefits begin. That makes the normal life expectancy the *break-even point*, as discussed in the above examples. Live beyond that point and you will benefit by waiting to receive benefits. Your lifetime benefits will exceed what you would receive by starting at age 62.

But the formulas were set in 1983, the last time Social Security was reformed, using life expectancy tables available at the time. Life expectancies have increased. For example, about half of men currently age 65 will live past age 85. So, more people will benefit from delaying benefits than was the case when the rules were set in 1983.

Another consideration is that the wages in your work history are indexed for increases in overall wages each year. That should increase your wage history and your benefits when you delay receiving benefits, even if you're not working and earning more income. If you actually wait until age 70 to begin benefits, you are likely to receive a higher benefit than the age 70 benefit estimated when you were age 62, because of the annual wage indexing. Also, when you decide to delay retirement and continue generating income from working, your benefits are likely to increase if those wages from those additional years are higher than the wages earlier in your career. Social Security uses only the highest 35 years of wages. If you can replace low early-career wages with higher late-career wages and knock the lower wages out of your top 35 years, that will increase your benefits.

The increase in life expectancy is a reason many should at least consider delaying benefits. If you have no reason to believe your life expectancy will be below average, the delay should make sense. Since half of your age group will live beyond life expectancy, and that life expectancy is higher than what was assumed in 1983, a majority of the age group will receive a higher lifetime benefit by waiting.

Another reason to consider delaying benefits is your spouse. Delayed Social Security benefits are a very low-cost form of life insurance when you were the higher-earning spouse. Your surviving spouse receives the higher of the benefit you were receiving and his or her earned benefit. For the cost of forgoing Social Security benefits a few years, that can be a good deal. We discuss more about spouses and benefits later in this chapter.

There also might be tax benefits when you delay Social Security benefits if that increases your drawdown of IRAs and other qualified retirement accounts. Required minimum distributions from qualified retirement accounts can greatly accelerate as one lives to the late 70s and beyond. In time, these taxable distributions could greatly exceed spending needs. This increases lifetime taxes and reduces the amounts available for heirs to inherit. We discuss that in more detail in Chapter 9. A good strategy can be to spend some money from the qualified retirement plan first, reducing future required minimum distributions and allowing Social Security benefits to increase. The approach might also make it less likely in the future that required minimum distributions from a qualified plan will trigger income taxes on Social Security benefits. Unless you expect to earn higher than an 8 percent after-tax return from your IRA, spending the IRA early to earn higher delayed Social Security benefits can be a good trade-off.

Another reason to delay benefits is that many baby boomers are likely to work past normal retirement age and certainly past age 62. A number of them will try retirement and, for lack of either money or things to do, will return to work. If they begin taking Social Security benefits early, returning to work could cause the benefits to be reduced. Working will increase their benefits later, but it might not be enough to make up for the reduction from taking benefits early.

INTRODUCING SPOUSAL BENEFITS

So far, we have analyzed when to take Social Security benefits in the context of a single person. Yet, Social Security retirement benefits come with a spousal benefit and several options. It is easy to overlook this when deciding to take benefits, but the age when a person begins his or her retirement benefits affects the level of benefits received by a surviving spouse and in some cases also affects the retirement benefits of a current spouse. Spouses also can increase joint lifetime benefits by coordinating when they take their benefits. Substantial changes were made in the strategies for spouses in the Bipartisan Budget Act of 2015. The law basically eliminated the ability to use several profitable strategies for married couples.

The important rule is that a married person can qualify for Social Security benefits based on either his or her own earnings or the spouse's. More than one quarter of Social Security benefits, in fact, are paid to survivors and family members.

A person who earned wages (or self-employment income) for at least 40 quarters (10 years) qualifies for his or her own Social Security benefits. A married person also is eligible for a retirement benefit that is 50 percent of his or her living spouse's benefit. A surviving spouse is entitled to receive 100 percent of his or her deceased spouse's retirement benefit. If a person is eligible for more than one retirement benefit, he or she receives only the highest of the available benefits.

Let's look at an example. Suppose Max and Rosie Profits each works until eligible for full retirement benefits. Max is entitled to a monthly benefit of $1,000 based on his earnings history, and Rosie is eligible for $300 based on her earnings history. Because Rosie's earned benefit is lower than 50 percent of Max's earned benefit, she'll receive the $500 spousal benefit based on Max's benefit. Together, they'll receive $1,500 in monthly benefits if they apply for benefits today at FRA.

Suppose Max dies before Rosie. Then, Rosie can change her benefit to the $1,000 per month she is entitled to as Max's widow—100 percent of Max's retirement benefit. She receives only the $1,000 and stops receiving the $500 spousal benefit she was receiving. So, her household income will decline to $1,000. If Rosie dies first, Max continues to receive his $1,000 benefit, because it is higher than 100 percent of Rosie's earned benefit that would be his survivor's benefit. (This example ignores the inflation adjustments that occur while they are receiving benefits.)

Because your spouse's retirement and survivor benefits depend on your benefit, they are something to keep in mind when choosing the starting date for your Social Security benefits.

For example, let's assume a married couple in which the husband earned more than his wife. The husband might decide, considering only his situation that it makes sense for him to begin benefits at age 62. The decision might change, however, if he considers the effect on his wife. As a woman, she is statistically likely to live longer than the husband. If she survives her husband, her survivor's benefit is going to be based on the husband's benefit, unless her earned benefit is higher. Also, during her life she'll receive the higher of her own benefit and 50 percent of her husband's benefit at FRA. For the husband in some situations, delaying Social Security retirement benefits can be a cheap form of life insurance that maximizes his wife's income after he's gone.

More on Spouses and Benefits

Now, we will look in more detail at how spouses' earnings and decisions can affect each other's benefits and how they can coordinate the timing of their benefits to maximize household income. There are options for each spouse that could greatly influence the lifetime Social Security earnings of both spouses. You'll learn that it is beneficial for spouses to coordinate when each begins benefits instead of separately considering their decisions.

Every married person eligible to receive Social Security benefits looks to two work records to determine the amount of benefits received. The person's own work record, of course, is one source. The spouse's earnings record is another. As we discussed earlier, the general rule is that a person receives the higher of the benefits earned under his or her own work record and 50 percent of what the spouse would receive at FRA. Keep in mind, however, that a spousal benefit can't be received until the other spouse actually files to begin receiving benefits. If the higher-earning spouse hasn't filed to receive benefits, the lower-earning spouse can't begin receiving a spousal benefit yet.

Note an important difference between the benefits of a spouse and a surviving spouse. While the higher-earning spouse is alive, the lower-earning spouse's retirement benefit is half of the higher-earning spouse's FRA benefit. But after the higher-earning spouse passes away, the lower-earning spouse's survivor benefit is the retirement benefit the higher-earning spouse actually was receiving if he or she was already receiving benefits. The amount of that benefit will depend on the age when the higher-earning spouse chose to begin benefits. If the higher-earning spouse began receiving benefits before FRA, the surviving spouse will receive less than the full retirement benefit as a survivor benefit.

There is an additional step in the computation of a spouse's benefit. The benefit received is based on a combination of the other spouse's benefit at FRA and the age at which the lower-earning spouse actually begins benefits. There's a reduction in benefits for starting before FRA whether a person's benefit is based on his or her earnings record or the spouse's. If a spousal benefit is begun before FRA, the benefit will be reduced on a sliding scale. If age 62 is selected, the benefit received will be 35 percent less than what he or she would receive at FRA.

Summarizing Spousal Strategies

We will build on the rules already discussed to develop strategies that might further boost the guaranteed retirement income of you and your spouse.

For a spouse to receive retirement benefits based on the other spouse's earned benefits, the other spouse first must be receiving retirement benefits. Let's assume the wife is the lower-earning spouse, and the husband is the higher-earning spouse. If the wife is ready to retire and wants to receive benefits before her husband is ready to, the wife's benefits will not be based on the husband's earned benefits; she can receive only her earned benefits. (The husband can begin receiving retirement benefits while continuing to work, but the earnings limit would further reduce the benefits. This is discussed in more detail later in this chapter.)

The wife can begin receiving benefits based on her own earnings record when the husband is not yet receiving benefits. After the husband begins receiving benefits, the wife can make a shift and receive spousal benefits based on the husband's earnings record. If the wife began receiving benefits before her FRA, the benefits received both times will be reduced by the formula that's used to reduce all benefits received before FRA. Let's look at some examples.

Rosie Profits has reached her FRA and wants to begin receiving benefits. Her husband, Max, hasn't reached his FRA and wants to delay benefits at least until his FRA. Rosie is entitled to $500 monthly at FRA based on her own earnings. When Max reaches FRA, he will be entitled to $1,800 monthly. Rosie can begin receiving $500 now. When Max begins benefits at his FRA, Rosie will receive an additional $400 to bring her total to $900 monthly—half of Max's benefits. (The example also doesn't consider inflation adjustments.)

Suppose Rosie begins receiving her benefits before her FRA. She will receive a reduced benefit based on her earnings history. Let's say her reduced benefit is $400 monthly. When Max retires at FRA, Rosie still will be able to switch to a spousal benefit and receive the additional $400. That will bring her monthly benefit to only $800. By beginning benefits before FRA, she permanently reduced her monthly benefit, even after Max retires at FRA and she begins the spousal benefit.

Now suppose Max begins benefits before reaching his FRA, and Rosie already began receiving $400 monthly before her FRA. Rosie can begin receiving the spousal benefit when Max begins receiving his benefits, but Rosie's benefit will be reduced again. It's reduced once because Rosie began receiving benefits before her FRA, and it's reduced again because Max is taking his benefits before his FRA and receiving less than his full benefit. She should receive less than the $800 monthly in the previous example. The exact reduction will depend on when each of them begins receiving benefits.

As you can see, the rules and scenarios can get complicated. Social Security's website calculators can help explore results under different scenarios. While the best option depends on the specific details, published studies indicate the strategies that are likely to be optimal for many couples. Under these studies, lifetime payouts are maximized when the lower-earning spouse begins taking his or her earned retirement benefits early, say when first eligible at age 62. The higher-earning spouse should wait to at least age 68 before taking benefits and preferably to age 70. Then, the lower-earning spouse can switch to receiving spousal benefits when they are higher than his or her own earned benefits.

Advanced Strategies for Spouses Curtailed by 2015 Law

Until the Bipartisan Budget Act of 2015, Social Security benefit rules allowed some interesting planning strategies for married couples beyond simply deciding when to begin benefits. Congress snuck a major change to Social Security benefits claiming strategies in the law. The change will cost retirees who would have planned carefully tens of thousands of dollars over their lifetimes. The loss is about $50,000 per couple, according to a Bloomberg.com estimate.

The law eliminated or curtailed two claiming strategies that were becoming popular. Apparently, some people in the administration and Congress had been opposed to these strategies and aimed to eliminate them. Instead of the usual process of proposing laws and having them discussed in committees, the provisions were inserted into the budget deal negotiated between the president and congressional leaders. Originally, the strategies were created in a 2000 law, and opponents of the strategies believe they were unintended loopholes or effects of the 2000 changes.

The two strategies are known generally as *restricted application*, or *claim now, claim more later*, and *file and suspend*. Here's a summary of them:

- *Restricted filing.* A married person generally receives retirement benefits of the higher of his or her own earned benefit and 50 percent of the amount his or her spouse would receive at FRA. But a special rule allowed anyone at normal retirement age (age 66 for those retiring in recent years) or older to file an initial claim for spousal benefits only. This allowed the person to receive some Social Security benefits while either continuing to work or simply allowing his or her own Social Security benefits to increase 8 percent annually through age 70. The person was allowed at any time to switch from spousal benefits to earned benefits. One spouse had to have already filed for retirement benefits in order for the other to file a restricted application for spousal benefits only.
- *File and suspend.* Spousal benefits can be received only if the other spouse has filed to claim retirement benefits. The file and suspend strategy allowed the lower-earning spouse to receive the spousal benefit while the higher-earning spouse continued to defer receiving benefits and accrued the 8 percent annual increase from delaying benefits. The higher-earning spouse would file for retirement benefits at FRA or later and then immediately suspend the benefits. Filing for benefits allowed the other spouse to file for the higher of his or her earned benefits and the 50 percent spousal benefit. Suspending the filing didn't affect that. But the suspension reinstated the monthly increase from deferring benefits until the higher-income spouse decided to begin benefit payments.

The strategies are largely eliminated in the 2015 law, but it phased in the changes, so some people still had the opportunity to take advantage. Here are the changes:

- *Restricted filing.* The ability to file a restricted application for spousal benefits at FRA or later is eliminated. The elimination applies to those who turn 62 after 2015 (those born in 1954 or later). Everyone in that age group will be treated as applying for the higher of his or her earned benefits and the spousal benefit whenever applying for benefits.

- *File and suspend.* This strategy is allowed for six months following enactment of the law, which is April 30, 2016. So, if the higher earning spouse was age 66 or older within the six-month period, the strategy still is available to the couple.

After the six-month grace period, someone who has filed for retirement benefits still can suspend them anytime after reaching FRA. The catch is that benefits also stop to almost anyone else who is receiving benefits based on that person's earnings. That includes spouses and minors and disabled children receiving benefits based on the person's earning history.

So, a higher-earning spouse isn't able to file and suspend in order to allow the lower-earning spouse to receive the higher spousal benefit. Keep in mind that while a spouse is entitled to the higher of his or her earned benefits and 50 percent of the other spouse's FRA benefit, the spousal benefit is payable only after the higher-earning spouse has filed to receive benefits. Now, the higher-earning spouse has to make a choice: file to receive benefits earlier than planned in order for the other spouse to receive the higher spousal benefit, or wait to begin benefits so that the benefit payment will be higher.

A reason the file and suspend strategy made sense was the survivor's benefit. When one spouse dies, the surviving spouse receives the higher of his or her earned benefit and what the other spouse was receiving at the time of death (or was entitled to at FRA if benefits hadn't begun). It made sense for the higher-earning spouse to wait until age 70 to receive benefits if possible, because it ensured that the surviving spouse of the two would receive the highest possible benefit for life. In effect, having the higher-earning spouse delay benefits is a cheap form of life insurance.

The survivor's benefit rule still is in place, and it still makes sense in most cases for the higher-earning spouse to delay benefits until age 70 to ensure the maximum lifetime benefit for each spouse. The lower-earning spouse will have to be content with his or her earned benefits during that time instead of a higher spousal benefit.

Another strategy that isn't affected is for those who have other reasons to suspend benefits after FRA. Suppose Max Profits is younger than 70 and files to begin receiving retirement benefits. Perhaps he was laid off or intended to retire. After some time, Max is back in the workplace and earning enough that he doesn't need the Social Security benefits. He decides it makes more sense to suspend the benefits so that they can earn some delayed retirement credits. When Max eventually resumes the benefits, they will be higher than when they were suspended because of the delayed retirement credits. In that case, he can suspend benefits any time after reaching FRA. But he can't suspend benefits until FRA. So, if he begins benefits as soon as possible at age 62, they can't be suspended until FRA.

The law didn't affect the benefits of divorced spouses. They still can qualify to claim benefits on an ex-spouse's earnings record without regard to whether the other spouse has filed to receive benefits or suspended benefits.

Here's another strategy that's affected. Suppose after filing and suspending benefits, Max decides he not only needs to resume the benefits but he also needs additional cash. Previously, he could have benefits resumed retroactively, receiving a lump sum for up to six months of past benefits plus have his benefit checks resume. Under the new law, the lump sum is no longer available.

Final Words on Spousal Strategies

Though married couples don't have as many options as they did before the 2015 law, there still are options and decisions to be made about when to receive benefits and coordinating them between spouses. Married couples need to take the time to analyze their Social Security strategies.

For example, consider the case of a married couple in which each spouse has a work history that qualifies for Social Security benefits. Let's say the lower earning spouse's benefits will be at least half of those of the higher earner. That means each spouse is likely to receive benefits based on his or her work history.

In this case, it likely is going to make sense for the higher earning spouse to delay receiving benefits until age 70. That ensures he or she receives the maximum possible benefit, and that whichever is the surviving spouse will continue to receive the highest possible benefit of the two. The probability is pretty high, around 60 percent, that at least one of the spouses will live long enough to justify delaying the higher earning spouse's benefits to age 70.

What about the lower-earning spouse? It makes a lot of sense for that spouse to begin receiving benefits early, perhaps as early as when first eligible at age 62. That's because after one spouse dies, the lower-earning spouse's benefit will stop, regardless of which spouse passes first. Also, there's a less than 50 percent probability that both spouses will live past the break-even point when it makes sense for the lower-earning spouse to delay benefits to at least normal retirement age. So, unless there is a family or personal history that raises expectations of both spouses living past their early 80s, it should make sense for the lower-earning spouse to claim early.

The last point is an important one. Family history and expectations of longevity are an important factor. You can't be sure of life expectancy, so you have to develop probabilities. If both spouses have a less than average life expectancy, then claiming early makes sense. If both spouses have longer than average expectancy, then it makes sense for both to delay claiming benefits.

The decision is more difficult when the lower-earning spouse's benefit is much less than half of the higher-earning spouse's benefit. In this case it probably makes the most sense for both spouses to claim benefits when the younger spouse reaches FRA, or when the higher-earning spouse reaches FRA if that occurs second.

The rationale is that the lower-earning spouse's earned benefit is going to be much lower than the spousal benefit of half the higher-earning spouse's benefit. The lower-earning spouse will want to receive the spousal benefit. Claiming any benefit before FRA wouldn't be beneficial, because in addition to being eligible for only a low benefit, the lower-earning spouse's benefit will be reduced further by claiming it early. The lower-earning spouse should wait to FRA so that the benefit won't be reduced.

Also, spousal benefits don't increase after FRA. There is no benefit to waiting any longer to receive a spousal benefit.

A spousal benefit can be received only when the other spouse already is receiving benefits. That means the lower-earning spouse can't receive the spousal benefit until the higher-earning spouse is receiving benefits. The couple has a choice of receiving no benefits at all until the higher-earning spouse is age 70 and has maximized benefits or beginning both benefits at FRA. That's why it probably makes sense for both to begin benefits as soon as the second spouse reaches FRA. It's unlikely that the higher benefits from waiting for the higher-earning spouse to maximize benefits at age 70 will be great enough to justify delaying receiving both the higher-earning spouse's regular benefit and the lower-earning spouse's spousal benefit after FRA.

Various calculators available on the Internet can help make these decisions. Be sure a calculator says it was updated for the 2015 law before using it. Good calculators that charge fees are at www.MaximizeMySocialSecurity.com and www.SocialSecuritySolutions.com. There also are good free calculators at the websites for T. Rowe Price and AARP.

MAXIMIZING BENEFITS FOR THE DIVORCED AND WIDOWED

Divorced and widowed taxpayers have other options and rules to consider. We'll first discuss the rules for divorced spouses.

A divorced person can collect retirement benefits based on an ex-spouse's earned benefits when they were married for at least 10 years, have been divorced at least two years, and the ex-spouse seeking to claim on the other ex-spouse's benefits has not remarried. A benefit of the rules for divorced people is that you don't have to coordinate with the ex-spouse. You can make choices without regard to whether the ex-spouse has applied for benefits or is remarried. You don't even have to inform the former spouse.

When the qualifications are met, you are entitled to the higher of your own benefit and one half of your ex-spouse's full retirement benefit if your ex-spouse is qualified for benefits, regardless of whether he or she has applied. Your benefit is reduced if you begin it before you are FRA.

Divorced spouse benefits can be helpful even when you were the higher-earning spouse. One strategy under this rule is for the divorced person to wait until at least age 66. At 66, you can file a claim that is restricted to spousal benefits, meaning collecting 50 percent of the other ex-spouse's earned benefits. Then, at age 70 you can file to claim based on your own earnings record and receive the maximum amount.

Divorced spouses also can receive survivor's benefits. When the other ex-spouse dies, the surviving ex-spouse, if not remarried and at FRA, can collect the higher of his or her own earned benefit and 100 percent of what the other ex-spouse was receiving at the time of passing.

Now, let's look at benefits for widows and widowers, also known as survivor's benefits.

When you are widowed, even if you remarried, take a look at the rules. You might be able to claim higher benefits under a deceased spouse's record even if you remarried.

When the surviving spouse was married to the deceased spouse at the time of death, the surviving spouse receives the higher of his or her earned benefit and 100 percent of the deceased spouse's earned benefit (or what the deceased spouse was receiving at the time of his or her passing). We already discussed that rule.

Survivor's benefits can begin as early as age 60 (age 50 if the survivor is disabled), but benefits will be reduced for taking them before FRA and will be about 71 percent of full benefits by taking them at 60. Full benefits can be received if the survivor waits until his or her FRA to begin the benefits.

Eligibility for survivor's benefits isn't affected when the survivor remarries after age 60, but there are no survivor's benefits when the survivor remarries before age 60. So, if you are widowed and considering remarrying in your late 50s, it might pay to delay the nuptials if your deceased spouse had a higher level of earned Social Security benefits than you or your next spouse.

You can see that the Social Security rules provide a lot of flexibility and choices, especially for married couples. By paying attention to the rules and investigating your benefits under different scenarios, you can maximize this lifetime stream of guaranteed, inflation-indexed income.

FIXING SOCIAL SECURITY CLAIMING MISTAKES

Fortunately, the timing of Social Security retirement benefits is not always the one-time decision many believe it is. There might be options for changing your benefits when your circumstances change or you believe you made a mistake the first time.

One strategy for changing your benefits isn't as flexible as it used to be. A complete do-over is possible if you make the decision within the first 12 months of beginning benefits. You file Form 521 with Social Security and repay all benefits received to date. (Interest is not charged on the repayment.) Social Security calls this *withdrawal of benefits*.

Withdrawal gives you a fresh start, as though you never filed a claim to begin benefits. Then, you can wait until FRA, age 70, or whatever starting point you want. You'll receive the higher benefit as though it were your first claim.

Before making a decision, know that the decision to withdraw benefits could affect others who were drawing benefits on your earnings record, such as a spouse or dependent. They might be required to repay benefits or will stop receiving benefits when yours cease.

The second strategy for changing a claiming decision is not as generous but is available to more people. You simply notify Social Security that you want your benefits suspended. The benefits will stop after about a one-month lag.

Two things happen when you suspend benefits. One event is that you stop receiving monthly benefit checks while the suspension is in effect. The other action is that you begin earning delayed retirement credits, increasing your future benefits by about 8 percent annually.

Retirement benefits can be suspended only at FRA or later. If you began receiving benefits before FRA, you can't suspend them until age 66 or whatever your FRA is. After reaching FRA, you can suspend benefits at any time.

Suppose you began receiving retirement benefits at age 62, and then at FRA (66) suspend them until age 70. Your benefits will increase about 32 percent during the delay. You'll never reach the benefit you would have received had you initially waited to age 70 to receive benefits, but the benefits might increase to the level of your initial FRA benefit.

There are a couple of additional points. You can suspend only your own earned retirement benefits, not spousal benefits. So, if you are receiving spousal benefits early, suspending them isn't an option. (You still can switch from a spousal benefit to your own earned benefit.)

Also, Medicare premiums generally are deducted from Social Security benefits. If you're enrolled in Medicare and suspend Social Security benefits, you'll have to begin making separate payments of the monthly Medicare premiums. (This is discussed in Chapter 6.)

Now, let's look at the opposite mistake: Someone who either delayed or suspended retirement benefits and then decided that was a mistake. You can end the suspension of benefits or apply for benefits. Before the Bipartisan Budget Act of 2015, you also could apply for a retroactive lump sum payment of up to six months of benefits. The lump-sum benefit payments no longer are allowed.

In some cases, claiming Social Security benefits is not a one-time decision. There is some flexibility. You can't completely return to your original position in all cases. But if your circumstances changed or you realized you didn't make the optimum decision the first time, there are ways you can improve the situation.

A CAUTION ABOUT DELAYING BENEFITS

There's a tie-in between Social Security and Medicare that you should know before deciding to delay Social Security benefits.

You need to sign up for Medicare Parts B and D at age 65 in most cases. If you don't, you'll pay a penalty of higher premiums for life. See Chapter 6 for details.

When someone is enrolled in Medicare Part B and also receiving Social Security retirement benefits, the Medicare premiums automatically are deducted from the Social Security benefits unless you specifically elect to pay separately the Medicare premiums. Remember also that Social Security benefits receive a cost-of-living adjustment. The COLA is based on the Consumer Price Index for urban wage earners for 12 months ending the third quarter of each year.

There's a "stop-loss" provision in the law. The law says that for people who have Part B premiums deducted from Social Security benefits, higher Medicare premiums can't cause a decrease in the net Social Security benefit. That means if the premiums rise more in dollar terms than the COLA boosts your benefits, you won't be charged the full premium increase.

Usually, this doesn't matter, but there have been three times when Part B premiums increased more than the Social Security COLA, preventing the full Part B premiums from being charged to many Social Security recipients: 2010, 2011, and 2016. In these cases, other Medicare beneficiaries pay the increase in premiums and actually pay more.

The law requires that Medicare premiums cover 25 percent of the estimated cost of the program for the year. When the bulk of Medicare beneficiaries have their premiums paid through Social Security and don't pay their full share of the premium increase, the other beneficiaries make up the difference. Estimates are that about 30 percent of Medicare beneficiaries don't have their premiums paid through Social Security. When the other 70 percent of Medicare beneficiaries don't pay higher premiums, the entire cost increase for the program that year falls on the 30 percent who don't have their premiums deducted from Social Security.

Three groups are likely to bear these higher costs. One group is those enrolling in Part B for the first time that year. They aren't protected by the stop-loss rule. Another group is higher income individuals who are subject to the Medicare premium surtax. The third group is those who are enrolled in Medicare Part B because they are 65 or older but who haven't yet begun Social Security benefits. There's a small fourth group who are enrolled in Part B and receiving Social Security benefits but chose to pay their premiums separately instead of having them deducted from Social Security benefits.

For 2016, the increase in Medicare Part B premiums was going to be substantial. Estimates were that premiums would increase by 50 percent for those without the Social Security stop-loss provision. In the Bipartisan Budget Act of 2015, Congress reduced the proposed increases and borrowed the rest of the money Medicare would need. The beneficiaries who would have owed the substantial premium increases would pay for the debt with $3 monthly premium increases until the debt is paid.

WORKING CAN REDUCE BENEFITS

Your monthly benefits might be reduced if you begin Social Security retirement benefits between ages 62 and your FRA. You aren't supposed to continue earning income from working or being self-employed while receiving benefits during that period. If you earn too much money, the benefits will be reduced. The limit on earned income depends on your age. The limits change each year based on inflation, and you can find the latest limits on the Social Security website.

From age 62 until the year you reach FRA, your benefits will be reduced $1 for every $2 earned over the limit. For 2015, the limit was $15,720.

Suppose Rosie Profits is 62 and commenced her Social Security retirement benefits. Based on her earnings record and the reduction for taking benefits early, she expected to receive $7,200 for the year. But Rosie continued working and expects to earn $35,000. Since she is well over the $15,720 earned income limit, she won't receive any benefits for the year. If she were to earn only $20,000, she would lose $2,140 of benefits. That is determined by subtracting the earned income limit from her earnings of $20,000. She earned $4,280 too much. She will lose $1 for every $2 of excess earnings, so divide $4,280 by two. That gives the lost benefits of $2,140.

The way the limit will be imposed is that Rosie won't receive any benefits from January through April. That would be withholding of $2,400, or $260 too much. She'll receive full benefits from May through December. Then in January the following year she'll be paid the excess that was withheld.

In the year FRA is reached, retirement benefits are reduced $1 for every $3 earned over the limit. The earned income limit for the year of FRA was $41,880 in 2015. This also is indexed for inflation, and the current number can be found on the Social Security website. The limit is applied for each month until you reach FRA. The month you reach FRA, full benefits are paid regardless of how much earned income you earn. The mechanics of computing and withholding the payments are the same as for the year before reaching FRA.

Earned income is any payments of money, property, or services from a job or self-employment. Most sources of income from providing service or selling goods or services count. Not included are sources of investment and passive income such as interest, dividends, capital gains, pensions, and IRA distributions. The Social Security website has details of the types of income that do and don't count toward the earnings limit. When income is from self-employment, only net self-employment income counts. That is gross income minus business-related expenses. For the self-employed, the SSA also looks at the amount of time devoted to self-employment. Someone who works fewer than 15 hours a month on self-employment is considered retired and faces no penalty for excess earnings. Someone who works between 15 and 45 hours a month isn't considered retired if the job requires a lot of skill or the person is managing a sizable business.

Only income earned after the date your benefits begin counts toward the earnings limit. When you begin Social Security retirement benefits during the year, all earned income before the benefits starting date is not counted toward the limit. In those years, the earnings limit is prorated and computed on a monthly basis.

You have to tell the SSA before the start of each year the amount of earned income you anticipate receiving in the following year. The SSA then will compute any penalty and withhold the appropriate amount from your benefits. You are required to tell the SSA if your earned income for the year changes in either direction during the year.

The penalty isn't a complete loss. Once you reach FRA, your benefits will be recomputed. You'll be given credit for both the lost benefits in months when the entire benefit was withheld and also for the earnings you were paid during that period. Continuing to work while receiving benefits might increase benefits over the long term. That's because only your highest 35 years of earnings are used to compute benefits. The years you earn income while receiving benefits could knock out some low-earning years and boost your overall benefit once you reach FRA. The SSA reviews your earnings history each year even after you begin receiving retirement benefits. An earnings year that exceeds one of the previous high 35 years should result in a higher benefit the following year and could result in a lump-sum retroactive benefit increase for the previous year.

A NOTE ABOUT SOCIAL SECURITY SOLVENCY

Social Security's long-term solvency has been in question for a long time. Each year the trustees of Social Security and Medicare issue their annual report, and that report updates the precarious financial condition of the programs.

Too many people use Social Security's precarious financial position as a reason to exclude Social Security from their planning. They assume they won't receive anything from the program or should plan as though they won't receive anything. That's a mistake. It can lead to saving too much during your working years and reducing your lifetime standard of living.

While Social Security's long-term financial health is in doubt, it isn't likely to stop paying benefits during your lifetime. The details of the annual trustees' report make clear that the tax revenue coming into the program is likely to be enough to pay 70 percent to 75 percent of all promised benefits for an indefinite period. Changes need to be made to make up the 25 percent to 30 percent of benefits the annual tax flow won't cover, but that is a far cry from saying Social Security will run out of money and fail to pay any benefits.

The gap is likely to be made up in several ways.

Means-testing of the program is likely to continue. Under means-testing, higher-income individuals will receive lower benefits or pay higher taxes or a combination of the two. This might be done directly with straightforward benefit reductions or payroll tax increases. Or Congress will continue its pattern of enacting stealth taxes in which it extracts money for the program indirectly.

Higher payroll taxes also are likely, but these won't affect people who already are retired. They are likely to be targeted at higher-income individuals, such as by raising or removing the ceiling on wages that are subject to payroll taxes. Congress also might do what it has done for Medicare several times and impose a payroll or income tax surtax on higher income individuals that is earmarked for Social Security.

Overall benefits could be cut. I think if that occurs it likely would affect only those under age 50 or 55. Older Americans would be protected because they would be too close to retirement to adjust to the changes. A means-testing approach that reduces the benefits of higher-income individuals is much more likely than an overall benefits reduction.

It's possible that general tax revenue will be used to shore up the program, but I think that's unlikely. It would be more of a last resort.

Higher-income individuals in particular should plan a cushion or flexibility in their retirement plans. They are more likely than others to face changes through benefit reductions and higher taxes.

GUARANTEED INCOME FROM ANNUITIES

Annuities are another source of guaranteed lifetime income available to almost every American. While Social Security has its share of controversies, annuities sometimes seem to be even more controversial. Only a small percentage of retirement-age Americans own annuities, and many financial advisors generally don't recommend them to clients. The financial media generally issue negative reports about annuities. In fact, I'm sure many people are thinking of skipping this section because they have heard so many negative things about annuities. That would be a mistake.

A properly selected insurance annuity can enhance the financial security of your post-career years. Independent studies show that an annuity can make your portfolio last longer and almost eliminate the risk of outliving your money.

Annuities are controversial for several reasons. There are many different types of annuities. Many different financial products are included under the "annuities" heading. Only a small number of these annuities provide the benefits just mentioned. Too many types of annuities have high fees, limited control, limited liquidity, risk, and terms that few annuity owners fully understand.

In this section we discuss in detail only two types of annuities: immediate annuities and longevity annuities. These are the two types that will generate guaranteed lifetime income at a reasonable cost. They also are easy to understand. We will discuss in less detail a few other types of annuities that often are considered as alternatives to those two types of annuities. Those annuities have their places in some portfolios, but for most people seeking guaranteed lifetime income, immediate annuities and longevity annuities are the best choices.

Most people buy annuities the wrong way. They have contact with a financial professional and are presented with a specific annuity. Then, they try to decide whether or not to put money into it. That's backward. The right approach is the one we've taken so far. Determine your cash flow needs and decide how much of that income you want covered by guaranteed lifetime income. Then, shop for the appropriate vehicle to generate that amount of income. This section is for investors who take the second approach.

IMMEDIATE ANNUITY BASICS

An immediate annuity essentially is a private individual pension plan. You transfer a lump sum to an insurer. In return the insurer promises to pay a specific amount to you at regular intervals, and the payments begin within a year after your purchase. Usually the payments are monthly, but they can be quarterly, semiannually, or annually—whichever you select. The payment amounts don't change, except for two variations of the standard annuity, which we'll discuss later.

In the standard, plain vanilla immediate annuity, the payments continue for the rest of your life, no matter how long you live. When you're married, you can elect to have the payments continue for the joint life of you and your spouse, known as a joint life or joint and survivor annuity. The payments continue at the same amount until both of you have passed. There are other options. The payments that continue to your surviving spouse can be reduced from what they were when you both are living. The standard options are for the payments to the surviving spouse to be either 75 percent or 50 percent of the amount paid when both spouses were living.

Another option is for payments to be guaranteed for a minimum period of years, so if you pass away before that period ends the payments will be made to a beneficiary until the minimum payment period ends. Some people select a payment for life with a guaranteed term of years. For example, when you select an annuity for life with 10 years guaranteed that means you'll receive payments for as long as you live. If you pass away before 10 years, your beneficiary will receive payments for the remainder of the 10 years.

The key to remember about all the options is that each option reduces the amount of the payments. An annuity that lasts for your life (a single life annuity) has the highest payout (other than annuity for a fixed period of years that is less than your life expectancy). A joint life annuity generates a lower income payment, because it lasts for two lives. The amount of the reduction will depend on the age of each spouse. An annuity for life with a term certain also will pay less than a single life annuity and probably less than a joint life annuity.

Those are the basics of immediate annuities. They are clean and simple. You deposit money with an insurance company, and it promises to pay you a fixed income for the period of time you select. You are told in advance the amount of the income payments. There are no extra costs or fees. All costs and fees are used to determine the amount of the lifetime payments, so they are embedded in the annuity.

Now, let's look at some details and variations.

Why People Don't Buy Annuities

Economists generally agree that almost everyone should use immediate annuities to secure at least part of their retirement paychecks. More and more financial planners are reaching that same conclusion. Yet, very few people purchase annuities to generate guaranteed income for life. Some economists refer to this as *The Annuity Puzzle*, and there is a growing body of research into the question of why more people don't buy annuities.

People give a lot of reasons for not adding annuities to their financial assets. The most commonly cited reasons for not buying immediate annuities are:

- At the end of the annuity owner's life, there won't be any money available to leave for loved ones or charity.
- When the annuity owner passes away before life expectancy, the annuity owner loses. He or she will have received less in lifetime payouts than the annuity cost. The insurer and its other annuity owners benefit from the unused portion of the nest egg.
- Some people don't want to give up control of their hard-earned nest eggs to an insurer or anyone else.
- Similarly, some people don't like the inflexibility of immediate annuities. Once you make the purchase, the payments are fixed. You can't change the amount of the payment. You also can't take an extra amount when you have unexpected expenses or want to make a major purchase. There are exceptions to this last point; many immediate annuities now will let you take up to 10 percent of the annuity's value in a year.
- Some people think they can earn a higher return with their money, though more people believed that before 2000 than do now.
- Many people find the buying process to be difficult or unpleasant. You have to find and meet with insurance agents or brokers. The prices might not be transparent or easy to compare, and you need to talk to several agents to learn what's available in the market. Once an annuity is selected, it's not as easy to complete the transaction as buying a mutual fund or stock.
- The insurer could become insolvent and stop making payments.
- The fixed amount of the payments will have its purchasing power reduced over time by inflation.

Let's consider these objections and suggest how to view immediate annuities as part of your retirement paycheck solution.

Annuities are a risk management and risk transfer tool. When you are concerned about the potential of outliving your assets and income, you transfer that risk to an insurer by purchasing an annuity. In return, the insurer provides you with income security.

The insurer takes the risks that you'll live a long time or that investment returns will be lower than anticipated. It is cheaper for the insurer to take those risks, because it sells a lot of annuities. Some buyers will live beyond life expectancy, and others won't. For the insurer, those will balance, unless the insurer makes serious errors in its estimates of life expectancies. The insurer also has more tools for dealing with low investment returns and is likely to have estimated lower investment returns than most individuals do. The insurer also essentially plans for an infinite life. It can withstand extended periods of low returns better than you can. It also keeps earning income by selling new policies, and it is likely to be around to reap the benefits when market returns are higher. The insurer also might have a diversified business and profit from selling other types of insurance. Profits in one of the businesses can make up for short-term problems in its annuity business.

Transferring these risks to an insurer isn't free. You have to give up control of the money so the insurer can pool it with the rest of its portfolio and invest for the long term. You might be able to earn a higher return and make the money last longer. But you'll be taking the risk that you won't earn that higher return or that you'll live a long time and deplete the portfolio despite higher returns. Another price you pay for transferring risk to the insurer is that the payments last only for your lifetime. When you live longer than life expectancy, the insurer loses. When you live less than life expectancy, the insurer has a gain. In an annuity transaction, the insurer is taking the risk you'll live a long time, and you're taking the risk you won't.

Insurers are trying to overcome many of the objections people have to immediate annuities by changing contract features. You can buy annuities that guarantee to return some or all of the premiums if you don't live a minimum period, that let you withdraw some of your initial premium even after payments have begun, or that have other features meeting the objections people have to annuities. Keep in mind that each of these features costs money. Each reduces the regular payments you receive from the insurer. My belief is that the annuity features designed to overcome the objections aren't worth their cost. I recommend focusing on standard, plain-vanilla immediate annuities and maximizing your guaranteed lifetime income.

The question you need to ask when considering an annuity is: Which risks are you willing to take, and which do you want to transfer to someone else? When your primary concern is that you might outlive your assets and income, consider purchasing an immediate annuity with part of your nest egg. It doesn't matter if you fear running out of money because of poor investment returns, unexpected spending, or a long life. The immediate annuity covers you in all these cases. Purchasing an immediate annuity transfers a large part of the risk to the insurer. An immediate annuity generates guaranteed lifetime income. When you want guaranteed income for at least part of your retirement cash flow, buy an annuity with part of your assets. When you're comfortable taking all the risks yourself, there's no need to buy immediate annuities.

I think most of the objections to annuities are overcome when you decide to put only a portion of your nest egg into an immediate annuity. Too many people consider annuities as part of an all-or-nothing decision. They consider either putting all their money in annuities or none of it. Very few people should put all or most of their assets into annuities. People who should consider putting most of their nest eggs in annuities are those with few assets, who aren't comfortable with investing, or have a strong potential for long life expectancy. Most people should consider putting 10 percent to 50 percent of their nest eggs into immediate annuities. That provides them with significant guaranteed income and financial security. It also leaves enough other assets outside the annuity to pay for their spending above the basics, to invest for growth and purchasing power protection, be available for unexpected spending, and to leave to loved ones or charity.

That's why most people should try to have enough guaranteed income to cover essential, fixed, living expenses. Use Social Security, any employer pension, and annuities to generate enough income to cover those expenses. That gives you the income security for your post-career period. The rest of your portfolio can be used to generate additional returns and income to fund nonessential expenses, make up for purchasing power lost to inflation, and establish a legacy fund.

You also don't need to fully fund your annuity allocation at the start of retirement or even all at once. The longer you wait to buy, the higher the income payments will be. The amount of the payments are determined partly by your life expectancy, so the older you are at the purchase date, the higher will be the income you'll receive each month. This is an individual decision, but I suspect most people would do well to purchase immediate annuities around age 70.

Another strategy is not to purchase your annuity allocation at one time. When you purchase an immediate annuity, you lock in current interest rates for the rest of your life. In the post-financial crisis period, you're locking in very low rates. A good strategy is to purchase immediate annuities in annual installments over five years or so, sometimes called an annuity ladder. You can't time interest rate changes to maximize annuity income, but you can avoid locking in all your non–Social Security guaranteed income at one rate by purchasing annuities on a schedule over a period of years. That also gives you some experience with annuities without putting all your planned allocation in them at once. Then, you can suspend or change your purchasing schedule if your experience indicates that's a good idea.

There's one more problem people have with annuities: It's not easy to buy them or to know you're getting a good deal. It's much easier to buy a mutual fund than an annuity. With an annuity, you have to go through a licensed broker or agent. Each broker normally represents only a few insurers; some represent only one insurer. So, to survey the market you need to contact at least several brokers.

Later in this chapter I give steps you can take to reduce these obstacles and inconveniences. I'll show you how to get a good overview of what's available in the market and how to find the best deal for you. You'll also learn how to increase your monthly income for life by as much as 20 percent.

Finding Inflation Protection

Another knock on immediate annuities is that you have no purchasing power protection. Social Security is indexed for inflation, but standard immediate annuities are not. The income payments are fixed. As inflation compounds over time, the purchasing power of your income is reduced.

You might be able to deal with this problem with the rest of your nest egg that is not deposited in the immediate annuities. This portfolio can generate income and returns that will supplement your guaranteed income over time and maintain your purchasing power. Yet, there are no guarantees that the portfolio will generate sufficient returns to maintain your purchasing power and also generate cash to pay for those expenses exceeding the basic living expenses.

Another strategy is an inflation-indexed annuity. This is an immediate annuity that has a cost of living adjustment similar to Social Security's. The income payments are adjusted upward for inflation but not downward for deflation.

When you buy an inflation-adjusted immediate annuity, the payments are increased automatically each year to match increases in the Consumer Price Index or some other selected benchmark. There usually are limits, such as a maximum one-year increase of 10 percent. There's a variation, generically referred to as a growing annuity or growth annuity, that allows you to select a fixed percentage amount the payments increase each year instead of having the payments tied to the CPI. The payments increase by the same amount each year, regardless of what the CPI does. Generally, you can select annual increases of from 2 percent to 5 percent.

The downside to inflation protection through annuities is that there's a cost. With an inflation-indexed annuity, your first-year payment is going to be 20 percent to 30 percent less than that of a fixed immediate annuity. The exact amount will depend on your age, life expectancy estimates of the insurer, and the inflation rates the insurer forecasts. This emphasizes the key point with all annuities and insurance products: You can transfer almost any risk you want to the insurer, but you'll pay something for transferring the risk.

Hint: You don't necessarily want to buy the inflation-indexed annuity that offers the highest first-year payout. The insurer could be assuming future inflation will be very low or that it will earn very high investment returns. You could be hurt down the road if the insurer runs into financial trouble because its assumptions were too optimistic.

A growing annuity should give you a higher first-year payment than a CPI indexed annuity, though that depends on the insurer's inflation estimates and the growth rate you select. Also, you'd know what the income increase would be each year and could factor that into your budgeting and spending, rather than having to wait to see what the year's CPI increase is. Of course, if inflation is higher than the automatic increase rate you selected, at some point you'll need to reduce expenses or supplement the income from another source to maintain your standard of living.

Here's how to compare a fixed annuity to an inflation-adjusted annuity and also compare different inflation-adjusted annuities.

Start with the estimated first-year monthly payment amount of each annuity. Then compare what the payments would be after 10, 15, and 20 years under different inflation scenarios.

For example, assume a 70-year-old could purchase a nonindexed immediate annuity with $500,000 and receive an initial $3,962.93 monthly payment. Assume also that if he selected a 2 percent annual increase, the initial payment would be $3,375.54. If he selected full CPI indexing, the initial payment would be $3,039.18.

Compare how the payments will change over time. After 10 years under the 2 percent option, the payment would be $4,736.07. The payment of the CPI-indexed annuity after 10 years would depend on the inflation rate, and you should assume different inflation scenarios to estimate future payments. It's best to use a computer spreadsheet program to make these calculations.

You need to look at how long it would take for the annual payments of the indexed and growth annuities to catch up with the fixed annuity income. You know that after that period you come out ahead by purchasing the indexed or growth annuity. You want to estimate how long it would take to reach the break-even point under different assumptions.

You also need to consider which risks you want to take. You could accept a lower initial payment and avoid the risk of having high inflation eat away at the purchasing power. But you'll take the risk that inflation will be lower than the insurer is assuming, and you'll end up with lower payments than you would otherwise have received. Or you can select your own annual increase and take the risk inflation will be higher.

Inflation-indexed and growth annuities usually are not sold as separate products. Instead, you shop for an immediate annuity and select an option or rider to have the payments adjusted for inflation or increase automatically at your selected rate.

You also might try to obtain inflation protection with a variable immediate annuity. This is an annuity that begins payments within a year after you purchase it. Your annuity account is invested in investments you select from among those offered by the insurer. After the first year, your payments rise or fall according to how your investment selections perform compared to a return benchmark selected when the annuity was purchased.

I don't recommend this type of annuity for most people. The payments are not fixed, so they don't meet the goal of establishing lifetime guaranteed income. Also, this type of annuity is complicated and has higher expenses. It is better to take your investment risk outside of the annuity where fees are lower and taxes can be managed.

Increasing Annuity Income for Life

After deciding you want a portion of your portfolio in immediate annuities and whether they should be inflation-indexed, it's time to search for the best annuity deal for you. The easiest, surest way to increase your retirement income is to shop for annuities just as you would for anything else. Few retirees or prospective retirees do this, but I've shown over the years that shopping will increase income. Even as the Internet supposedly makes markets more competitive and drives prices down, prices for annuities vary considerably.

Earlier we discussed what's sometimes called *The Annuity Puzzle*. Economists and many financial planners believe most people in retirement should purchase immediate annuities for guaranteed lifetime income. But only a small percentage of retirees do that. I suspect a major reason people don't buy annuities is that the shopping and buying process is less efficient and more unpleasant than the way we buy most other things. Shopping for an annuity still has roadblocks that make it less convenient for consumers than shopping for televisions, books, and even cars. It's more like buying a house. Nevertheless, to obtain retirement security you need to overcome the obstacles and shop for annuities.

Insurers use different assumptions to determine their annuity payouts. They consider estimated investment returns (and recent investment losses), their life expectancy estimates, and their annual expenses and desired profit margin. Each of these assumptions varies between insurers. I suspect some insurers also count on consumers not to shop around.

The financial stability of the insurers also varies and makes a difference in the payouts from annuities. Insurers with better financial positions can pay less because of the increased security they offer. The highest annuity payouts often are offered by insurers with lower financial ratings because they present more risk.

Each insurance broker or agent usually offers products from a small number of insurers. Some deal exclusively with one insurer. To get a good view of what's available in the market through brokers and agents you often have to meet with several brokers and agents.

An easy way to shop is to visit websites, such as www.immediateannuities.com. These essentially are online insurance brokers that deal with a larger number of insurers than the typical agent or broker. You visit the website and type in your age, state of residence, and the amount you want to invest in an annuity. After providing some other personal information, you'll receive a report showing the payouts you'd receive from different insurers. Some websites show the results on the screen. Others mail a package of the proposals to you.

Over the last 20 years or so, every few years I've surveyed the immediate annuity market through websites and brokers. Each time, the survey had the same results. When the survey is limited to insurers that have the top financial safety ratings, there is about a 20 percent difference in the payouts between the highest- and lowest-paying insurers. That's a 20 percent difference in your income every month for the rest of your life. This survey shows that it pays to shop around, despite the inconvenience.

The income can be increased even higher if you want to deal with an insurer that has less than the top safety ratings. Insurers with the lower safety ratings generally pay more on their annuity contracts than the more conservative, higher-rated insurers. You don't have to lower your standards to the lowest-rated insurers to receive higher payouts. Your income can be increased substantially if you're willing to take the risk of using a middle-rated insurer. You don't want to gravitate automatically to the highest-payout annuity. You want to consider the financial stability of the insurer. Be sure you are comfortable over the long term with an insurer's financial stability before buying. An insurer can have a less-than-top financial safety rating and still be a good risk.

One way to increase financial security is to split your annuity purchases among several insurers. The odds of all the insurers you select defaulting should be very low. You balance the payouts of the different insurers with their financial stability and by having diversification of income sources.

Another annuity source to consider if you're still working is your employer-sponsored retirement plan. The 401(k) plans sponsored by many large employers offer an option that lets you purchase the annuity with your 401(k) balance. Compare the payout of this annuity with the private options.

THE ADVANTAGES OF LONGEVITY ANNUITIES

The longevity annuity is a relatively new option, available in the United States only since about 1984. It is a close sibling, however, of the immediate annuity and also is easy to understand.

In a longevity annuity, also known as a deferred income annuity (DIA), you deposit a lump sum with an insurer. Unlike the immediate annuity, you don't receive income payments within a year. Instead, the income payments are delayed anywhere from 2 years to 45 years. You decide on the income starting date when you purchase the annuity. Once income payments begin, they last for life no matter how long you live.

As with the immediate annuity, you can adjust the terms of the longevity annuity and change the risk sharing.

Under the original longevity annuity, the annuity owner took the risk of living a short life. If the owner died before the annuity payments began or before receiving enough income to recover the initial deposit, the insurer benefited. That doesn't have to be the case now. You can have a longevity annuity that ensures at least the initial premium is returned to you as income or paid to a beneficiary.

The standard longevity annuity also doesn't have inflation protection. You know what the annual income will be in the future when you purchase the annuity, but you don't know what its purchasing power will be because of inflation. Now, you can opt for some inflation or purchasing power protection in your annuity.

You also can purchase a longevity annuity that pays income for the joint life of you and a beneficiary, whether a spouse or someone else. That is less expensive than purchasing two separate single life annuities.

As with the immediate annuity, opting for any of these protections or features will reduce the initial income payment. Compare the income you'll receive from a standard longevity annuity to the income from one with inflation protection to decide if the inflation protection is worth the cost.

There are several ways longevity annuities can be used in your retirement plan.

The initial selling point of longevity annuities was as a late-in-life income kicker. The longevity annuity payments would begin at a late age such as 75 or 80. That's when a retiree's financial security is most at risk. At that point, assets and cash flow might be dwindling because of high inflation, low investment returns, or higher-than-expected spending. The longevity annuity income would kick in to restore purchasing power or replace lost income and assets. The initial arguments for using longevity annuities stressed that the annuity could be purchased when the owner was in his 50s or 60s, and the income would begin at a later age.

More recently, longevity annuities have been used differently. Most purchasers buy the annuities when they are in their 50s and 60s and schedule the income payments to begin between ages 65 and 70, when they expect to retire. This can be a good strategy because a longevity annuity usually is cheaper per dollar of income than an immediate annuity. That's because you give the money to the insurance company earlier, and it invests the money for a few years before beginning payments. The additional investment returns are factored into the income you'll receive.

Essentially, you have two strategies to consider for using an annuity to established guaranteed income.

The first strategy is to buy a longevity annuity with part of your nest egg sometime before retirement. The second strategy is to retain the money and invest it until you are ready for the income to begin. Then, you deposit the money with an insurer in an immediate annuity.

Determining which is the better strategy depends on the investment returns you can generate. If you generate higher after-tax, after-expense returns than the insurer company assumes it can, then you probably would buy more lifetime income by retaining and investing the money as long as you can and eventually buying an immediate annuity. Otherwise, a longevity annuity that begins payments in the future would be better. Remember, of course, that the income from the longevity annuity is guaranteed. The investment returns you might earn from investing the money for a few more years aren't guaranteed. They could be either higher or lower than you anticipate. If the returns are lower, then your retirement income will be permanently lower.

Another way longevity annuities are used is to reduce required minimum distributions (RMDs) from IRAs. As we discuss in Chapter 9, the RMDs that must begin after age 70½ can be a problem for IRA owners as they age. The IRS issued regulations in 2014 that allow IRA owners to use a type of longevity annuity, known as a qualified longevity annuity contract (QLAC), to delay some of the RMDs.

Under the 2014 regulations, the amount invested in QLACs isn't used to calculate RMDs, up to a total of $125,000 invested or 25 percent of your IRA balance, whichever is less. The limit is calculated by aggregating all your IRAs. In other words, it is a per taxpayer limit, not a per IRA limit. The limit is determined by comparing the amount invested in QLACs to the IRA balance as of the end of the previous calendar year. Married couples apply the limits per person. Each spouse can invest up to $125,000, or 25 percent of his or her IRA in QLACs. When you own a QLAC in your IRA, the balance in the QLAC isn't used to calculate your RMDs until income begins or age 85, whichever occurs first.

QLACs also can be purchased through participating 401(k) and similar plans and limit RMDs from them. The 25 percent limit applies to each plan, and the $125,000 limit is per person. In 2015, it was difficult to find a 401(k) plan that offered a QLAC as an investment option, but that should change over time.

The $125,000 limit is indexed for inflation, but it will rise only in $10,000 increments. At recent inflation rates, it will take it a while to increase.

Once a QLAC is purchased, limited changes are allowed. Most insurers allow one change to the payout date. You also might be able to add money to the annuity, but a new income payout amount will be calculated for that contribution. That could be a better deal than buying a new, separate annuity with the additional money.

You should know that not all longevity annuities are QLACs. Any annuity issued before the July 2, 2014, date of the IRS regulations doesn't become a QLAC. Your IRA can own a longevity annuity that isn't a QLAC, but it won't help reduce the RMDs. Instead, you have to buy an annuity issued after the regulations. The insurer has to identify it as a QLAC meeting the IRS regulations and not as a standard longevity annuity. Variable annuities, indexed annuities, and other types of annuities also aren't going to meet the QLAC requirements.

You can't own a QLAC in a Roth IRA. You might want to own a regular longevity annuity in a Roth IRA to provide guaranteed income later in life. Only a few insurers issued longevity annuities for years. But the IRS regulations quickly brought change. Major insurers began introducing their versions. In mid-2015, about 10 insurers issued QLACs and 15 offered DIAs.

Another strategy is to use the longevity annuity to protect the purchasing power of your guaranteed lifetime income. You aren't restricted to choosing either an immediate annuity or a longevity annuity. You can purchase both. You can start with an immediate annuity early in retirement to cover your fixed living expenses. You know that inflation is likely to reduce the purchasing power of that income over time. You believe, however, that the income reduction from an inflation-indexing rider on the annuity is too high. Instead, you purchase a longevity annuity at the same time. You have the additional income begin sometime in the future to restore the lost purchasing power of your immediate annuity. You decide when purchasing the longevity annuity when you want the income payments to begin.

OTHER ANNUITIES YOU MIGHT HEAR ABOUT

As mentioned earlier, there are many different types of annuities. They aren't all appropriate for the guaranteed income portion of your retirement plan. None compares to the simplicity, safety, and low cost of an immediate annuity or longevity annuity. Each of the other types of annuities has its own bells and whistles, each of which carries costs. We'll review a few of those in this section.

My bottom line is I think there are times when these types annuities can be useful in the growth stage of a portfolio's life. But insurers are selling them with income riders to make them more attractive to those seeking guaranteed income. I believe this is an expensive way to establish guaranteed lifetime income. Instead, consider these products for a growth portion of your portfolio without the expensive income riders. When you're ready for guaranteed lifetime income, consider immediate annuities or longevity annuities.

Variable annuities with lifetime income riders are available in many versions. They generically are called variable annuities with guaranteed minimum withdrawal benefits or with guaranteed lifetime income benefits.

A variable annuity essentially is a collection of mutual funds in a tax-deferred annuity. You invest with the insurer, and then you choose how your account is invested from among funds offered by the insurer. Your account balance can rise or fall with the performance of your investment selections. Variable annuities often come with a form of life insurance in a guarantee that a beneficiary always will be able to inherit at least your initial premiums, regardless of how the investment account performs.

The guaranteed income rider usually provides that after a period of time passes you can begin taking fixed annual withdrawals from the annuity. It is guaranteed that you can withdraw a certain percentage of the account (usually 3 percent to 6 percent) each year for the rest of your life. The income is guaranteed no matter how long you live and how the investments perform. Even after you've drawn down the account you continue to receive the income for as long as you live. If your investment account performs well, the income can increase over time.

These types of annuities often are very confusing to buyers. I believe most owners of these annuities don't fully understand what they have purchased. Often, for example, the guaranteed income is computed based on a value other than the actual account value on the day the income payments begin. A lesser value is used. The contract has to be read carefully to understand what the income is likely to be under different scenarios.

In addition, significant fees are attached to all these features, and other features are available. The owners who understand the annuities generally are overpaying for the guaranteed income with the hope that the income will increase because the investments will do well. There also are restrictions on the investments and on access to the account value.

If you consider this type of annuity, evaluate it by comparing its potential payoff with alternatives such as investing the money yourself in a portfolio of low-cost investments and to buying an immediate annuity or longevity annuity. To do this type of analysis properly you have to fully account for differences in taxes and fees. The variable annuity does have the advantages of offering benefits to heirs, the potential for the payout to increase, and often more liberal conditions for terminating the annuity or changing your distribution schedule.

Fixed indexed annuities are another option. With these annuities, you make a deposit with an insurer. Your account is credited with interest each year. The amount of the interest is determined by the performance of one or more market indexes or benchmarks. Usually you can select one or more of the indexes from among those offered by the insurer.

These annuities often are very complicated because of the way the interest credited to your account is determined. You don't receive simply the total return of the index for the year minus the insurer's fees. The formulas used to determine the interest are less straightforward. There also are limits on the amount of interest with which you can be credited each year. When the index returns 20 percent in a year, you might have only 5 to 10 percent credited to your account.

I won't go into all the details of these types of annuities, because the details aren't relevant to their potential role in generating lifetime guaranteed income. In recent years, most of the fixed indexed annuities issued were sold with some form of guaranteed income riders similar to those for the variable annuities.

As with the variable annuities, you'll be charged a fee for the income guarantee. The fee usually is charged by reducing the amount of interest credited to your account each year. There's the potential that when earnings for the account are low, the income might not be enough to pay the expenses. Then, the fees could be paid out of principal or previous years' earnings. This is an expensive and uncertain way to generate guaranteed lifetime income.

I believe that fixed indexed annuities and variable annuities can have roles in the accumulation phases of your life. But they are not the best ways to secure guaranteed lifetime income. You're better off focusing on immediate annuities and longevity annuities.

ANNUITY SAFETY

When you buy any type of annuity, bear in mind that though the income is guaranteed, it is guaranteed only by the insurance company. You are depending on the solvency of the insurance company to help fund your retirement. Most states have a guarantee fund that covers the annuity obligations of failed insurers, but the coverage varies from state to state. In most states, a maximum of $100,000 is guaranteed. In some cases only the original investment is guaranteed. Earnings aren't covered or are covered at the option of the guarantee agency. Of course, these guarantees are only as good as the solvency of the guarantee fund, and that also varies by state.

That's why you want to examine the financial solvency of the insurer whose annuity you're considering. Examine the ratings issued by the firms that evaluate insurers. These should be readily available from the insurer or broker you're dealing with. Don't be tempted by the highest payout or other attractive features. These terms usually are offered by insurers who are in trouble and need to bring in more money or those that operate with more risk than other insurers. To be especially safe, limit your exposure to any single insurer. Diversify your annuity purchases the same way an investment portfolio is diversified by spreading your annuity purchases among different insurers.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is correct regarding Social Security:**

A. most people should not plan on receiving Social Security benefits when they retire

B. for many retirees, Social Security is the only guaranteed lifetime income received

C. ninety percent of current retirees estimate that Social Security provides 34 percent of their retirement income

D. Social Security does not account for inflation

2. **For those born in 1960 or later, the full retirement age (FRA) for Social Security is ________________.**

A. 62 years old

B. 65 years old

C. 67 years old

D. 70 years old

3. **All of the following are reasons to consider delaying receiving Social Security benefits <u>except</u>:**

A. retirees have longer life expectancies now than in the past

B. delayed benefits are a very low-cost form of life insurance if you are the higher-earning spouse

C. there might be tax benefits to delaying benefits

D. there are no benefits to waiting; every retiree should start receiving their benefits at age 62

4.	**A surviving spouse is entitled to receive ___________________ of his or her deceased spouse's retirement benefit.** **A.** 25 percent **B.** 50 percent **C.** 75 percent **D.** 100 percent
5.	**Which of the following is correct regarding stopping your Social Security benefits after you have started to receive them:** **A.** once you have started receiving benefits, there is no way to stop them **B.** within the first 12 months of beginning benefits, you can choose a withdrawal of benefits **C.** a withdrawal of benefits can only have an impact on the retiree receiving those benefits **D.** filing Form 521 with Social Security is the only step needed to complete a withdrawal of benefits request
6.	**Which of the following is correct regarding purchasing an immediate annuity:** **A.** it transfers a large part of the risk to the insurer **B.** it generates guaranteed lifetime income **C.** it can help to ensure that a retiree doesn't outlive their money **D.** all of the above

CHAPTER 3: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. Social Security plays a huge role in almost all retirement plans.

B. CORRECT. For most American retirees, Social Security provides a meaningful portion of their retirement income, and it is the only guaranteed lifetime income received by many.

C. Incorrect. Thirty-four percent of current retirees estimate that Social Security provides 90 percent or more of their retirement income.

D. Incorrect. Social Security payments are among the very few inflation-indexed sources of income.

(See page 46 of the course material.)

2.

A. Incorrect. Sixty-two is the minimum age to start receiving Social Security benefits, but it is not the FRA.

B. Incorrect. The FRA is higher than 65.

C. CORRECT. For a person born in 1960 or later, the FRA is 67.

D. Incorrect. Seventy is older than the FRA for anyone born after 1960.

(See page 49 of the course material.)

3.

A. Incorrect. The increase in life expectancy is a reason that many retirees should at least consider delaying benefits.

B. Incorrect. Delayed Social Security benefits are a very low-cost form of life insurance when you were the higher-earning spouse. The surviving spouse receives the higher of the benefit you were receiving and his or her earned benefit.

C. Incorrect. There might be tax benefits when you delay Social Security benefits if that increases your drawdown of IRAs and other qualified retirement accounts.

D. CORRECT. There are many reasons to consider delaying receipt of benefits past the age of 62. Longer life expectancies, spousal considerations, and tax benefits are some of the reasons.

(See page 52 of the course material.)

4.	**A.** Incorrect. The surviving spouse is entitled to more than 25 percent. **B.** Incorrect. The surviving spouse is entitled to more that 50 percent of his or her deceased spouse's retirement benefit. **C.** Incorrect. The surviving spouse will receive more than 75 percent of the benefits. **D.** CORRECT. A surviving spouse is entitled to 100 percent of his or her deceased spouse's retirement benefit. *(See page 53 of the course material.)*
5.	**A.** Incorrect. There are ways to stop your Social Security benefits after you have chosen to start receiving them. **B.** CORRECT. A complete do-over is possible if you make the decision within the first 12 months of beginning benefits. Social Security calls this withdrawal of benefits. **C.** Incorrect. The decision to withdraw benefits could affect others who were drawing benefits on your earnings record, such as a spouse or dependent. **D.** Incorrect. A withdrawal of benefits occurs when the retiree files Form 521 with Social Security and repays all of the benefits received to date. *(See page 60 of the course material.)*
6.	**A.** Incorrect. Purchasing an immediate annuity does transfer a large part of the risk to the insurer, but this is not the only correct response. **B.** Incorrect. Immediate annuities generate guaranteed lifetime income, but this is not the only correct selection. **C.** Incorrect. An immediate annuity can ensure that a retiree doesn't outlive his or her money because of poor investment returns, unexpected spending, or a long life. However, this is not the only correct selection. **D.** CORRECT. Purchasing an immediate annuity can have many benefits for a retiree including minimizing risk, guaranteeing lifetime income, and helping to ensure that a retiree does not outlive his or her retirement income. *(See page 67 of the course material.)*

CHAPTER 4: TAPPING YOUR NEST EGG

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the pros and cons of the 4 percent rule.

The missing link in many retirement plans is the withdrawal, distribution, or spending strategy. For a retirement plan to be successful, you need a strategy for drawing down your nest egg. Saving and investing on the way to retirement are important steps. Once you're ready to spend for retirement, you should have a distribution strategy. Your plan must ensure that you spend the nest egg at a rate that is sustainable. You don't want to run out of money. The spending strategy we discuss in this chapter must be coordinated with your estimated spending discussed in Chapter 2. If there's a gap between your spending strategy and the estimated spending, then the estimated spending should be reduced.

Accumulating money for retirement isn't the hardest part, though it's far from easy. Developing a spending strategy is more difficult. Many people enter retirement with what seem to be adequate resources. Yet, recent studies concluded that a high percentage of Americans die owning their home equity and little more. Many retirees end up relying heavily on Social Security to fund their later years' spending.

Some of this shortfall is due to unexpected spending, especially medical and long-term care expenses, and not having insurance or a plan to help with those expenses. Most often, however, the shortfall is due to people entering retirement without a spending plan or with a poorly conceived plan. For example, as we discuss shortly, many financial planners believe that a retiree can safely spend only 4 percent or less of a nest egg per year. Spend more and you risk running out of money after fewer than 30 years. Yet, surveys of Americans age 50 and over find that most believe they safely can spend safely seven percent or more of their nest eggs each year. Too often, Americans enter retirement with no idea how much they can safely spend each year.

So far in this book, we learned how to estimate how much it will cost to maintain the retirement lifestyle you desire. We also reviewed how to establish guaranteed lifetime income to fund the fixed or basic expenses of retirement. Now, we're going to examine how to determine the amount of the nest egg you safely can spend each year in retirement. By "safely spend," I mean the rate at which you can spend money with a low risk of running out of money during a likely retirement.

A spending strategy can make or break a retirement plan. People who accumulated a reasonable amount of money before retirement found themselves running out of money and having to make changes because they spent money too freely in the early years of retirement. Other people live securely on much smaller nest eggs because they developed reasonable spending plans and kept their lifestyles within those spending plans.

The risk of running out of money is not the only risk of having the wrong spending strategy. Some people are too conservative in their estimates. They live at a much lower standard of living than they could afford. They shortchange themselves during their lifetimes. That's good news for the loved ones and charities who benefit from their frugality, but it means those people deprived themselves of opportunities they could have had during their lives.

The money from this part of your assets is meant to cover those expenses that aren't covered by the guaranteed lifetime income you receive, as we discussed in Chapter 3. When your estimated spending exceeds the sum of your guaranteed annual income and the amount that can be withdrawn under your spending strategy, then you need to make changes in your estimated spending. You need to adjust your planned retirement lifestyle and spending so that they match the sources of cash. Otherwise, your financial security and independence are at risk.

In this chapter, we're going to discuss how you can develop the right spending plan for you. The goal is to determine how much money you can draw from your assets and maintain a low probability of running out of money during a reasonable estimate of your retirement period.

Keep in mind that we're talking in this chapter about spending money other than that used to generate guaranteed lifetime income. We're trying to determine how much we can spend on expenses that aren't covered by Social Security, any employer pension, and any annuities with lifetime guaranteed income.

You can use the strategies in this chapter even if you choose not to have any annuities that pay lifetime income. In fact, when you don't have guaranteed income from annuities or a pension, using these strategies is more important. In that case, your only guaranteed lifetime income is Social Security, so it is more important that you don't spend down your nest egg too quickly.

This was a topic that hardly was discussed only a few years ago. Most retirees simply invested their money in safe investments such as certificates of deposit, short-term and intermediate-term bonds, money market funds, stocks that pay dividends, and the like. They primarily lived off the income from those investments and rarely spent their principal. Because interest rates have been very low since about 1998 and especially since 2008, that strategy isn't viable for most people. You need a lot of money to generate a reasonable income at low interest rates and dividend yields. Retirees and near-retirees have to develop other investment strategies, and they have to spend more than their investment income during retirement.

As I said, this topic hardly was discussed a relatively short time ago. Discussions among professionals began in the 1990s. The discussion in the first edition of this book was one of the few available to a general audience for years. Research and discussions about safe spending formulas became more frequent and numerous over the last 10 years. We're going to review the different strategies, discuss their advantages and disadvantages, and show you the way to develop a spending strategy so that you can tap your nest egg safely.

HOW LONG SHOULD IT LAST?

A dangerous and frequently made mistake in retirement planning is to underestimate life expectancy. It wasn't necessary for previous generations of retirees to worry about life expectancy. Most only lived about five years after retiring. In recent decades, however, life expectancy for Americans over age 60 has increased. Retirees and preretirees today need to study life expectancy and understand how long they are likely to live. Many will live 20 or 30 years in retirement. It isn't unusual for people to live as long or longer in retirement as they spent in their careers, and that could be more common in the near future. This longevity is why it is vital for a retiree to establish a reasonable distribution policy to reduce the risk of running out of money in retirement.

There are many tools available on the Internet to estimate your life expectancy. One good free calculator I recommend is on the Social Security website. Another simple and useful calculator is the Simple Life Expectancy Calculator on the site of the Society of Actuaries (www.soa.org) that works with Microsoft Excel®.

The SOA's simple calculator lets you estimate the life expectancy of an individual or a couple. In addition to providing average life expectancy, it also provides probabilities for living a certain number of additional years.

For example, a 65-year-old man in 2015 had an average life expectancy of 16.5 years (to age 81.5 years). But he had a 37 percent probability of living another 20 years and a 17 percent probability of living another 25 years. There was a 4 percent probability of living 30 more years. Of course, the numbers were higher for a 65-year-old woman. She had an average life expectancy of 19.2 years and a 50 percent probability of living another 20 years. She also had a 28 percent probability of living another 25 years and a 10 percent likelihood of living another 30 years.

It's important to note that as you age, your life expectancy increases. For example, a 70-year-old man in 2015 has a life expectancy of 13.1 years (age 83.1). That's two years longer than the 65-year-old. The 70-year-old also has a 19 percent probability of living to 90. That's a higher probability than many people realize.

In a married couple, the probability of one spouse living to at least age 90 is fairly high and most couples should plan for that. More and more financial planners say that they prepare financial plans in which at least one spouse lives to 100.

Keep in mind that these are averages. You could live more or fewer years depending on family history, lifestyle, and current health. There are other websites that try to give a more customized life expectancy estimate. You enter personal data and the site prepares an estimate based on the data it has. You can find the ones currently available by entering "life expectancy calculator" in your favorite Internet search engine. In 2015, I found detailed calculators on the websites for the Wharton School at the University of Pennsylvania, bankrate.com, the book *Living to 100*, and insurer Northwestern Mutual.

THE 4 PERCENT RULE

The first published strategy for tapping your nest egg now generally is referred to as the 4 percent rule or the safe spending rate. I was among early critics of using the strategy as anything more than a general guide. It requires modifications for different retirees and situations.

Here are the basics of the strategy. The research assumed that you'd withdraw a percentage of your nest egg the first year. Each year after that, you'd withdraw the same dollar amount that was withdrawn the previous year increased by the inflation rate of the previous year. If your first year's withdrawal was $50,000 and the Consumer Price Index for that year was 4 percent, the second year you would withdraw $52,000. If inflation was 2.5 percent the second year, the third year you would spend $53,300. The original study capped the annual spending increase at 3 percent, even if the CPI increase was higher. Some studies have used a flat annual increase of 3 percent instead of adjusting it for inflation.

Another assumption was that the nest egg would be invested in a traditional portfolio of 60 percent U.S. stocks and 40 percent U.S. bonds. Follow-up studies changed the investment allocation a little but not much, generally assuming a mix of U.S. stocks, U.S. bonds, and cash.

The question the study sought to answer was: What is the maximum percentage of the portfolio that could be withdrawn while maintaining a low risk of running out of money in fewer than 30 years? The answer in the original study and most follow-up studies was greater than 4 percent and less than 5 percent, with the answer usually closer to 4 percent than 5 percent. So, the answer was shortened to the 4 percent rule.

An advantage of the studies is that, unlike most retirement plans developed previously, they didn't assume the portfolio earned a steady average rate of return each year. The researchers realized the danger of what now is called sequence of returns risk. While investments have long-term average annualized rates of return, they don't return the average every year. In fact, U.S. stock indexes rarely have a year in which they return their long-term averages. Instead, the return in a particular year is likely to be much higher or lower than the long-term average.

More importantly, markets, especially stock markets, are likely to have long-term bull and bear markets. In bull markets, returns are likely to be significantly above the long-term average, and in bear markets the returns are likely to be significantly less than the long-term average. These long-term market cycles are likely to persist for years. When someone retires at the start of a long-term bear market, the portfolio is likely to earn significantly less than the long-term average. In the first edition of this book I discussed a study by mutual fund firm T. Rowe Price. The study found that someone who retired in 1968, at the beginning of a significant bear market, would run out of money by 1983 if he spent money at a rate that was sustainable if long-term average return was earned each year. On the other hand, if that person retired in 1982 when the next bull market began and spent at the same rate, his portfolio would last more than 30 years and he would die with a rather substantial net worth. He could have spent far more money during his lifetime.

The research that produced the 4 percent rule factored in this sequence of returns risk. It used different market returns. Some researchers used actual historic market returns. Others had computer programs generate random returns. In either case, the goal was to find a withdrawal rate that would allow a portfolio to last at least 30 years under all or most investment environments. The answer, as I said, is that the safe spending rate is around 4 percent of the portfolio's initial value.

Shortcomings of the 4 Percent Rule

While the rule is a useful starting point, I've been among the critics of the 4 percent rule from the start. Many others have joined over the years.

There are key shortcomings in the rule. In some cases, it is too optimistic. In others, it is too conservative. Here is a summary of the shortcomings:

- The rule doesn't guarantee your money will last at least 30 years. Under the scenarios run in the research, there are high probabilities a nest egg will last 30 years under the assumptions, but the probabilities are less than 100 percent.
- As we discussed earlier, 30 years might not be a long enough test period for many people. Life expectancies are increasing, and there is a reasonable probability that in many married couples at least one spouse will live longer. Saying it is safe to spend at 4 percent for 30 years is not the same as saying it will ensure everyone's nest egg lasts through retirement.
- What really counts is the extent of a shortfall. By how many years or how many dollars does a spending strategy fall short? If the shortfall is by less than a year and a relatively small dollar amount, a few modest adjustments in investing or spending could allow a higher spending rate. But if the strategy runs out of money years before retirement is likely to end, then it is a major problem.
- Different investment portfolios and strategies are going to have different results. A conservative investor who can't bear the volatility of a portfolio that is 60 percent in stocks is likely to earn a lower long-term return than in the studies. For that person, a 4 percent spending rate is too high. On the other hand, a more diversified portfolio than those used in the studies is likely to have better results and substantially reduce the sequence of returns risk. Further, a portfolio that successfully uses tactical asset allocation, changing the portfolio's allocation based on market factors, also is likely to have better results than in the studies. Better investment performance would allow a higher spending rate or cause the portfolio to last longer.
- Where the investment markets are in a long-term bull market or bear market cycle is important. It's often said that the most important years for a retirement plan are the five years before and the five years after retirement begins. When a serious bear market occurs during that period, it will be harder for a retiree to maintain the planned spending level. The portfolio will begin to decline quickly because it will have negative or low investment returns when the retiree begins drawing it down. On the other hand, when there's a strong bull market beginning during this period, the retiree is likely to earn higher returns than anticipated and be able to spend more than initially planned. The 4 percent rule essentially assumes you're starting retirement during a bad investment period. That's a safe, conservative assumption, but it means people who retire at other times could spend more.

- It might not be valid to assume historic U.S. investment returns will be repeated. Some researchers argue that the United States was a smaller, faster-growing economy during the periods tested. In the future, for several reasons, they believe the United States is likely to grow at a slower rate. If that's the case, then investment returns are likely to be lower. Historic investment returns probably aren't very relevant to people retiring in the wake of the financial crisis. Several studies indicate that economic growth and investment returns tend to be below average for years following a financial crisis. Some researchers now argue that a safe spending rate taking the current investment environment into account is 2 percent or less.
- An important flaw in the studies is that no one really spends money in retirement the way the models assume. You'll find very few retirees who total their spending for one year, and then decide they will spend in the next year last year's spending increased by the inflation rate or by a fixed percentage. Spending is more dynamic and changes in a fairly predictable pattern during the retirement years, as we discuss below. Most spending plans also have flexibility. A retiree might be able to spend more in the early years with an understanding that some spending will be reduced or eliminated if investment returns don't meet a minimum level. We'll discuss this in more detail below.

The 4 percent rule is important research, but it should not be followed mechanically in a retirement plan. It is an important benchmark. It should be used as a starting point and modified according to the current investment environment and the individual's situation. In Chapter 2, we demonstrated that the old rule of thumb that people spend in retirement 80 percent of their preretirement income was invalid. Likewise, the 4 percent rule might apply on average but shouldn't be applied by any individual.

There isn't a maximum safe spending rate that will work in all scenarios if you plan to invest for a decent return that subjects you to market risk, interest rate risk, and other risks. Instead of searching for a safe spending rate, you need to either invest for safety and keep your spending within the cash generated or have a flexible spending plan under which your spending increases or decreases with both your goals and market changes.

UNDERSTANDING DYNAMIC SPENDING

The fact is that very few people spend in retirement the way envisioned by the 4 percent rule and many other traditional strategies. Spending changes during retirement. To some extent, the changes are predictable.

The retirement spending cycle has been revealed in the periodic consumption studies done by the Department of Labor. Over decades these studies have revealed a consistent lifetime spending pattern, and spending patterns during retirement also are clear and consistent from the data. The studies were analyzed in a 2014 award-winning article by David Blanchett of Morningstar published in the *Journal of Financial Planning*.

Spending tends to steadily decrease during much of retirement. In fact, lifetime annual spending tends to peak sometime in the average person's 40s or 50s. After age 60, spending tends to decrease on average by a steady 1 percent annually after inflation. That means in current dollar terms the spending might increase because of inflation. But after adjusting for inflation, the real spending tends to decrease by about 1 percent annually. Spending might increase in the later years, due primarily to medical expenses and the need for assistance with daily activities. Blanchett describes this pattern as a "retirement spending smile."

The pattern is logical. When people retire they generally are still fairly young, healthy, and active. They have time to fill that used to be spent working. They also are likely to have a list of activities in which they want to engage that have been deferred because of work or the need to support their children. People also might move or make other significant changes in the early years of retirement that cost money.

As time passes, however, people will have engaged in some of those delayed activities. The novelty of retirement wears off, and they settle into routines. Also, as they age people become less active and could become less healthy.

In addition, the basket of goods and services consumed by a household is not steady during retirement. Most people don't incur the same percentage of their total expenditures on the same categories of expenses over time. It's not surprising that the amounts spent on pensions and insurance decline over time or that medical spending rises as one ages. People also tend to spend less on food as they age, but they give more to charity.

It's important to keep this lifetime spending cycle in mind both when estimating retirement spending and, more importantly, when developing a lifetime policy for drawing down assets.

Keep in mind that these patterns are averages. They differ for different households and for people in different financial situations. For example, Blanchett found households that begin retirement with lower spending than average tend to have lower declines over time than others. Also, households that began retirement with less money than they need to sustain their lifestyles tend to reduce spending at a faster rate than others. Financially secure people might reduce spending at a slower rate than average.

An interesting finding concerns households that are spending less in the first years of retirement than the data indicates they can afford. These households do increase spending from ages 65 to 75, but the rate of increase declines. These apparently are fiscally conservative households who are concerned about outliving their money. They place a premium on remaining financially secure, or perhaps their priorities are to leave legacies for their loved ones or charity.

It's possible that this real reduction in retirement spending is due to a recognition of financial constraints that weren't apparent at the start of retirement. It's also possible that it is a choice to spend more in the early years of retirement and to be less active and spend less as they age. The exact reasons for the spending pattern aren't clear from the data, but the pattern is clear and consistent over time.

Blanchett concludes, as I do, that traditional retirement models such as those that use the 4 percent rule overestimate the cost of retirement. Retirement plans should assume that most people will spend more in the early years of retirement when they are more healthy and active and less in the later years.

Another possible conclusion is that retirement assets might not need as much inflation protection as most plans assume. We learned in Chapter 3 that annuities can have inflation adjustments to protect purchasing power over time, but that inflation protection comes at a cost. The studies indicate that full inflation protection might not be necessary. A typical retiree might be better off owning some inflation-adjusted annuities and some that pay the same income for life.

Now, we'll look at retirement withdrawal strategies that assume spending is more dynamic and flexible than the 4 percent rule and traditional retirement models assume.

THE ENDOWMENT FORMULA

In *Retirement Watch* newsletter and in the first edition of this book, I introduced the endowment formula as a way of modifying the 4 percent rule. I patterned it after the spending formula used by the Yale University Endowment Fund.

A group of Yale's economics professors and its endowment officials developed the spending rule years ago. Under the rule, spending increases over time only as the markets allow. It also avoids overspending in good years and sharp spending reductions in bad years. In other words, the rule allows market performance to gradually influence spending but keeps market performance from causing sharp changes in year-to-year spending. Yet, it also ensures that the endowment will last as long as the university needs it. Spending adjustments are made automatically, but gradually.

Here's one way to adapt the Yale spending rule for your own retirement fund. First, decide the first year spending percentage of your portfolio. This is where the 4 percent rule studies can serve as a benchmark. You can use 4 percent of the nest egg as your first year spending. Or you can adjust it based on the shortcomings of the 4 percent rule. If you think circumstances when you retire indicate a higher rate will work, consider spending 5 percent or so the first year. If you're more cautious and concerned about future investment returns, select a lower first-year spending rate. Let's say you pick 5 percent. That's the amount you withdraw the first year of retirement.

After the first year, use a formula that divides the annual distribution spending into two portions to arrive at the amount to spend. The first portion is last year's spending plus whatever inflation was last year. Multiply this by 70 percent. The other portion is your target first-year distribution rate from the fund. Multiply this by 30 percent. Add the two numbers, and that is your distribution for the year.

Example

Suppose you have a $500,000 retirement fund. You set a 5 percent spending rule, your first-year spending was $25,000, and inflation was 2 percent. Here's how you do the calculations for the second year.

Last year's spending plus inflation is $25,500. Multiplied by 70 percent, that is $17,850. Five percent of your fund is $25,000. Taking 30 percent of that gives you $7,500. Add the two results, and you will take $25,350 from the fund the second year.

Now, suppose the portfolio declines to $480,000 for the next year, and inflation is 2 percent. One bucket of your spending will be $25,350 (last year's spending) increased by 2 percent, or $25,857. Take 70 percent of that to get $18,100. The other bucket is 5 percent of the fund's new value, or $24,000. Take 30 percent of that, or $7,200. Add the two and your spending is $25,300. You will have a small spending reduction to recognize the reduced value of your portfolio.

For comparison, under a fixed 5 percent plus inflation rule, you would have spent $25,500 the second year and $26,010 the third year.

The endowment spending rule is designed to make your fund last longer than under the strict percentage-plus-inflation rule, as an endowment fund is supposed to last forever. If your portfolio experiences a period of poor investment returns, distributions gradually will be reduced under this method, because 30 percent of the spending is based on the portfolio's value. Under the traditional spending formula, your distributions will increase each year regardless of what happens to your portfolio.

The endowment approach also means you are less likely to be deprived in good times, because if market returns exceed expectations, distributions will rise with the returns.

A benefit of this approach is that about 30 percent of many retirees' budgets tends to be flexible. You can defer purchases of new cars, clothing, and other things. Travel, recreation, and entertainment spending can be reduced. The exact amount of flexibility depends on each retiree's budget and spending patterns.

Because an individual's retirement fund doesn't have to last forever, unlike an endowment, you get additional flexibility. If bad markets cause spending to decline for several years in a row to the point that essential spending is being deferred, you can suspend the spending rule and dip into principal for necessary spending. The next year's spending would incorporate this, because 30 percent of the spending would be based on the fund's value.

Some spending strategies put a limit on the amount that distributions can change in any year and a floor on the amount they can be reduced over time. For example, a strategy might say that the distribution can't rise or decline more than 5 percent in one year or more than 20 percent from the peak. The limits on declines keep really bad markets from severely reducing your spending. But they also mean the nest egg might be spent down faster if poor investment returns persist for years.

A Summary of Other Strategies

There now are a large number of withdrawal strategies to consider for your nest egg. When I wrote the first edition of this book, there were very few. As the first baby boomers reached retirement age, more researchers developed ideas they tested with data. We won't discuss all the strategies in detail. Many were published only in the last few years and haven't been thoroughly tested by other researchers or real life. All try to address the shortcomings of the 4 percent rule while giving retirees spending strategies that deliver high probabilities of never running out of money without forcing a retiree to be overly frugal.

I've selected the ones I think merit your consideration.

Buy Immediate Annuities

In Chapter 3, I mentioned that some people should consider putting all or most of their nest eggs in guaranteed lifetime income products such as immediate annuities and longevity annuities. People who have saved just enough to fund their retirements and who don't think they can handle even short-term reductions in their net worths due to market actions should consider this. Also, people who are going to invest very conservatively anyway might find they have higher incomes if a large portion of their nest eggs is in guaranteed income annuities.

Buy a Ladder of TIPS or Other Bonds

This is a favorite of some economists. TIPS are Treasury Inflation-Protected Securities. These are treasury bonds that pay interest but the value of the bond principal is increased with changes in the Consumer Price Index each year. Your income doesn't change, but the purchasing power of your principal is protected. Eventually, the bond is redeemed for the amount you invested plus the inflation adjustments.

The belief of the economists is that you don't want to take any risk with the portion of your nest egg that will be used to support your standard of living. So, they recommend buying a ladder of TIPS. A ladder of bonds such as TIPS is when bonds are purchased so that a different group of bonds matures and is redeemed each year. They recommend buying a ladder of TIPS so that enough bonds mature each year to pay your estimated living expenses for the year. They recommend buying 30 years' worth of TIPS, with a different bond or set of bonds maturing each year. There is no interest rate or inflation risk from owning the bonds and holding them to maturity. Unlike buying annuities, this strategy leaves something for loved ones if you pass away before 30 years.

This strategy probably is theoretically correct but isn't practical in the real world. TIPS had extremely low interest rates in late 2015. They were so low that a person would have to have accumulated all his retirement spending before starting retirement and count on almost no investment income to help pay retirement expenses. You also take the risk of running out of money if your retirement lasts longer than 30 years.

Spend No More than a Fixed-Term Annuity Would Pay

This strategy was published by Laurence Siegel and Barton Waring, and they called it "The Only Spending Rule Article You Will Ever Need." The strategy is simple in principle but can be a little harder to implement.

Basically, they say you should spend no more each year than you would receive from purchasing a term of years annuity that year. A term of years annuity is one that pays a fixed annual amount each year for a certain number of years. After that number of years passes, the payments cease. You can calculate the amount by using a formula that requires you to plug in current interest rates each year. Or you can contact some insurers and determine an average of their payouts.

Let's say you want to assume a 30-year retirement period. (You can adjust this time period up or down.) The first year of retirement you determine what the payout would be from an immediate annuity that was guaranteed to pay the same amount every year for 30 years, assuming you used your entire nest egg to purchase the annuity. You spend no more than that amount the first year. The next year, determine how much income you would receive by purchasing a 29-year annuity with what remains of your nest egg. That's the amount you spend the second year. You go through the same exercise each year.

You're not buying these annuities. You're investing your nest egg as you believe is appropriate. The strategy is used only to determine the maximum amount you'll withdraw from the nest egg each year. Under this approach, your spending adjusts up or down each year based on the value of your nest egg and the latest interest rates. The major downside is that it anticipates depleting your nest egg after 30 years. Of course, you don't have to spend that amount each year. It is a calculation of the maximum amount you should spend. Another potential disadvantage of the strategy is that spending could be volatile from year to year as interest rates and the value of your nest egg fluctuate.

The 20–10 Strategy

This sounds like another strategy that assumes retirement lasts 30 years. In fact, it covers an infinite period after 20 years. You split the nest egg into two portions. One portion will pay for the first 20 years of retirement. The other portion will pay for whatever period you live after 20 years. Any of the other strategies discussed in this chapter can be used to determine spending for the first 20 years of retirement. The difference is that in this strategy that portion of your nest egg has to last only 20 years, not for an unknown number of years that could be 30 or even well beyond 30 years. A conservative person could buy a ladder of TIPS that mature each year for 20 years. A more aggressive person could invest the nest egg and take withdrawals each year to fund spending. Your goal is for that portion of your nest egg to last for at least 20 years.

The other portion of your nest egg is used to buy longevity annuities that will begin paying income after 20 years. You need to deposit enough in the annuities to generate income that will cover your estimated expenses each year after year 20.

Under this strategy, there won't be anything for your heirs unless the first portion of your nest egg isn't spent during the 20 years or you have some life insurance.

This approach gives peace of mind to some people. They aren't worrying about making their nest eggs last for a lifetime. They know that if they live more than 20 years in retirement, they'll have a steady stream of income for the rest of their lives. Also, by purchasing the annuities 20 years in advance, the annuities are relatively inexpensive.

Follow the IRA Rules

The tax code requires a minimum amount to be distributed from IRAs after age 70½, as we discuss in detail in Chapter 8. You can use this same formula to decide on the maximum amount to be withdrawn from your nest egg after retiring. As you'll learn in Chapter 8, the required minimum distribution (RMD) formula increases the percentage of the IRA distributed each year, so there's a built-in inflation escalator. The formula also always leaves some amount unspent almost no matter how long a person lives. Some who favor this approach say it produces similar results to the 4 percent rule.

The RMD rules, however, weren't designed for this purpose. They were designed to ensure an IRA is close to empty after a person's lifetime and to limit what can be passed on to the next generation. The distribution pattern doesn't follow most people's spending patterns. In fact, it is the opposite of the retirement spending pattern most people have. A complaint many people have with RMDs is that it increases distributions steadily as they age, forcing them to take distributions they don't want or need. Using the IRA rules is a good way to ensure your nest egg lasts a long time, but it doesn't do a good job of matching the distributions to your likely spending.

Spend a Fixed Percentage of the Portfolio Each Year

This is a hybrid of the 4 percent rule and the Endowment Strategy. You choose a beginning spending percentage such as 4 percent. You spend up to that percentage of the portfolio each year. The difference is that you don't make any adjustments. Whatever the portfolio's value is at the end of a year, your maximum distribution for the next year is 4 percent of that amount.

A nest egg is likely to last longer under this strategy than under the 4 percent rule, because it doesn't have the regular increases for inflation. Also, the spending changes automatically with fluctuations in the market value of the portfolio. There's an automatic reduction if the portfolio tumbles and automatic increases if markets do well. Also, because there aren't automatic inflation increases, the strategy allows for a higher first-year spending rate than the 4 percent rule.

A potential problem is that the changes in the maximum spending amount are likely to vary greatly from year to year unless the portfolio is invested to remain fairly stable. A traditional portfolio that is 60 percent in stocks and 40 percent in bonds is likely to have wide swings in value from year to year.

Add a Floor and Ceiling

This is a supplementary strategy that can be added to almost any of those already discussed but was first developed as an improvement to the fixed percentage strategy discussed immediately above. It can reduce the fluctuations in allowable spending and also allow a higher first-year spending rate.

You smooth fluctuations in the maximum spending amount by creating rules that don't allow the spending to vary more than a maximum amount each year. For example, For example, you might say in any year spending can't rise or fall more than 10 percent from the previous year. You could also say spending can't fall more than a fixed percentage below the first year's spending. The wider the floor and ceiling, the less likely you are to run out of money. The tighter the floor and ceiling, the less fluctuations there can be in spending but the greater the risk of spending too much too soon. There are many variations of floor and ceiling strategies, and some researchers developed some detailed formulas for setting the limits.

Other distribution strategies have been proposed in recent years. Some of these have high probabilities of success, but that have fairly detailed rules. Most individuals probably would be unable to follow the strategies, especially as they age, and would need the strategies to be implemented by financial planners who are proficient with the strategies.

SUMMARY

Keep in mind that your investment strategy is a key factor in how successful your withdrawal strategy is. When your investment strategy doesn't come close to meeting your target rate of return, the portfolio is going to diminish faster than anticipated. Also, when the investment strategy causes the portfolio's value to fluctuate greatly from year to year, the maximum distributions are going to fluctuate if you use a flexible formula. A volatile portfolio also means that as you track the success of your strategy, the likelihood of success is going to change a lot from year to year.

No spending formula or plan is perfect. You want to develop a plan that is flexible, recognizes changed circumstances, takes emotions out of the process, and makes gradual changes. I think it is important for a withdrawal or spending rule to make adjustments as the market value of a portfolio changes, but the adjustments should be gradual or smoothed. The endowment formula meets these goals. It also gives you an edge by increasing the likelihood that your fund will outlast the worst markets. Several of the other strategies also provide flexibility with smoothing.

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CHAPTER 4: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **All of the following are correct regarding the safe spending rate <u>except</u>:**

A. it is also commonly referred to as the 4 percent rule

B. the studies that created the safe spending rate assumed the portfolio earned a steady average rate of return each year

C. the studies that created the safe spending rate system accounted for the sequence of returns risk

D. the safe spending rate system has some key limitations

2. **Which of the following is generally true regarding spending during retirement:**

A. spending increases during retirement

B. spending will fluctuate wildly year to year in retirement

C. spending tends to steadily decrease during retirement

D. retirement spending is static

3. **Which of the following is correct regarding the endowment spending rule:**

A. it is based on the Harvard University Endowment Fund

B. the endowment spending rule is designed to make your fund last longer than under the percentage-plus-inflation rule

C. the endowment spending rule ensures that a retiree's distributions will increase each year regardless of what happens to their portfolio

D. a benefit of the endowment spending rule is that about 70 percent of many retirees' budgets tends to be flexible

4.	**Treasury bonds that pay interest while the value of the bond principal is increased by the Consumer Price Index each year are called:** **A.** EE savings bonds **B.** Treasury bonds **C.** Treasury Inflation-Protected Securities (TIPS) **D.** Treasury notes

CHAPTER 4: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Another name for the safe spending rate is the 4 percent rule. **B.** CORRECT. Most retirement plans prior to the safe spending rate studies assumed a steady average rate of return each year on portfolios. The studies that led to the creation of the safe spending rate did not assume a steady average rate of return. **C.** Incorrect. The researchers realized the danger of the sequence of returns risk. While investments have long-term average annualized rates of return, they do not return the average each year. **D.** Incorrect. There are shortcomings to the safe spending rate. In some cases the rule is too optimistic, and in other areas it is too conservative. *(See pages 84 to 85 of the course material.)*
2.	**A.** Incorrect. Spending can indeed increase at the beginning of retirement, but typically does not increase the further you progress in retirement. **B.** Incorrect. Spending may sometimes fluctuate, especially when health costs are incurred, but generally speaking this is not the spending arc of a traditional retirement. **C.** CORRECT. Generally speaking, retirees spend less as their retirement progresses. **D.** Incorrect. Spending is generally not static through the course of a retirement. *(See page 86 of the course material.)*
3.	**A.** Incorrect. The endowment spending rule is based on the Yale University Endowment Fund. **B.** CORRECT. The endowment spending rule is designed to make your fund last longer than under the strict percentage-plus-inflation rule, as an endowment fund is supposed to last forever. **C.** Incorrect. Under the traditional spending formula, a retiree's distributions will increase each year regardless of what happens to their portfolio. **D.** Incorrect. A benefit of the endowment spending rule is that about 30 percent of many retirees' budgets tend to be flexible. *(See pages 88 to 89 of the course material.)*

4.	**A.** Incorrect. EE savings bonds are a secure savings product that pay interest based on current market rates for up to 30 years. **B.** Incorrect. Treasury bonds pay interest every six months and mature in 30 years. **C.** **CORRECT**. TIPS are the treasury bonds that pay interest, and the value of the bond principal is also increased with changes in the Consumer Price Index each year. **D.** Incorrect. Treasury notes are government securities that are issued with maturities of 2, 3, 5, 7, and 10 years and pay interest every six months. *(See page 90 of the course material.)*

CHAPTER 5: MANAGING YOUR NEST EGG

Chapter Objective

After completing this chapter, you should be able to:

- Identify various retirement strategies.

Most investment plans for retirees and preretirees are wrong. They aren't likely to deliver the risk-adjusted returns or income the investor needs to fund spending during the post-career years. Some don't have enough inflation protection or take too much stock market risk for someone in or near retirement.

At this point, you have estimated retirement spending and determined how much income to receive from guaranteed sources of income. You also set a policy for withdrawing money from the part of your nest egg that doesn't generate guaranteed income, your investment portfolio. You're going to review that withdrawal policy regularly and adjust it as necessary to make your nest egg meet your goals.

The next step is to learn how to manage your investment portfolio. You need an investment plan and strategy that will complement the withdrawal strategy. The withdrawal strategy assumes a minimum investment return or income yield. That goal must be met for the nest egg to last long enough to supplement your guaranteed income for life and meet any other goals you have, such as leaving a legacy for loved ones.

The investment needs of retirees and those nearing retirement historically received little attention from either the financial services industry or academics who studied investing. For the first generation or so of retirees that didn't matter. Most of their income came from guaranteed sources, and they didn't live long in retirement. They followed a traditional retirement investment strategy, which we'll discuss shortly, that was safe and generated sufficient income. More recently, that strategy hasn't worked well. Retirees and near-retirees generally had to develop their own strategies or use strategies meant for younger people and hope they worked. Only in the last few years has the unique situation of those in or near retirement been addressed by the industry and academics.

Several useful investment strategies were developed in recent years for retirees and near retirees. First, we'll review some traditional strategies and explain why they aren't suitable or optimum for this group of investors. Then, we'll present an overview of some approaches to investing that are likely to help people meet their goals.

THE CLASSIC ADVICE

The investment advice for retirees used to be simple. As retirement approaches, the portfolio should be shifted from riskier investments—such as stocks—into safer, income-producing investments—such as annuities, bonds, certificates of deposit, money market funds, and some dividend-paying stocks. The theory behind this advice also was simple. A retiree needs regular income to pay expenses. A retiree also does not want the principal of the portfolio to fluctuate as much as stocks do. That's why, according to this advice, a retiree wants a portfolio that pays income and maintains a reasonably stable value.

The strategy made some sense when the average retirement lasted about five years, as it did for those who were in the first generation of retirees. It also made sense when interest rates and dividend yields were much higher than they are now. Also, for those early retirees an investment portfolio was a mere supplement to Social Security and employer pensions.

Things are different now.

The traditional retirement investing strategy is made more difficult by the very low interest rate policy that Federal Reserve has followed most of the time since 2001 and especially since 2008. It's tough to generate sufficient income from an investment portfolio when yields on the safest investments are near historic lows, and yields on investments with much greater risk and volatility aren't much higher.

Other factors also work against the traditional retirement investment strategy.

As we discussed, retirement can last a long time now, 20 years or longer. The key problem over this time is inflation. The purchasing power of income declines steadily over time. Even a low inflation rate will eat away at the purchasing power of income each year. Over 10, 20, or 30 years, the compounding of that inflation will dramatically reduce the income's purchasing power. The purchasing power of the principal also will decline. To maintain purchasing power in the face of inflation, both the income and principal have to increase by at least the inflation rate each year. To maintain the purchasing power of $40,000 when inflation is only 2 percent annually, after 15 years more than $53,000 of income is needed. When inflation is higher, even higher returns are needed to preserve purchasing power.

For a retirement plan to be successful, purchasing power must be maintained over an extended period. Preserving purchasing power requires growth in both the income and the principal, neither of which is likely under the traditional strategy in today's conditions.

The classic investment advice for retirees makes sense now in only a few circumstances. The classic strategy can be used if retirement is expected to last five years or less so that the effects of inflation and changing interest rates would not be severe. The strategy also can work if the income from the portfolio exceeds the amount that must be spent, so that the excess can be reinvested. If inflation is 3 percent annually, an amount equal to 3 percent of the portfolio should be reinvested to maintain the purchasing power of the principal and the income. If the portfolio returns 5 percent when inflation is 3 percent, up to 2 percent can be spent and the rest should be reinvested. The classic strategy also can work when there are other sources of income that will help overcome the loss of purchasing power over time.

INVEST LIKE THE REST

The advice most frequently given to retirees and preretirees the last couple of decades was to invest like everyone else. Don't change the portfolio as retirement approaches to invest for income and safety. Instead, continue to hold a diversified portfolio of assets and invest for total return (income and capital gains) without regard to how much income (interest and dividends) the portfolio generates.

The income produced by the portfolio is spent. When additional cash is needed to pay expenses, some shares of a stock or mutual fund are sold to generate the cash needed. It doesn't matter whether a person is spending income, capital gains, or principal, as long as the total return of the portfolio over time at least meets the target in the retirement plan.

Some versions of this strategy went as far as to say the portfolio should own only stocks. Stocks have the highest long-term return, so they are the assets most likely to make the investor financially secure. Short-term changes in the value of the portfolio don't matter, as long as the long-term return goals are met. Most versions of the strategy recommend that an older person own a lower percentage of stocks than a younger person, but a healthy percentage of the portfolio still is in stocks.

As we discuss in more detail shortly, a modern "diversified" portfolio looks diversified on paper, but the returns and volatility of the portfolio are heavily tied to the stock market indexes. For many portfolios, 90 percent or more of the volatility and returns depend on the action of major stock indexes.

Being tied to the stock market can cause major problems for investors in or near retirement. Stocks can have severe price declines in any year, and they also have extended bear markets in which they lose substantial value and don't recover that value for years. It is difficult for someone who depends on that portfolio to maintain a standard of living for decades to adhere to the investment strategy when it is losing substantial value. Many people who try to follow such a strategy will change their minds and sell all or most of the stocks at an inopportune time.

Another and more significant problem with the strategy applies to those who stick with it. We discussed in Chapter 4 the importance of sequence of returns risk. Suppose a person enters retirement with a traditional portfolio that is highly correlated with the stock market indexes. That person's retirement goals are in jeopardy if a long-term bear market begins near the start of the person's retirement. While the portfolio's value is down, the retiree still has to withdraw money from it to pay expenses. That money is no longer in the portfolio to benefit from the eventual rebound in the investments. That's why a traditional portfolio is more risky for someone in or near retirement than for a younger person.

In Chapter 4 we mentioned the study from mutual fund firm T. Rowe Price that demonstrated a person who retired in 1968 when a bear market was in its early stages would run out of money before the next bull market began in 1982. That's the result of the combination of a decline in a portfolio's value coupled with the portfolio owner's need to withdraw money from the portfolio to fund retirement spending.

Buying-and-holding for the long-term can be a good strategy for a young person who has a career of 30 or more years ahead to be followed by a retirement of 30 or more years. But it is dangerous for someone who already lived most or all of that career and now is looking at leaving the workplace and depending on the portfolio to help finance spending for the rest of his or her life.

Research shows that the most critical investment years for a retirement plan are the 10 years that begin five years before retirement and end five years after retirement. During this period, the nest egg is likely to be at its highest value, and the retirement plans are based on that value. A substantial decline in the portfolio's value during this period is going to reduce its dollar value by a much larger amount than would be the case in the earlier years. The decline also is a more serious setback to the retirement plan, since the plan is based on starting retirement with that higher value. It will take the portfolio a while to recover those losses. In addition, the retirement plan usually assumes the portfolio will continue to earn positive returns and grow to a higher value the next few years. So, the portfolio's value is far behind what was anticipated in the retirement plan and could fall farther behind.

After a person or couple has been retired for more than five years, a portfolio decline has less serious consequences if the portfolio continued to meet its goals during the first five years of retirement. There now is more of a cushion to ride out the losses. The portfolio owner also has become more comfortable living without a steady paycheck, has more confidence in the plan, and is more likely to stay with the overall strategy.

For these reasons, approaching retirement with a portfolio that is strongly correlated with the stock indexes can be dangerous. If stocks have a bear market at that time, the retirement plan might need serious adjustments. At a minimum, the prospective retiree is likely to suffer increased anxiety and reduced confidence.

TWO PORTFOLIO ANCHORS

Before we discuss specific investment strategies for those in or near retirement, there are two other strategies that should supplement any investment strategy. These strategies provide an additional level of protection and safety. They make it easier for an individual to adhere to an investment strategy during periods when it isn't working. They also allow an investor room to take additional risk with the rest of the portfolio and with that additional risk comes the potential for higher returns.

The Safety Fund

The first strategy is to establish a spending or safety fund.

The fund is established by setting aside an amount of cash equal to the anticipated expenses for the next one to five years. The time period is selected by the retiree and depends on how conservative he or she wants to be. A conservative person who wants to be on the safe side would have a spending fund covering up to five years of spending. Someone who isn't as concerned about market fluctuations would establish a one- or two-year fund.

To determine the size of the fund, take your total expected expenses over the period and subtract the amount you expect to be covered by guaranteed lifetime income. Then, you sell enough investments to produce cash equal to the rest of the anticipated expenses for the period. This cash is put in safe, liquid investments. Possibilities are a money market fund or short-term bond fund. You also could put the money in short-term bonds or certificates of deposit if you buy a ladder of the investments so that they mature at different times over the selected time period.

You're not trying to earn a high yield or investment return from the money in this bucket. You want the principal to be safe so that you know you don't worry about having enough money to cover expenses for the time period. You aren't planning to live off the income from this fund; you're going to spend both principal and income. You pay bills with cash from the spending or safety fund.

The advantage of the fund is that you are less likely to worry about short-term fluctuations in the investment portfolio, or even intermediate-term fluctuations. You know there is cash readily available for your expenses over the time period covered by the fund. That should make you less likely to be concerned over a decline in your portfolio or the markets and less likely to overhaul your investment strategy during a bad market period. The fund has the dual effects of allowing you to sleep easier at night and making you less likely to overreact to a change in the markets.

With the spending fund, you also don't have to assess your portfolio each month and decide which assets you're going to sell to raise cash for expenses.

A disadvantage of the strategy is that the money in the spending fund is likely to earn lower returns than the rest of your portfolio. That could lower the long-term return for your investments, which is the usual cost of reducing risk.

After establishing the safety fund, periodically you sell investments from the invested portion of your nest egg to raise cash for the spending fund. There are a number of ways to replenish the fund; you should select the one that works best for you.

You could decide to move cash from the investment portfolio to the spending fund at the same time each month. Some people make the transfer less frequently but still on a calendar schedule: every 3 months, 6 months, or 12 months. Whatever timetable you select, you review the investment portfolio on that schedule and decide which investments should be sold.

Another approach is to let the markets tell you when to make moves. After an investment has had a period of good appreciation, it probably is a higher percentage of your portfolio than planned. You should rebalance the portfolio as part of your regular strategy. You can rebalance the portfolio by selling some of the investment and putting all or some of the cash proceeds in the safety fund. Or after an investment has declined in value and shows a paper loss, consider selling it to take advantage of the tax deduction from the loss and put all or some of the proceeds in the spending fund.

Tax planning probably should have a role whichever approach you take. Income taxes are a major expense for many retirees. You want to plan your asset sales to keep taxes on your investments as low as possible.

As a practical matter, you probably hold investments in different types of accounts: taxable accounts, traditional IRAs, Roth IRAs, and perhaps others. For tax reasons you might not want to have one safety fund. For example, you might sell some investments in the traditional IRA and move them to a money market fund within the IRA. That way, you aren't taking the amount out of the IRA and into gross income until you plan to spend it. Instead of one safety fund, you might have different safety funds within the different types of accounts you own. The total value of the funds equals what would be in one safety fund.

This strategy often is called the buckets or silo strategy. You have at least two investment buckets or silos. One bucket is for short-term spending and investing. The other bucket is your longer-term positions.

Some financial advisors have elaborate and detailed bucket strategies. They establish multiple investment buckets for different time periods. The buckets for the next few years are invested in safe, conservative assets. Investments for intermediate periods, such as 5 to 10 years away, can take a little more risk but still have a high level of safety. These buckets might be invested in intermediate term bonds and similar investments. The buckets that aren't likely to be spent for 10 years or longer can be invested in riskier assets such as stocks, because the short- and intermediate-term fluctuations shouldn't matter. Those buckets can try to earn higher returns. To pursue one of the more elaborate bucket strategies you probably should use a financial advisor who uses the strategy.

Having Guaranteed Lifetime Income

The other strategy we discussed in Chapter 3. It involves depositing a portion of your nest egg in immediate or longevity annuities to generate guaranteed lifetime income.

In Chapter 3, we discussed the advantages of knowing your fixed expenses will be covered by guaranteed income for life. There are additional benefits to having this guaranteed income. Various studies have demonstrated that having immediate annuities or similar assets as part of a nest egg can make the nest egg last longer. There's never a risk of running out of money, so the guaranteed income can be more effective than bonds or similar investments. In addition, the security of the guaranteed income allows you to take more risk with the rest of the investment portfolio. If this risk-taking is successful, the result can be higher investment returns and more money to either spend during retirement or leave as a legacy to loved ones or charity.

BETTER WAYS TO BUILD RETIREMENT PORTFOLIOS

There are many different investment strategies. Of course, they're not all appropriate for investors in or near retirement, and some aren't appropriate for most investors. There are three broad categories of investment strategies that can be used successfully by retirees and those near retirement. The details of implementing these strategies can vary, but the basic elements should be the same as I describe in the following sections.

The High-Yield, Income-Growth Strategy

This strategy was quite common from the early days of the stock market until it began to fade in popularity in the 1960s and 1970s. It still can be effective today, and it might become more popular as investment markets change.

It wasn't too long ago that common stocks had fairly high dividend yields. In fact, stocks of quality companies often had dividend yields that were higher than the yields on their bonds. Retirees and those who wanted to invest for safety would buy common stocks. They weren't too concerned with fluctuations in the prices of the stocks. They simply wanted the dividends. Stocks of high-quality companies would have dividend yields of 5 percent and more.

There's a hidden advantage to investing in dividend-yielding stocks. Companies that pay regular dividends usually increase the dividends and do so on a regular schedule when they can. This is a significant advantage over bonds and other income investments. You need to maintain the purchasing power of your income over time, and a good way to do that is to have the income increase. Regular increases in dividends are an easy, low-risk way to increase your income over time. There are a number of companies that have issued regular dividends for many years and increase those dividends every year or almost every year.

Dividend investing fell out of favor for several reasons:

- *Investors became more interested in the growth of stock prices than in the income stocks could generate.* The post–World War II economic growth was an obvious cause of this. Rapid growth in the economy resulted in rapid growth in stock prices.
- *Changes in corporate and tax policy also were factors.* Corporations can't deduct dividends but can deduct interest payments. It made more sense to many corporate managers to retain their cash and even borrow to fund operations. Let investors benefit from rising stock prices instead of dividends. In recent years, more and more public companies have been borrowing money and using the loan proceeds to buy back their own stock instead of to issue dividends. Buying back stock causes the earnings for each of the remaining shares to increase, and the interest on the loans is deductible. Another factor that diminished the desire for dividends was that for much of the time dividends were taxed the same as ordinary income. Investors were able to keep only a portion of dividend income, so they favored capital gains over dividends. In recent years, dividends were given the same preference as long-term capital gains, increasing the popularity of dividends among investors.
- *As investors age, they shift away from stocks.* As the baby boomers enter or approach their retirement years, more investors have been interested in safety and income than capital gains.

You should consider investing a portion of your nest egg in common stocks that pay decent dividends, especially stocks of companies that have long histories of increasing their dividends.

Some investments other than stocks have high yields and income that increases over time. The strategy can be expanded beyond stocks to real estate investment trusts, master limited partnerships, closed-end funds, and some other investments. Many of these vehicles are focused on providing high levels of income to their investors, and having the income increase over time also is a priority.

The strategy is not for trading stocks or even seeking high returns. The goal is to generate income and preferably income that increases over time. To implement this strategy successfully, you have to be unconcerned about the short-term changes in the prices of the investments, whether they are common stocks or other vehicles. Your primary reason for investing is income, and you plan for the income to fund your retirement spending. The prices of the investments will fluctuate. Over time, the prices should increase, but over shorter periods and perhaps longer periods they could decline. You have to understand this and accept it before starting the strategy.

True Diversification

"Buy and hold" has been the mantra of many investment advisors for some time. Most investors were educated to have a buy-and-hold portfolio with all or most of their assets. There are good reasons for buying and holding. Most investors don't make good decisions about when to buy and sell different assets. It's better to endure the ups-and-downs of the markets when you know in advance that you're a long-term investor and will ride the market fluctuations. Simply set up a long-term portfolio that takes a level of risk you can tolerate and is likely to meet your return goals.

Unfortunately, many investors who followed a buy-and-hold strategy since the late 1990s aren't happy. Their portfolios have been more volatile than they expected, and their returns aren't close to meeting their goals.

A buy-and-hold strategy can work. It's a good solution for people who aren't trained in finance and investments or who don't want to spend much time following their portfolios.

The problem isn't with the policy of buying-and-holding a fixed allocation. The problem is that the investment allocations in most buy-and-hold portfolios aren't suitable for long-term holding, especially by someone in or near retirement.

Most portfolios that appear to be balanced or diversified in fact are heavily correlated to the stock market indexes and require strong stock market returns to meet their goals. For example, a portfolio that is 60 percent stocks and 40 percent bonds has about a 98 percent correlation with a 100 percent stock portfolio. Because equities are much more volatile than bonds, the equities drive both the volatility and the total returns of the portfolio. (One study found that a 90 percent stock and 10 percent bond portfolio had returns and risk similar to the 60–40 portfolio.) Such a portfolio is most suitable for a period of strong, positive economic growth and declining interest rates. Or it can be used by someone who is relatively young and can ride out the ups and downs of the stock indexes. If you own one of the traditional buy-and-hold portfolios and in the 10 years before retirement or early in retirement you encounter a long-term bear stock market or even a mediocre equity market, you'll have a problem funding retirement. You won't meet your investment return goals, and that will require adjustments to your spending plans. Certainly in the years since 2000 the traditional buy-and-hold portfolios haven't worked well for many people.

I don't think you want your investment results and quality of your retirement to depend on having the good fortune that the economy and stock markets are in the ideal environment during those important years before and in the early part of retirement. You can avoid that risk by putting together your buy-and-hold portfolio the right way, so that it has what I call *true diversification*.

As I said, the typical buy-and-hold portfolio is heavily dependent on stocks. The portfolio might hold a number of different mutual funds and perhaps other investments, but most of the investments rise or fall with the stock indexes and the entire portfolio will rise or fall with stocks. In investment geek-speak, the investments are highly correlated with stock indexes. More than 90 percent of the returns and volatility of the typical "diversified" buy-and-hold portfolio are tied to the stock market indexes. A long-term stock bear market means an extended period of low or negative returns for such a portfolio. A volatile stock market means a volatile portfolio.

Buy-and-hold investing can work in almost any economic and investment environment when the portfolio has true diversification. The portfolio can't be overweighted to stock market risks and returns. The portfolio should be equally balanced among different risks instead of being dependent on the stock market.

There are different ways to identify the risks you want to balance, but I believe the portfolio should be balanced among investments, strategies, and funds that do well in different economic environments. The major mistake many people make when putting together a buy-and-hold portfolio is they don't consider diversification among different economic environments.

The major influences on investments over periods other than the short term are inflation and economic growth. These factors can either rise or fall. You want investments that do well in each of the possible environments: rising growth, falling growth, rising inflation, and falling inflation. As I said, there are different ways to approach and implement this concept. The idea of balancing risks or drivers of performance is what's important.

Another mistake investors make is to balance investments based on the capital or dollar allocations. That's a mistake because investments have different levels of volatility, or risk. Stocks are the most volatile investments. Bonds aren't very volatile, especially when compared to bonds. A portfolio with true diversification balances the risk or volatility of the investments that do well in each economic environment. You want roughly equal volatility of the portfolio allocated to each investment, not equal amounts of capital. A high volatility investment such as stocks will have less capital allocated to it than a low-volatility asset. You want less capital in the investments with a lot of volatility, such as stocks and commodities, and more capital in low volatility investments. That way, the portfolio should do well in almost any environment and the volatility will be consistent over time.

In addition to having low correlations with the major stock indexes, the investments in a portfolio with true diversification also should have low correlations with each other. This will occur naturally if you consider each economic environment and make sure you have at least one investment that does well in that environment.

The result is that the swings in the portfolio's value are less dramatic and are smoother than for a traditional portfolio. The value of your nest egg won't rise as much in a strong stock market rally, but it won't decline nearly as much in a bearish stock market. You'll recover your losses more quickly than in the traditional portfolio. The portfolio will grow more smoothly and steadily than the traditional portfolio.

The key to higher long-term returns is to avoid large losses. It takes a lot of time and large positive returns to make up major losses. You're better off avoiding the large losses and accepting lower returns in strong stock markets. The result will be long-term returns similar to or higher than those of a traditional portfolio and with less volatility and uncertainty. You'll have higher risk-adjusted returns. That means you earn higher returns for the level of risk you're taking than in a traditional portfolio.

You achieve true diversification and its benefits by adding more types of investments and strategies than are in the traditional portfolio. You want some investments that do well when growth is rising, and some when it is falling. You also want investments that increase when inflation is rising, and some that increase when inflation is falling.

As I said, there are different ways of implementing this strategy. It was pioneered by the hedge fund firm Bridgewater Associates with its All Weather portfolio™. The Bridgewater offering is available only to institutional investors and now is closed to most of them. Others who adapted the strategy usually call it a Risk Parity strategy. Individual investors can build their own versions using mutual funds or exchange-traded funds.

Dynamic Investing for Risk Management

A buy-and-hold portfolio is not for everyone. Some people want to seek higher returns by investing in primarily investments they believe are likely to perform well for a while. Other investors don't want to suffer through significant declines in a portion of their portfolios, even if the declines are temporary. They want to reduce or eliminate investments with the most risk.

Dynamic portfolio management, or tactical asset allocation, can be effective for many investors. You can reduce risk and increase returns through effective management of your portfolio. But there are several caveats to this endorsement. I'm not recommending day trading, market timing, or a strategy with frequent portfolio shifts. I also don't recommend trying to earn the highest returns or locate the next hot investment.

When dynamically managing your portfolio, you're engaged in risk management. Higher long-term returns follow naturally when you manage the portfolio to reduce or eliminate risks you don't want to take, such as owning a lot of stock market positions after stocks have had a strong run and are highly valued. Remember, a key to strong long-term returns is to avoid large losses.

Another caveat is that most people need support and guidance to invest dynamically. One way to obtain this help is to invest in one or more mutual funds that invest dynamically, delegating the decisions to the fund managers. You also could have an investment manager handle your portfolio. Other sources of help with dynamic investing are newsletters and websites. My point is that unless you're involved in the markets regularly, you should obtain help from one or more sources who are experienced with the strategy before using dynamic investment management.

Most people who consider dynamic investing assume it's for investors who are seeking total return or long-term capital gains. But investors seeking primarily income also can benefit from dynamic investing. In fact, I recommend the strategy for income seekers. There is a wide array of income investments to choose from: treasury bonds of different durations, investment grade corporate bonds, high-yield corporate bonds, emerging market bonds (both sovereign and corporate bonds), international bonds, preferred stock, master limited partnerships, floating rate debt, high dividend yield stocks, real estate investment trusts, and closed-end mutual funds that invest in any of the preceding and might use leverage to increase yields.

Income portfolio strategies these days usually fall into two categories. One set of portfolios is filled with the traditional mix of bonds that, when added together, aren't much different from a bond index fund. In recent years, that meant you're earning a low yield, have little or no inflation protection, and watch your principal move up and down in the opposite direction of interest rates. You're at risk of losing a lot of principal when interest rates rise and a lot of purchasing power when inflation rises.

The other category of income portfolios seeks the highest yields. Advertisements will boast of yields of 10 percent, 12 percent, and more, even in today's low interest environment. You don't earn those kinds of yields without taking a lot of risk. You have to invest in securities of financially troubled companies, use leverage, or employ other aggressive strategies. Too often these types of investments suffer losses that exceed the additional yield they paid.

Each of those strategies will work well in a particular market environment and then blow up when the environment changes.

They aren't strategies you can rely on.

A better approach to consider is to invest for high income but also use a dynamic strategy. Since higher-income investments are highly volatile when the economy and markets change, you want to adjust the portfolio periodically.

Just as with other portfolios that use dynamic investing, risk management should be the guiding principle of your dynamic income portfolio. You want to sell or reduce investments that appear to be highly valued or have a high level of risk. You want to add or increase investments that appear to have lower risk and a good potential for appreciation or income. Always seek investments that appear to have a margin of safety. You also should use diversification and balance. No matter how confident you are of a particular market or economic outcome, don't have the portfolio 100 percent dependent on that outcome.

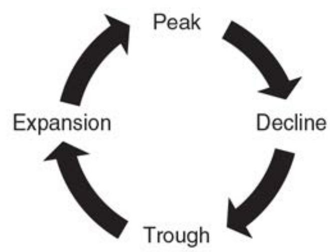
Your dynamic income portfolio won't be restricted to the safest investments. At times, you'll buy investments that are historically risky and you don't want to hold for the long term. You'll buy them when they appear to be low in price and carry less-than-usual risk. In addition, risky investments can be balanced with other investments. A portfolio overall is less risky when you pair investments that separately are risky but aren't correlated with each other. Also, by managing the portfolio dynamically you are able to sell investments when their level of risk is above average and invest the proceeds in less risky investments. You make changes as the valuations and risk of the investments change.

How to Manage Your Portfolio Dynamically

Whether you invest for total return or income, you can use a dynamic investment strategy. Dynamic investing is not market timing. You don't make frequent trades in the portfolio, though you do make periodic changes. The intent is not to try to capture short-term trends in the markets or to respond to the latest headlines and market noise. Instead, the strategy is to sell assets that are overvalued and buy assets that are undervalued or that are likely to benefit from what seems to be the next phase of the valuation cycle. I recommend taking a one-year to three-year outlook when making portfolio adjustments.

The valuation cycle is the most important and most overlooked factor in investment success. Each asset has a long-term cycle during which investors swing from extreme optimism to extreme pessimism and back. Because of that, you can refer to this as the sentiment cycle instead of the valuation cycle. In U.S. stocks, a full cycle can take decades, and there are shorter cycles within the full cycle. For other assets, the cycle might be shorter. The valuation cycle exists for all investments and subsectors of investments. All of us have seen this in action. We know that there will be extreme bull and bear markets for each asset in each generation. We also know that at the same time some investments will be in bull markets while others are in bear markets.

It is important that investors who aren't using a true diversification strategy recognize the valuation cycle and manage their investments with an eye on it. At a minimum, watching the cycle enables an investor to reduce holdings of assets that are in the extremely optimistic phase. That reduces risk and reduces losses when the cycle begins its path toward extreme pessimism.



An investor can't determine the exact top and bottom of a cycle in advance and shouldn't try. What is important is to capture the intermediate trends. An investor who can capture some of the good intermediate trends and avoid some of the bad trends will increase long-term returns with less risk.

As already discussed, in a dynamic strategy you aren't seeking the next hot investment. Instead, the approach should be to reduce risk by limiting exposure to investments that seem overvalued and at risk of tumbling. Eliminating the high-risk assets and seeking those with lower risk automatically avoids the likely big losers. It also positions the portfolio in the assets that are likely to do well over the next few years. The strategy reduces the risk and volatility of the portfolio.

It is not easy to call the turns in a valuation cycle, whether one is trying to call the long-term cycle or the intermediate turns. Identifying turning points isn't any easier for income investments than it is for stocks. You need to use several tools when dynamically managing a portfolio. You need to use more than one factor to determine which investments to buy. Many investors like to identify one valuation factor or other data point to make investment decisions. It's a bad idea. No single piece of data has a strong enough record of accuracy to use it this way. You have to use a number of different factors together and make a decision only when most of them are saying the same thing. Even then, you're likely to make some moves that are on the wrong side of the markets. The best investors carefully track their investment moves and calculate the results. Even the very best find that they are wrong about one third of the time. So, don't expect all your investment moves to be winners.

I recommend using a combination of valuation measures and momentum. Valuation measures show you whether the current price of an investment is high or low relative to historic prices. The better valuation method to use depends on the investment, and no valuation measure is a precise guide to buying and selling. They only indicate whether the value is relatively high or low. An investment can continue at an extreme valuation for some time before turning. That's why I say don't try to pinpoint tops and bottoms. Momentum measures, such as moving averages, indicate whether an investment's popularity is increasing or decreasing. They give you an idea of whether an investment trend is beginning, accelerating, or slowing. Watching momentum helps you avoid buying or selling an investment too soon, which is likely to happen if you use only valuation measures. The risk of momentum measures is that momentum can change very quickly.

Because neither valuation nor momentum signals are precise, it's important to monitor an investment after buying it. Be prepared to conclude that a move was a bad idea and should be reversed.

Also, in dynamic investing, you need diversification and balance to limit the effects of mistakes. The asset you believe has the most potential will be the largest portion of the portfolio, but other investments also should be included.

This has been a brief summary of the key principles of dynamic investing. There are books, newsletters, and websites that describe in detail different approaches to dynamic investing and how to manage investments in different assets.

For those who are willing to do the additional monitoring and trading, dynamic investing can increase income and total returns and reduce risk. My approach to dynamic investing is best described in the lyric of a song that was popular in the 1990s ("The Bug"): "Sometimes you're the windshield; sometimes you're the bug." Dynamic investing can make you the windshield most of the time. Let others risk becoming bugs by seeking the highest returns, following the latest fads, or ignoring the risks in their portfolios.

YOUR RETIREMENT INVESTMENT STRATEGY

There's no universal right way to manage a portfolio for those in or near retirement. Factors that determine the best strategy for you depend on your interest and knowledge of investments, the amount of time you want to spend on your investments, and your goals and risk tolerance. Some readers of my newsletter, *Retirement Watch*, use each of the main strategies. They have a core portfolio that is managed using a buy-and-hold, true diversification strategy. Some of the portfolio is invested for high income, and another part of the portfolio is invested dynamically. More details about my ideas on investing are in my book *Invest Like a Fox, Not Like a Hedgehog* (Wiley, 2007).

Investing is an area in which many people would be better off seeking help from professionals. One simple, low-cost way to have professionals help you is through mutual funds. There are mutual funds that invest dynamically, buy-and-hold, or use other strategies. You might want to own a portfolio of mutual funds that implement these strategies. You also could have a financial planner help you decide on a strategy and set up the portfolio. The planner might manage the portfolio or offer continuing advice to you. Of course, you also can work with one or more money managers. Interview a number of them to learn their strategies and to determine if you would work well with them. You could give your money to one of them or split your investment assets among several of them. Over time, you might consolidate with one of them or continue to diversify among investment professionals.

Much of the success of a retirement plan depends on achieving the income and total return goals set for your nest egg. It's important that you understand the goals you need to reach. Then, understand the different strategies available to reach those goals and select one or more strategies with which you are comfortable. Finally, implement the plan and don't hesitate to seek the help of financial professionals.

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CHAPTER 5: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is not a reason why a traditional retirement investment strategy is more difficult to implement for today's retirees:**

A. retirements are shorter today than ever before

B. the purchasing power of income declines over time

C. the Federal Reserve has implemented a very low interest rate policy

D. preserving purchasing power is harder under a traditional retirement planning strategy

2. **For many "diversified" portfolios, ____________________ of the returns depend on the action of the stock market index.**

A. 25 percent or more

B. 50 percent or more

C. 75 percent or more

D. 90 percent or more

3. **Which of the following is correct regarding a truly diversified portfolio in comparison to a traditional portfolio:**

A. swings in a traditional portfolio's value are less dramatic and smoother than those of a truly diversified portfolio

B. in a traditional portfolio, an investor's nest egg won't rise as much in a strong stock market rally as it would in a truly diversified portfolio

C. in a traditional portfolio, an investor's nest egg will decline much more in a bearish stock market than it would in a truly diversified portfolio

D. a traditional portfolio grows more smoothly and steadily than a truly diversified portfolio

4.	**Which of the following is true regarding a dynamic investment strategy:** **A.** dynamic investment strategy works whether you invest for total return or income **B.** dynamic investing is about market timing **C.** the intent of dynamic investing is to try and capture short-term trends in the market **D.** the strategy involves making frequent trades in the portfolio

CHAPTER 5: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. The first generation of retirees planned on a 5-year retirement. Today's retirees may be retired for 20 years or longer. **B.** Incorrect. Due to inflation, the purchasing power of income declines steadily over time. **C.** Incorrect. The traditional retirement planning strategy is made more difficult by the very low interest rate policy that the Federal Reserve has followed most of the time since 2001 and especially since 2008. **D.** Incorrect. Preserving purchasing power requires growth in both the income and the principal, neither of which is likely under the traditional strategy in today's conditions. *(See page 100 of the course material.)*
2.	**A.** Incorrect. The percentage is much higher than 25 percent. **B.** Incorrect. Much more than 50 percent of the returns depend on the action of the stock market index. **C.** Incorrect. Seventy-five percent is too low. **D.** CORRECT. Ninety percent or more of the volatility and returns rely on the action of the stock market index, even in supposedly "diversified" portfolios. *(See page 101 of the course material.)*
3.	**A.** Incorrect. The swings in a truly diversified portfolio's value are less dramatic and are smoother than for a traditional portfolio. **B.** Incorrect. In a truly diversified portfolio, the value of an investor's nest egg won't rise as much in a strong stock market rally as it would in a traditional portfolio. **C.** CORRECT. In a truly diversified portfolio, the value of an investor's nest egg won't decline nearly as much in a bearish stock market as it would in a traditional portfolio. **D.** Incorrect. The truly diversified portfolio will grow more smoothly and steadily than the traditional portfolio. *(See page 107 of the course material.)*

4.	**A.** CORRECT. Whether an investor is looking for total return or income, he or she can use a dynamic investment strategy. **B.** Incorrect. Dynamic investing does not involve market timing. **C.** Incorrect. The intent is not to try and capture short-term trends in the markets or to respond to the latest headlines and market noise. **D.** Incorrect. An investor does not make frequent trades in the portfolio, though he or she does make periodic changes. *(See page 109 of the course material.)*

CHAPTER 6: HANDLING THE MEDICAL EXPENSE WILD CARD

Chapter Objective

After completing this chapter, you should be able to:

- Recognize how Medicare affects retirement planning.

Medical expenses are among the greatest fears of retirees and preretirees. One survey found that medical expenses and long-term care expenses are more of a worry for retirees than death. Medical insurance and other ways to pay for the expenses are among the least understood (or most misunderstood) parts of retirement finance. It’s not surprising.

People are living longer, and aging is associated with higher medical expenses. Also, many people live those longer lives with chronic diseases or conditions. Older Americans often regularly take prescription medications to control diseases or conditions such as high blood pressure, diabetes, high cholesterol, heart disease, and others. There also are treatments and procedures for other conditions that once had no real treatment. These prescription drugs and treatments are doing wonderful things. Yet, someone has to pay for them.

Paying for medical care during retirement used to be simple. Most retirees had medical care covered by their former employers or labor unions. By the 1980s, 70 percent of even early retirees still had employer-paid health care coverage. But rapidly rising health care costs—due to longer life spans, more sophisticated medical technology, and greater use of prescription drugs—caused employers and unions to cut back on retiree health coverage. Another important factor was a change in accounting rules. The rules were changed to require companies to recognize on their books today the cost of promised future retirement medical benefits. That helped trigger moves by many companies to reduce or eliminate retiree coverage. The reductions began in the mid-1980s and accelerated through the 1990s and 2000s.

Now, very few employers offer retiree medical coverage. Those that do offer coverage are mostly the largest employers, and even they regularly reduce the coverage. Many of the employer and union plans that offer retiree medical benefits now are integrated with Medicare. Retirees are required to enroll in Medicare, and the employer or union plan covers only some care and expenses that Medicare doesn’t.

It’s clear that you’re largely on your own when it comes to paying for retirement medical expenses. The cost has shifted from former employers to retirees. Even those who have some employer-paid retirement coverage shouldn’t rest easy, because most employers can reduce or even eliminate coverage for those already retired. Courts usually uphold their rights to do so.

Yet, many people don’t adequately plan for medical expenses in their retirement plans.

While surveys consistently report that Americans are concerned about retirement medical expenses, only about 12 percent take account of medical costs in their retirement planning, according to a 2015 study by Nationwide Financial. More than half admit to knowing very little about Medicare. What's remarkable is that even people who are already retired underestimate their current and future medical expenses. When asked, most underestimated their costs by about 50 percent, according to the Nationwide study. Most respondents guessed at the answer rather than making any calculations or doing research.

Medical expenses are likely to be substantial in retirement and to be a higher portion of your total spending than before retirement. On average, medical expenses rise from 5.64 percent of total spending from ages 45 to 54 to 11.88 percent from 65 to 74 and to 15.08 percent at ages 75 and older, according to the Bureau of Labor Statistics. Medical expenses are a big reason why a recent study found that many Americans when they pass away have only about $10,000 in assets. They often spend their assets on medical expenses and long-term care.

There's also great misunderstanding about Medicare, the government program to help pay medical expenses of those ages 65 and older. Many people believe Medicare will cover all or most of their retirement medical expenses. That's not the case by a large margin, which I'll discuss in more detail shortly.

You're going to have substantial out-of-pocket medical expenses in retirement. The average person covered by Medicare will pay more than $4,300, or $8,600 annually per couple, for out-of-pocket medical expenses, according to the Center for Retirement Research at Boston College. A healthy 65-year-old male will pay cumulative expenses, including premiums, of over $369,000 over the rest of his life. Since women live longer, the average woman will pay 13 percent more, or $417,000. These are only medical expenses; they don't include long-term care costs. Fidelity Investments also develops annual estimates of lifetime retirement medical spending. The Fidelity estimates are somewhat lower than the CRR estimates. Fidelity estimated in 2015 a total of $230,000 lifetime expenses for a 65-year-old couple. Significant differences in the estimates are that Fidelity assumes each spouse lives only to average life expectancy and excludes costs such as over-the-counter medicines and dental care. CRR assumes different life expectancies and has a more comprehensive definition of medical spending.

Remember, in addition to being estimates, these numbers are only the averages. About half the people will spend more, and some will spend substantially more.

Let's look at how you can reduce the uncertainty of your out-of-pocket retirement medical expenses and plan to have them paid. We'll focus on Medicare. Despite its gaps and shortcomings, for U.S. retirees Medicare is the main source of retirement medical insurance.

SOME MEDICARE BASICS

More than half of Americans age 40 and older responding to surveys admit to knowing very little about Medicare. That's about the only question about Medicare in the surveys they answer correctly. In fact, many answer even that question wrong, because far more than half of Americans know very little about Medicare. So, those who didn't admit to knowing very little about Medicare were wrong.

Here are some basic facts about Medicare, many of which are surprising to a number of people.

There are several different parts to Medicare.

Part A covers hospital expenses, and most people pay no premiums for it. Part B, also known as traditional Medicare, covers doctors' care and basic medical care, and you pay premiums, which are discussed in more detail later in this chapter. When you are enrolled in traditional Medicare, you also can sign up and pay a premium for a supplemental policy, or Medigap policy. Those policies are issued by private insurers under rules governed by Medicare. The supplemental policies pay some of the deductibles and copayments of Part B and also cover some care that Medicare doesn't. When you're in traditional Medicare, you also can sign up for a Part D plan that will cover some prescription drugs not covered by Parts A and B.

An alternative to Part B traditional Medicare is a Medicare Advantage Plan (Part C). These plans combine elements of Part B and Part D. They often provide a comprehensive care package like an HMO or similar organization, because your basic medical services and prescription drugs are covered by the same package. These have become popular in recent years, enrolling about a third of Medicare beneficiaries. It's not legal to sell you a Medicare supplemental policy or a Part D prescription drug policy when you are enrolled in Medicare Advantage.

Most vision and dental care isn't covered by any part of Medicare, and there are other coverage gaps. You have to pay out-of-pocket for any care that isn't covered by Medicare. For some treatments, such as medical devices, Medicare might not pay for the quality or features you prefer. You have to pay for the difference between the treatment or service Medicare will cover and the one you prefer.

Most of Medicare isn't free. Premiums are required of those who are covered by Part B. Medicare Part B premiums are set each year to cover 25 percent of the estimated costs of the program for the coming year. That means many years they increase faster than the Consumer Price Index, though that isn't always the case. In 2014 and 2015, the premiums held steady but in 2016 they increased substantially.

Most Medicare beneficiaries have the Part B premiums deducted from their Social Security retirement benefits. Medicare premiums are taking a bigger share of Social Security benefits, because Medicare premiums generally increase at a faster rate than Social Security benefits. In 2012, Medicare Part B premiums took 8.2 percent of the average Social Security benefit; in 2000, the premiums took only 5.1 percent of benefits. From 2001 to 2012, average Social Security benefits rose 31 percent while Part B premiums doubled.

There is a protective clause in the law, often known as a *stop-loss provision*. Once you are a Medicare beneficiary and having the premiums deducted from your Social Security benefits, the premiums can't increase by a greater amount than your benefits increase. That means an increase in premiums can't cause your net Social Security benefits to decline. In years when the Social Security COLA is low, the 70 percent or so of Medicare beneficiaries who have their premiums deducted from their Social Security benefits won't share in the full cost increase of Medicare. Instead, the other 30 percent of beneficiaries will have more than a pro rata premium increase to ensure that total premiums pay for 25 percent of Medicare's estimated cost.

Since 2007, higher-income taxpayers have paid a Medicare surtax. This technically isn't a higher Part B premium, though it effectively is. The surtax rises as income rises. Means-testing of this type probably will be a bigger part of the program in coming years. The Medicare surtax was increased for some taxpayers in a 2015 law, with the higher surtax effective in 2017. We'll discuss the surtax in more detail later in this chapter.

In addition to the premiums, you pay deductibles and co-payments for most covered care.

There are many types of care that either aren't covered by Medicare or that have limited coverage.

Changes from the Affordable Care Act of 2010

The Affordable Care Act (ACA) of 2010 (also known as Obamacare) made some changes in Medicare, though the effects aren't fully clear yet.

Insurers were scheduled to be reimbursed less for Medicare Advantage plans than in the past. As a result, members began paying higher premiums, deductibles, and copayments, or receiving fewer benefits, or a combination of both. So far, the lower reimbursements weren't as great as initially forecast, so the effects on beneficiaries haven't been as significant as anticipated. The popularity of the Advantage plans continued to increase.

The ACA attempted to slow the growth in medical care costs by limiting the annual increases in payments to doctors, hospitals, and other providers. But Congress historically didn't let such limits stick, and in 2015 it passed legislation that ended the payment reductions and set a long-term schedule of payment increases.

The Part D prescription drug plans originally had a coverage gap or "doughnut hole." Once a policyholders' annual medical spending exceeded a certain amount, the policyholder had to pay 100 percent of additional prescription drug costs until the total prescription spending for the calendar year exceeded a certain amount. Under the ACA, reductions in the coverage gap are phased in until the gap is eliminated by 2020.

Also, beginning in 2012, Part D members in the doughnut hole pay only 50 percent of the cost for brand-name drugs and 86 percent of generic drug costs. By 2020, they'll pay only 25 percent for both types of drugs after reaching the deductible for their policies.

Most preventive care and screening was included in basic coverage under Medicare beginning in 2011. The usual deductibles and 20 percent coinsurance don't apply to these types of care.

The Limits of Medicare

Traditional Medicare beneficiaries pay on average $4,000 to $9,000 annually out of their own pockets for medical expenses each year, depending on whose estimates are used. The out-of-pocket costs are because of the premiums, deductibles, and coverage limits of Medicare. When Medicare covers a medical expense, in most cases you pay 20 percent of the cost, regardless of how high the cost is. We discuss the limits of traditional Medicare later in this chapter. As mentioned, some people buy a Medigap or Medicare supplement policy to help pay for these limits.

Medicare over the years aggressively reduced its costs by reducing payments to doctors, hospitals, and other providers. As a result, a significant percentage of doctors refuse to take new Medicare patients. The American Academy of Family Physicians reported in 2012 that 19 percent of family doctors are not taking new Medicare patients. Older Americans frequently have complained about difficulty in finding doctors and having to wait longer than other patients for nonemergency care. Those problems are bound to increase, especially for those living in rural areas.

This chapter isn't going to tell you everything about Medicare. You will learn, however, how to incorporate Medicare and other options in your retirement plan, maximize your benefits, and, most importantly, make medical expenses less of a wild card than they are for most people.

You'll learn how to project medical spending in retirement with reasonable accuracy. You'll also know when to sign up for basic Medicare and the other policies. You'll also learn how to evaluate the different choices for Medicare supplement policies and Part D prescription drug coverage. I'll also show you how to deal with some other sticky issues related to retirement medical expenses.

ENROLLING IN MEDICARE

Many people unnecessarily increase their retirement medical expenses right from the start. They don't enroll in Medicare or buy the related insurance policies on time, and that results in higher premiums for life. Even if you don't need or want the coverage, there's a time in life when you have to enroll in Medicare or take the risk that when you do enroll you'll pay a premium penalty every year the rest of your life. The rules can be tricky, causing some people to believe they are entitled to a later enrollment deadline when they aren't.

Most people don't have to worry about Part A. You're automatically enrolled when you're eligible, and there are no premiums. If you're among the few who doesn't qualify for premium-free Part A and want to enroll and pay the premiums, your enrollment deadline is the same as for Part B.

The general rule is that you enroll in Medicare Part B within the seven-month period that begins three months before your 65th birthday and ends three months after that birthday. If you're already receiving Social Security retirement benefits before your 65th birthday, you automatically will be enrolled in Medicare Part B or C. When you aren't receiving Social Security before 65, you still are required to enroll in Medicare Part B or C within that initial enrollment period.

If you're interested in Part C (Medicare Advantage), you have to enroll in Part B first. So, the deadline for Medicare Advantage is the same as for Part B.

It doesn't matter whether you are beginning Social Security retirement benefits. In most cases if you don't sign up for Medicare during this time, when you do sign up for it you'll pay a penalty of higher premiums for the rest of your life.

Of course, there are exceptions to the general rule.

There's a no-penalty extension of the Medicare enrollment deadline when you are covered by a qualified medical expense plan during the initial enrollment period. This is an area where people often receive wrong information, so proceed carefully. Qualified coverage means a group plan through your employer (or former employer if you have retirement medical benefits), and the employer has 20 or more employees. That means if you work for (or are retired from) an employer with 19 or fewer employees or are self-employed, any medical insurance doesn't qualify for the extension no matter how good the coverage is. You need to enroll in Medicare during the standard enrollment period to avoid penalties later in life.

Again, you need to be careful with this exception. Some people believe they don't have to sign up for Medicare during the initial enrollment period because they have coverage through the group plan of an employer with 20 or more employees. But many group plans say that once a covered person turns 65, his or her primary insurer is Medicare. The group plan will pay only for care that Medicare doesn't cover. People in this situation probably don't have to enroll in Medicare during the initial enrollment period to avoid the premium penalty. But they could face a higher financial penalty. When they don't enroll in Medicare at 65, they are responsible for all the expenses Medicare would have covered. The employer plan won't cover those expenses. Read your employer plan closely. If it designates Medicare as the primary insurer, you could be responsible for anything Medicare would have covered.

Once you leave an employer or otherwise lose qualified employer coverage after age 65, you have eight months to sign up for Medicare and avoid late enrollment penalties. Here's another trap. When you retire from or otherwise leave an employer, you're entitled to pay for the employer coverage out of your own resources for another 18 months through COBRA. But, while COBRA extends your access to the employer plan, it doesn't extend your special Medicare enrollment period. You no longer are considered to be covered by a qualified employer plan. Instead, you are considered to own an individual policy. You have eight months after leaving the employer to sign up for Medicare and avoid premium penalties, not the 18-month COBRA extension period.

Because of the nuances of the penalty for signing up late for Medicare, verify all the facts before concluding that you have an extension of the Medicare enrollment deadline. Long before your 65th birthday, ask the administrator of an employer group plan in which you are enrolled if the plan is a qualified group plan for purposes of extending the Medicare enrollment deadline. Most plans will send enrollees a letter before their 65th birthday stating whether theirs is a qualified plan for this purpose.

When you miss the initial enrollment period for Medicare, you can sign up only during the general enrollment period from January 1 to March 31 each year. The coverage won't take effect until July 1 of that year.

The penalty for failing to sign up for Medicare on time can be steep. For the rest of your life, the monthly Part B premium is increased 10 percent for each full 12-month period that you could have been enrolled in Part B but weren't.

The enrollment rules for Part D are very similar. The initial enrollment period is the same as for Part B. You also receive a penalty-free extension of the enrollment period if you had "creditable coverage" at the time. Creditable coverage is prescription drug coverage that is on par with a Part D plan. Again, you need to ask your plan administrator if you have creditable coverage. If not, then you don't have an extension of the initial enrollment period. When you had creditable coverage and then lose it, you can enroll in a Part D plan without penalty for two full months after the month in which you lose creditable coverage or were notified of the loss of coverage, whichever is later.

When you miss the initial enrollment period and didn't have creditable coverage, you can sign up for Part D plan during the annual open enrollment period from October 15 to December 7.

The penalty for late enrollment in Part D is more complicated than for Part B and difficult to estimate. The penalty is imposed when after your initial enrollment period there was a period of 63 or more consecutive days when you didn't have Part D or creditable coverage. The penalty is 1 percent of the "national base beneficiary premium" for Part D plans for each full month you delayed enrollment. The national base beneficiary premium changes annually but was $33.13 for 2015.

Suppose Max Profits was without a Part D plan or creditable coverage for 31 months after his initial enrollment period ended and enrolled in Part D in 2015. His penalty is 31 percent of $33.13, or $10.27. This is the penalty Max will pay each month in 2015 as long as he has Part D coverage. The penalty is recalculated each year based on the current national base beneficiary premium and will be imposed on Max each month for the rest of his life as long as he has Part D coverage.

Many people reach age 65 thinking they won't buy a Part D policy because they don't take many prescription drugs yet and don't see a point in paying the premiums. The cost of taking this approach and later needing prescription drug coverage can be steep. A better move is to enroll in Part D when first eligible and purchase the lowest cost policy available to you. Later if you need better coverage, you can switch to a different policy. But keep in mind that you can change policies only during the annual enrollment period, so you'll still go through a period when you believe you need broader coverage but have to wait before purchasing it. You also might have to pay a higher initial premium than you would have if you had enrolled in that plan when you first were eligible, because you're older and the cost of policies in general probably will increase.

Purchasing Medicare supplement or Medigap policies is a bit different from enrolling in Part B and purchasing a Part D policy. The initial enrollment period for Medigap policies is the six months that begin on the first day of the month in which you're both 65 or older and enrolled in Part B. Medigap policies are issued by private insurers under guidelines determined by Medicare. The insurers set their own premiums.

Medicare doesn't impose a financial penalty for purchasing a Medigap policy late. But during the initial enrollment period you're guaranteed to be issued a policy. The insurers who choose to offer Medigap policies can't refuse to issue a policy for health reasons during this period. If you wait to buy a policy after the initial enrollment period, however, the insurer can decline to issue a policy for health or other reasons or can charge you a higher premium. So, you might find that you are unable to buy a policy when you don't take advantage of the initial enrollment period.

PART B PREMIUMS

In Part B, you pay a monthly premium. Remember, if you choose Part C you first have to join Part B. So, you'll still pay the Part B premium, though it might be paid directly to the insurer.

The Part B premiums are calculated so that the total premiums paid during the year are estimated to cover 25 percent of the government's actual costs of Part B. Each fall, the government calculates the premiums to be paid beginning January 1 of the following year. It issues a public notice and also notifies beneficiaries.

Since 2007, Medicare has become more of a means-tested program. Higher-income beneficiaries pay higher premiums than others. The higher premiums are called a surtax and technically aren't premiums or part of the premiums. When first enacted, the premium surtax was set to gradually increase over several years. In 2015, a new law was enacted that increased the surtax for certain income levels. That surtax schedule will take effect in 2019.

The surtax is based on your modified adjusted gross income (MAGI) from two years earlier. Your adjusted gross income is the last line on the front page of Form 1040, Federal Income Tax Return. This becomes MAGI by adding any tax-exempt interest, EE savings bond interest used for education expenses, and excluded foreign earned income for the year. If you're eligible for Part B in 2017, your 2015 MAGI will determine your 2017 surtax.

The surtax begins with MAGI of $85,000 for single taxpayers and $170,000 for married taxpayers filing jointly. The surtax increases as income rises with the individual paying a higher percentage of the estimated costs at higher incomes. Instead of the standard 25 percent of costs, the percentage rises in the different brackets from 35 percent to 50 percent, 65 percent and ultimately 80 percent in the top bracket. The 2015 law changed the tables so that the 65 percent and 80 percent brackets are reached at lower incomes.

Table 6.1 shows the brackets and premiums for 2016.

TABLE 6.1 WHO PAID HIGHER PREMIUMS IN 2016?

Premium You Pay	% of Cost You Pay	If Your Modified Adjusted Gross Income Is:	
		Single	Married Couples
$121.80	35%	$85,000 or less	$170,000 or less
$170.50	50%	$85,001–$107,000	$170,001–$214,000
$243.60	65%	$107,001–$160,000	$214,001–$320,000
$316.70	75%	$160,001–$214,000	$320,001–$468,000
$389.80	80%	Above $214,000	Above $428,000

Beginning in 2019, single beneficiaries with MAGI higher than $133,500 (marrieds filing jointly with MAGI higher than $267,000) will begin paying 65 percent of estimated costs through their premiums. Those earning $160,000 to $214,000 per year ($320,000 to $428,000 for couples) currently pay 65 percent of their costs through premiums but beginning in 2019 will pay 75 percent.

There's a two-year lag between when income is earned and when you pay the premium surtax. The process is that first your return is received by the Internal Revenue Service. Your 2016 income tax return, for example, is received in early 2017. The IRS processes the return and sends the data to the Social Security Administration. The SSA processes that data, calculates your premium, and sends you a letter with the results. For example, the 2016 tax returns will be used to determine 2018 premiums. The SSA will receive the data from the IRS during 2017 and send letters to beneficiaries by mid-November 2017, notifying them of the premiums to be effect January 1, 2018.

Reducing the Premium Surtax

You can reduce the premium surtax by considering it in your tax and financial planning, though you have to plan a couple years in advance. You'd have to be aware of the potential for the surtax to hit you in 2018 when planning your 2016 income.

Since the premium surtax is determined by your MAGI, the best-known traditional income tax deductions won't reduce the surtax. Mortgage interest, charitable contribution deductions, real estate taxes, and other itemized deductions on Schedule A of the income tax return have no effect on the premium surtax. Only the items on the front page of Form 1040 affect MAGI and therefore the surtax.

In addition, some traditional tax planning strategies also won't reduce the surtax, because some forms of income that are excluded under the regular income tax are added when calculating MAGI for the surtax. That means you won't reduce MAGI by turning taxable bond interest into tax-exempt bond interest. You also won't benefit from the foreign earned-income exclusion or from EE savings bond interest that is used for education purposes.

There are other actions that will limit income and also limit MAGI.

You can limit withdrawals from retirement plans and annuities that would be included in gross income. Avoid taking distributions from traditional IRAs, retirement plans, and annuities that exceed your spending needs. Instead, consider taking withdrawals from Roth IRAs or from other accounts.

Another strategy is to manage your capital gains. Avoid selling assets and recognizing capital gains unless there are strong investment reasons to do so or you need the money. Look for assets that have declined in value that can be sold to offset capital gains or other income.

Losses from businesses, partnerships, and the like that pass through to your individual tax return also can be helpful in avoiding the Medicare premium surtax. These will be subtracted from sources of income to determine adjusted gross income.

You don't want the premium surtax to be the main focus of your tax and financial planning. It is one factor to be considered when making decisions about your finances. A strategy that might not seem viable or sensible when considering only federal income taxes might become viable when the premium surtax and other stealth taxes are considered.

When Your Life Changed

Two years elapse between when your MAGI is determined and when the premium surtax is imposed. Events can occur in those two years that change your financial position. The law recognizes this and provides an opportunity for you to appeal the premium surtax. The details of the appeal process should be described with the letter that notifies you what your premium will be.

The SSA will view an appeal favorably when one of the following changes occurred between the time the income was earned and the year the premium surtax is due:

- Divorce
- A spouse's death
- Job loss
- Reduced working hours
- Retirement
- Bankruptcy

When your appeal is granted, you can submit updated financial information and have that used as the basis for determining your premium and any surtax. That means one of these events won't automatically eliminate or reduce the surtax for you. Instead, you have the opportunity to show that one or more events changed your financial situation enough to justify eliminating or reducing the surtax for that year.

TRADITIONAL MEDICARE VERSUS MEDICARE ADVANTAGE

The initial decision is whether to enroll in traditional Medicare, also known as Part B, or Medicare Advantage, also known as Part C. About two-thirds of beneficiaries choose traditional Medicare, though that is down from about 80 percent not too many years ago. Medicare Advantage has been gaining in popularity. This book isn't going to delve into the details of what is and isn't covered in traditional Medicare. That changes almost annually, and you can find the details on the Medicare website or by asking for the free book, *Medicare and You*. With the Medicare Advantage plans, the details of the coverage vary by the plan. I will discuss how to compare the options and decide which is best for you.

Coordinated versus Traditional Care

Medicare Advantage is similar to a health maintenance organization (HMO) and related providers in that all or most of your care is delivered under one umbrella. When you go the traditional Medicare route, you'll select your own primary care physician and any specialists and decide when to make office visits or receive other care. You'll also have to consider buying a Medicare supplement policy and a Part D prescription drug policy. (We discuss details of those policies later in this chapter.)

In a Medicare Advantage plan, all the doctors and specialists are likely to be in the same organization. Care is likely to be coordinated. Many of the plans also are proactive, suggesting when an office visit or other care is needed. Plan employees also might follow up to ensure you are responding as expected or following the doctors' recommendations. An Advantage plan also is likely to have your records together instead of your having to ensure each doctor has access to your complete history.

Also, prescription drug coverage and some of the features of many Medigap policies are part of Medicare

Advantage plans. The idea behind Advantage plans is that Medicare reimburses the insurer or plan sponsor more per person than under a fee-for-service plan. The Advantage plan then provides a wider range of services and coordinates care with the expectation of achieving better outcomes than the fee-for-service model. By choosing an Advantage plan, you make one decision instead of three or more (Part B plus Part D and Medigap policies).

Factors in Choosing Between Part B and Part C

When making the choice between Part B and Part C, there are a number of factors to consider. Keep in mind, this is not a lifetime decision. There are opportunities at least annually to switch between Parts B and C or to change from one Part C plan to another. Even if you like your current care and plan, it is a good idea after age 65 to become familiar with the alternatives in your area every year or two. The plans available and their terms change over time and have changed quite a bit in recent years. You might find there is a better alternative even when you like your current arrangement.

Here are some key questions to ask when evaluating your choices.

Do You Have a Choice of Doctors?

Many people are attracted to traditional Medicare because they are allowed to choose their doctors and specialists and when to visit them. The patients aren't given a limited list of professionals from which to choose. They also don't have to go through a gatekeeper or receive permission to see a specialist. Traditional Medicare is fee-for-service. You receive the medical care you want, and Medicare pays for whatever is covered. In an Advantage plan, you have to choose from among the providers selected by the plan if you want the care fully covered. Advance approval from your primary physicians or someone else usually is required to see a specialist or receive treatment if you want the services covered (though there is an appeal process).

Which Doctors Belong to the Plan?

When you're considering an Advantage plan, you can check the list of doctors and specialists in advance. You also might want to check with the offices of any doctors you like so verify if they are covered by the plan. Often, a physician's office will be able to say if the doctor is thinking of adding or dropping participation in some plans.

Which Prescription Drugs Are Covered?

When you look at an Advantage plan, examine the prescription drug coverage in the same way you would for a Part D plan (which we discuss later in this chapter). If you're taking medications regularly, see if they are covered under the plan. Some plans require generic drugs except under certain circumstances. The plan also might limit the choice of drugs when more than one is available for a condition.

What Other Services Are Covered?

Some people want vision, dental, and mental health in one plan. For others, this isn't important. These types of care generally aren't covered under traditional Medicare but might be under an Advantage plan.

What Preventive Care Is Covered?

This is less of an issue since the Affordable Care Act required plans to offer basic preventive tests and services without additional charge and required some consistency between Part B and Medicare Advantage on the issue. Beyond that, however, you might want to see if an Advantage plan limits coverage for other preventive tests. Some plans won't pay for tests unless there are symptoms or a doctor's order. Others cover preventive tests only on a schedule based on age and health history. Ask about any limits on coverage for annual exams and preventive testing and compare that with traditional Medicare if that's important to you.

Is There a Wellness or Disease Management Program?

There usually is with a Medicare Advantage plan. In traditional Medicare, there usually isn't, although it can depend on your choice of doctor. Patients who have or are at risk for chronic diseases might control their conditions better and improve overall health by participating in programs designed to educate them and closely follow their conditions.

What Are the Typical Annual Costs Likely to Be?

Premiums, copayments, deductibles, prescription costs, and other expenses add up. Draw up a schedule of likely medical care during a typical year for you, assuming no new conditions or problems. See how much that would cost under the options being considered.

What Is the Worst-Case Cost?

Select some possible major medical problems and try to estimate what your out-of-pocket cost would be under the different choices.

A Little-Known Medicare Advantage Plan

When you turn 65 or otherwise enroll in Medicare, see if a Medicare Savings Account (MSA) is available in your area. These are similar to Health Savings Accounts, but they are a little different. MSAs are linked to high-deductible Medicare Advantage plans. You would sign up for a high-deductible Medicare Advantage plan and also open the MSA affiliated with the plan. Medicare gives money to the plan each year, and the plan deposits some of that money into your MSA each year. You don't make any deposits in the MSA, and aren't allowed to.

You then can choose to draw money from the MSA to pay for any medical expenses not covered by the Medicare plan or to meet deductibles. When you use money from the MSA to pay for part of a deductible, it is treated just as if you paid the deductible with your own money. If you don't incur enough deductibles or noncovered expenses to draw down the balance, or choose to pay those costs from other sources, then the MSA balance is rolled over to the next year and you still will receive the next year's deposit. This means you can allow the MSA to compound for years until you really need to draw down the account.

MSAs aren't widely available. There isn't an option in some areas, and in other areas there are only one or a small number of options. The MSA probably isn't a good enough benefit that it should dictate your choice of Medicare plans. But you need to understand what they are so you can decide on the best plan for you.

SHOPPING FOR MEDICARE SUPPLEMENT PLANS

The limits of Medicare coverage are a surprise to many retirees. Some learn the lesson during their preretirement planning. Others don't find out until they incur medical expenses in retirement.

Medicare covers only about half the medical expenses incurred by retirees, according to studies over the years. The specifics vary for each beneficiary, of course. Some people incur far more uncovered expenses than others.

For example, Medicare doesn't cover many types of medical care (dental, vision, most prescription drugs, and some other treatments). It also has limited coverage of some types of care. Most importantly, there's a 20 percent deductible on almost all covered care. So, if you incur a major medical expense, you might have to pay 20 percent of the cost with no limit.

You need a plan to pay the medical care that isn't covered by Medicare. You could plan to pay the uncovered expenses out of pocket and build flexibility to pay those expenses in your saving and spending plans. But that route results in a lot of uncertainty. You can't forecast the amount and timing of the medical expenses you'll incur. You need a big cushion and a lot of flexibility in your retirement plan to choose this route.

Another choice is to join a Part C or Medicare Advantage plan. These plans generally cover more than traditional Medicare. The exact coverage depends on the plan, so check plan documents carefully.

For those who belong to traditional Medicare Parts A and B, the best way to control medical expense uncertainty is to purchase a Medicare Supplement, or Medigap, insurance policy. (You aren't allowed to buy a Medigap policy if you're in Medicare Advantage.) You pay premiums for the policy, which will increase your fixed annual expenses. But the policy will increase coverage and create more certainty about your maximum exposure for medical expense. It's an important protection for those concerned about the uncertainty of retirement expenses or the potential for large, unexpected medical expenses drain their estates.

The first and best time to buy a Medigap policy is your initial open enrollment period, as discussed earlier in this chapter. This is a six-month period that begins the month you turn 65 and are enrolled in Part B. During this period, you can purchase any policy offered in your area and can't be declined or charged a higher premium for health reasons. Once you purchase a policy during this period, the insurer can't cancel your policy as long as you pay the premiums.

After that, you can buy or change a Medigap policy at any time, but the insurer can decline to issue a policy for health reasons or delay coverage of preexisting conditions for up to six months. (Even if the Medigap policy excludes coverage for a preexisting condition, traditional Medicare still will cover its share of the costs of the preexisting condition.) Or you can be charged a higher premium because of your age or health.

Also, as we discussed earlier in this chapter, if you buy a Medigap policy for the first time after your initial open enrollment period, in most cases you'll incur a penalty that results in higher premiums for the rest of your life. The exceptions apply to those who had other types of coverage, such as Medicare Advantage or an appropriate employer plan, during their initial open enrollment periods.

The Medicare Supplement policies are standardized by the federal government. Gone are the days when older people were sold numerous policies with overlapping coverage or few benefits. The types of policies and the benefits that can be offered under each type are standardized. Insurers aren't allowed to sell you duplicative coverage, and that's why Medicare Advantage members aren't allowed to buy Medigap policies. Table 6.2 summarizes the coverage of the different plans that are authorized. Examine the table to determine the plan or plans you want to consider.

TABLE 6.2 COVERAGE OF AUTHORIZED PLANS

Coverage Category	Medigap Plan Type									
	A	B	C	D	F*	G	K	L	M	N
Part A coinsurance and hospital costs up to an additional 365 days after Medicare benefits are used up	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Part B coinsurance or copayment	✓	✓	✓	✓	✓	✓	50%	75%	✓	✓***
Blood (first 3 pints)	✓	✓	✓	✓	✓	✓	50%	75%	✓	✓
Part A hospice care coinsurance or copayment	✓	✓	✓	✓	✓	✓	50%	75%	✓	✓
Skilled nursing facility care coinsurance			✓	✓	✓	✓	50%	75%	✓	✓
Part A deductible		✓	✓	✓	✓	✓	50%	75%	50%	✓
Part B deductible			✓		✓					
Part B excess charges					✓	✓				
Foreign travel exchange (up to plan limits)			✓	✓	✓	✓			✓	✓
Out-of-pocket limit**							$4,800	$2,400		

** Plan F also offers a high-deductible plan. If you choose this option, this means you must pay for Medicare-covered costs up to the deductible amount of $2,110 (in 2013) before your Medigap plan pays anything.*
*** After you meet your out-of-pocket yearly limit and your yearly Part B deductible, the Medigap plan pays 100% of covered services for the rest of the calendar year.*
**** Plan N pays 100% of the Part B coinsurance, except for a copayment of up to $20 for some office visits and up to a $50 copayment for emergency room visits that don't result in inpatient admission.*

Traditionally the advice to maximize your coverage has been to consider Plans F and G. These plans cover most deductibles and copayments under traditional Medicare Parts A and B. They also cover medical care while traveling outside the U.S. and some other costs. The main difference is Plan G doesn't cover the Part B deductible while Plan F does, which means Plan F provides "first dollar" coverage. Another difference is that Plan G isn't guaranteed issue, so the plans don't have to accept less healthy applicants. That allows insurers to make Plan G premiums a little lower and more stable than Plan F as a general rule.

Unfortunately, a law enacted in 2015 requires Plan F to be eliminated by 2020. Congress didn't like the first dollar coverage, believing that it leads to overuse of medical care and higher overall prices. The elimination of Plan F isn't required until 2020, and policies already issued can remain in force beyond 2020. It is likely, however, that the law will cause premiums on those Part F policies to rise substantially over time. That's because there won't be a stream of younger and healthier policy holders joining the premium pool. The policies will be held only by older and sicker people, requiring premium increases each year.

Because of the change in the law, Plan G now is the better choice for those who want the broadest Medigap coverage. Existing Plan F owners should consider switching to Plan G if they can to avoid the potential for substantial future premium increases.

The other plans offer less coverage and vary in the coverage they exclude. Less coverage should result in lower premiums than for a Plan F or G policy. As with other types of insurance, you're transferring risk and uncertainty to the insurer in return for higher premiums. Your fixed annual costs from using Plans F or G are higher, but your potential total costs are more fixed and certain, and are much lower if you turn out to need a lot of medical care.

Once you've determined the type of policy you want to consider, take the time to shop around for a policy. Many people are overpaying for Medigap policies by as much as 100 percent because they don't shop around, according to a study by CSG Actuarial. Because the federal government standardizes the policies, the coverage is the same between insurers for each plan type. The differences are in premiums, customer service, and factors such as speed of reimbursements. Some insurers have different expense levels or make different assumptions about the costs they'll incur. Others assume people won't shop around. The important point is that premiums vary considerably for the same type of policy in the same area.

Shopping for Medigap can be fairly easy. You can see summaries and details of all the policies offered in your area on the Medicare website at www.medicare.gov or you can talk through the choices with someone at Medicare by calling 1-800-MEDICARE. Your local Area Office on Aging or other local government agencies or nonprofits might offer assistance, and there are financial planners who also assist in evaluating policies.

Don't buy a policy because it seems to be the best-seller in your area or everyone seems to have it. It might be the best policy, or perhaps the insurer is good at marketing or offers above-average commissions to agents.

Don't automatically select the policy with the lowest initial premium. Some insurers offer low premiums because they are relatively new to the business or are trying to increase market share. Others might simply make poor estimates of their likely revenues and expenses. These types of insurers are likely to increase premiums substantially over time.

You want a financially sound insurer that's issued Medigap policies for a long time. If you really want to do the research and dig into the details, look for an insurer with average-to-low-costs compared to the industry and that pays reasonable but not high commissions to agents.

Another sign that high premium increases are likely down the road is the insurer offers guaranteed-issue policies outside the initial open enrollment period. Guaranteed-issue means a policy will be issued regardless of age or health and everyone the same age is charged the same rate. Such insurers are likely to attract people with health problems.

Another important detail is whether the insurer uses the “attained age” or “issue age” method to determine future premiums. An attained-age insurer bases premiums on the policyholder’s age and steadily increases premiums as a person ages. An issue-age insurer bases future increases on the insurer’s expenses and overall health costs, not the age of the insured. As a general rule, attained-age policies tend to have lower initial costs but over time are subject to higher increases. Over time with all other things the same, an issue-age policy is likely to cost less and have less volatile premiums.

After purchasing a Medigap policy, even if you shopped carefully when purchasing it and are happy, you should shop around regularly if you’re in good enough health to be insurable. Insurers increase premiums by different amounts each year and for different reasons. Your insurer might have incurred more claims than expected or had other expenses increase, to give two examples of events that might cause premiums to rise. A policy that was competitive when you purchased it might not be after a few years. Check the Medicare website to see if there’s something better. Don’t cancel your existing policy until you’ve been approved for a new policy and know the premium.

EXAMINING PART D PRESCRIPTION DRUG PLANS

Traditional Medicare Part B has very limited coverage of prescription drugs. Generally, only medicine related to a surgery or similar treatment is covered. The prescription medications that many people take on a regular basis aren’t covered. Part D was created to provide a prescription drug coverage option for traditional Medicare beneficiaries. The plans have been around only since 2008, but they’ve been very popular with beneficiaries.

One constant about Part D so far is change. Premiums, other costs (such as deductible and copayments), and coverage all change as insurers gain experience and drug costs and availability change. In some years, average premiums increase substantially, while other years they are fairly stable from year to year. Beneath the averages, there often are plans with major changes in premiums and policy terms from one year to the next.

Part D prescription drug plans are offered by private insurers under guidelines established by the Centers for Medicare and Medicaid Services. The CMS sets the guidelines, reviews proposals from insurers, and decides which plans are approved to be offered. There are several national plans available. Generally, however, an insurer decides in which localities to make a plan available and the premium to charge in each locality. Almost all areas of the country now have low premium, limited coverage plans available. Some populous areas have dozens of plans available, while less populated areas might have only a few plans from which to choose. Details of all the plans are available on the Medicare website or by calling 1-800-MEDICARE and talking with a representative.

Before choosing a Part D plan, consider enrolling in a Medicare Advantage plan. As discussed earlier in this chapter, they combine the hospital care of Part A, doctor’s services under part B, and other coverage, such as prescription drugs and dental and vision care. These plans have been rising in popularity, and about one third of those who receive prescription drug coverage under Medicare receive it through Advantage plans.

One goal of many seniors is increasing certainty in their medical expenses. Part D plans increase certainty of prescription drug costs, and Medicare Advantage plans increase certainty of overall medical costs. Consider all your medical coverage together instead of looking only at Part D plans.

Don't ignore Part D policies simply because you aren't taking many prescription drugs around age 65. Remember that there's a penalty if you don't sign up for a policy during the initial enrollment period. You'll pay higher premiums for the rest of your life if you first sign up for a policy after the initial enrollment period, and the longer you delay signing up the higher the penalty is. A better strategy if you don't need much coverage now is to enroll in the lowest-cost policy available to you. Later, if you decide you need more robust coverage you'll have the option of changing policies during the annual open enrollment period. But keep in mind you can switch only during the open enrollment period. So, if your need for broader coverage arises between enrollment periods, you'll bear more of the cost of prescription medicines until you can enroll in a new policy.

Factors to Consider

There are several key factors to consider when reviewing prescription drug plans.

There is an annual deductible, which varies by the plan. The deductible is the amount that you must pay each year for prescription medicine before the Part D policy will pay any costs. Medicare doesn't allow the annual deductible to be more than $360 in 2016, and the amount is adjusted for inflation each year. Some plans don't have a deductible.

Each plan also has copayments or coinsurance. This is the amount you pay on each prescription after you've paid the annual deductible. A copayment is a dollar amount, such as $10 per prescription. Coinsurance is when you pay a percentage of each prescription's cost, such as 25 percent. The copayments and coinsurance usually are based on your receiving only a one-month supply per prescription. Each policy has its own copayments or coinsurance. Some policies will have different amounts for different types of drugs, often known as tiers. The most common tiers are generic drugs and prescription drugs. Often a policy will have a lower copayment or coinsurance for generic drugs than for brand name drugs to encourage policyholders to prefer generic drugs.

You also should study how the policy treats the coverage gap, also known as the doughnut hole. Once you spend a certain amount on prescription drugs for the year, the policy coverage is reduced during the coverage gap. In 2016, the coverage gap begins after you spend $3,310 on covered drugs. The coverage gap floor changes with inflation each year. In the coverage gap you pay 45 percent of the plan's cost for a brand-name drug, though 95 percent of the price will count as out-of-pocket costs. In the coverage gap you pay only 65 percent of the plan's price for generic drugs, and that will slide down to 25 percent by 2020. But for generic drugs only the amount you actually pay counts as an out-of-pocket cost. You are out of the coverage gap and back to regular policy terms when your total spending for prescription drugs exceeds the upper limit of the coverage gap. The upper limit is $4,850 in 2016.

Once your spending exceeds the upper limit of the coverage gap, you now have catastrophic coverage. Under catastrophic coverage you pay only 5 percent of most prescription drugs for the rest of the calendar year.

Not all Part D plans treat the coverage gap in the same way. Some plans will provide some coverage during the coverage gap.

One way to deal with the gap is to always use your Medicare card when paying for drugs. This likely will get you a lower price than without the card. Another strategy is to use generic drugs or less-expensive brand-name drugs whenever possible. Mail-order pharmacies and low-cost pharmacies also might help control costs. Many pharmaceutical companies offer price breaks for those with lower incomes, and the states also have assistance programs for those with lower incomes. Additional information about the pharmaceutical and state programs is on the website at www.medicare.gov.

Another key feature of a drug plan is the formulary. The formulary is the list of medicines covered by a plan. Don't assume that because you are buying a "prescription drug plan" that it covers all prescription drugs. Each policy has its own formulary, and the differences in formularies can make a big difference in your out-of-pocket costs.

New or experimental drugs often are not covered. Also, coverage might not be available when an approved drug is prescribed for an *off-label* use.

More importantly, a plan might limit the drugs covered for specific treatments. If a generic drug is available, you might be required to at least try it before a brand name is covered. When more than one brand-name drug is available, the plan might cover only one of them. Usually when a specific generic or brand-name drug is required by the plan, you are covered for an alternative only if the preferred drug is not effective for you or you have an adverse reaction. Some medicines come in different forms. For example, a drug might be available as a lotion, cream, or gel. Or it might be available as either a tablet or a capsule. Or a drug might be available in different doses. In all these cases, a plan might not cover all the options.

You can check the formulary for each plan available to you on the Medicare website at www.medicare.gov. If you already are taking drugs, you can see which plans cover them and see the details of the coverage limits. If you are not using drugs, you can review the lists for an idea of how restrictive the plans are. If personal or family history indicates you might need a certain medicine in the future, you can see how the formulary treats it.

The Medicare website lists all the plans available in your area. It also has a tool that searches for plans with certain features and another that compares plans you select. You can enter the prescription drugs you use, and the comparison feature will estimate your out-of-pocket costs for each of the plans, assuming no changes in your use. The comparison feature on the website is an important tool to use when selecting a plan.

There are a few other plan features to consider.

Some plans require authorization from the insurer before a prescription will be covered. That might require some discussion between your doctor and the insurer about the choice of medication.

If you take a prescription regularly, many plans require you to receive it through mail order and from a specific pharmacy. Some plans cover only drugs dispensed through a specific pharmacy or pharmacies.

Choosing a Policy

Once you determine the policy features you want shop around. Insurers count on people not shopping around. Studies have found that premiums for the same coverage can vary as much as 100 percent between different insurers. Use the Medicare website or the staff at 1-800-MEDICARE to compare both coverage and premiums for the policies available to you.

Don't automatically choose a popular plan. A plan might have a large enrollment because it does a lot of marketing or because a lot of low-income members were automatically enrolled in it as the lowest-cost plan. Or an insurer might be trying to increase market share with low premiums for the first year. Instead, look for plan terms that are right for you and an insurer that has experience. Then, look at the premiums.

Once you're enrolled in a plan, be prepared to reevaluate your choice each year during the annual enrollment period. The terms of Part D policies can change a lot from year to year as insurers have more experience or change their business goals. The terms of your policy might change adversely, or better options might join the market.

The Premium Surtax

Higher-income Medicare beneficiaries are subject to a premium surtax on Part D prescription drug policies just as they are on Part B premiums. The surtax officially is known as the Part D income-related monthly adjustment amount (IRMAA). The surtax kicks in at the same income levels for both parts of Medicare. Remember that there is a two-year lag between income and the surtax. Your 2014 modified adjusted gross income determines your 2016 Medicare surtax.

The amount of the surtax is determined differently for Part D, because the Part D policies are issued by private insurers and have their own premiums. There are hundreds of different Part D policies available each year. You pay your premium plus the monthly addition for your income. The monthly addition can change each year. The monthly addition is transferred to Medicare, though it is collected by your insurer with the regular premium payments.

Table 6.3 shows the additional premiums for 2015.

TABLE 6.3 WHO PAID HIGHER PART D PREMIUMS IN 2016?

Married Filing Jointly			Singles		
When 2013 MAGI Is		**2015**	**When 2013 MAGI Is**		**2015**
More than	**But not over**	**Part D Premium Addition**	**More than**	**But not Over**	**Part D Premium Addition**
$170,000	$214,000	$12.70	$85,000	$107,000	$12.70
$214,000	$320,000	$32.80	$107,000	$160,000	$32.80
$320,000	$428,000	$52.80	$160,000	$214,000	$52.80
$248,000		$72.90	$214,000		$72.90

THE RETIREMENT ADVANTAGES OF HSAs

There's an advantage in the medical insurance changes of the last few years, but few people are maximizing it. The Affordable Care Act of 2010 of course changed insurance for preretirees, whether they buy individual policies or have employer-provided coverage, and you need to know how to use the changes to your advantage in your retirement planning.

The major change is the switch to high-deductible plans in both employer-provided and individual policies. The law and other factors caused premiums to increase significantly for many, and the best way to reduce premiums is to increase deductibles. Insurance with higher deductibles covers fewer routine expenses. The individual pays those expenses out-of-pocket.

A high-deductible policy has advantages and disadvantages, but often carries with it eligibility for a health savings account (HSA). An HSA is a valuable financial tool that isn't exploited by many who are eligible. Your insurer can tell you if the policy makes you eligible for an HSA. If you're married and your spouse has separate medical coverage, check the rules carefully to see if you're eligible to open an HSA and qualify for the full annual contribution.

More than a way to pay for current medical expenses, the HSA can be an important part of your retirement planning. Properly used it often is better than a 401(k) or even a Roth IRA as a planning tool. I believe the advantages of an HSA for retirement planning are so significant that reasonably healthy people who haven't been forced into HSA-eligible coverage during their working years should seriously consider switching to such coverage and maximizing use of the HSA.

The basics of an HSA are simple. Either the account owner or his or her employer makes contributions to the account. (Actually, like a 529 college savings plan, anyone can make deposits into your HSA.) The deposit is deductible from gross income if you make it or excluded from your gross income if the employer makes it. The maximum contribution in 2015 was $3,350 for an individual policy or $6,650 for a family policy. The limit changes each year with inflation. Account owners who are 55 or older add $1,000 to those limits as catch-up contributions. The account can be invested in anything the account administrator allows, and investment earnings of the account compound tax free.

Here's the second big payoff. When distributions are taken from the HSA for qualified medical expenses, the distributions are tax free. So, the money is tax free or deductible going into the HSA, and tax free coming out when used to pay for qualified medical expenses.

Qualified medical expenses are those that are deductible as itemized expenses on your tax return if you had paid for them with after-tax dollars and they weren't reimbursed by insurance. That means an HSA can pay for expenses that aren't covered by many medical insurance plans, such as dental and vision care.

The idea behind an HSA was that you would have the high-deductible policy and use the HSA to pay for deductibles, copayments, and noncovered expenses as they are incurred.

A better strategy is to let the HSA accumulate for your retirement years. Pay current medical expenses from your income, unless some major catastrophic expenses are incurred. Then, use the HSA in retirement to pay for expenses not covered by Medicare, premiums for Medicare supplemental insurance (Medigap) and Part D prescription coverage, and any medical expenses not covered by them.

The HSA also will be available to pay for nonmedical expenses if you need it. When distributions from an HSA are used to pay for other than qualified medical expenses, then the distribution is included in gross income. In that case it works just like a traditional IRA, except there aren't required minimum distributions.

If there is a balance in your HSA when you pass away, the balance is inherited by your estate or a beneficiary you designated with the administrator.

You need to choose an administrator for your HSA, just as you need a custodian for an IRA. There are many available HSA administrators. As with IRAs and other financial accounts, look for low fees, broad investment options, and any other features that are important to you, such as robust online tools or good telephone customer service. Take a look at HSA Bank (www.hsabank.com), which allows accounts above a minimum balance to be invested through TD Ameritrade, and Health Savings Administrators (www.healthsavings.com), which allows investments through Vanguard.

Most HSAs now offer a free debit card that you can use the same as any other payment card to pay for medical services (or anything else if you want to incur the taxes). Most will issue checks that are just like regular bank checks, but for an additional fee. You also can issue payments or transfer funds to one of your other financial accounts either online or over the telephone.

As you reach age 65, there's a tricky interplay between HSAs and Medicare to be aware of.

You're generally required to sign up for Medicare at age 65 unless you meet one of the exceptions. There's also a rule that once you sign up for Medicare, contributions to an HSA no longer are allowed. Neither personal nor employer contributions are allowed.

This means that after age 65 you can't have additional contributions to an HSA unless you meet one of the exceptions for delaying Medicare enrollment past age 65. You can leave money in the HSA and use it as already described after you retire, but new contributions have to stop.

HSA contributions might also have to stop at age 65 if you have filed for Social Security benefits, because you'll automatically be enrolled in Medicare Part A at age 65 if you filed for Social Security benefits, even if you filed for them and then suspended payments.

Filling the Biggest Gap in Retirement Health Care

The biggest gap in your retirement medical insurance probably is one you hardly think about and that gets little attention. Among the many needs not covered by Medicare is dental care. You also won't find dental coverage in Medigap (Medicare supplemental) policies. Unless problems with your teeth and mouth are related to an accident or certain diseases, you won't receive help from these policies and programs.

Apparently, few retirees know about this gap or do anything about it. While 80 percent of children and 54 percent of working adults have some kind of dental coverage, only 30 percent of seniors do. According to one survey, half of Americans ages 65 and older didn't visit a dentist at all in 2014.

There are a number of private options for obtaining dental coverage, but unlike prescription drug, Medigap, and long-term care policies, these options aren't regulated by or associated with Medicare in any way.

You might not think you need help paying for a couple of teeth cleanings a year, and you probably don't. It's the other potential treatments for which you might want some coverage. In many areas, root canals and crowns incur charges of about $1,000 each. Costs can be higher or lower depending on where you live. Dentures, implants, and other treatments that are routine among seniors are more expensive. You might not want to reach into your pocket to pay the retail cost of such treatments when you need one or more of them.

You have two basic options for dental care coverage: dental insurance and dental discount plans.

I suggest you consider a discount plan instead of dental insurance. Most of the time a discount plan controls your out-of-pocket costs better than insurance.

Dental insurance premiums vary around the country, but the premiums typically are around $500 annually. (Age usually isn't a factor in determining premiums.) For this premium you're covered for two cleanings and exams annually and usually for periodic x-rays. In addition, the policies will cover many other dental treatments you might need.

The limits and fine print in the coverage, however, reduce the policies' benefits. There's usually an annual coverage limit of between $1,000 and $1,500. (You can increase the coverage limit a bit by paying a higher premium.) No matter how much dental care you need, the insurance won't pay more than the annual limit. You also will have a copay or coinsurance on most treatments that are covered, usually of 20 percent to 50 percent of the cost.

Also, some important dental treatments might be excluded entirely, especially cosmetic treatments, so check the details before signing up for a policy. In addition, expect a waiting period of 12 months to 18 months for many types of care beyond the routine cleanings to be covered.

The good news in dental insurance is that the insurer negotiates prices with the providers. Your charges for any treatments are likely to be less than the dentist's price to patients who aren't covered, even when the insurer provides little or no assistance for the treatment.

Essentially with dental insurance you're prepaying for two annual cleanings and a few other services plus the negotiated rates.

A better option might be a dental discount plan. These usually have annual premiums of around $100. Again, the cost varies around the country.

The discount plans negotiate with a network of dentists in your area. If you have your dental work done at one of the network dentists, you'll pay substantially less than the dentist's "sticker price." The discounts can be substantial. I reviewed several plans in my area, and the discounts are 40 percent to 50 percent on a range of services, and sometimes are higher. There's rarely a waiting period for a discount plan's benefits.

In addition, usually you can opt for an annual premium of around $200 annually and receive some basic services for no charge, such as one or two annual cleanings and periodic x-rays. So, you'll have coverage similar to that of insurance for a lower premium.

Your regular health insurer or Medigap insurer might offer or be affiliated with one or more dental insurance or discount plans. Plans in your area also can be found at DentalPlans.com or the National Association of Dental Plans website at nadp.org/about/cdorganization.aspx. There also is an insurance plan affiliated with AARP and administered by Delta Dental Insurance Company. Check the AARP website for details.

Health Care Orphans: Covering the Bridge Years

Most Americans retire before age 65, though the average retirement age has crept higher since the financial crisis of 2008–2009. Some retire early involuntarily, because of workforce reductions or personal health problems. Others retire before 65 because they want to. Whatever the reason for leaving the work force, those who retire early need medical insurance. For most people, Medicare eligibility doesn't begin until age 65. Before that, you have to find other sources for coverage of retirement medical expenses.

Some large employers still offer health care coverage to former employees who are under age 65. When large corporations offer buyouts or dismiss large numbers of employees, continuing medical insurance typically is part of the package. Even among large companies, however, the number offering medical coverage is declining. The numbers are even lower outside the universe of large employers.

The Affordable Care Act of 2010 makes finding coverage before age 65 easier than it used to be. People don't have to hunt as hard to determine the policies that are available. Also, insurers no longer can deny coverage because of medical history or unhealthy habits. But the law only made coverage more available than it used to be. The ACA didn't reduce medical insurance premiums, especially for those who are middle-aged or older, and some analysts believe the law increased premiums by requiring more coverage. The premiums for someone age 50 or older can be fairly high and a shock to many people who were used to subsidized employer coverage.

The easiest way to decrease medical insurance premiums is to raise the deductible and copayments. In other words, self-insure for the routine expenses and let insurance cover the higher costs. Changing residences also can change premiums. The cost of medical care and insurance varies around the country based on factors such as the availability of doctors and hospitals. The costs even can vary in areas near to each other, such as by crossing a county line. An individual could reduce premiums by moving to an area where medical care costs are lower.

There also might be other sources of medical insurance. Those considering early retirement should do extensive health insurance research early, several years before deciding to retire. There are many sources to consult to avoid paying too much for a policy with limited coverage. Here are the steps prospective retirees or new retirees need to take:

- Contact your employer. There is at least one option and possibly two options available through the retiree's former employer.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) requires employers with 20 or more employees to offer medical expense coverage to former employees for up to 18 months. The employees have to pay for the coverage, plus they can be charged an administrative cost of up to 2 percent, but this might be a good deal. Coverage is guaranteed. More importantly, an employer policy usually is a group plan, and insurers generally charge less for group premiums than for an older person's individual policy. Under a group policy, younger members subsidize or offset the costs of older members. Using the COBRA provision is a good short-term option, especially for someone who retired unexpectedly or without anticipating the need to secure health insurance. It gives the retiree up to 18 months to find a longer-term solution.

The COBRA option, however, might turn out to be too expensive. If the employer has what employees consider a good health plan, then it probably has low deductibles and copayments and covers many expenses. The premiums are likely to be high.

The second option is that the employer might offer some kind of continuing health care coverage to former employees, especially if the employer is large. Again, this kind of coverage is disappearing, but it is worth asking about.

- Check affinity groups, such as professional, trade, alumni, and other associations. Many such associations offer some kind of medical expense insurance plan. These are group plans, so the premiums potentially are lower than for an individual policy. Any retiree or prospective retiree who belongs to an association should check the offerings from such associations. Anyone who belongs to a special interest organization should check available benefits.
- Contact local brokers and agents. There are many health insurance companies in the United States, and each insurance broker and agent works with only a few. Few health insurers work directly with individuals. That is why it is important to comparison shop among several brokers and agents.
- Ask national brokers and agents. A number of websites operate as medical insurance brokers and deal with multiple insurers instead of only one or two. These can be found through an Internet search engine. A widely used site is ehealthinsurance.com.
- Ask other retirees about their health coverage.
- Get advice from government agencies and the Internet. Local governments generally provide free counseling to older Americans through an Area Office on Aging or similar agency. On the Internet, www.healthfinder.gov offers a lot of free information on health care insurance and buying a policy. It is run by the U.S. Department of Health and Human Services. Of course, for specific policy information you can visit the medical insurance exchanges created under the ACA. If your state set up an exchange, you can visit it. The federal exchange is at www.healthcare.gov.

- Consider short-term health insurance. This is a niche in the insurance industry offering health care coverage for up to 12 consecutive months. The coverage can be much cheaper than most other plans, but there are reasons for the low cost. The policies usually have high deductibles. In addition, preexisting conditions generally are not covered. When the policy expires, longer-term insurance must be obtained. If a chronic disease or lingering injury is incurred while under a short-term policy, then when a longer-term policy is obtained the chronic problem likely won't be covered for the first six months or longer. That's why this insurance generally is sold only to young, unemployed people. Some states prohibit these types of policies.

- Some people return to work either full- or part-time primarily for the health insurance. Or, one spouse remains employed using employer health insurance that covers both spouses until they are both old enough for Medicare.

PLANNING AND ESTIMATING RETIREMENT MEDICAL EXPENSES

Now that you know about Medicare, you can set up a plan for paying retirement medical expenses and begin to estimate retirement medical expense spending. It is important to incorporate a reasonable estimate of medical expenses in your plan, because being able to pay for medical expenses is a key to a sustainable and successful retirement.

There are several methods to estimate retirement medical expense spending. You could take the estimates for lifetime medical spending we discussed earlier in this chapter from the Center for Retirement Research at Boston College or Fidelity Investments and plug those into your plan. There are potential problems with those methods, which we discussed earlier. These are average expenses, and yours could be considerably higher or lower. Also, those estimates aren't going to reflect your out-of-pocket spending, because they don't account for different types of insurance coverage and different costs around the country.

Another approach would be to consult the Department of Labor's studies of household spending at different age levels. You could assume that you'll spend the same percentage of income on medical expenses at different ages as indicated in those studies. Again, those are averages and might not apply to your situation. It's also difficult to use that approach unless you are fairly certain what your income will be through retirement.

I suggest a more systematic approach to estimate retirement medical expenses. This approach will estimate a baseline for the spending and also can help you develop a plan that will reduce the uncertainty of retirement medical spending.

Most likely, you won't receive much in retirement medical benefits from former employers or unions. Medicare will be your prime retirement medical insurance.

Part A benefits under Medicare are free to most people. So, we start with Part B, also known as traditional Medicare. This will be your main coverage. The standard Part B premium in 2015 was $104.90 per month or $1,258.80 annually. As we discussed earlier, retirees with higher incomes pay a Medicare surtax. That effectively raises premiums, though the surtax technically isn't a premium.

Part B doesn't cover everything. It has deductibles, copayments, and excluded care. Because of that, you should consider a Medicare supplement, or Medigap, policy. You could go without such a policy and save the premiums each year. The policy, however, reduces uncertainty. You have the certainty of paying the premiums each year and know that if you incur any of the expenses covered by the policy, it will pay them. There are a range of Medigap policies, and premiums vary by the type of policy and where you live. You can find current premiums for the different policies available in your area by checking the Medicare website or calling 1-800-MEDICARE. For now, let's take an average cost of $2,000 annually for Medigap policy.

Next, consider prescription drugs. These receive very limited coverage under Parts A and B. Generally, Medicare covers only drugs related to a stay in a hospital, such as those related to a surgery. Yet, prescription drugs are becoming a larger part of medical care and are a significant unplanned expense for many retirees. They usually are listed as the highest portion of retirement medical expenses.

The best way to control prescription drug expenses is by purchasing a Part D prescription drug policy. These policies are issued by private insurers but regulated by Medicare. Policy terms and premiums vary considerably. Some are "barebones" policies that provide limited coverage and have premiums of $40 and less per month. Others have much broader coverage and higher premiums. For projections, you'll want to check prices in your area and use the premiums for a policy you're likely to buy. Check the Medicare website for details or call 1-800-MEDICARE. For now, we'll use a 2015 national average of about $700 annually in premiums.

As an alternative to this package of policies, you might choose to join a Medicare Advantage plan. These plans combine the coverage of Part B, some Medigap plans, and the Part D and prescription drug policies. Again, the exact coverage and premiums vary by the individual plan. You can see the choices in your area on the Medicare website or by calling 1-800-MEDICARE. Overall, the cost is likely to be similar to the cost for the package of Part B plus Medicare Supplemental and Part D policies.

The premiums for this package of coverage were about $4,000 annually in 2015 using our estimates. Remember, your estimates will vary based on where you live and which policies and terms you choose. You might choose policies with higher premiums and broader coverage to reduce the uncertainty of unexpected expenses. Or you might choose policies with lower premiums and take the risk of large unexpected medical expenses.

You also might assume you're going to incur at least the minimum amount of medical care each year and pay the deductibles. For Part A there's a deductible of $1,260 for each benefit period. (A benefit period generally is a hospital stay.) Under Part A, you also begin paying a daily coinsurance after 60 days in the hospital. The Medigap and Part D policies also will have deductibles and copayments that vary by the policy.

Let's stick with the premiums and say you incur a minimum of $4,000 a year in retirement. That's for one person. If you're married, that likely is doubled. Don't forget the Medicare premium surtax if you're a higher income household.

That is the cost only for one year and is in 2015 dollars. Inflation has to be factored in for future years. Medical expenses generally rise faster than inflation, though Medicare Part B premiums held steady in

2014 and 2015. For example, in Fidelity's annual estimates it used to assume 6 percent annual inflation in medical expenses but beginning in 2010 used lower rates. If premiums are $8,000 for you and your spouse this year, in 30 years of retirement without inflation that's a total of $240,000 in premiums. If annual premium inflation is 3 percent, the one-year premiums in year 30 will be $19,000.

There also is care that isn't covered by any of those policies, most notably dental and vision care. You might choose some separate coverage for those or decide to pay them out-of-pocket.

You can reduce these minimum costs by having less insurance coverage. For example, you could enroll in Part B but not take out a Medigap policy. That would save money at least in the short run, because you won't have the premiums. When you do that, however, you take the risk that you'll be in the half of the population that incurs higher-than-average medical expenses, and you'll have to pay those expenses out of personal funds.

FINAL WORDS ON RETIREMENT MEDICAL EXPENSES

Many people approach retirement with misunderstandings about retirement medical expenses. They assume Medicare pays for almost everything or that inflation is low. A 2014 study for Fidelity found that 48 percent of those ages 55 to 64 believed retirement medical expenses are likely to total around $50,000. In this chapter, you were exposed to realistic estimates of retirement medical expenses. You learned the different types of insurance coverage available to U.S. retirees, and in general what is and isn't covered. You also learned how to plan for and reduce the uncertainty of retirement medical spending. I showed you how to develop a reasonable estimate of your retirement medical expenses.

You don't have to live in fear of retirement medical expenses or have them chip away at your financial well-being.

Follow This Plan

Budget for medical expenses. It's not easy to forecast lifetime medical expenses, because your future health is unknown. But don't assume they'll be the same as during your working years. Understand the difference between employer coverage for employees and Medicare. Know the rules about premiums, deductibles, and coinsurance. Also, know which care isn't covered. Then, prepare a separate forecast of medical expenses.

Review the Options

Almost everyone has Medicare Parts A and B. In Part B, you can choose between traditional Medicare and Medicare Advantage. Also, consider whether you should have a Medicare supplement policy to fill the gaps in traditional Medicare. If you opt for traditional Medicare, also consider a Part D prescription drug policy. Finally, consider buying long-term care coverage, which is discussed in Chapter 7.

Don't Miss the Deadlines

You'll face a coverage gap and higher lifetime premiums if you don't sign up for a Medicare part or buy a policy when you're first eligible. For Parts A and B, you'll be enrolled automatically at age 65 if you're receiving Social Security. If you're not, you need to apply for Part B and buy a Part D policy (if you want one) during the period that begins three months before your 65th birthday and ends three months after. But the enrollment dates are extended if you're working for an employer with 20 or more employees or have retiree health coverage from a former employer. Know your deadline and don't miss it.

Consider Extending Your Career

Staying in the workforce longer provides at least two benefits. You keep earning money, and so you can keep adding to your nest egg instead of draining it. Some people work an extra two or more years and earmark all of the additional savings for lifetime medical expenses. Working longer also means you don't retire before age 65 and won't have to seek coverage to fill the gap between your former employer's coverage and when Medicare begins at 65.

Remember Inflation

People often overlook the role of inflation in their retirement planning, as we discussed in Chapter 2. The problem is more acute for medical expenses, because their rate of inflation is higher than for consumer prices.

Shop for Coverage

In Part B, you can choose between traditional Medicare and Medicare Advantage. In most areas, you have a choice of Medicare Advantage plans. There also are a wide range of Medicare supplemental plans (Medigap plans) to consider. In most areas, there also are numerous Part D prescription drug plans.

The terms and costs of these options are very different. The right plan for you depends on how well the coverage suits your medical profile and the cost. Too often, people are paying much more than they need to for medical care because of they don't shop for the right policy. Or they pay too much for a policy, because a similar policy is available for less.

Medicare makes shopping around relatively easy through both its website (www.medicare.gov) and 800 number 1-800-MEDICARE (800–633–4227). Don't hesitate to seek help from Medicare, a seniors' agency, or tax-exempt group in your area, or from a financial planner.

CHAPTER 6: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. Which of the following is correct regarding employer-paid health coverage:

A. more retirees have employer-paid health coverage today than ever before

B. if a retiree has employer-paid health coverage, that coverage will last until he or she dies

C. employer-paid health coverage has increased, in part, due to a change in accounting rules

D. many of the companies and unions that offer retiree medical benefits now are integrated with Medicare

2. Medicare Part B, or traditional Medicare, covers which of the following:

A. hospital expenses

B. doctors' care and basic medical care

C. prescription drugs

D. all of the above

3. Larry turns 65 in June. He is required to enroll in Medicare Part B or C in which of the following timeframes:

A. in June

B. anytime in the next 12 months

C. between June and December of that year

D. between March and September of that year

4.	**Which of the following is <u>not</u> correct regarding Medicare Savings Accounts (MSAs):** **A.** MSAs are similar to Health Savings Accounts **B.** MSAs are not widely available **C.** each year, the retiree makes a deposit directly into his or her MSA **D.** money from the MSA can be used to pay deductibles
5.	**Which of the following is correct regarding Medigap policies:** **A.** the best time to buy a Medigap policy is during the initial enrollment period **B.** Medigap policies work best in conjunction with enrollment in Medicare Advantage **C.** Medigap policies vary widely from state to state **D.** a Medigap policy purchased in the initial enrollment period can be cancelled by the insurer at any time
6.	**Which of the following is the easiest way to decrease medical insurance premiums:** **A.** lower the deductible and copayments **B.** lower the deductible and increase the copayments **C.** increase the deductible and lower the copayments **D.** increase the deductible and copayments

CHAPTER 6: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. In the 1980s, 70 percent of even early retirees still had employer-paid health coverage. Today, very few retirees have employer-paid health coverage. **B.** Incorrect. Even if a retiree has employer-paid health benefits today, it doesn't mean he or she will have them tomorrow. Most employers can reduce or eliminate coverage for those already retired, and the courts usually uphold their right to do so. **C.** Incorrect. The change in accounting rules, requiring companies to recognize on their books today the cost of promised future retirement benefits, has led to most companies reducing or eliminating retiree coverage. **D.** CORRECT. Many of the employer and union plans that offer retiree medical benefits now are integrated with Medicare. Retirees are required to enroll in Medicare, and the employer or union plan covers only some care and expenses that Medicare doesn't. *(See page 117 of the course material.)*
2.	**A.** Incorrect. Medicare Part A covers hospital expenses. **B.** CORRECT. Medicare Part B, or traditional Medicare, covers doctors' care and basic medical care. **C.** Incorrect. Medicare Part D covers prescription drugs. **D.** Incorrect. Only one of the selections is correct. *(See page 119 of the course material.)*
3.	**A.** Incorrect. The initial enrollment period is longer than the birth month. **B.** Incorrect. The initial enrollment period is shorter than one year. **C.** Incorrect. The enrollment period does not start with the birth month. **D.** CORRECT. The enrollment period is generally within the seven-month period that begins three months before the 65th birthday and ends three months after that birthday. *(See page 121 of the course material.)*

4.	**A.** Incorrect. MSAs are similar to Health Savings Accounts, but they are slightly different. **B.** Incorrect. MSAs are not widely available. In some areas, they are not currently an option. **C.** CORRECT. Medicare gives money to the Medicare Advantage plan each year, and the plan deposits some of that money into the MSA. The retiree does not make any deposits in the MSA, nor are they allowed to. **D.** Incorrect. A retiree can choose to withdraw money from the MSA to pay for any medical expenses not covered by the Medicare plan or to meet deductibles. *(See page 128 of the course material.)*
5.	**A.** CORRECT. The first and best time to buy a Medigap policy is during the initial open enrollment period. **B.** Incorrect. A retiree is not allowed to buy a Medigap policy if they are enrolled in Medicare Advantage. **C.** Incorrect. Medigap policies are standardized by the federal government. **D.** Incorrect. Once a retiree purchases a policy during the initial enrollment period, the insurer cannot cancel the policy as long as the premiums are paid. *(See pages 129 to 130 of the course material.)*
6.	**A.** Incorrect. Lowering the deductible and copayment amounts will increase medical insurance premiums. **B.** Incorrect. Lowering the deductible amount while increasing the copayments is not the easiest way to decrease medical insurance premiums. **C.** Incorrect. Medical insurance premiums won't be as low as they could be by increasing the deductible while lowering the copayment amounts. **D.** CORRECT. Increasing both the deductible and copayments is the easiest way to decrease medical insurance premiums. *(See page 139 of the course material.)*

CHAPTER 7: DEALING WITH THE CRISIS IN LONG-TERM CARE

Chapter Objective

After completing this chapter, you should be able to:

- Identify which services long-term care (LTC) covers.

Long-term care (LTC) is a great American paradox. On the one hand, most people don't want to talk about it. One survey found that 25 percent of adults would rather go to the dentist than discuss LTC. Fewer than 30 percent of adults have had a conversation about long-term care planning with an advisor or loved ones. Yet, paying for LTC and the financial cost of long-term care are the greatest financial concerns of Americans over age 40. They worry that if they need LTC the cost will dissipate all their assets and impose a burden on their loved ones.

LTC generates more confusion and misinterpretation than many other topics. Probably because Americans don't like to discuss LTC, when they do consider or discuss LTC and long-term care insurance (LTCI), the discussions tend to be filled with errors.

One survey of Americans 40 and older revealed the depth of the confusion about and discomfort with LTC and LTCI. About half of people said they understand most people are likely to need long-term care sometime after age 65, but believe they won't be among those who need it. Most people say they expect family to provide needed care, though 60 percent say they haven't discussed this with relatives. They also haven't assessed whether any family members are able to perform the tasks needed for in-home care or would have the time.

The cost of long-term care is significantly *underestimated by* 60 percent of the respondents. Yet, most people significantly *overestimated the* cost of insurance to cover long-term care. They believe the insurance costs far more than it does. Only 20 percent underestimate the cost, and a mere 16 percent stated the correct range. Perhaps that is why only about 5 percent of those 40 and older own LTCI. The mistaken belief of 56 percent of those surveyed is that the annual premium for a healthy 55-year-old couple is $7,000 or more. The actual average cost in 2014 was only $2,700, according to the American Association for Long-Term Care Insurance.

Another mistaken belief is that Medicare or Medicaid will pay for long-term care. Medicare pays only a small percentage of long-term care costs, and those payments primarily are for relatively short-term rehabilitation after an illness or injury. Medicaid does pay a significant portion of the nation's long-term care costs, but coverage isn't automatic. You have to meet the definition of being impoverished before Medicaid will cover you.

About the only question concerning LTC and LTCI answered correctly by a majority of the respondents was when they were asked how familiar they were with the topics: 53 percent said they were not too familiar with the topic, and another 26 percent said they were not at all familiar with it. Another survey found that two-thirds over 40 have done little or no long-term care planning.

Complicating decisions about handling LTC is that the insurance market has been in turmoil since 2009. Insurers began raising premiums substantially on long-term policyholders, some by over 40 percent in one year, even insurers that resisted substantial premium increases in the past. A number of insurers dropped out of the LTCI market. Those insurers that continued to offer LTCI changed their underwriting practices, making it harder for people to obtain LTCI, and for the most part increased premiums. There have been anecdotes and some data indicating that a few insurers increased the number of claims they declined to pay.

Most states imposed rate stabilization laws over 10 years ago to reduce the volatility of premiums. The laws require insurers to justify large premium increases by documenting unusual or unexpected circumstances. Premium increases have to be reviewed and approved by state regulators before they can be imposed. Despite these hurdles, the insurers had the rate increases approved.

Several factors were behind the premium increases and other changes, and they all boil down to actual experience being different from the assumptions made when the policies were written:

- *Interest rates are low.* Rates and investment returns were much higher when the policies were written. Insurers collect premiums and invest them for years before claims are paid. The investment returns are a significant portion of the money insurers use to pay claims and generate profits. Low interest rates led to a significant shortfall of investment income for insurers.
- *People kept their policies.* Premiums were determined assuming a certain percentage of people would pay premiums for a few years, and then let the policies lapse. Fewer people than expected dropped their policies, and over time that leads to the insurers paying more claims than expected when the policies were issued.
- *People are living longer.* LTC is most likely to be needed by those 80 and older. As that age group increases faster than insurers expected, claims on policies are higher than planned.
- *Long-term care costs keep rising.* Again, these increases exceed what insurers planned.
- *Some insurers did a poor job of underwriting.* They issued policies to applicants without thorough medical reviews, underestimating the amount of claims that eventually would be filed by policyholders. That is fairly common in the history of LTCI. In the past, however, the large, experienced LTCI carriers didn't commit that error, but in recent years some of them did.

The result of all these factors is insurance companies lost money on LTCI, or at least earned a lot less than they expected and could earn elsewhere.

In this chapter we're going to discuss LTC. You'll learn the potential of incurring LTC costs and what those costs could be. We'll also discuss the different ways to pay for LTC, including the pros and cons of

LTCI. You'll learn how to incorporate LTC in your retirement plan. Along the way I hope to dispel many of the myths and correct the misunderstandings about LTC and how to pay for it.

WILL YOU NEED LONG-TERM CARE?

A battle of statistics takes place whenever LTC is discussed.

The U.S. government reported in 2014 that 70 percent of those then aged 65 or older would need some long-term care in their lifetimes. That number is used to make the case that everyone should own long-term care insurance (LTCI). But a close look at the data indicate that only 19 percent of men and 31 percent of women should purchase LTCI, according to a study from the Center for Retirement Research at Boston College.

Both sets of statistics are misleading.

Most people think of LTC as a long-term stay in a nursing home. That's not the case. Despite its name, LTC encompasses a wide range of care, from a few days of rehabilitation after surgery to many years of custodial care in a nursing home. LTC includes home-based care, residence in an assisted living facility, and more.

Within that wide scope, it is no surprise that most of those 65 and older will need some LTC at some point in their lives. Yet, most of that LTC won't be a crushing financial burden. Medicare, for example, pays for nursing home stays of 100 days or less that follow hospital stays of more than three consecutive days. That covers the nursing home stays of 50 percent of men and 40 percent of women, according to the CRR study.

Men on average who enter nursing homes spend a year or less there, while women on average spend about 16 months, according to the CRR study.

The CRR study does much to correct the exaggerations in the government's 70 percent figure, but the CRR study also doesn't tell the whole picture.

Many people believe that LTC is nursing home care, and LTCI is nursing home insurance. Those beliefs are incorrect. A wide range of care counts as LTC.

Most LTC these days occurs outside of a nursing home. A majority of LTC is delivered at home or an assisted living facility. Even most nursing home stays these days are short-term stays for rehabilitation after a surgery, an injury, or major illness. LTC includes part-time or full-time help with two or more of the activities of daily living (ADLs), including dressing, bathing, eating, using the toilet, transferring, and walking. Medical care and treatment often is only a small part of LTC. A home care aid who visits a few hours each day to clean the house and prepare meals is a common form of LTC.

Most people prefer to remain in their homes for as long as possible, and the home care industry has developed to fulfill these wishes. LTCI also has changed over the years so that it covers qualified LTC wherever the care is delivered. Even adult day care now is covered by most LTCI policies.

The information you really are interested in when considering LTC in your plans is the probability of needing any form of LTC for an extended period and how much it will cost. Here's some data that are on point and relevant for your decision.

About 40 percent of people after age 65 will need two or more years of LTC, according to the American Association of Long-Term Care Insurers. Just under half of those over 65 will need some form of LTC for 90 days or more. Women are more likely than men to need LTC for an extended period for two reasons. Women live longer, and the very old are likely to need help with some tasks of daily living, even when they're relatively healthy. Women also have a higher incidence of Alzheimer's disease. This doesn't mean men don't need LTC, but women on average have a greater need.

Most LTC needs are for less than a year. While not the multiyear instances most people fear, they're still significant and expensive. Your plans should determine how you would pay for different potential LTC needs. How will you pay if LTC is needed for 90 days or less? Up to one year? What if you or your spouse needs LTC beyond one year?

I mentioned that most people underestimate the cost of LTC. You can find reasonable estimates of the cost of LTC at the websites of two of the major LTC insurers: Genworth and John Hancock. These insurers publish updated annual estimates of the cost of LTC. In recent years, they began breaking down the costs by locality and type of care (home care, assisted living, and nursing homes). Of course, you can find national figures on the average annual cost of a nursing home or other care, but that doesn't help much in your planning. The cost of care varies considerably around the country.

For example, according to the John Hancock Insurance website, in 2015 in Buffalo, New York, a semi-private nursing home room cost $300 per day today, or $109,500 per year. A home health aide cost $132 for six hours. For a year the cost is $48,180. Adult day care cost $84 per day, or $21,840 for one year of five days a week attendance. A one-bedroom unit at an assisted living facility cost $98 per day, or $35,760 for a year.

Move a little bit up the state to Rochester and the costs were very different. The semi-private nursing home room was $354 per day or $129,210 per year, almost an additional $20,000 per year than in Buffalo. The home health aide was $144 per day, or $52,560 annually. But adult day care cost less in Rochester, $70 per day, or $18,200 annually. Assisted living cost $124 per day, or $45,348 for a year.

Those are examples of the variations in two places in one state. Price variations across the country are more significant. The Genworth and John Hancock surveys also are of median costs in an area. Quality of care and services varies between providers, as does price. A more precise fix on the cost can be obtained by contacting providers in your area and asking about costs and services.

You can see from these examples that even home care is what most people would consider expensive. Keep in mind that these prices are only for the basic services. If someone needs additional services or levels of care, the cost is higher.

These estimated costs are for care in 2015. People generally don't need those services until they are in their late 70s or older. If you are 65 today, you probably won't need the care for another 15 years or longer. In the meantime, the costs are likely to increase at a steady rate. John Hancock's website assumes 3 percent inflation to estimate future costs for all the services. Genworth says the five-year annual growth has varied from 4 percent for nursing homes to 1 percent for a home health aide. Inflation substantially increases the dollar amounts the care would cost in 15 or more years.

LTC is difficult to plan for, because you have a low probability of incurring a very high cost. Many people focus on the low probability portion of the equation, as you can tell from the survey cited earlier. As surveys show, most people also significantly underestimate the potential cost. The result is they put their own independence and financial security at risk as well as the independence and security of their loved ones. If you are among the minority who needs extended LTC, the cost will be extremely high. You own homeowner's and auto insurance for protection from risks that also have low probabilities but high potential costs.

Planning for LTC should be part of every retirement plan. You want to plan for LTC to avoid becoming a burden on your family, to protect the assets of you and your family, and to avoid dependence on others.

LTC planning involves a lot more than buying insurance. This is especially true considering the turmoil in LTCI following the financial crisis and the uncertainty about its future. When planning for potential LTC costs, you need to examine all the options: family, Medicare, Medicaid, LTCI, hybrid, or combination insurance policies (annuities and life insurance with LTC riders), permanent life insurance, and personal assets (self-insurance).

We'll discuss each of these options. For most people, it's best not to rely on only one of the options. Instead, a plan that uses all the tools in the toolbox to some extent is likely to offer a good amount of coverage of potential LTC expenses without costing excessive premiums.

RELYING ON FAMILY

There's a joke among financial planners and others who discuss LTC with people. The planner is sitting in his office with a married couple who are in their 50s or 60s. The planner says, "Now, let's discuss long-term care insurance." The husband nods toward his wife and says, "You're looking at her."

Many people do consider a spouse or other family members to be their likely source of long-term care. We've all known people who spent a lot of time helping to care for an elderly parent or other relative who no longer could live alone without help. For some people, it works out well. The care isn't needed for an extended period of time, and the parent and adult child might bond in ways that wouldn't have happened otherwise.

No doubt, most of us have adult children or others who are willing to provide help in a pinch. Helping around the house for a period of time, however, is very different from being a primary long-term care provider, especially for an indefinite or extended period of time.

Before considering family as your primary source of LTC, carefully consider all the facets of that decision:

- *Availability.* For one or more adult children to provide home care, he or she must be available. The person would have to live near you or be able to change his or her life by moving to your home for however long the care is needed. There might be competing obligations to his or her own children or to an employer or both. Even your spouse might not be fully available. If you're elderly and in need of care, it's likely your spouse will have physical limitations that make providing full-time care for someone else difficult.

- *Burden.* Many retired Americans report in surveys that they don't want to be burdens on their children. Providing care for someone is burdensome after a period of time. Even when the caregiver loves the person receiving the care, providing care for an extended period can be stressful and exhausting. The caregiver also is likely to incur expenses to the extent that aren't appreciated, even by the caregiver.

- *Qualifications.* Sometimes caregiving involves doing basic chores around the home: cooking, cleaning, and maintenance. It might even be as simple as directing others who are hired to do the work. That's the case when the person needing care doesn't have any serious physical or mental issues but simply is too old or frail to perform these tasks. Other times the care needed requires a person with some training. These tasks could include monitoring health and administering medication. Even providing assistance with bathing and dressing can require training when certain medical conditions are present. People with dementia and related diseases can be violent or have other types of behavior that are best coped with by someone with training.

- *Fairness.* Often there is one adult child in a family upon whom the burden of caregiving falls. Sometimes only one child is available. Other times only one child is willing to make the effort to provide care. Sometimes after one child begins providing care, the others don't feel a need to help.

- *Family harmony.* When one sibling or other family member provides care to the extent that others don't, discord can be created in several ways. Of course, the person providing the care might feel taken advantage of. The other family members might feel guilty and express that in different ways. Sometimes the caregiver receives compensation, either explicitly or though extra gifts or bequests. The other family members can become jealous of this or believe that the caregiver is overcompensated or used undue influence.

- *Facilities.* Home care is essential when family caregiving is a part of the plan for LTC. While more and more LTC is provided at home, it isn't always possible. Some conditions require residence at a place where professional caregivers or certain facilities are available all or most of the time, such as nursing homes or assisted-living facilities.

In most families, one or more family members are able and willing to provide some care. There are potential pitfalls and disadvantages, however, to planning for family members to be the primary caregivers when LTC is needed. Family caregiving might not be practical or could create long-term problems for one or more family members. In some cases, family caregiving isn't possible because a higher level of care is needed.

WHAT MEDICARE OFFERS

In Chapter 6 we discussed some of the myths and misperceptions about Medicare. Perhaps the most widespread and persistent myth about Medicare is that it pays for long-term care, especially nursing home care. Most people believe that, according to surveys. Yet, Medicare won't cover most needs of true LTC.

Medicare was created to cover primarily doctor and hospital expenses. It wasn't and isn't set up to cover custodial care or most other long-term care.

Medicare will cover 100 days or less of LTC following a hospital stay of more than three consecutive days. The coverage is meant for rehabilitation and recovery after a major surgery, injury, or illness. Much of it probably is for short-term nursing home stays but it also can include home care and assisted living care. Earlier we discussed how the study from the Center for Retirement Research at Boston University concluded that this rule covers 50 percent of nursing home stays of men and 40 percent of those of women. But these aren't instances of true LTC. These are short-term stays in nursing homes primarily for physical therapy and to gain the strength before the person can be discharged to home or an assisted living facility.

When we talk about LTC in a retirement plan, we're talking primarily about custodial care. This is needed when a person's age or infirmities make him or her unable to perform at least two of the activities of daily living. LTC also includes instances when dementia or similar conditions mean a person shouldn't live alone or is unable to care for himself or herself. Hospital stays rarely immediately precede these types of LTC, and so Medicare doesn't cover them. These types of LTC aren't covered by Medicare.

MEDICAID AND MEDICAID TRUST STRATEGIES

The other government program that pays for LTC is Medicaid. Medicare is the program for those 65 and over, while Medicaid is for all ages but only for those with limited incomes and assets.

Many people assume Medicaid will pay for their LTC, and that is their plan. Medicaid is one of the largest government programs and does pay about 45 percent of the nursing home bills in the United States. Dig a little deeper, however, and you'll see that relying on Medicaid isn't a viable option for many people.

Medicaid doesn't cover any assisted living care, which is a popular and fast-growing type of LTC. Medicaid also pays only limited home care. Home care is the preference of most people and also is a fast-growing type of care.

Medicaid is confusing to many people mainly because it is a joint federal-state program. The federal government provides roughly half the funding and also sets broad rules and guidelines. The level of federal funding varies from state to state. Each state has some flexibility in the details of its program, including who is eligible and which services are covered. There also are pilot or test programs within Medicaid that a state can establish with the approval of the federal government.

To have Medicaid pay for your LTC, you must be a U.S. citizen or have an appropriate visa, be a resident of the state in which you apply, and be 65 or older or permanently disabled or blind. You also must have a Medicaid-authorized professional (often a nurse from a local social services agency) determine that you meet Medicaid's functional limits standards for LTC. Finally, and perhaps most importantly, you must meet the financial tests for Medicaid eligibility.

The financial tests are both an income limit and an asset limit. As I said, each state sets its own rules within federal guidelines. A person might be eligible for Medicaid in one state but not in another. The income limit can be based on either the federal poverty level of Supplemental Security Income (SSI) benefits for the state, sometimes known as welfare. A state can set its income limit as high as 300 percent of the SSI benefit if it wants.

Not all states have formal income limits. The formal income limits generally are around $2,200 per month. Some states simply require a person to spend all or most of his or her income on LTC, perhaps excluding some allowances. The state then will pay any additional LTC costs.

There are allowances that allow you to keep income above the eligibility maximum. A maintenance monthly needs allowance is available when the person needing LTC has a spouse with a limited income. Each state sets its own allowance, and they generally range from $2,000 to $3,000 monthly. A personal needs allowance of $30 or more is available for items not provided by a nursing home, such as personal care items or services, taxi fares, and even movie tickets. Income used to pay for out-of-pocket medical costs can be an allowance.

Income from a trust also might be excluded or treated as an allowance. These trusts are known as qualifying income trusts, supplemental needs trusts, or Miller trusts. A person can have regular sources of income, such as Social Security or annuity distributions, paid into the trust and it won't be counted when determining Medicaid eligibility. To receive that treatment, however, all income and principal of the trust can be spent only on your needs. Also, the state must be remainder beneficiary of the trust so that it receives any assets remaining in the trust after you pass away.

The asset limit usually is tighter than the income limit and the hardest for many people to meet. Generally you total all the assets you own and subtract exempt assets. To be eligible for Medicaid, the remaining amount can be only $2,000, or $3,000 for a married person. That's why this sometimes is known as the impoverishment test. To be eligible for Medicaid, a person must spend or give away assets until he or she essentially is impoverished, except for the exempt assets.

The exempt assets under the federal rules are:

- A home that is the principal residence of the applicant and is in the same state in which he or she is applying for Medicaid. The home can be of any value, but federal rules say the equity can't exceed $500,000 (indexed for inflation), though states can increase that up to $750,000. A state also can require that there be a reasonable likelihood that the applicant will be able to return to the home.
- One automobile of any value if it's used for transportation of the applicant or a household member. An additional automobile may be excluded if it's equipped for use by a handicapped person, if it's needed to go to work or to perform essential daily activities due to distance, climate, or terrain, or if it's used to obtain regular medical treatment.
- Up to $2,000 of personal items and household goods.
- Life insurance with a face value of $1,500 or less per person.

- Burial funds of up to $1,500 each for the applicant and spouse, plus accrued interest.
- Any property essential to self-support, such as property used in a job or business.
- Other resources used to achieve self-support.
- Some types of annuities.

When the applicant is married, all assets owned separately by either spouse or owned jointly are included in the assets of the applicant spouse. Either the applicant or the spouse can ask the state to assess the couple's combined countable assets. This process often increases the exemptions. Exempt assets when the applicant is married are:

- A home of any value if it is the nonapplicant spouse's principal residence.
- The furniture, furnishings, kitchen items, and other household goods in the house without limit.
- The personal effects of the spouse without limit.
- A community spouse resources allowance. This is an additional amount of exempt assets of any type that don't fit in the other categories. The nonapplicant spouse is allowed to keep half of those assets. The federal government says the states can set the allowance from a minimum of $23,844 to a maximum of $119,200 in 2015, with those amounts indexed for inflation each year. The nonapplicant spouse can keep only half whatever allowance the state sets or the minimum amount of $23,844, whichever is higher. The remaining balance won't affect Medicaid eligibility but must be spent on the applicant spouse's care.

Keep in mind that this is an asset ownership test, not a net asset or net worth test. Any debt owed by the applicant isn't considered. It is possible that a person has a negative net worth, because his debts exceed the value of his assets. Yet, he won't be able to keep all the assets because they exceed the asset limits of the Medicaid eligibility test.

The Asset Shifting Strategies

Many older Americans have seen promotions for seminars and publications on how to shift assets to qualify for Medicaid's nursing home coverage. Here is a brief guide to those strategies and the angles to consider before pursuing them.

As we've seen, Medicaid is the program for those with limited assets and income. Seniors have to be impoverished in order to qualify for Medicaid's nursing home coverage. Medicaid uses both income levels and asset ownership to determine who qualifies for coverage.

The income limits vary a bit from state to state, but can be met by giving as many income-producing assets as possible to a spouse and children. Likewise, the net worth or resource limit can be met by giving away assets that are not on Medicaid's list of exempt property.

The first of the Medicaid strategies is to put wealth into an expensive house. Other assets are sold to buy a house that is bigger than needed and otherwise probably wouldn't be purchased. That way, the wealth is kept in the family but is not counted against Medicaid qualification. Married couples also can load up on an expensive car, personal effects, and household furnishings in many states.

Another strategy is to transfer to individuals or to trusts any other assets that exceed the Medicaid resource limits. These have to be irrevocable transfers under which the original owner is not legally entitled to get the assets back or receive income from them. To discourage these strategies, any assets transferred to a person or trust within 60 months (five years) of applying for Medicaid are considered owned by the applicant when determining Medicaid eligibility.

That means to qualify for Medicaid, either the trust must be funded more than 60 months before entering a nursing home or enough assets must be retained to fund up to the first 60 months of nursing home care. Medicaid then is applied for after 60 months of long-term care.

This 60-month period is known as the look-back period. If you violate the look-back period, then there is a penalty that is an additional waiting period before you are eligible for Medicaid.

Here's how the look-back penalty works. The gifts and transfers you made in the 60 months before applying for Medicaid are divided by the average monthly cost of a nursing home in your area. The result is the number of additional months you must wait to be eligible for Medicaid to cover your LTC.

Suppose someone transferred $300,000 to his children during the 60-month look-back period. He then applies for Medicaid. The average monthly cost of a nursing home in his area is $10,000. Dividing $300,000 by $10,000 results in 30. This means that after the man enters a nursing home and meets Medicaid eligibility requirements, he has to wait an additional 30 months before he is eligible for Medicaid.

Some states allow an applicant to work down the penalty period by paying for nursing home care. In this example, assume that the man entered the nursing home and family members began paying for the care. Each month the man spends in the nursing home is one month off the penalty. Also, each month the man or a family member pays for the nursing home care is another month off the penalty. So, the man is eligible for Medicaid after 15 months instead of 30 months.

The waiting period doesn't begin until the person who made the transfers has moved to a nursing home and has applied for Medicaid coverage and been approved for coverage except for the waiting period.

Suppose a woman transferred $100,000 in assets to her children on November 1, 2015. She moves to a nursing home on November 1, 2016. Her Medicaid application and review were completed by that date. The $100,000 is included in her assets and is deemed to violate the 60-month look-back period. If the waiting period is determined to be 10 months, she won't be eligible for Medicaid until August 1, 2017, 10 months after she moved into the nursing home.

There are other nuances and details to Medicaid eligibility. If you're considering such strategies, don't undertake them without the advice of an attorney who is familiar with Medicaid law in the state where you'll be applying.

Before implementing these strategies, consider the potential drawbacks. The biggest drawback is that Medicaid's reimbursements to nursing homes generally are less than it costs to adequately care for someone. Nursing homes that take primarily Medicaid residents often provide care that is inferior to care in nursing homes that have primarily non-Medicaid residents. Those contemplating these strategies should compare a Medicaid nursing home to one that takes primarily private pay residents. Then those who have resources to pay for non-Medicaid care should decide if they really want to be cared for in a Medicaid facility.

Also, even if the strategies are followed precisely, a state has the option of arguing that transfers made under a Medicaid impoverishment strategy were fraudulent. That has not been seriously tested in the courts, but no one can rule out a state's winning that argument.

The strategies also might generate taxes. Transfers to individuals or trusts are gifts that, after exceeding the annual exemption amount, either are applied against the lifetime estate and gift tax credit or incur gift taxes. These taxes are not a major issue now that the lifetime exemption amount is $5 million, indexed for inflation. But some people will have to consider taxes before undertaking a strategy. The person transferring the property must pay the gift taxes.

The strategies also could increase income or capital gains taxes on the family. The person receiving the gift takes the same tax basis in the property the prior owner had. That means when the donee eventually sells the property, he or she will pay capital gains taxes on all appreciation that occurred during the donor's ownership. If the property were held until death instead and received by inheritance, the basis would be increased to its current market value and capital gains taxes on the past appreciation would be avoided.

Medicaid also has a clawback policy, known formally as estate recovery. States are required to seek repayment of all Medicaid money paid for nursing home care. They are to seek the repayment from the estates of the beneficiaries as well as their families.

It doesn't matter if an asset was exempt from the income or asset limits under Medicaid eligibility rules. The state can seek reimbursement from any asset that's in your estate, including exempt assets. Recovery can be sought from both probate and non-probate estates. The probate estate is assets you owned and that pass through the probate process, such as real estate, financial accounts, and personal possessions. The nonprobate estate includes annuities, life insurance, trusts, jointly owned property, and some other assets. There are some exceptions for a residence. Generally if a house was an exempt asset for Medicaid eligibility, the state won't seek to recover its Medicaid expenses by selling it until your spouse has passed away and any blind or disabled child of yours is at least age 21, if they were living in the house.

Some states are more aggressive than others in seeking recovery from estates and relatives. You should check the situation in your state before deciding that having Medicaid pay your nursing home expenses is part of your plan.

Finally, consider the ethics. Medicaid was set up for poor people, not for people who have the resources to pay for nursing home care but don't want to spend their money that way. Some people think it is unethical to arrange assets so that taxpayers pick up the tab.

EVALUATING LONG-TERM CARE INSURANCE

We discussed earlier in this chapter the turmoil in long-term care insurance since 2009. About half of the major insurers who were in the LTCI market decided to fully or partially leave the market. A number of insurers, though not all, substantially increased premiums on long-term policyholders. It's also become more difficult and more expensive to buy LTCI.

The situation complicates an already difficult decision for many people. A lot of misinformation and confusion typically surrounds LTCI, and the turmoil doesn't help. In this section we're going to look objectively at LTCI and establish guidelines for deciding how to incorporate it in your planning.

Not many people buy LTCI. Insurer industry groups estimate that only about 3 percent to 5 percent of the likely LTCI buyers (mostly those 50 and older) purchased the policies.

The premium increases in recent years scare people away from LTCI, but perhaps they shouldn't. The premium increases were a result of several factors we discussed earlier. In the wake of these factors, insurers have changed practices. They've adjusted to lower investment returns, longer life expectancy, fewer policy lapses, and rising LTC costs. These factors now are incorporated into the process for setting premiums on new policies. The weak insurers and those with little experience in LTC have dropped out of the market. That could mean that for new policy buyers, future surprise premium increases are much less likely.

Many people say they don't purchase the policies because they're expensive. Surveys indicate that could be due to bad information, because a majority of people in surveys estimates the cost of LTCI at about twice what it really costs.

That's not to say that LTCI is cheap. The cost will depend on your age, health history, where you live, and other factors. Where you live is a major factor, because the cost of LTC varies considerably around the country. In 2015, a married couple with each spouse age 55 would pay an annual premium of about $2,350 to cover both spouses. That's a national average premium. If the couple were older or not in excellent health, the premiums would be higher.

We'll learn later in this section that there are a number of provisions in an LTCI policy that can be adjusted to meet the policyholder's needs or preferences. Changes in these provisions can cause the premiums to be higher or lower. Because of that flexibility, a generic premium quote or estimate isn't useful. You can change the policy terms so that you still have coverage but the premiums are more affordable.

Many people say they don't like the use-it-or-lose-it aspect of LTCI. You can pay premiums for decades and pass away without needing much LTCI or filing a claim. In that case, there is no reimbursement to you or your estate. (You can buy policies with a return-of-premium or similar features, but the features increase your premiums.) Of course, most of us do the same each year with homeowner's and automobile insurance. We don't expect to receive much for our premiums and hope we don't have to file a claim.

Instead of focusing on premiums and return of premiums, a better approach to deciding whether or not to purchase LTCI might be to compare the potential benefits of a policy with the potential loss from not having LTCI. An example of how to analyze the issue this way was presented by Joe Tomlinson on AdvisorPerspectives.com in 2015.

In the example, a 55-year-old was paying premiums of $3,400 annually for an LTCI policy that would pay daily benefits of up to $225 for up to five years of care and with inflation protection. The policy would pay benefits only after the first 90 days of LTC. The present value, or cost in today's dollars, of the premiums through age 85 is $60,000.

Looking at data on the need for LTC, Tomlinson estimated that there was a 60 percent probability that no claim would be filed under the policy. That's what keeps many people from buying LTCI. That essentially would mean a $60,000 loss for the man, because no financial benefit would be received from the premiums.

There was 20 percent probability one year of care would be needed. Tomlinson assumed that care would cost $57,000 in current dollars and would rise 3.5 percent annually. Also, the policyholder would pay for the first 90 days of care, and the policy would pick up the tab only after that. The net result is a $12,000 present value loss from purchasing the policy.

There's also a 10 percent probability of needing three years of care. After netting all the factors, that's an $85,000 present value gain from purchasing the insurance.

The probability of needing five years of care was 10 percent. Netting all the factors would result in a $183,000 present value gain from the insurance, according to Tomlinson.

Now, instead of looking only at the insurance, let's add other factors. Assume the man has $250,000 in investment assets at age 55 and invests conservatively. He expects to be able to leave this to his children through his estate. Consider how that goal is satisfied under different scenarios when there is no insurance:

Scenario 1: No need for LTC. That leaves the full $250,000 available for the heirs.

Scenario 2: One year of care is needed. The estate is reduced to $202,000.

Scenario 3: Three years of care are needed. The nest egg is reduced to $105,000.

Scenario 4: Five years of care are needed. The estate is reduced to $7,000.

The different scenarios indicate there is a lot of variability in the amount that will be available to the man's children. It also shows that the financial effects of a low probability event, needing LTC for three to five years, will greatly reduce the estate. That's before considering the scenario that concerns most people, which is a very long need for LTC.

As I said earlier in this chapter, LTC has a low probability but a high potential cost.

The man might decide to essentially self-insure and still try to leave substantial assets for his children by investing more aggressively to earn higher returns. But the investment returns are not guaranteed. The investment strategies could generate low returns or even losses, as well as high returns. That approach introduces another layer of volatility and uncertainty to an already volatile and uncertain situation.

Suppose the investment strategies don't work, and the man also needs LTC? Tomlinson estimated that not buying LTCI is more risky than aggressive investing on its own. He estimated that not buying LTCI is six times more risky.

Buying and Designing a Policy

Many of the long-term care insurance policies issued over the years have not paid benefits. There are some estimates that less than 5 percent of policies issued have paid benefits to date. Part of the reason is that the bulk of the people who purchased the policies still are healthy. Another reason is that apparently a large percentage of long-term care policies are allowed to lapse after a few years. The policy owners decide that they cannot afford the premiums or that the premiums are not worth the potential benefits, so they stop paying premiums. Some probably switch to policies they find more attractive. Other policies haven't paid benefits because the policy terms were restrictive. The owners might have needed help with care-related expenses, but their care didn't qualify for reimbursement under their policy terms.

Once a decision is made to buy a long-term care insurance policy, careful consideration must be given to the design of that policy. Always remember that some of the provisions in the policies can be dropped, added, or changed. The terms selected determine the premiums charged and the coverage received. There are five key policy terms that can be adjusted to make the premiums more affordable, while still ensuring that expenses the family cannot afford are likely to be covered.

Customizing a Policy

Following are some key terms and how they can be adjusted to design a custom-made long-term care insurance policy.

Daily Benefit

Long-term care policies promise to pay a maximum daily benefit for each day of covered care. There usually are separate daily benefit levels for home health care, assisted living, and nursing home. There also might be benefit levels for adult day care and other covered care. The insured picks the daily benefit amounts and counts on personal or family income and assets to make up any difference between the covered amounts and the actual cost.

The national average daily cost of a nursing home is $181 for a semiprivate room. There usually are additional costs. The average daily rate covers room, board, and some basic nursing care. Most residents need additional care, and these generally amount to about 20 percent of the daily cost. The additional costs can be for prescription drugs, physical therapy, personal grooming, and other expenses. Some of these costs might be covered by other insurance. Others won't be. Costs are higher in urban areas and lower in rural areas. The home health care benefit often is set at a percentage of the nursing home benefit, usually 75 percent to 100 percent of the nursing home benefit, though it also can be set as a dollar amount.

Survey nursing home costs before picking a daily benefit, but give careful thought to the area surveyed. The choice of a nursing home or other care facility often is made by a woman in her 40s or 50s. In other words, a daughter or daughter-in-law usually decides where a parent or an in-law resides. When an insured's children live in a different area from the insured, the relevant costs might be those in the area where the children live. The children are likely to move the parent to a nursing home in their area instead of in the parent's area.

Once the cost for an area is determined, decide whether or not the policy should cover the full cost. An individual might not be able to afford $130 or more per day for an indefinite period, but insuring for the full amount might make the policy premium too high. On the other hand, the insured might be able to pay $20 or more per day indefinitely if the need should arise, and reducing the daily benefit by that amount might make the policy affordable. For example, suppose Social Security pays the insured $10,000 annually. If there is not a spouse who would need that income, it is available to pay for long-term care. That means the daily benefit can be reduced by about $27 per day ($10,000 annually).

Keep inflation in mind. Long-term care costs historically rise faster than consumer price inflation. Historically, the average annual increase in LTC is 7 percent. The rate has declined in recent years to the 3 percent to 4 percent range.

Waiting Period

This also is known as the deductible or elimination period. It is the length of time that the insured receives covered care before the policy starts paying benefits. Insurers usually offer waiting periods from 0 to 365 days. Most people choose 90 days. The insured (that's you) pays for all long-term health care during the waiting period. Then, if care still is needed, the insurance company begins paying its obligations under the policy.

Here's a key point that sometimes confuses people. The waiting or elimination period doesn't start to run until you actually begin receiving care that you or someone else is paying for. Some people think that after they've been diagnosed with a need for LTC, they can stay at home and receive help from family and friends for 90 days (or whatever the elimination period is) and then begin LTC that is fully paid by the policy. That's incorrect. You have to begin receiving care that qualifies under the policy and that you pay for to start the elimination period running.

The insured selects the waiting period, and it is a form of self-insurance. Selecting a longer waiting period is similar to selecting a higher deductible on a home or car insurance policy. The longer waiting period reduces the premiums on the policy.

The insured might decide that the policy is only for the worst-case scenario when long-term custodial care is needed for years. In that case, the owner would select a waiting period of 365 days. That turns the policy into a catastrophic long-term care policy and should substantially reduce premiums. The reduction might make the policy affordable or might allow the daily benefit to be raised high enough so that none of the insured's assets are used after the waiting period.

Do a little arithmetic before making a decision. You could have an LTCI policy that pays benefits from the first day you need care, or you could opt for a 90-day elimination period. On average, going for the 90-day elimination period reduces annual premiums by about $750. Also on average, the 90 days of LTC will cost $30,000 or more. You'll have to pay for that. It will take about 40 years of saving $750 to equal $30,000. So, you need to own the policy for a long time for the longer elimination period to be a benefit.

The lesson is that before electing a policy change that reduces premiums, calculate how much responsibility you're taking on and how much it could cost you in the long term. Balance that against the short-term benefit of lower premiums.

Benefit Period

This is the length of time the policy pays benefits. Many policies call this the maximum lifetime benefit. For example, a three-year benefit period is a maximum lifetime benefit of 365 days times three times the maximum daily benefit. A $150 daily rate would make the lifetime benefit about $165,000.

The maximum lifetime benefit has a great influence on a policy's premium. A maximum of three years of coverage costs about half that of unlimited lifetime coverage. A five-year limit reduces the premium by about 25 percent below the unlimited amount. One of the adjustments insurers made in recent years is not to offer unlimited lifetime benefits. Most policies available now allow the insured to choose a maximum policy benefit of no more than five years.

While most long-term care these days is for a relatively short time, those whose needs extend beyond the short term tend to need care for a considerable length of time. One study reported that long-term home care in general lasted on average 4.5 years, while long-term nursing home care on average lasted for 2.4 years. Remember, these numbers exclude short-term stays and include only people who need LTC for more than 90 days. Only about 9 percent of all nursing home stays are for five or more years, though some studies put that number higher.

The issue for the insured is how much to reduce premiums by taking on the longer-term risk. Those who are using the insurance to protect against the worst case will take the longest benefit period they can afford and use other provisions to reduce premiums. Other policy buyers might be comfortable reducing premiums by assuming they won't exceed the average long-term stay of two and a half to three years.

Inflation Protection

The younger the insured, the more important it is to protect against inflation. Even relatively older insureds, however, should seek inflation protection. The effects of compounded price increases, even at relatively low inflation rates, increase the cost of care substantially over 10 years and longer. Most people should not skimp on inflation protection in a long-term care policy.

The standard inflation protection is a maximum of 5 percent annually. Some policies offer a simple inflation protection option, but the compound inflation protection option offers better protection. After 10 years, the difference is substantial. Compound protection is worth the cost if it does not make the premiums unaffordable. If simple inflation protection is the only option, a better choice might be to drop inflation protection and opt for a substantially higher daily benefit. Usually this offers more protection for the premium dollar.

Inflation protection is expensive, so you might want to consider a higher daily benefit as an alternative to inflation protection. Because of the way insurers determine their premiums, the premiums are likely to be lower when taking this approach. It can make sense to pick a daily benefit that exceeds the current average cost and is close to what the cost is likely to be in 10 or 15 years after inflation. That way the insured is well covered without having to pay for expensive inflation protection.

Covered Care

This used to be a big hole in long-term care policies but now is less of a problem. The policy should cover both skilled and custodial care. The care should be covered whether it is given in a nursing home, assisted living facility, or at home. Many policies now will cover adult day care and some other forms of care. The daily benefit amount will differ, but you want as many types of care covered as possible. Avoid home-care provisions that say only professional licensed home-care services, such as registered or licensed practical nurses, will be covered. Someone who needs home care often needs help with basic chores such as cooking and cleaning. Older policies, in particular, would limit covered care only to those provided by licensed professionals. You should avoid such coverage limits.

Joint Policies

Many insurers now allow a married couple to purchase one joint policy covering the couple instead of two individual policies. The premiums for a joint policy usually are lower than for two individual policies by about 20 percent. The potential downside of a joint policy is that the first spouse to need LTC exhausts the policy benefits and there is no coverage should the second spouse need care. It’s a low probability event but could happen. You need to consider this scenario when deciding on the benefit limits of a joint policy.

The previous six provisions can be used to structure a policy that meets most of an individual’s needs and is affordable. The insured must estimate the amount of income and assets that can be devoted to long-term care in the future. Some people will decide they can pay expenses for only a limited time, say 90 days or a year. After that, insurance will have to take over. Others will decide that they can pay a small portion of the expenses indefinitely but that insurance will have to cover most of the cost. Policy provisions can be adjusted to accommodate those two scenarios as well as many others.

Factors Outside the Policy

There are three more factors to consider before buying a policy. These are factors outside the individual policy terms, but they can affect either the cost of your coverage or whether the coverage is available when you need it.

Financial Condition

Be sure to check on the financial safety ratings of the insurer. The ratings should be available from any insurance agent or broker, as well as from your local library or the Internet. Lower premiums probably are available through the less-sound insurers. However, these policies are designed for long-term protection, so the insured should make relatively certain that the insurer will be around for many years.

Premium Increases

Premiums will increase. Long-term care policies still are fairly new, and insurers are learning. They made mistakes in the past by grossly underestimating claims. An early indication of probable future increases is how closely the company checks out a prospect before issuing a policy. An insurer that checks out a prospect’s health carefully before issuing a policy probably will have a good premium history. An insurer that does little more than require a short questionnaire is likely to be surprised by higher claims than anticipated and to resort to sharp increases in premiums.

The insurance company or broker should provide a history of rate increases for the type of policy being considered. The state insurance department also can provide a premium increase history.

If someone can barely afford a policy now, odds are that after premium increases it won't be affordable in 5 or 10 years and will be dropped—probably just when it is needed most.

These are the key decisions that determine the cost of long-term care insurance and its benefits. What they boil down to is determining the risks the insured is willing to retain and which should be shifted to an insurance company. The specific terms of the policy can mean the difference between making a policy affordable and not being able to purchase one.

The Long-Term Care Partnership

Over 40 states now participate in the Long-Term Care Partnership Program. The program encourages people to purchase and keep in force private LTCI by relaxing some of the Medicaid LTC rules. When a person has a qualified policy and applies for Medicaid to cover LTC after the policy's benefits have expired, the amount of exempt assets to be eligible for Medicaid is increased by the maximum coverage under the policy, and the beneficiary's estate might be exempt from the requirement that the state seek reimbursement from the estate for any funds spent on LTC.

The Importance of Shopping Around

I mentioned earlier that a high percentage of Americans over age 40 believe LTCI costs substantially more than it really does. That's not surprising, because prices of very similar policies vary considerably. Some insurers apparently count on consumers' not liking to shop for insurance and failing to comparison shop the way they do for other goods and services.

You easily can spend about twice what you should for an LTCI policy. In 2012, premiums on almost-identical policies ranged from $7,129 to $3,815, according to the American Association of Long-Term Care Insurance.

Insurance is an inefficient market. Insurers don't make their premiums readily available to consumers. You generally have to talk with insurance agents, and only a few agents sell policies from more than one company. It can take a lot of work to find a good deal on LTCI, but it is worth the effort.

When Should You Buy LTCI?

Many people who are interested in buying LTCI as part of their protection package are unsure of the age at which they should buy. It's understandable that they don't want to pay decades of premiums before filing claims and receiving benefits. That prospect makes it tempting to wait before buying.

There are some potential benefits to delaying the purchase of LTCI. You won't be paying premiums during the period you don't own the policy. There's a possibility that policy terms could improve, as they have since the policies became mainstream about 30 years ago. The ideal scenario for many people is to purchase an LTCI policy a relatively few years before the benefits are likely to be needed.

The problem is that there can be costs and disadvantages to waiting. While most people don't need LTC until they are in their late 70s or beyond, there are exceptions. There's no way of knowing whether in the next few years you'll have an accident or other event that triggers a need for LTC.

Another reason not to delay is that insurers have a history of changing and upgrading their policies every few years. These changes generally result in premium increases of about 3 percent over the prior version. It might be less expensive in the long term to buy a policy now and lock in current rates, at least to the extent they can be locked in.

The main disadvantage of delay is that you might not be able to buy coverage at any price. The older you are, the more likely it is that you'll have a physical condition that causes an insurer to either deny coverage or offer it only at a very high premium. Table 7.1 estimates the percentage of LTCI applicants in different age groups who were denied coverage in 2014. From the table, it's best to seek coverage in your early 50s. Each year after that your ability to obtain any coverage is reduced.

TABLE 7.1 PERCENTAGE OF LTCI APPLICANTS DENIED COVERAGE

Age	Decline Percentage
55 to 59	37%
60 to 64	39%
65 to 69	46%
70 to 74	50%
75 to 79	63%

Compare Group and Individual Coverage

Many larger employers offer group long-term care policies to employees. Employers rarely pay any of the premiums, but use their purchasing power to negotiate favorable terms and premiums for the employees. If a group policy is available, certainly compare it to the individual offerings.

A big advantage of group policies is that an applicant is less likely to be denied coverage for current health problems. Another advantage is that the premiums could be lower than for comparable nongroup policies. Also, the employer has done most of the hard work of the buying process.

Group policies are not without disadvantages. A group policy usually limits the available options. That's one way employers streamline the process and cut costs. There's no disadvantage unless the applicant wants a feature that is not offered or wants to modify a term, such as the elimination period, that is locked in for everyone in the group.

Also, group policies are not always less expensive. Group policies tend to attract people with medical problems who would not qualify for policies or for low premiums on individual policies. A healthy or relatively younger individual might be able to get cheaper rates through a separate policy.

Tax-Qualified or Nonqualifed Policy?

One more factor to consider before choosing a long-term care policy is whether it should be tax qualified. Tax-qualified policies were created in a 1996 law. Their premium payments can be deductible as medical expenses on your income tax return, and any benefits received from these policies are tax free. Before the law, the tax treatment of LTC policies was uncertain, but the premiums were generally believed to be nondeductible. The tax benefits of a tax-qualified policy look tempting, but let's dig a little deeper:

- *The tax deductions are limited.* The first limit is by age. The IRS sets the maximum deduction for each age group annually. In 2015, the maximum premium deductions were: age 40 and under, $370; ages 41 to 51, $700; 51 to 60, $1,400; 61 to 70, $3,720; over 70, $4,660. The amounts are indexed for inflation, and the latest amounts can be found in IRS Publication 502 each year. Another limit is that the deduction is available only to those who itemize expenses on Schedule A.

  A further limit is that the premiums are included with other medical expenses and are deductible only to the extent that when added to other medical expenses, the total exceeds 10 percent of adjusted gross income (7.5 percent of adjusted gross income for those ages 65 and over until 2019). Few people deduct any of their medical expenses because of these limits.

- *Qualified policies have certain required terms and provisions.* One requirement for a qualified policy is that it pays benefits only if the insured cannot perform at least two of the activities of daily living (eating, dressing, bathing, walking, etc.) or is suffering from Alzheimer's disease. In addition, a doctor must certify that care will be needed for more than 90 days. A nonqualified policy, on the other hand, often pays benefits if the insured has a medical necessity, and a minimum need period of 90 days is not required. Thus, nonqualified policies can provide more coverage.

  Because the coverage is a bit broader, a nonqualified policy generally costs 5 percent to 20 percent more than a comparable qualified one. Insurers supposedly expect to pay 20 percent to 40 percent fewer claims under the tax-qualified policies, so they charge lower premiums.

- *While the benefit payments from a tax-qualified policy clearly are* tax free, it is not clear whether benefits from a nonqualified long-term care policy are taxable. The IRS, courts, and Congress have not ruled on the issue. Recipients of benefits under nonqualified long-term care policies usually treat the benefits as tax free, and the IRS has not challenged this treatment to date.

For all these reasons, it is possible that tax breaks under qualified long- term care policies cost more than they are worth. It probably is best to buy the policy you want. After you select a policy, ask about its tax status.

Will LTCI Pay Benefits?

Many people ask: Will a long-term care insurance policy actually pay benefits after I file a claim? Many people apparently are concerned that they will pay premiums for years or decades. Then, when they need care the insurer will decline to pay benefits or find policy loopholes to avoid paying. Media reports, rumors, and data generate uncertainty about the issue.

Reports and anecdotes indicate that in the early days of LTCI, some insurers made their money by collecting premiums and then denying many claims filed by policyholders. In some policies, the conditions under which claims would be paid were vague. Other times, people believed insurers simply denied most claims and made insureds appeal in order to have their claims paid.

Many things have changed since the early days of LTCI, including the process for determining whether a claim should be paid. (Remember, LTCI is fewer than 40 years old.)

The major change was the Health Insurance Portability and Accountability Act of 1996 (HIPAA). The law is best known for its provisions on the privacy of medical records. Another part of HIPAA, however, specified the terms under which benefits would be paid under some LTCI policies. The law defined how disabled a person must be and how the disability is measured to determine when benefits should be paid. While the law applies only to tax-qualified LTCI, most insurers adopted the claims standards as the minimum for all their policies.

There are two possible benefit triggers under LTCI, a physical benefit trigger and a cognitive benefit trigger. A claim should be paid when the insured qualifies under either trigger.

The physical benefit trigger is when the insured is unable to perform at least two of the five or six (depending on the policy) activities of daily living (bathing, dressing, toileting (and in some policies continence), transferring, walking, and eating). The condition is certified by a physician or nurse and must be expected to last at least 90 days. The cognitive benefit trigger is a loss or deterioration in intellectual capacity, such as from Alzheimer's disease or dementia. Some policies provide care is covered if a licensed medical professional certifies that it is needed.

Once a claim is filed, the insurer will evaluate it. The evaluation process varies based on the insurer and the type of claim. The insurer might send one of its employees or contractors to perform an in-person assessment of the insured. Or the insurer might have its staff review medical records or accept a written certification from a licensed healthcare worker. When a policyholder is reported to suffer a severe stroke, for example, the insurer might require only a telephone call or letter from the treating physician. When Alzheimer's or dementia is claimed, the insurer might require a cognitive test by either the patient's doctor or its own staff or contractors.

The fear of some potential LTCI buyers is insurers will use the standards and process to deny most claims. Here's the data I could find. In 2007, nearly 96 percent of LTCI claims received immediate approval. Of the 4 percent that weren't initially approved, about half of those eventually were approved. The other 2 percent were denied because the benefit triggers were not met. This is from a report by the Kaiser Family Foundation published in 2008. The Government Accountability Office reviewed data from five states and found the total number of complaints about LTCI fell from 846 to 721 between 2001 and 2007, but complaints about claims settlement in particular rose from 215 to 315.

The National Association of Insurance Commissioners says the data are hard to interpret, because insurers report data differently. For example, if a claimant is in a nursing home that charges $150 per day but the policy provides for only a $100 daily benefit, some insurers report this as an approved claim while others report it has both an approval of the $100 claim and a denial of the $50 balance. Also, the rise in the number of complaints about claims might be because as the population ages more people are filing claims, so complaints also are likely to rise.

In 2014, a record $7.85 billion in benefits were paid under LTCI policies to 250,000 individual beneficiaries. The total benefit payouts increased five percent from 2013, according to the American Association of Long-Term Care Insurance.

Many fears of nonpayment of LTCI claims were reinforced by a 2007 article in *The New York Times* by Charles Duhigg. The article said *The Times* conducted numerous interviews and reviewed confidential depositions and concluded that "some long-term-care insurers have developed procedures that make it difficult—if not impossible—for policyholders to get paid." It also said that elderly policyholders were faced with "unnecessary delays and overwhelming bureaucracies."

That sounds pretty damning about LTCI and the insurers that offer it. A key qualifying statement, however, comes a little later in the article, where it states that most of the complaints were from policyholders of three companies, two of which were related. These companies experienced a much higher rate of complaints per policyholder than other insurers. At least one of the companies eventually exited the LTCI business and turned its policies over to the state and a trust to administer. The largest long-term-care insurer, on the other hand, received only one complaint for every 12,434 policies. If you want to read the article, go to your favorite web search engine and search for "Charles Duhigg & long-term care."

Almost all insurers will pay promptly claims that qualify for coverage under the policies they issue. But every insurer receives some complaints and denies some claims. It's important that you and others close to you know your policy and understand it. Often claims are filed by someone other the person who bought the policy, or the person who bought it isn't physically or mentally sharp. The elimination period, or deductible, often is a source of conflict between insurers and insureds. Also, the care provider, whether a person or a facility, must have the licenses, certifications, and other standards required by the insurer. Check on that before selecting a provider. Also, be aware of the paperwork and tests the insurer will require to process and pay a claim.

When considering LTCI, don't buy the policy with the lowest premiums. You don't want to trade low premiums today for big problems down the road. You want an insurer with financial stability and that has been in the LTCI business for a while. Check with your state insurance commissioner for histories of both complaints and premium increases regarding each insurer. Be sure you understand the details of the policy before you buy, even if it takes time.

Enhancing LTCI

LTCI is an important and complicated consideration. There are several steps that can generate optimum benefits for you:

- *Shop around.* Despite the number of insurers who left the market after 2009, there still are quite a few insurers offering LTCI. Premiums and policy terms can vary considerably. Take the time to compare similar policies from a range of insurers.
- *Consider innovative policies.* It used to be that you had to determine the maximum benefits you wanted in LTCI and pay premiums for them from the start. There always was an option to reduce benefits when the premiums rose too high, though refunds weren't made for past premiums paid for the higher benefits. Now, insurers are offering LTCI policies that allow you to increase benefits later without fresh evidence of being insurable. That allows you to lock in a policy at an affordable minimum level of coverage now and increase coverage later if you want.
- *Purchase a joint policy.* Married couples usually can obtain savings of 20 percent or so by purchasing a policy that covers both of them instead of individual policies. Be sure that you understand the coverage limits of the policies you're considering and how they are affected if each of you needs LTC during your lifetimes.
- *Check the claims history.* Most LTCI carriers have been in the business for a long time and promptly pay claims that are due under their policies. There are a few insurers who made a practice of denying claims and forcing the policyholders to appeal in order to receive their benefits. Check the claims history of an insurer with your state insurance department.
- *Don't jump at the lowest premium.* The lowest price isn't necessarily the best deal. The insurer might be inexperienced with LTCI and be making bad assumptions about future claims experience and other factors. Or the insurer might be trying to increase market share by underpricing policies. Too often, the lowest price policies in the first year are the ones that impose sharp premium increases after a few years.
- *Consider long-term partnership policies.* Over 40 states now are in the long-term care partnership. When you have an LTCI policy that qualifies under the partnership, the state is less like to seek reimbursement from your estate if you also need Medicaid to pay for your LTC after the policy benefits are reached.

EXPLORING THE HYBRID OR COMBINATION POLICIES

A minority of people who are in the prime ages for buying LTCI actually buy the traditional stand-alone policies. A major reason for the low ownership rate apparently is the use-it-or-lose-it nature of LTCI. Like auto, homeowner's, and term life insurance, you don't receive benefits from the policy if you don't file a claim. When you don't need LTC in your lifetime, the policy expires with your passing. There isn't a cash value or other amount to be paid to your heirs. If you decide during your lifetime that you no longer want the policy, there also isn't an account to be returned to you. What you received for your premiums is peace of mind that the policy was there if you need LTC.

Because of this issue, insurers developed alternatives. The hybrid, or combination, policies are growing in popularity. In 2014, sales of traditional LTCI declined 24 percent from 2013 for a total of 131,000 policies sold. About 15 years earlier, 750,000 LTCI policies were sold in a year. Meanwhile, hybrid policies (also called linked-benefits policies or combination policies) increased approximately 500 percent in the six years ending 2014, according to the AALTCI.

These are annuities and permanent life insurance policies with LTC riders or benefits attached. You receive the benefits of the annuity or life insurance, but if you need LTC during your lifetime, the policies will pay benefits.

Insurers have different ways of charging for the benefits. With an annuity, you might receive a lower interest rate credited to your account each year than would be the case with a straight annuity. With life insurance, the insurance benefit could be less than if you paid the same premium for a straight permanent life insurance policy, or there could be an additional premium amount for the LTC rider.

Another potential benefit to a hybrid policy is that someone who can't qualify for traditional LTCI for age or health reasons might be able to qualify for a hybrid policy. I'm not saying that anyone can receive LTCI through a hybrid. The insurers do have underwriting standards for these policies. But when the LTC is the secondary benefit under the policy, the insurer might accept some applicants who were denied traditional LTCI. It depends on the insurer and the type of policy.

Some insurance analysts say the coverage under a hybrid policy might not be as robust as stand-alone LTCI. That largely depends on the policy and probably was more true of the early hybrid policies than most of those available now. Some hybrid policies have terms on their LTC riders that are comparable to standard LTCI. Others have differences, such as paying benefits under different conditions, not paying for all the types of care that LTCI covers, and other terms.

When considering a hybrid policy, you need to examine the LTC rider in the same way you would stand-alone LTCI. Consider all the same terms and conditions. Be sure you have the coverage you think you do.

In a hybrid policy, the non-LTCI portion of the policy usually is drawn down before the LTC benefits are used. That means you're spending your and your heirs' money first and the insurance company's money only after your money is exhausted.

Here's an example of one specific annuity/LTC hybrid that first was available in 2013. This is but one example. There are a lot of variations in the details of the hybrid policies, so don't assume every hybrid policy offered to you will have these or similar terms.

The annuity is purchased with a lump sum deposit of from $35,000 to $400,000, or $600,000 for a joint annuity for a married couple. (You also can make a tax-free exchange of an existing annuity.) Your deposit immediately begins accumulating interest. The interest rate in 2013 was 3 percent for deposits over $200,000 and 2.5 percent from lower amounts. The rate changes annually but can't fall below 1 percent.

The LTC benefits were up to three times the annuity's value for those in good health. If you deposited $100,000, you had up to $300,000 of LTC coverage. For those with some health problems but who still qualified for coverage, the LTC benefits were twice the deposit. The cost of the LTC coverage won't increase over time and won't reduce your principal. As interest earnings increase the annuity account value, the LTC coverage also increases. Remember, the cost of the LTC coverage is that your annuity account is credited a lower interest rate than it would receive without the LTC rider.

As with a standard long-term care insurance policy, the LTC benefits are triggered when you can't perform two or more of the six activities of daily living (determined by a licensed medical professional) or are cognitively impaired. Eleven long-term care services are covered, including adult day care, home care, homemaker services, and residence in an assisted living facility or nursing home. There's no waiting period for reimbursements for home health care or respite care, and a 90-day waiting period for other types of care.

Since this is an annuity, your deposit and accumulated interest are available for other uses. You can withdraw up to 10 percent of the contract value each year or schedule regular annuity distributions, such as a single life annuity or a joint life annuity covering the lives of both you and your spouse. Keep in mind that any lifetime distributions reduce your LTC benefit. The account value you don't distribute or use for long-term care can be transferred to your heirs or other beneficiaries.

A withdrawal of the full account within the first nine years faces an early withdrawal fee. The fee is 8 percent of the amount withdrawn the first year and one percentage point less each year until there is no fee for distributions in year 10 and later. This early withdrawal fee, or liquidity fee, doesn't apply to any of the up to 10 percent annual withdrawals.

When LTC reimbursements are triggered, they first reduce your annuity account value. After the account is exhausted, additional LTC reimbursements from the insurer continue until the coverage limit is reached. If you pass away after the account value is exhausted but before using the maximum LTC benefits, your annuity beneficiary receives nothing. Also, if you exit LTC after exhausting the account value, there is no account value left for you to use.

A maximum monthly LTC reimbursement is set by the insurer based on the premiums you deposit. The limit was $4,220 monthly, during the first year, for a 65-year-old male who put in $100,000, which meant there were 72 months of coverage from a $100,000 deposit. Assuming you take the maximum monthly LTC limit, the payments would last 72 months for a single insured and 90 months under a jointly insured annuity. If your monthly reimbursement is less than the maximum, the number of months you'll have coverage is extended. Keep in mind that the maximum monthly payment for LTC is set by the insurer. If you have LTC that costs more per month, you have to make up the difference from other means.

There was no medical exam to qualify for the LTC coverage, only an application and telephone interview.

Married couples can elect Joint LTC Coverage, which can be advantageous. The two spouses share the maximum benefits, which last for 90 months if the maximum monthly reimbursement is taken. This means if the spouses both need LTC but at different times, they have a joint 90 months of care. But if they need care at the same time, the maximum benefit period is shorter because they're using two months of coverage each month they both receive reimbursements.

Of course, the annuity qualifies for the usual tax deferral of interest earnings of the annuity.

Here's an example of how the annuity can work. Max Profits has $100,000 in CDs. He doesn't expect to need the money unless he suffers a financial reversal or has unplanned expenses such as long-term care. He hopes it is available for his children to inherit, but he's keeping it in safe investments partly as an emergency fund for unexpected expenses and partly because he doesn't trust other investments these days.

Max uses the maturing CDs to make a deposit in the annuity. He'll earn 2.5 percent interest for the first year, and it will compound tax-deferred in the annuity. If he needs cash, Max can withdraw up to 10 percent of the annuity's value during a year free from the insurer liquidity charges, and there won't be an early distribution IRS tax penalty as long as he is 59½ or older. Such distributions would reduce the LTC benefits. After nine years, Max can withdraw the entire amount without penalty if he wants.

Should Max need long-term care while he owns the annuity, he'll have long-term care benefits of more than $300,000 if he qualified for maximum coverage or $200,000 under regular coverage. If Max passes away without taking any distributions or needing LTC, his beneficiaries receive the annuity account value. If he does need LTC, the reimbursements reduce the account value available to his heirs until the account value is spent.

That's one example of an LTC/annuity hybrid policy. There are many variations of the details, and there also are permanent life insurance policies with LTC riders. A common feature of the products is that when you start drawing LTC benefits, these reduce either your annuity account or life insurance benefit first. Only after these are exhausted will the insurer begin paying additional benefits for LTC.

As I said, a major appeal of the hybrid policies is the elimination of the use-it-or-lose-it nature of traditional LTCI policies. If you never need LTC or need only a modest amount, the remaining benefits in the annuity or life insurance are received by your beneficiary. In general you should buy a hybrid policy only when you also have a need or use for either the annuity or permanent life insurance. For example, if you have money you are keeping in safe investments for an emergency or to leave for loved ones, putting some of that money in a hybrid annuity might be a good idea. Also, if you plan to self-insure for at least some of your LTC needs, putting the designated money in a hybrid annuity might be a good way to self-insure.

USING PERMANENT LIFE INSURANCE

Some people plan to use traditional permanent life insurance to fund their long-term care needs. Permanent life insurance comes in several versions. The most common is whole life insurance. You give premiums to an insurer. In return you receive life insurance coverage. You also have a cash value account that earns interest at a rate set by the insurer. You can borrow from the cash value if you need money. Unlike term life insurance, permanent life insurance doesn't expire as long as you pay the premiums. The death benefit always is payable to your named beneficiaries. There are variations with more complications, such as universal life insurance and variable life insurance.

Some people prefer using permanent life insurance because they view it as being cheaper than LTCI and it also will pay benefits eventually, unlike LTCI.

There are a couple of ways permanent life insurance can be used to pay for LTC.

One way would be to borrow against the policy's cash value when LTC is needed. This isn't recommended as a primary way to pay for LTC. The amount you can borrow will be less than your life insurance benefits. Also, the loans will reduce the life insurance benefits eventually paid to your beneficiary. Finally, it is unlikely the cash value will be enough to pay for a significant amount of LTC.

Another way some people use permanent life insurance to fund LTC is to pay for any LTC expenses out of their existing assets and income. This spending will reduce or deplete their estates. After they pass, however, the life insurance policy pays benefits to either their estates or their loved ones. The life insurance ensures that there is a substantial inheritance regardless of how much is spent on LTC.

There are some potential disadvantages to this strategy.

The strategy might not work well when you have a spouse who survives you. The estate could be substantially reduced or even depleted. While the life insurance might be substantial, it might not be enough to sustain your spouse's standard of living for life, including any LTC he or she might need.

Another potential disadvantage is that you need the assets or income to pay for the LTC. Essentially, you need enough liquid assets to pay for the LTC. Otherwise, there's a risk that assets will be sold in a hurry to pay for care or be sold by someone who doesn't know how to maximize their value. If your strategy is to spend down your assets to pay for LTC and then have Medicaid pay for your LTC, be sure to review the rules carefully to ensure you know all the details. For example, the state might seek reimbursement from either your estate or loved ones for the money it spent on LTC.

FORGING YOUR LTC PLAN

As we've seen, there are a number of ways to pay for any LTC you or your spouse might need.

A threshold question is who should consider the tools other than paying from personal assets. There are two categories of people who should consider using only personal assets and then Medicaid to pay for LTC.

One group who should consider personally financing LTC is the very wealthy. They can pay for the costs from their own resources. They don't have to be concerned about finding an appropriate policy and paying premiums that might not result in benefit payouts.

There are several factors to consider before deciding you are wealthy enough to self-finance LTC you or your spouse needs.

An important factor is that the cost of LTC varies greatly around the country, as does the definition of very wealthy. Someone who can easily afford LTC in the Midwest might not be able to afford it in New York City. That's why a bright line net worth level of who should consider self-financing LTC can't be developed. It depends on where a person is located or will receive LTC.

The type of assets that comprise your wealth also is important. LTC costs have to be paid in cash. It's not unusual for someone to be wealthy on paper but to have much of that wealth in assets that can't easily and quickly be converted to cash: real estate, small businesses, and other illiquid assets. You probably don't want to have to sell assets, especially at fire-sale prices, to raise cash for LTC. No matter your net worth, if you don't have enough liquid assets to pay for a couple years of LTC plus support your dependents, you probably aren't wealthy enough to self-insure for LTC.

Inflation should be another concern. LTC generally rises faster than the Consumer Price Index, usually at about twice the CPI rate. LTC expenses that seem affordable to you today might not be in 15 or 20 years if LTC costs rise faster than the amount of liquid assets you have.

Keep in mind that others might be depending on your assets. What would happen to the assets available to support them if you need years of LTC? Be sure to consider all the demands on your assets before deciding to self-insure.

The second group of people who should consider self-insuring are those of very modest means. Premiums for LTCI would consume a substantial percentage of their annual incomes, forcing them to dramatically reduce their standards of living. They also probably don't have enough assets to be able to buy one of the hybrid policies to cover LTC. People in this group are those for whom the Medicaid coverage of LTC was created. They should assume that if they need LTC they'll spend down what assets they have until they qualify for Medicaid.

For everyone else, to plan for LTC you need to consider all the tools that are available and use the ones that will work for you. Consider how family can help. Review the benefits you might be able to receive from the government programs, Medicare and Medicaid. Then look at the insurance options. There are individual LTCI policies as well as policies that might be available through employers or other group plans. Take a look at some hybrid policies. You might even want to consider permanent life insurance as a way to restore to your loved ones some of the money you might spend on LTC. Of course, you'll have to self-insure to some extent by paying for LTC from your assets. The government programs and insurance options don't cover LTC costs from day one and also aren't likely to cover all the costs you'll incur.

LTC costs scare many people who are in or approaching retirement. Most people have a low probability of needing the dreaded multiyear residence in a nursing home or at home with full-time assistance. For those who have that need, however, the cost can mount quickly and drain your estate as well as assets of loved ones. That's why you want to develop a plan for covering as much potential LTC expenses as you can and limiting the probability of becoming a financial burden and losing your independence.

CHAPTER 7: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is correct regarding long-term care (LTC):**

A. about 30 percent of people aged 65 and older will need LTC in their lives

B. LTC only refers to a long-term stay in a nursing home

C. LTC includes home-based care

D. most LTC occurs inside a nursing home

2. **Which of the following is a consideration to keep in mind when determining whether or not to have a family member be the primary source of LTC:**

A. availability to provide LTC

B. qualifications to provide LTC

C. the impact on family harmony

D. all of the above

3. **Which of the following is <u>not</u> an eligibility requirement to have Medicaid pay for LTC:**

A. the person must be a U.S. citizen or have an appropriate visa

B. the person must be at least 55 years of age

C. the person must meet the financial tests for Medicaid eligibility

D. the person must be a resident of the state in which he or she applies

4.	**Which of the following is a correctly stated exemption of a married applicant for the purposes of determining the Medicaid impoverishment test:** **A.** a home whose value is less than $500,000 if it is the nonapplicant spouse's principal residence **B.** burial funds up to $5,000 per person **C.** up to $2,000 of personal items and household goods **D.** a community spouse resource allowance whose amount varies by state
5.	**All of the following are included in the activities of daily living <u>except</u>:** **A.** sleeping **B.** bathing **C.** walking **D.** eating

CHAPTER 7: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A majority of those 65 and older will need some LTC at some point in their lives. **B.** Incorrect. Although most people think of LTC as a long-term stay in a nursing home, it actually encompasses a wide range of care, from rehabilitation after a surgery to nursing home care. **C.** CORRECT. LTC includes home-based care, residence in an assisted living facility, nursing home care, and more. **D.** Incorrect. Most of the LTC these days occurs outside of a nursing home. A majority of LTC is delivered at home or an assisted living facility. *(See page 151 of the course material.)*
2.	**A.** Incorrect: Availability is a huge consideration when dealing with LTC from a family member. However, it is not the only correct option. **B.** Incorrect. Whether or not a family member is qualified to provide LTC is a serious consideration to keep in mind. However, it is not the only correct selection. **C.** Incorrect. The family dynamic can be upset when a family member provides LTC, but it is not the only correct selection. **D.** CORRECT. Among the many considerations to keep in mind when considering whether or not to have a family member provide LTC is that person's availability, qualifications, and the impact on family harmony. *(See pages 153 to 154 of the course material.)*
3.	**A.** Incorrect. One of the eligibility requirements for Medicaid to pay for LTC is that the person must be a U.S. citizen or have an appropriate visa. **B.** CORRECT. One of the requirements that has to be met for Medicaid to pay for LTC is that the person must be 65 or older or permanently disabled or blind. **C.** Incorrect. One eligibility requirement is that the person must meet the financial tests for Medicaid eligibility. **D.** Incorrect. An eligibility requirement that must be met in order for Medicaid to cover LTC is that the person must be a resident of the state in which he or she applies. *(See page 155 of the course material.)*

4.	**A.** Incorrect. A married applicant's home, regardless of value, is considered an exempt asset if it is the nonapplicant souse's principal residence. **B.** Incorrect. Burial funds are exempt for the applicant and spouse up to $1,500 plus accrued interest. **C.** Incorrect. For a married person, the furniture, furnishings, kitchen items, and other household goods are exempt without limit. **D.** CORRECT. A community spouse resources allowance is an additional amount of exempt assets of any type that do not fit in the other categories. The federal government allows the states to set the allowance. *(See page 157 of the course material.)*
5.	**A.** CORRECT. Sleeping is not one of the activities of daily living that will trigger long-term care insurance. **B.** Incorrect. Bathing is one of the activities of daily living. **C.** Incorrect. Walking is considered to be one of the activities of daily living. **D.** Incorrect. Eating is one of the five activities of daily living. *(See page 169 of the course material.)*

CHAPTER 8: MANAGING IRAs TO LAST

Chapter Objective

After completing this chapter, you should be able to:

- Identify requirements for individual retirement arrangements (IRAs).

Individual retirement arrangements (IRAs) are simple at first. You contribute some money each year and select some investments. Congress threw in some complications over the years by changing the contribution amounts and phasing out deductions for contributions as income rises if you participate in an employer retirement plan. Some people need some of their money early and have to deal with the 10 percent early distribution penalty and the ways to avoid it. For most people, however, there's not much more to IRAs than contributing and investing.

All that changes as the late-career years approach.

IRAs are among the most valuable assets people own, especially when they rollover 401(k) accounts to IRAs. It is the main source of retirement financing for many people. People now also can choose between traditional IRAs and Roth IRAs, and they have the option to convert a traditional IRA to a Roth IRA.

Managing your IRA to make it last as long as possible becomes vital. There are many rules to know and traps to avoid.

Taxes and penalties can drain significant cash from IRAs. Traditional IRAs provide tax breaks during the accumulation period. Contributions might be deductible, and income and gains compound in the IRA tax deferred. When money is rolled over from a 401(k), the contributions to the 401(k) weren't taxed, and the income and gains earned on the contributions compounded tax deferred. There's a price to be paid for those tax breaks, and that price is paid when money is distributed from the traditional IRA or 401(k).

Distributions from a traditional IRA are included in gross income and taxed as ordinary income. If the contributions were deductible, those are taxed as ordinary income, as are distributions of income and gains. When contributions weren't deducted, they are tax free when distributed but the compounded income and gains are taxed as ordinary income when distributed.

In effect, you took out a mortgage on your IRA each time you made a contribution. That mortgage comes due in installments when distributions are made. You include the distributions in income (except for distributions of non-deductible contributions), and they are taxed as ordinary income. Another way you pay the mortgage is by having all the taxable distributions treated as ordinary income. Long-term capital gains earned by the IRA, which would receive favorable tax treatment if earned in a taxable account, lose their special tax breaks when earned within an IRA. Those are the costs you pay for the tax breaks of traditional IRAs.

In this chapter, we discuss how to manage IRAs to maximize after-tax wealth and extend the lives of the IRAs. We assume that you are near or in the post-career years. You long ago made decisions about which types of retirement accounts to use and how much to contribute to them. Now, you're approaching the distribution years. You want to know how to manage IRAs and their distributions to maximize how long an IRA will last. In this chapter, we discuss required minimum distributions (RMDs), ways to invest IRAs to last, rolling over 401(k)s to IRAs, converting traditional IRAs to Roth IRAs, and other strategies.

NAVIGATING THE REQUIRED MINIMUM DISTRIBUTION MINEFIELD

Required minimum distributions (RMDs) for those over age 70½ are a key source of lost wealth, and that is only going to get worse. The IRS in recent years concluded that RMD mistakes are a major source of lost tax revenue, so it is cracking down. The IRS receives enough information from IRA custodians to identify people who might have made RMD mistakes. The penalty for not taking the full RMD is 50 percent of the amount you should have distributed but didn't. It's one of the steepest penalties in the tax code.

While it's important to meet the IRS's rules for RMDs, that shouldn't be your only goal. There are planning opportunities for RMDs that can reduce taxes and increase after-tax wealth. You have flexibility and choices, and you need to carefully consider them.

RMDs are required from traditional IRAs after age 70½. The first RMD is required by April 1 of the year after you turn 70½. For example, those who turn 70½ in 2016 must take the first RMD no later than April 1, 2017, but also can take that first RMD before the end of 2016.

It's often best to take the first RMD in the year you turn 70½, because you'll have to take the second RMD by Dec. 31 of the following year. That would give you two RMDs in one year if you defer the initial RMD until April 1 of the year following the year you turn 70½, and then take the second RMD by Dec. 31 of that year. Taking two RMDs could push you into a higher tax bracket, reduce tax breaks, and cause other problems.

In the years after you turn 70½, you must take an RMD each year by December 31.

You also have to take RMDs from traditional employer plans, but the rules are a bit different. In this chapter, we focus on RMDs from traditional IRAs. There are no required minimum distributions for original owners of Roth IRAs.

To compute your RMD for the year, start with the ending value of the IRA on December 31 of the previous year. When you turn 70½ in 2016, you use the closing value for 2015, even if you wait until early 2017 to take that first RMD. In years after you turn 70½, you use the IRA value at the close of the previous year. Those taking regular 2016 RMDs use the IRA values on December 31, 2015.

After determining the correct IRA balance to use, find your life expectancy in the tables furnished by the IRS in Publication 590, available free on the IRS website at www.irs.gov.

There are three life expectancy tables. Table I is for beneficiaries (those who've inherited IRAs). Table II is for married IRA owners whose spouses are both more than 10 years younger than they are and are the sole principal beneficiaries of the IRAs. Every other IRA owner uses Table III, also known as the Uniform Lifetime Table.

After locating the correct table to use, locate your current life expectancy in the table and divide the IRA balance at the end of last year by your life expectancy for this year. If you turn 74 in 2016, your life expectancy under Table III is 23.8. If your IRA balance on December 31, 2015, was $150,000, your RMD for 2016 is $6,303.

When you own multiple IRAs, compute the RMD by aggregating the balances of all your IRAs and dividing the total by your life expectancy. Then, you have flexibility. You can take the RMD from the IRAs in any combination you want. Take it all from one IRA or take different amounts from the IRAs in any ratio you want.

This rule allows you to use the RMD to rebalance your overall portfolio when it's out of balance or simplify your finances by drawing down one IRA at a time.

An RMD doesn't have to be taken in cash. The tax law allows the distribution to be taken in property, and most IRA custodians allow noncash distributions. A property distribution is easy when the custodian is a broker or mutual fund company and the IRA holds conventional assets such as stocks or mutual funds. With most IRA custodians, the form to request the distribution allows you to designate whether you want the distribution to be in cash or in particular assets. To make a property distribution, if you don't already have a taxable account at the custodian, most brokers and mutual fund companies simply set up a new taxable account to receive the distribution. Then, the designated number of shares of the stock or mutual fund is transferred from the IRA to the taxable account.

Consider taking an RMD as a property distribution when you don't need the RMD in cash to pay living expenses and want to continue owning the asset in your portfolio or don't want to incur the costs of selling an asset.

When you take a distribution of property, the fair market value on the date of the distribution is included in your gross income, regardless of what happens to the asset's price the rest of the year. That value also is your tax basis in the asset. If you sell the asset during your lifetime, there will be capital gain on any appreciation or a capital loss if the asset declines in value. The gain or loss is determined by taking the amount realized on the sale and subtracting the basis.

You can take RMDs during the course of the year on any schedule you want, as long as you take distributions totaling at least the minimum amount by December 31. There are different factors to consider when deciding on the timing or you RMDs.

T. Rowe Price did a study some years ago covering the years 1993 to 2003. The study found that an IRA owner who waited as late as possible in the year to take RMDs accumulated a bit more money over time and made the IRA last longer than an owner who took RMDs at the start of the year. The study assumed the IRA owner took distributions in cash. Since investment assets generally were appreciating during that time, it made sense to leave the investments to appreciate in the accounts for as long as possible before selling to generate cash for the distributions.

The result would have been different if the accounts were more conservatively invested or markets weren't booming. In fact, in the Price study, the late-distributing IRA owner was far ahead of the other IRA owner through 1999. After that, the early-distributing IRA owner rapidly caught up because the value of his IRA wasn't declining by as much as the other owner's. Only the stock market rally of 2003 pushed the late-distributing owner back into a clear lead. The timing also wouldn't matter nearly as much if distributions were taken in property instead of cash.

There are other factors to consider before determining the timing of RMDs, and these factors generally favor taking RMDs early in the year.

Early distributions ensure the task is not forgotten or left to a last-minute rush when IRA custodians are busy and likely to make mistakes or perform tasks late. Taking the RMD early in the year also ensures there is no problem in case anything should happen to you during the year. Executors must take RMDs from the IRAs of those over age 70½ who passed away during the year. But many overlook this or take too much time to accumulate enough information to know how much they need to take. The result is a late RMD and a penalty. Taking RMDs early in the year avoids these potential problems.

Don't forget to either factor the RMD in your estimated tax payments for the year or have the custodian withhold an appropriate amount for taxes. You don't want to be hit with an underpayment of estimated tax penalty.

Keep in mind that you always can take more than the RMD from the IRA each year. The RMD is the minimum amount you are required to distribute.

RMDs also are required of beneficiaries who inherit either traditional or Roth IRAs. Those rules are different. The RMDs for beneficiaries should be considered as part of an estate planning strategy, and you should be sure anyone you plan to inherit an IRA from you knows about the rules. We don't discuss them in this chapter.

Strategies to Reduce RMDs

RMDs create tax and financial planning problems for some people. The purpose of RMDs is to force the IRA to be spent down during a person's life expectancy, whether you need the cash or not. When you examine the IRS life expectancy tables and estimate future RMDs under different scenarios, you'll see that the percentage of the IRA that must be distributed each year steadily increases.

The RMD distribution schedule doesn't match the spending patterns or income needs of most retired Americans. They don't steadily increase spending as they age, and many people are more inclined to spend the same or a lesser percentage of their net worth as they age to ensure they don't run out of money. We discussed this in some detail in Chapter 4.

In addition, there are a number of people who have sufficient income and assets outside of their IRAs to sustain their retirement standards of living. They don't need the early RMDs to fund their spending, and they certainly don't need the progressively higher RMDs as the years go by. People in this situation often view their IRAs as emergency spending sources or something they are saving for their heirs to inherit.

You can see how RMDs create tax problems for people in these situations, especially when the IRAs are large because they were funded with rollovers from 401(k) plans.

Remember that IRA distributions are included in gross income and taxed as ordinary income, except for distributions of nondeductible contributions. As RMDs increase over time, they steadily increase gross income and adjusted gross income (AGI). AGI is the last line on the bottom of the front page of Form 1040. AGI is very important, because it determines whether you are subject to what I call the "stealth taxes." These are tax provisions that increase your gross income, reduce tax deductions, or impose additional taxes as income levels rise. We discuss the major stealth taxes in detail in Chapter 9. They include the Medicare premium surtax, tax on Social Security benefits, reductions in personal and dependent exemptions and itemized deductions, the alternative minimum tax, and more.

RMDs put retirees at risk of triggering or increasing the stealth taxes. Many retirees find that as they enter their late 70s and beyond, the RMDs increase to the point that their tax planning is hindered. They are paying substantial income taxes on income they don't need. This reduces their nest eggs and also reduces the legacies they planned to leave to loved ones or charity.

Fortunately, there are strategies for those who don't want that steady increase of distributions during their lifetimes. We discuss them in this chapter. They include:

- *Take money out of the IRA before you are required to, and the earlier the better.* This means draw down the IRA first instead of letting it compound.
- *Convert the traditional IRA to a Roth IRA.* Pay the taxes now, avoid the future RMDs, and have the benefit of tax-free investing and future tax-free distributions from the Roth IRA.
- *Let the RMDs happen, but use the after-tax amount to purchase permanent life insurance.* Your heirs inherit the insurance benefit tax free, and it is likely to be much higher than the after-tax amount of the IRA would be.
- *Use the family bank strategy.* Draw down the IRA early, pay the taxes, and use the after-tax amount to buy a permanent life insurance policy that will serve as a family bank. You can tap the cash value for tax-free loans if you need cash. Otherwise, your heirs inherit the life insurance benefit.

EMPTY AN IRA EARLY?

The conventional advice is to delay distributions from tax-deferred accounts for as long as possible so that tax-deferred compounding can continue its work. That advice works for most people. Yet it is not the right advice for everyone. As we just discussed, RMDs can increase taxes later in life. Tax deferral can come back to bite the IRA owner instead of providing tax benefits. For people in such a situation, it makes sense to consider taking IRA distributions before being required to. In fact, emptying the IRA early, in effect accelerating taxes, can be more profitable in the long run.

Years ago, when I first addressed the problems of RMDs and owners of "excess IRAs," there were few options. Roth IRAs initially weren't available, and conversions of traditional IRAs to Roth IRAs were allowed only to people with adjusted gross incomes up to $100,000. So, I did the calculations and determined that it can make sense to empty an IRA early instead of maximizing tax deferral. That's still the case today.

For example, Max Profits has a $1 million IRA that earns 9 percent annually, and he is in the top tax bracket. He has to begin RMDs this year, and the first distribution will be $38,168. In five years, the RMD will be $58,250, and at age 82 the distribution will be $102,813. If Max lives to age 90, the RMD is up to $176,238. Max's expenses aren't likely to rise at that rate.

Between federal and state income taxes, Max could be paying close to half these distributions in taxes. If Max hadn't already been in the top tax bracket, the RMDs would push him into it. The RMDs also could increase taxes on Social Security benefits, trigger or increase the Medicare premium surtax, and cause Max to lose other tax benefits because of the phase-out of deductions and exemptions for higher-income taxpayers.

Suppose Max is only age 65, and the rest of the facts are the same. He has to begin RMDs after age 70½, and the first distribution will be $56,154. Five years later, the RMD will be $78,011, and at age 82 the distribution will be $145,308. If Max lives to age 90, the RMD is up to $243,077. At that point, the IRA still is worth more than $2.5 million.

Max and others in similar situations can slash their lifetime tax burden by taking an unconventional step. They can begin taking more from the IRA than the law and their spending needs require.

To make a point, let's take an extreme example and say that Max in the second case lives to 100 and takes only the RMDs. He'll pay just over $2 million in federal income taxes on these distributions at the 35 percent rate. The exact amount of taxes will depend on Max's other income, deductions, and other factors. He still will have over $1.6 million in the IRA at age 100. That amount will be taxed when distributed to him or his heirs.

Suppose instead that, to avoid the higher income taxes down the road, Max decides not to let the IRA grow as much. Max decides to take large enough distributions so that the IRA grows no more than 4 percent from its original balance. Then, the lifetime taxes on the distributions at age 100 are down to just over $1.2 million.

Let's say Max puts into a taxable account the after-tax distributions that exceed the RMDs. That account grows 7 percent annually before taxes, and taxes are paid at a 20 percent rate each year. By age 100, the taxable investment account exceeds $1.75 million. The IRA still is worth over $700,000.

In this scenario, Max's heirs have more after-tax wealth available to them if he limits the growth of the IRA. The IRA still has significant value, and they will be able to spend its after-tax value. All or most of the taxable account is available to them without additional taxes.

Taking the money out early works for a couple of reasons. First, Max no longer is converting long-term capital gains into ordinary income. Once money comes out of the IRA and the after-tax amount is invested in taxable accounts, the appreciation becomes long-term capital gains taxes in 2016 at a maximum rate of 20 percent. Second, Max can control when taxes are incurred. Instead of being forced to take distributions on a schedule whether he needs the money or not, Max can let gains compound in the taxable account and not incur taxes when he doesn't want to. He also can use other strategies to limit the taxes on the taxable account.

The strategy provides an additional benefit to Max's heirs. When an IRA is inherited, the tax basis of the assets is not increased. The beneficiaries who inherit the IRA pay taxes on distributions the same as the original owner would have. In other words, the ordinary income still has to be recognized for the heirs to spend the money. Another way to look at it is that the heirs don't really inherit the full value of the IRA. They really only benefit from the after-tax value.

When assets outside a tax-deferred account are inherited, however, heirs receive a benefit. They are allowed to increase the tax basis of the assets to their current fair market value. That means all the appreciation that occurred during the previous owner's life isn't taxed. The heirs can sell the assets at fair market value and not owe any capital gains taxes. They benefit from the full value of the assets outside the IRA.

Is It Right for You?

The benefits of taking more out of an IRA than the law and spending needs require depend on the individual situation.

The strategy should be considered by those whose IRAs, after considering other sources of income, greatly exceed lifetime spending needs. In effect, the IRA is operating as an emergency savings account, a supplement to other sources of income, or a likely legacy for loved ones. In those cases, benefits can be generated by getting money out of the IRA early instead of letting it compound indefinitely in the IRA.

The earlier one begins the strategy, the better the results will be. (Don't begin before age 59½, to avoid the 10 percent premature distribution penalty.) You will pay income taxes on the early distributions and be able to invest in the taxable account the after-tax amount of the distributions. The taxable account will need time for the investment returns to make up for paying the taxes early.

Also important are the assumptions about rates of investment return, tax rates on and turnover in the taxable account, and longevity. Other factors are whether the RMDs would push the owner into a higher tax bracket, cause the loss of itemized deductions and personal exemptions, or increase taxes on Social Security benefits.

The prime beneficiaries are people like Max: A relatively young retiree whose IRA exceeds by a significant amount likely lifetime spending needs. Without extra distributions, future RMDs would force large taxable distributions as the owner ages. Lifetime taxes by the owner and his heirs would be much higher than if the IRA were emptied early, the taxes paid, and investment income compounded in a taxable account.

CONVERTING A REGULAR IRA TO A ROTH IRA

The Roth IRA is one of the most attractive tax-advantaged vehicles Congress ever created. Congress went a step further and gave many people a chance to convert their traditional IRAs to Roth IRAs. It doesn't matter if the traditional IRA contributions were made because the owner was unaware of the

Roth's advantages or was not eligible to make Roth contributions. It also doesn't matter if the traditional IRA was opened before the Roth IRA was created in 1997 or as a result of rolling over a 401(k) or other retirement plan into the IRA. The IRA can be deductible or nondeductible. In any of these cases, the IRA owner might be able to convert the traditional IRA into a Roth IRA. In addition, the IRA owner can choose to convert the entire IRA or any portion of it into a Roth IRA. Once a traditional IRA is converted into a Roth IRA, it is treated the same as an original Roth IRA.

There is a cost to converting a regular IRA into a Roth IRA. Taxes must be paid as though the amount converted were distributed to the taxpayer from the traditional IRA. For example, suppose there is a deductible traditional IRA with a balance of $100,000. If the owner decides to convert the entire amount, then $100,000 must be included in gross income in the year of the conversion. If $50,000 is converted, then $50,000 is included in gross income. If the IRA has nondeductible contributions, then the conversion of the nondeductible contributions is not taxed. (If the IRA owner is younger than age 59½, the 10 percent early distribution penalty does not apply to amounts that are included in income because of the conversion.)

The rules are simple. The trick is determining when it makes sense to incur the cost of converting an ordinary IRA into a Roth IRA. The answer depends on several factors. The IRA owner has to make assumptions about these factors and compare the results of continuing to own the traditional IRA with converting to a Roth IRA. Here are the factors to consider and how they affect the decision:

- *Is money outside the IRA used to pay the conversion taxes?* The more money that is left inside the IRA to benefit from tax-free compounding, the more advantageous it is to convert to a Roth IRA. A conversion is less beneficial if money is taken out of the IRA to pay the taxes—though it still can make sense to convert if the remaining balance is left in the IRA to compound for 10 years or more after the conversion. In addition, if the owner is under age 59½ and uses an IRA distribution to pay conversion taxes, the 10 percent early distribution penalty will be owed on the amount that actually was distributed in addition to income taxes. In that case, it will take longer for the conversion to make sense.

- *How long will the money be left in the Roth IRA for income and gains to compound before distributions begin?* The longer the money is left in the Roth IRA before beginning withdrawals, the more sense a conversion makes. In most cases for a conversion to pay, the owner should be prepared to leave the Roth IRA alone for at least 7 to 10 years after the conversion, if the average annual total return is at least 8 percent. A lower return will take longer to make the conversion pay off. The payoff period also is affected by whether the money eventually is withdrawn in installments or in a lump sum. The longer the distributions can be delayed or stretched out, the more sense it makes to pay taxes to convert to a Roth IRA.

  In fact, one of the best uses of an IRA conversion is when the owner doesn't plan to spend the IRA. The traditional IRA is converted to a Roth IRA, and the owner doesn't take distributions during his or her lifetime. Instead, the Roth IRA is left for younger loved ones to inherit. They receive tax-free income from the Roth IRA. In effect, the original

IRA owner has prepaid income taxes for them. A conversion to a Roth IRA can be a great estate-planning tool.

- *Is there a difference between the tax bracket at conversion and the tax bracket when distributions are made?* The more the tax rate is expected to decline at distribution time, the less sense it makes to pay taxes at today's rate. Keep in mind that the conventional wisdom about tax rates decreasing during retirement frequently might not be true, as will be discussed in Chapter 9.

- *How much of the IRA will be converted?* Conversion is not an all-or-nothing question. Any percentage of the IRA can be converted to a Roth IRA (depending on the IRA custodian's minimum account requirements). Suppose the owner is using the IRA to pay living expenses now and cannot wait seven years or more after the conversion to begin taking distributions from a Roth IRA. Then the owner might decide to leave enough in the regular IRA to cover expected expenses for seven years or more, and convert the rest into a Roth IRA. Or if the owner doesn't have enough cash to pay taxes for converting the entire IRA, a smaller amount can be converted. The entire IRA can be converted in stages over the years. One strategy is to convert each year only an amount that will keep you from rising into the next tax bracket.

- *Will Social Security benefits be taxed?* Converting to a Roth IRA also can reduce taxes on Social Security benefits. Distributions from a regular IRA are included in gross income, boosting the amount of Social Security benefits that are taxable. Nontaxable distributions from a Roth IRA are not included in gross income, so they won't make Social Security benefits taxable.

- *How does the state tax the Roth IRA?* Many states automatically conform to federal law, but some states don't grant Roth IRA distributions the same tax-free status they have under federal law. Check your local tax law.

- *Will required minimum distributions from a traditional IRA exceed spending needs?* Minimum annual distributions (discussed earlier in this chapter) are required from a traditional IRA but not from a Roth IRA. The required distributions can dramatically increase income taxes as one ages. If the owner anticipates that required minimum distributions will significantly exceed spending needs, then a Roth IRA should be considered.

How to Decide

Deciding whether to convert a traditional IRA into a Roth IRA obviously involves some projections and number-crunching. There are some general rules that can be used as guidelines. The longer the Roth IRA will be allowed to compound before distributions begin, the more sense a conversion makes. The higher the expected investment rate of return on the Roth IRA, the more sense a conversion makes. A conversion also makes more sense if the taxes are paid with funds that are outside the IRA. A conversion makes less sense if the tax rate will decline after traditional IRA distributions would begin.

Fortunately, there are many convenient ways to do the number-crunching so that general rules don't have to be relied on. A number of websites offer free calculators for projecting the results of a Roth IRA conversion. These calculators allow the user to quickly change the assumptions on the key factors. Most mutual fund firms and brokers have calculators on their websites. The best probably are at vanguard.com, fidelity.com, and troweprice.com. T. Rowe Price also sometimes offers a separate program called IRA Analyzer for a small fee. Many financial publication websites also have calculators.

The mutual fund and brokerage firm calculators often are not full-featured or what the programmers call robust. A more sophisticated Roth IRA calculator can be found at www.rothira.com. A couple of other calculators with no ties to financial products or services are at www.datachimp.com, www.volition.com, www.dinkytown.com, and www.customcalculators.com. I recommend using at least two different online calculators. They almost certainly will get different results, and using different calculators allows you to see which items are variable in the different calculators and which are assumed to be true for all users. Most financial planners also have software calculators that have many features and allow comparisons of many different scenarios. Having a financial planner, estate planner or CPA do the calculations makes sense when the IRA balance is large. For those who don't use computers, many mutual funds and brokers also have worksheets or workbooks that enable the user to make similar calculations on paper.

There is one trick to conversions for those already over age 70½. Taxpayers who already are subject to the required minimum distributions must take the required distribution for the year of the conversion. A required distribution cannot be avoided by converting a traditional IRA to a Roth IRA.

The best candidate for converting a traditional IRA to a Roth IRA is a wealthy individual who really doesn't need the IRA income, plans to pass the account to the next generation or two, and wants to reduce income and estate taxes. But that is not the only situation when a conversion is appropriate. For example, someone who won't take distributions from the IRA for at least 7 to 10 years and who has enough cash outside the IRA to pay the conversion taxes also could benefit from a conversion. The only way to decide with considerable confidence is to make forecasts using estimates for the factors already outlined.

Tilting Your Finances to Favor a Conversion

You might balk, understandably, at paying the taxes to convert a traditional IRA to a Roth IRA. Or you might run the numbers and find that a conversion doesn't make financial sense for you. In these situations, there are strategies to consider. They can reduce the taxes paid on a conversion and perhaps turn a situation in which a conversion isn't viable to one in which a conversion makes sense.

Look for opportunities to use these strategies:

- *Reduce gross income.* A range of strategies can reduce gross income. You may have enough flexibility to reduce some income received for the year. Reduce optional distributions from IRAs and annuities. Defer salary from employment. Avoid taking capital gains by limiting asset sales during the year of the conversion. Take capital losses to offset gains. Each of these actions reduces gross income.

Business losses from an S corporation, partnership, LLC, or a proprietorship reduce gross income. There are a number of hurdles in the tax code to taking the deductions. For example, you must materially participate in the activity, and it must be profit seeking and not a hobby. But if you qualify and can time business income and expenses to generate a loss, it will reduce the cost of the IRA conversion.

- *Reduce adjusted gross income.* Gross income minus certain deductions leads to adjusted gross income (AGI). The deductions, listed on Form 1040, include retirement plan contributions, medical insurance premiums for the self-employed, and one half of self-employment taxes. There are other deductions. Study the list to see if you qualify for any of them.

- *Increase charitable contributions.* This is a strategy for people who are inclined to make significant charitable contributions either annually or through their estates. Bunching the contributions in years when an IRA is converted can make a lot of sense. You donate a lot in the year you do the conversion, and the tax deduction from the contributions can reduce the taxes on the conversion. Be sure to do careful tax planning to ensure that the interplay of different tax code provisions doesn't offset some of the benefits of the contributions.

  You don't have to actually give all the money to specific charities the year of the conversion. You can donate to a donor-advised fund, such as those run by Schwab, Fidelity, and many localities. Then, donate the money to specific charities over time.

- *Donate appreciated assets.* You can generate substantial charitable deductions without using cash by donating appreciated assets. When appreciated securities and real estate are donated, you deduct the fair market value on the date of the contribution. You don't owe capital gains taxes accrued during your ownership. This is a way to accelerate charitable contributions without tapping cash or incurring capital gains. Go through your portfolio and consider donating mutual funds, stocks, or real estate that are substantially higher than your purchase price.

- *Take capital losses.* Capital losses offset capital gains for the year dollar for dollar. Additional losses up to $3,000 can be deducted against other income. Any leftover losses can be carried forward to future years and used in the same way.

When you sell assets that have paper losses or you have carryovers of losses from past years, they make it possible to sell appreciated assets and shelter all or most of the capital gains. That generates more cash to pay the taxes for the Roth conversion. You've raised the cash to pay the taxes on the IRA conversion without incurring additional taxes. Or you can consider donating to charity the cash from selling losing assets so the deduction will offset some of your IRA conversion taxes. Run the numbers both ways to see which has the best cash flow.

Changing Your Mind

Once a decision is made on whether or not to convert a regular IRA to a Roth IRA, the IRA owner should continue to monitor the results. Changes in the value of the IRA should trigger a reevaluation of that decision:

- *Suppose a conversion was made.* The law allows this decision to be reversed as late as the date the tax return for the year is due. This is known as a recharacterization. The Roth IRA can be converted back to a traditional IRA and no taxes would be due on the transactions for the year. A recharacterization should be considered when the value of the IRA decreases significantly after the conversion. If the conversion is not reversed, then taxes still are due based on the IRA's value on the conversion date. The owner would be paying taxes on wealth that no longer exists. It makes sense to reverse the conversion. Then, the owner can decide to reconvert into a Roth IRA. A conversion can be done after a recharacterization after a waiting period. The second conversion can't be done until the later of 30 days after recharacterization and the next January 1 has passed.
- *Suppose a traditional IRA was converted into a Roth IRA.* The owner then becomes unemployed or for other reasons suffers a decline in income. The owner determines that the reversal of fortune is likely to continue into the following year and will be severe enough to drop him or her into a lower tax bracket that year. Then it makes sense to recharacterize the Roth IRA as a traditional IRA before the year closes. The conversion can be made the following year when the owner will be in a lower tax bracket and the cost of conversion will be lower.
- *Suppose the owner decided not to make a conversion.* Again, if the value of the IRA drops significantly later in the year, the decision should be reconsidered. If the conversion was not made because the owner did not have enough other assets to pay the taxes, then the lower value of the IRA might make the conversion affordable. In addition, making the conversion when the value is lower means that all appreciation from the new lows will be tax free when eventually distributed from the Roth IRA. Without the conversion, those gains would be taxed as ordinary income.

A recharacterization is simple. A conversion may be reversed any time until the final due date for the tax return for the year, including extensions. That means the decision can be delayed until as late as October 15 of the year following the conversion. The recharacterization is done on Form 8606 filed with the regular tax return, or with Form 1040X (amended tax return) if the regular return already was filed.

When the calculations show that conversion makes sense, the biggest risk is that the government will change the rules. Once many people have accumulated significant wealth in Roth IRAs, Congress might impose some kind of income taxes on future distributions.

Tips for Maximizing IRA Conversion Benefits

There are some strategies that will increase the benefits of an IRA conversion or help you turn a conversion mistake into a benefit.

Convert in Stages

It can be expensive to convert all of a large IRA in one year. You might not have enough cash to pay the taxes, or the conversion could push you into a higher tax bracket. Instead, convert a portion of your IRAs each year. Convert just enough to keep you from rising to the next tax bracket or triggering stealth taxes.

Convert to Multiple IRAs

Ideally, a diversified traditional IRA shouldn't be converted into one diversified Roth IRA. Instead, each different investment or asset class in the traditional IRA should be put into its own Roth IRA.

You see, the taxes on a conversion are computed on the value of the assets on the date of the conversion. If the converted IRA subsequently declines in value, you still pay taxes on the higher converted value. You could recharacterize the entire IRA, but the overall loss might not be enough to justify all the changes and incurring the waiting period before you can convert again.

When you put each asset in a separate Roth IRA, you have the option to recharacterize (reverse the conversion of) any asset that declined in value and keep the others in their Roth IRAs. You won't be paying taxes on a value that no longer exists, and the rest of your portfolio is safely in tax-free Roth IRAs. You could convert the other asset, probably at a lower value, after the waiting period.

Monitor Converted IRAs

You have the right to reverse a conversion by October 15 of the following tax year. Follow your converted IRA or IRAs and recharacterize those that have declined substantially as you near the recharacterization deadline.

Reconvert

You have another shot at a conversion if you converted assets and then recharacterized them. The reconversion can't occur in the same year as a recharacterization. Also, at least 30 days must pass between the recharacterization and reconversion:

Examples

Example 1. A converted Roth IRA is recharacterized to a traditional IRA on December 15, 2015. The owner can't reconvert until January 15, 2016. He has to wait until the later of the next calendar year and 30 days before reconverting.

Example 2. A converted Roth IRA is recharacterized to a traditional IRA on July 1, 2015. The IRA can be reconverted on January 1, 2016, because that is the later of 30 days and the next calendar year after the recharacterization.

Roth Accounts Are Not Only for the Young

There are some strategies that will increase the benefits of an IRA conversion or help you turn a conversion mistake into a benefit.

Roth IRAs aren't very old, but they have already spawned some rules of thumb. The most common rule of thumb for Roth IRAs is that they're for relatively younger people. Unfortunately, this rule of thumb is the result of some good research that is distorted and misapplied. It's causing many people to not use Roth IRAs when the vehicles could benefit them people and their heirs.

The rule of thumb began from a sensible base. As we discussed, a Roth IRA needs to compound income and gains for a while to make up for paying taxes early. The tax benefits of the Roth IRA (tax-free distributions, no required minimum distributions on the original owner) are back-end loaded, while the tax benefits of a traditional IRA are front-end loaded. But it doesn't take as long as many people now think for the Roth IRA to pay off, and how long it takes depends on several variables.

Earlier we discussed why it makes sense for most people to let the Roth IRA compound for some years in order for a conversion to make sense. Under likely circumstances, the Roth IRA should compound for 7 to 10 years before taking distributions. Research by others supported this conclusion. The pay-off period depends on investment returns, the difference between tax rates at the time of conversion and the time of distributions, how the taxes on the conversion are paid, and other factors.

Rules of thumb distorted this research. Some advisors routinely say that people older than certain ages shouldn't consider Roth accounts. Yet, a careful look at the facts and the numbers shows converting to a Roth IRA can be a great estate-planning tool, even for older people.

Fortunately, new research specifically addresses the issue of older Americans and Roth IRAs. Before delving into the research, you should know that Roth 401(k)s now are available through many employers, especially large employers. Workers can choose between a traditional 401(k) and a Roth 401(k). This choice is in addition to the choice between a traditional IRA and Roth IRA. You also have the option to convert a traditional IRA or 401(k) to a Roth version.

The new research concludes that many older Americans should consider Roth accounts instead of traditional IRAs and 401(k)s. This applies to both annual contributions to accounts and conversions of traditional accounts to Roth versions, according to a study by Stuart Ritter of mutual fund firm T. Rowe Price.

Let's look at a 50-year-old worker who can choose to contribute to either a Roth or traditional 401(k) plan. He contributes $5,000 annually until age 65, and then begins annual withdrawals. He earns a 7 percent annual return and is in the 28 percent tax bracket the whole time. At first glance, it appears he'd have the same account balance in each scenario, which would be $38,061 after 30 years, according to Ritter's assumptions and calculations.

The Roth balance, however, is tax free. The worker or his heirs will benefit from that full amount. The traditional account, however, will be taxed at the 28 percent rate, leaving the worker or his heirs with only $27,404 to spend. Also, higher distributions have to be taken from the traditional account to have the same after-tax spending money as the Roth version.

The worker could select a traditional 401(k) and invest the income tax savings from his contributions in a brokerage account. But that wouldn't be enough to match the Roth IRA. That's because the brokerage account earnings would be taxed, so it wouldn't compound at 7 percent annually after taxes.

What if the worker is in a lower tax bracket after retirement? Keep in mind that's less likely these days with only a few tax brackets. But Ritter's numbers show that the Roth 401(k) still is a better deal if the worker's income tax rate drops by as much as 10 percentage points in retirement.

What about an older worker? Ritter's work shows that the Roth 401(k) is the better deal for workers into their early 60s.

Of course, these are hypothetical scenarios. They might not apply to you. The Roth option could be even better for you, or it could be a bad deal, depending on the particulars of your situation and what you want to assume about retirement tax rates, investment returns, and other factors. The important point is that you shouldn't let rules of thumb and other people's experiences or views determine your strategy. Take a look at the data.

A strategy we'll discuss more in Chapter 9 involves using a Roth account essentially to help you decide the tax bracket you want to be in during retirement. You'll have other sources of income you can't control, such as Social Security, annuities, distributions from mutual funds or stocks, and required distributions from traditional accounts. When those don't meet your spending needs, you can sell some investments at a long-term capital gains rate of 20 percent and you can tap the Roth account tax free, maintaining your standard of living while controlling your tax bill and rate.

Another advantage of having some money in a Roth account is the flexibility. If you have a large one-time spending need (new car, child's wedding, major home repair), you can take the money from the Roth IRA without pushing yourself into a higher tax bracket or triggering the stealth taxes.

What about conversions of traditional IRAs to Roth IRAs? Are those only for the young or youngish? Not always. In fact, it can make sense for someone to wait until retirement to convert retirement accounts.

Consider that your income might be lower in the first years of retirement than during the working years, so you'll be in a lower tax bracket or at least in a lower portion of the same tax bracket. That makes it less expensive to convert an IRA or 401(k).

Also, a conversion is most likely to pay off (or pay off faster) when the taxes on the conversion are paid from other funds instead of using part of the IRA or 401(k) to pay the taxes. Many people are likely to have lower fixed expenses in retirement, so they're more comfortable tapping other accounts to pay the taxes. You also might have generated some cash from the sale of your home or other preretirement transactions.

You might move to a no-income-tax or lower-income-tax state in retirement. The converted amount is taxed by both the state and federal governments. So, it is less expensive if you've moved to a state with lower taxes.

These factors will make it cheaper or easier to pay for a conversion to a Roth account, and that will reduce the time the Roth account has to compound before the conversion pays off.

We've covered some specific guidance and examples in this discussion. But those shouldn't be your main focus. The main point is that there are variables involved, and what is best for one person on this issue isn't best for another. You need to consider the variables in your case and run the numbers or have a financial advisor run them for you. Rules of thumb aren't the way to make these important decisions. Also, because things change you have to reconsider the decision regularly. Not converting might be the right decision this year, but circumstances could change next year or the year after.

USING RMDS TO BUY LIFE INSURANCE

Another strategy for reducing or avoiding RMDs will provide a tax-free, guaranteed inheritance to your children and grandchildren and also can provide tax-free lifetime income to your spouse plus funding for charity.

Here's how the strategy works.

First, you change the secondary or contingent beneficiary of your IRA to a charity; your spouse is generally the primary beneficiary. The best bet might be to name a donor-advised fund as the charity. Next, acquire a life insurance policy (ideally a joint and survivor policy issued to both you and your spouse). Then, you use required minimum distributions or regular distributions from the IRA to pay the premiums. It usually is best to have the life insurance benefit be equal to your IRA value and have it owned by an irrevocable trust to ensure it isn't included in your estate for tax purposes. The trust benefits your children, and perhaps the grandchildren. You don't need a trust if you're confident that your estate won't be subject to estate taxes, even after adding in the life insurance benefits.

Here's an example.

Max Profits is 71 and his wife Rosie is 65. Max has a $2 million traditional IRA, and he's going to have to begin RMDs, with the first one being about $73,000. He doesn't need anywhere near that much money from the IRA to fund his expenses, and he certainly doesn't want that much additional taxable income.

Max and Rosie first obtain coverage under a joint and survivor life insurance policy with a benefit of $2 million. Their good health results in a premium of $25,213. They also establish a life insurance trust to be the beneficiary and owner of the policy, with their three children and four grandchildren as future beneficiaries of the trust.

The Profits establish an account at a donor-advised fund and change the beneficiary designation form of Max's IRA to name the fund as the contingent or secondary beneficiary of the IRA. Rosie is the primary beneficiary, so the charity won't receive anything until Rosie passes away.

During Max's lifetime, he takes RMDs from the IRA and contributes a portion of them to the trust to be used to pay the insurance premiums. These should qualify as tax-free gifts to the children under the annual gift tax exclusion if the trust is properly drafted.

After Max passes away, the IRA is available to Rosie for income, and she continues to use a portion of the income to make gifts to the trust to pay insurance policy premiums as needed.

After Rosie passes away, the remaining value of the IRA goes to the donor-advised fund. There are no taxes on this transfer. The children and grandchildren then can serve as directors of the fund and make charitable gifts from the fund over the years in accordance with the bylaws that you had set up years prior.

Also after Rosie's passing, the life insurance policy pays $2 million to the insurance trust, and the trust makes income and principal distributions to the children and grandchildren according to the terms Max and Rosie set when they created the trust. Distributions could be made all at once or over time. The life insurance proceeds avoid all income and estate taxes for both the trust and the beneficiaries.

The result is that the children and grandchildren receive the IRA's full initial value without any depletion by taxes, Max's RMDs, or poor investment returns. Max and Rosie both have access to the IRA during their lifetimes if needed. The remainder of the IRA goes to the charitable fund set up by Max and Rosie, and their children and grandchildren oversee it. Because of the leverage in the insurance policy and the lack of taxes, there is more money available than before, so all these goals can be met.

A number of variations in the details are possible. The Profits can choose from several premium payment schedules for the insurance policy, such as paying the premiums over seven, 10 or 15 years, or paying them annually up to age 100. Instead of naming Rosie as the sole initial beneficiary of the IRA, a charitable remainder trust could be the beneficiary. It would pay Rosie a lifetime income, and any remainder would go to the foundation or other charities. Or after Max's passing the IRA could buy an annuity payable to Rosie for life.

There are many choices for the charitable beneficiary of the IRA. You could name individual charities you like, but naming a donor-advised fund provides more flexibility. You don't know today how much money will be available or which charities will be family favorites. The donor-advised fund allows the decisions to be deferred and allows the charitable contributions to be spread over years. It also provides an opportunity for your offspring to work together selecting charities and to develop the habit of giving.

This strategy was brought to me by David Phillips at Estate Planning Specialists in Phoenix, Arizona (888-892-1102).

The earlier you start on this strategy the better so that you can obtain the lowest cost life insurance. Waiting can only increase the premiums.

USING THE FAMILY BANK STRATEGY

Another strategy to avoid escalating RMDs and a variation of the previous strategy is the Family Bank Strategy.

The IRA is distributed to the owner and the income taxes paid on the distribution. The after-tax amount of the distribution is used to make a single-premium deposit on a permanent life insurance policy. The cash value portion of the policy will have interest earnings each year of about 5 percent to 8 percent that will compound tax free. Eventually, the policy beneficiaries receive the life insurance benefit free of income taxes. During the owner's lifetime, if money is needed, he or she can borrow against the cash value of the policy. The cash value loans are tax free. If they aren't paid back, the loan amount and accumulated interest reduces the death benefit paid to beneficiaries.

This strategy is especially good when you convert only enough of your IRA to bring your taxable income up to the maximum of your tax bracket. For example, a couple earning $150,000 will be in the 28 percent federal income tax bracket until their income reaches about $227,000 (the amount changes each year with inflation). They could transfer another $76,000 annually from the IRA into the Family Bank Strategy before being pushed into the 33 percent bracket.

The really big advantage is that the life insurance benefit is always going to be worth substantially more than the money you transferred into the policy. And, unlike an IRA, market changes aren't going to cause the insurance policy's value to decline. If your loved ones inherit a traditional IRA, they'll really inherit only the after-tax balance, and the balance will change with the markets.

It's possible that even a Roth IRA owner might be better off with the Family Bank Strategy. If the Roth IRA exceeds your likely needs and primarily is for loved ones to inherit, consider turning it into a permanent life insurance policy. That way, your beneficiaries will inherit the tax-free policy benefit, which is likely to be higher than the Roth IRA balance. There's no investment risk with the insurance policy, and you still have tax-free access to the money through loans.

There are four general types of permanent life insurance, and many variations of each. For the Family Bank Strategy, you only want to consider Participating Whole Life or Indexed Universal Life. There's a vigorous debate among insurance professionals who implement the strategy over which type of policy to use. You need to know the arguments on each side and decide which is best for you.

For details about the strategy and how to use it in different situations, read the book by David Phillips, The Family Bank Strategy. It's available on Amazon.com or by calling 888-892-1102.

WHICH ACCOUNT TO SPEND FIRST?

Most retirement-age Americans have both taxable and tax-deferred accounts. Many now have tax-exempt accounts, such as Roth IRA or Roth 401(k)s. Each of these types of accounts receives different tax treatment, and sometimes different investments receive different tax treatments in the same type of account. The order in which money is withdrawn from different types of accounts will affect how long the wealth lasts.

In this section, we're going to discuss the best order in which to draw down the different types of accounts to maximize the life of the entire collection of assets. This is one way to determine the sources of your retirement spending over the years. Before making a decision, however, consider the strategy demonstrated in Chapter 9. There we discuss a strategy for remaining in a low tax bracket of 20 percent or so for life. You can take the approach taken in that chapter or in this section.

Now, let's look at the best order in which to draw down accounts.

Fortunately, in most cases, this is an issue for which the traditional thinking is correct. Most people would say intuitively that money in taxable accounts should be spent first and money in tax-advantaged accounts such as IRAs should be spent after that so that the tax-deferred compounding can continue for as long as possible. Money in Roth IRAs should be spent last, since no taxes are incurred.

Most people would be well-served by following that advice. A study published in the *AAII Journal* in May 2002 found that wealth lasted longer when money from taxable accounts was spent first and IRA money was spent only after taxable accounts were exhausted. The higher the rate of return on the investments, the longer wealth lasted by spending taxable accounts first. Also, the higher the individual's tax bracket, the more important it is to allow the tax-deferred compounding of IRAs to continue as long as possible. I've confirmed these results with my own calculations and show in Table 8.1 how long an individual's assets last under different scenarios. The figures assume that the individual's assets are evenly split between taxable and tax-deferred accounts and that each account earns the same rate of return.

TABLE 8.1 WHICH ACCOUNT TO SPEND FIRST?

Rate of Return	Taxable Account First	Tax-Deferred Account First
6%	18+ years	15+ years
8%	25+ years	18+ years
10%	51+ years	24+ years

The second and third columns show how long the owner's accounts will last under the stated distribution order and rate of return.

There is an exception to the general conclusion. The exception is when higher-returning investments are held in the taxable account and the after-tax return is four percentage points or more higher than the return earned by the tax-deferred account. In that case, you want to take distributions from the tax-deferred account first and let the higher after-tax returns compound in the taxable account for as long as possible.

The individual's wealth can be made to last even longer when the taxable accounts are managed and liquidated tax-efficiently. Some basic rules should be followed when managing taxable accounts for maximum longevity.

Investments showing losses should be sold first. A capital loss first offsets any capital gains realized for the year. If the losses exceed the year's gains, then up to $3,000 of net losses can be deducted against other income. If there still are unused capital losses, they are carried forward to future years to be applied in the same way until they are exhausted. Most investors are hesitant to sell losing investments. They don't want to make the loss of capital final. Instead, they want to hold the investments until the values at least recover to their purchase prices. Investors, however, would be better off selling the losing investments, using the tax losses to reduce gains on other income, and spending the sale proceeds or investing them in something else.

After harvesting losses, the next investments to be liquidated from taxable accounts should be those that would incur the lowest taxes as a percentage of their value. Take the taxes that would be incurred from the sale of the asset and divide them by the market value of the asset. The result is the percentage of the asset that would be taxed, in effect the tax rate on that asset. The asset with the lowest tax rate should be sold first.

By following these strategies, a taxable account can, in effect, become a partially tax-deferred account. The longer taxes are deferred, the more after-tax wealth can be accumulated before taxes are paid, and the greater the after-tax wealth will be.

There also might be tax-deferred accounts for which distributions are partially taxed. An example is an IRA with nondeductible contributions. Part of each distribution from such an account will be taxable and part nontaxable. These accounts should be liquidated before the fully taxable IRAs.

Of course, these results were derived from examples using assumptions. Individuals need to determine which assumptions apply to them before adopting a strategy and to consider factors that have not been discussed. For example, state tax laws need to be considered. Some states exempt from state taxes some retirement income, including distributions from IRAs. Retirees in those states might want to take distributions from IRAs up to the exempt amount before selling assets in taxable accounts.

Another factor to be considered is the investor's asset allocation. Taking distributions from any account will change the investor's asset allocation, because the assets sold no longer will be in the portfolio. Changes to the other accounts might have to be made to ensure that the desired ratio between stocks, bonds, and other assets is maintained for the long term. Taxes and other costs could be incurred when rebalancing the portfolio.

WHICH INVESTMENTS FOR TAX-DEFERRED ACCOUNTS?

When you own several different types of accounts, the order in which to withdraw money from the different accounts is not the only issue that determines how long the assets last. Another important decision is how to invest the different accounts. The overall after-tax wealth an individual can accumulate changes depending on which investments are in the tax-advantaged accounts and which are in the taxable accounts. The results surprise many people.

The longstanding conventional wisdom was very simple. It stated that income-producing investments—those that paid regular, taxable interest and dividends such as bonds and stocks with high dividend yields—should be purchased through tax-deferred accounts such as IRAs and 401(k)s. Investments that can earn tax-advantaged capital gains should be purchased through taxable accounts.

The rationale was that in a taxable account, interest and dividends were taxed as ordinary income at the taxpayer's highest tax rate. That didn't leave much income after taxes to compound over the years. Therefore, income investments should be in tax-advantaged accounts where the full income can compound tax-deferred. Stocks and equity mutual funds, if held for more than one year, were subject to a maximum tax rate of 20 percent on their capital gains when held in taxable accounts. If stocks were held in tax-deferred accounts, such as traditional IRAs, the gains would compound tax deferred but the distributions would be taxed as ordinary income. Putting assets with the potential for long-term capital gains (such as stocks) into tax-deferred accounts had the effect of converting tax advantaged long-term capital gains into higher-taxed ordinary income. Tax-wise investors generally want to do the opposite.

While the conventional wisdom was logical, it wasn't always the best advice. The best advice on how to divide investments between IRAs and taxable accounts depends on the individual investor involved.

The conventional advice still works best for investors who buy individual stocks and hold them for a long time. Those investors will be able to take advantage of the lower long-term capital gains rates on investments held for more than one year. The conventional approach also is good for investors who own equity mutual funds and hold them for more than one year, if the mutual funds make no or small taxable distributions each year.

The problem is, many investors do not fall into these two categories. Studies show that whether they own individual stocks or equity mutual funds, individual investors buy and sell too frequently to take advantage of the long-term capital gains rates on most of their equity gains. While that is not the best way to maximize investment returns, it is the way many investors manage their portfolios. Other investors own mutual funds and hold them for more than one year. Many of those funds, however, make taxable distributions each year of a significant portion of their total returns. In these two situations, most of the gains from the stocks and mutual funds would be taxed as ordinary income.

Investors in these situations often can be better off keeping their income-earning investments, such as bonds, in taxable accounts. Their investments with potentially higher returns—such as stocks that are traded after less than one year—that will be taxed as ordinary income should be purchased through tax-advantaged accounts. The tax-deferred accounts protect the annual gains from taxes and allow the gains to compound to a much higher amount than would be possible in a taxable account. Even after paying the taxes when the money is distributed from the tax-deferred account, the investor has more after-tax wealth than would have been accumulated by holding the stocks in a taxable account. The more gains that can be compounded before taxes are incurred, the greater the investor's lifetime after-tax wealth will be.

Another factor to consider is the difference between the investor's ordinary income tax rate and the long-term capital gains rate. An investor who faces the top ordinary income tax rate of 39 percent and a top long-term capital gains rate of 20 percent has a lot at stake in this decision. An investor in a lower tax bracket has a smaller difference between the two rates. He or she still would benefit from getting the allocation right, but the benefit would not be as great.

Perhaps even more important is any difference between the ordinary income tax rate during the accumulation years and during the distribution years. While fewer people see their tax rates decline after retirement, it is possible an investor will be in a much lower tax bracket at retirement. Someone who believes he or she would be in a significantly lower bracket in retirement could come out ahead by putting the highest returning investments in tax-deferred accounts. Taxes would be paid at a much lower rate in the future when the gains are withdrawn.

OWNING NONTRADITIONAL IRA INVESTMENTS

More and more IRA owners are considering investments other than traditional stocks, bonds, and mutual funds. It's not surprising. The Federal Reserve's zero interest rate policy boosted returns of stocks and bonds the last few years but probably pulled forward a lot of future returns into those years. For the next 5 or 10 years, returns from traditional investments are likely to be less than historic averages.

The tax law allows your IRA to be invested in a range of vehicles other than publicly traded stocks, bonds, and mutual funds. There are some obstacles you must navigate, but doing so could allow you to invest in unconventional and profitable investments. The most popular unconventional IRA investments probably are real estate and privately traded stock. Other frequent investments are making loans and mortgages and owning some precious metals.

It's the IRA custodians who limit most investments. Your IRA must have an approved custodian or trustee, and most of them are traditional financial institutions that restrict IRA investments to traditional vehicles.

To own nontraditional investments in an IRA, you need a custodian or trustee that allows a true self-directed IRA, one that allows you to invest in any asset permitted by the tax law. (In fact, some let you invest in assets not permitted by the tax law. It's up to you to know the rules and be responsible for any penalties the IRS imposes.) Many traditional IRA custodians and trustees say they offer self-directed IRAs, but they mean only that you can choose from among the traditional investments available on their platforms.

To find a true self-directed IRA custodian or trustee, go to your favorite Internet search engine and search for "self-directed IRA." In addition to articles about traditional self-directed IRAs, you'll find websites for trustees and custodians of true self-directed IRAs.

To use a true self-directed IRA, you should be prepared to pay higher fees across the board. The trustee has to do more work, and there are fewer IRAs of this type so the custodian doesn't have the scale and efficiencies of traditional IRAs. In addition to an annual fee and transaction fees, you might pay to have your IRA's investments valued each year.

A move that might reduce fees is to form a limited liability company and have it wholly owned by the IRA. Then, the LLC makes the investments in its name. But keep in mind the LLC can engage only in transactions allowed for an IRA directly. There will be costs to forming the LLC, and it probably will have to file an annual tax return and pay an annual license fee. So, it doesn't eliminate all the extra costs.

Once you set up the self-directed IRA, either with or without an LLC, the next step is to be sure your investments don't violate IRS rules, especially those against prohibited investments and transactions.

The list of prohibited investments for IRAs is short. It consists of life insurance and collectibles. Collectibles include art, antiques, rugs, stamps, coins, metals, gems, and alcoholic beverages. The IRS can add to the list but hasn't. There are some exceptions. The largest is for U.S.-minted gold coins that are legal tender. An IRA is allowed to own them.

The longer and more significant list is of prohibited transactions. It's easy to make a mistake and stumble into a prohibited transaction and its penalty. You want to avoid prohibited transactions, because the penalty is that the entire IRA will be treated as fully distributed when the prohibited transaction was made. The IRA owner must include the IRA's full value in gross income, regardless of the amount of the prohibited transaction. If the owner has multiple IRAs, only the IRA that engaged in the prohibited transaction is penalized.

Basically, a prohibited transaction is an investment or deal between a related or disqualified person and the IRA. It doesn't matter if the transactions are at fair market value. They are prohibited at any price.

There are six prohibited transactions between IRAs and related parties. The first four are specific, and the last two are general.

The four specific prohibited transactions are:

- A sale, exchange, or lease of property
- A loan of money
- Furnishing goods, services, or facilities
- A transfer or the use of the income or assets of the IRA

The two general prohibitions are: an act in which the related party deals with the IRA income or assets as his or her own; and the receipt of any benefit for the related party's personal account in connection with a transaction involving the IRA's income or assets.

Stated in clear, plain English, the prohibited transactions can be summarized as: No deals are allowed involving the IRA and its owner or a person related to the IRA or its owner. Persons include entities, such as trusts, corporations, LLCs, and others.

A related person for an IRA is the IRA owner; anyone who makes decisions for the IRA; anyone providing services to the IRA; an ancestor, spouse, or descendant of the IRA owner, of the owner's spouse, of a decision maker for the IRA, or of anyone providing services to the IRA; a corporation, trust, partnership, or estate that is 50 percent or more owned by any of the above persons; an officer, director, highly compensated employee, or 10 percent or greater owner of any of the above; and a partner of any of the above.

Though the list of related persons sounds comprehensive, there are some gaps. Not included as related persons are brothers, sisters, step relatives, nieces, and nephews of the IRA owner. Also not included are friends and neighbors of the owner. A "significant other" to whom the IRA owner is not married also is not a related person.

Roth IRAs don't escape these rules. A Roth IRA is subject to the same rules as traditional IRAs and other qualified retirement plans unless specifically exempted. There isn't an exemption to the prohibited investment and transaction rules for Roth IRAs. In addition, the IRS appears to have gone a step further for Roth IRAs. It issued a notice stating that any transaction between a Roth IRA and a "related party" would be considered a tax shelter or an abusive transaction required to be registered with the IRS. For this notice, the IRS considered brothers and sisters as related parties (IRS Notice 2004-8).

Though the list of prohibited transactions is long and comprehensive, the Department of Labor is allowed to grant exemptions and frequently does. It grants exemptions to specific taxpayers for specific transactions and also grants broad class exemptions that apply to anyone who matches the facts in an exemption. Under these exemptions, IRAs and owners have been allowed to engage in transactions involving real estate, stock, loans, and more.

To find details on the exemptions, go the Department of Labor website at www.dol.gov. Look for the "Employee Benefits Security Administration" among the department's agencies. On the home page for the EBSA, look for "Technical Guidance." I'd give a more specific web address, but the Labor Department frequently changes its website. You can look at the class exemptions that have been granted to see if what you want to do qualifies. You also can look at individual exemptions to see if there is something close enough to make it worth your while to apply for one.

With an individual or class exemption, you might be able to use an IRA to buy real estate (including a vacation home), invest in your business, or lend money to a relative. I don't recommend engaging in these transactions on your own. The rules are technical, and you have to comply fully with them. You should consult with an accountant or attorney who is well-versed in the rules for IRAs and retirement plans before engaging in a transaction. The penalty for mistakes is steep and should be avoided.

CHAPTER 8: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is the correct date for when the first traditional IRA required minimum distribution (RMD) must be taken:**

A. the first RMD must be taken by December 31st of the year in which the individual turns 60½

B. the first RMD must be taken by April 1st of the year after the individual turns 60½

C. the first RMD must be taken by December 31st of the year in which the individual turns 70½

D. the first RMD must be taken by April 1st of the year after the individual turns 70½

2. **RMDs may be taken in which of the following formats:**

A. cash

B. property

C. noncash distributions

D. any of the above

3. **In which of the following situations does converting from a traditional IRA to a Roth IRA make the least amount of sense:**

A. if the tax rate will decline after traditional IRA distributions would begin

B. the longer the Roth IRA will be allowed to compound before distributions begin

C. the higher the expected investment rate of return on the Roth IRA

D. if the taxes are paid with funds that are outside the IRA

4.	**Which of the following is <u>not</u> a strategy recommended to reduce the taxes paid on an IRA conversion:** **A.** reduce gross income **B.** increase adjusted gross income **C.** increase charitable contributions **D.** take capital losses

CHAPTER 8: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The first RMD is not required to be taken by December 31st, nor by the age of 60½. **B.** Incorrect. The age requirement for the first RMD is not 60½. **C.** Incorrect. Although the individual must take the first RMD at age 70½, the deadline to do so is not December 31st of that same year. **D.** CORRECT. The first RMD is required by April 1st of the year after an individual turns 70½. *(See page 182 of the course material.)*
2.	**A.** Incorrect. Cash is one option when taking an RMD, but it is not the only correct selection. **B.** Incorrect. RMDs can be taken in property, but this is not the only possibility. **C.** Incorrect. Most IRA custodians allow noncash distributions, but this is not the only option. **D.** CORRECT. An RMD doesn't have to be taken in cash. The tax law allows the distribution to also be taken in property, and most IRA custodians allow noncash distributions as well. *(See page 183 of the course material.)*
3.	**A.** CORRECT. A conversion makes less sense if the tax rate will decline after traditional IRA distributions start. **B.** Incorrect. The longer the Roth IRA will be allowed to compound before distributions begin, the more sense a conversion makes. **C.** Incorrect. The higher the expected investment rate of return on the Roth IRA, the more sense a conversion makes. **D.** Incorrect. A conversion makes more sense if the taxes are paid with funds that are outside the IRA. *(See page 189 of the course material.)*

4.	**A.** Incorrect. Reducing gross income, by various means, is a recommended strategy to reduce taxes paid on an IRA conversion. **B.** **CORRECT**. Increasing adjusted gross income is not a recommended strategy to use when trying to minimize taxes on an IRA conversion. **C.** Incorrect. Increasing charitable contributions can reduce the tax burden on an IRA conversion. **D.** Incorrect. Taking capital losses can be an effective strategy for reducing the taxes paid on an IRA conversion since capital losses offset capital gains for the year. *(See pages 191 to 192 of the course material.)*

CHAPTER 9: BEWARE THE RETIREMENT TAX AMBUSH

Chapter Objective

After completing this chapter, you should be able to:

- Identify the major stealth taxes.

Tax rates and taxes will be lower in retirement. That used to be true. Over the last couple of decades it became one of the most dangerous myths in retirement planning, and it is becoming more of a myth each year.

These days, it is rare for a person's tax rate to decline after retiring unless he or she does some careful planning (which we'll discuss in this chapter). For years, without saying so, Congress and the IRS have looked to older Americans to increase government revenues. After all, today's older Americans are the richest generation in history and also a very large generation. That's where the money is. As the Baby Boomers age, those over age 50 will become an even bigger target. Federal income taxes are not the only issue for retirees and preretirees. State and local taxes also generally are rising and likely to continue rising in many states and localities.

Taxes are one of the larger expenses in a retiree's budget—if not the largest.

Retirees face the same tax burdens and rules as other Americans. There also are a number of special tax rules that affect those in and near retirement more than most other Americans.

As a result, retirees today can incur some of the highest marginal tax rates in U.S. history. For example, Social Security benefits were tax free for many decades. Since 1993, when a couple's income is greater than $44,000 ($34,000 for single taxpayers), up to 85 percent of Social Security benefits are included in gross income for each additional dollar earned. Earn an extra dollar of investment income, and not only is that dollar taxed but 85 cents of Social Security benefits also are taxed.

These are the types of rules that can create a marginal tax bracket (the tax rate on the last dollar earned) higher than 70 percent for many seniors. A retiree can face a marginal tax rate of 90 percent or higher if he or she lives in a state with high income tax rates.

More Social Security beneficiaries pay taxes on their benefits each year because the income levels at which the tax takes effect are not indexed for inflation. The percentage of Social Security recipients who pay income taxes on some of their benefits is expected to increase steadily every year.

That is just one example of how the income tax burden increases and the tax code becomes more complicated as retirement nears. There are several areas of the tax code that affect older Americans more than other taxpayers or that are specifically directed at postretirement taxpayers. I call these the *stealth taxes*.

THE STEALTH TAXES

The tax law is replete with stealth taxes. These are hidden taxes that take money out of people's pockets without increasing tax rates. The taxes are hidden because they can be incurred by actions many taxpayers don't even realize might trigger higher taxes. Often, a taxpayer learns about a stealth tax for the first time only after completing an income tax return and seeing that the tax was triggered. It used to be that only the wealthy worried about stealth taxes, because they are imposed as income increases. In recent years, however, these taxes snared more and more taxpayers, and older taxpayers are among those most likely to pay stealth taxes.

There are six main stealth taxes: the alternative minimum tax (AMT), the Pease tax (the itemized deduction reduction), the PEP (personal exemption phase-out), the tax on Social Security benefits, the Medicare premium surtax, and the 3.8 percent tax on net investment income. There are others scattered throughout the tax code, but they either affect fewer taxpayers or more discrete groups of taxpayers.

The stealth taxes, intentionally or not, are imposed on those in or near retirement more than other groups of taxpayers. Fortunately, taxpayers can avoid or minimize stealth taxes if they know about them ahead of time and take action. We discussed the Medicare premium surtax in Chapter 6. We discuss the others and some other tax issues in this chapter.

To keep income taxes low in retirement and in the years before retirement, you need a dual focus. One focus is to keep adjusted gross income low, which we explain in the next section of this chapter. The other focus is to manage your finances to pay the lowest effective income tax rate. A lower effective tax rate makes your tax bill lower and reduces the amount you need to withdraw from your nest egg to fund your standard of living. We discuss that in a later section.

The Importance of Adjusted Gross Income

There was a time when good tax planning meant reducing taxable income. That's not always the case today.

The stealth taxes aren't based on gross income or taxable income. The focus of these taxes is adjusted gross income (AGI), or modified adjusted gross income (MAGI). They generally are said to be imposed on high-income taxpayers, though that's not always the case because they are based on AGI and MAGI. So, the key to avoiding or reducing the stealth taxes is to reduce AGI or MAGI.

When you look at the standard Form 1040, adjusted gross income is the last number at the bottom of the first page. First, you add all sources of income that are taxable to arrive at gross income. Then, you subtract what are called deductions for adjusted gross income. The remainder is your AGI. Note that itemized expenses such as charitable contributions, medical expenses, and mortgage interest won't help reduce the stealth taxes. Those deductions appear later on the tax return.

MAGI is a special calculation for some of the stealth taxes. It can vary slightly between the stealth taxes, but generally you take AGI and add back a few items that are excluded from gross income when computing the regular income tax. These additional income items usually are tax-exempt bond interest and foreign-earned income.

Reducing AGI and MAGI

Fortunately, there are steps that can reduce the taxes.

There are two broad strategies for reducing AGI. One way is to keep gross income low. The other way is to increase deductions for AGI (except deductions for AGI won't decrease taxes on Social Security benefits.)

The deductions for AGI tend to be for very specific expenses that often don't apply to many people age 55 and over, especially those already retired. But there are some that might be available to you. The deductions include special deductions for teachers, reservists, performing artists, and fee-basis government officials. Also included are health savings account deductions, moving expenses, the deductible part of self-employment taxes, self-employed health insurance premiums, and some self-employed retirement plan contributions. There are a few others that don't have real planning opportunities, such as alimony payments. Some of these deductions periodically are set to expire, but to date Congress has extended them for an additional year or two.

By all means, maximize these deductions to the extent you can. But they don't offer the most planning opportunities for those in or near retirement.

The best opportunities for reducing the stealth taxes are to reduce gross income. Progress here reduces taxes on Social Security benefits as well as the other retiree taxes.

Here are strategies that work best for reducing gross income.

Consider Tax-Exempt Bonds

Here's where things get tricky. Interest from tax-exempt bonds is excluded from gross income for computing the regular income tax. But it is added AGI to create MAGI for most of the stealth taxes. So, it appears there is no benefit from earning tax-exempt bonds instead of taxable bonds.

Because they are tax-exempt, however, the bonds usually pay a lower interest rate than comparable taxable bonds or certificates of deposit. Adding the tax-exempt interest to your other income should result in lower MAGI than if you owned taxable bonds. So, if you own bonds outside an IRA or other tax-favored account, you'll likely owe less in retiree taxes by investing in tax-exempt bonds instead of taxable bonds or CDs.

Defer Income

It might be possible to defer income to future years. Sometimes you have to plan this in advance. Employment income, for example, can be paid in either salary or deferred compensation that will be paid in cash later. If you're still working, you might negotiate to defer and spread out such compensation.

There are other ways to defer income. Don't take distributions from traditional IRAs, annuities, and similar accounts unless you need the money or are required to. Consider the stealth taxes before selling investments, and consider selling assets in installment sales instead of for a one-time payment.

Convert IRAs

When you take distributions from a traditional IRA or 401(k) plan, the distributions are included in gross income and treated as ordinary income, except for nondeductible or after-tax contributions. But Roth IRA distributions aren't included in gross income for purposes of the regular income tax or when computing the retiree taxes. Perhaps even better, with a Roth IRA you aren't required to take distributions after age 70½. With a regular IRA, those forced distributions trigger higher taxes even when you don't need the income. We discussed the difficulties caused by RMDs in detail in Chapter 8.

The stealth taxes are one reason why converting a traditional retirement account to a Roth IRA can pay off over the long term.

Keep in mind that in the year an IRA is converted, the conversion amount is included in gross income. The converted amount might trigger or increase the Medicare surtax, tax on Social Security benefits, and other stealth taxes. That one-time cost has to be considered in determining whether or not a conversion makes sense.

Manage Your Taxable Investments

Tax-wise investment strategies are more important when additional gross income might trigger these extra taxes. You don't want taxes to dictate investment strategy, but the potential for higher taxes determines whether a particular investment or strategy is best.

It's a good idea to harvest investment losses. Sell investments that have other-than-modest paper losses to lock in the losses. You can deduct the losses against capital gains and deduct up to $3,000 of additional losses against other income. Any losses remaining after that are carried forward to future years to be used in the same way. If you still like the investment long term, you can buy it back. With stocks, mutual funds, and some other investments you have to wait more than 30 days to repurchase if you want to deduct the loss in the year of the sale.

Be sure your portfolio isn't generating income you don't need. High-dividend stocks and mutual funds that distribute most of their gains each year will increase your gross income and perhaps the stealth taxes. Consider switching to investments that don't increase gross income as much.

Don't trade too much in your portfolio. Keep in mind that each capital gain that isn't offset by deductible losses increases gross income and is a potential trigger for increasing the stealth taxes. Even if you are earning a tax-favored long-term capital gain, it could increase gross income high enough to increase one or more of the retiree taxes.

You also could favor tax-advantaged investments such as master limited partnerships and investment real estate. Again, don't invest only for the tax benefits. But consider how the tax benefits will avoid the retiree taxes and increase your after-tax returns.

Business Losses

A loss from a business activity can be deducted from other sources of gross income and thereby reduce AGI and MAGI. Business losses might come from ownership of a pass-through entity, such as a partnership, limited liability company, or S corporation. You might be the sole owner or one of several owners. The business losses also could come through a sole proprietorship.

There are some tax rules designed to limit the ability to deduct such losses. The activity must be operated in a business-like manner and with the intention of earning a profit. Also, to deduct the losses on your tax return it can't be considered a passive activity for you. You need to materially participate in the business, which is defined in some detailed IRS regulations.

Some retirees own rental properties that generate tax losses. Others have longtime hobbies, pastimes, or diversions that can be turned into business activities. If you have such an activity, consider participating it in a way that will reduce taxes.

Those are the basics of how to reduce AGI and MAGI. Now, we'll look at another way to manage your retirement finances to minimize all taxes. Following that, we review individual stealth taxes and some additional tax strategies that are important to retirees.

MANAGING FOR A LOW TAX BRACKET

Most retirement tax planning and tax discussions have the wrong focus. They look at marginal tax rates, which is the tax rate on the next dollar of ordinary income earned. If you're married and earning $50,000 annually, for example, your next dollar will be taxed at the 15 percent rate. Or the discussions take your tax bracket as a given and try to reduce taxes a bit by deferring some income or finding ways to increase some deductions.

Those approaches work fine during the working years for most people. While working, most people don't have much influence on their levels of income and therefore can't change their tax brackets. For retired people, some self-employed people, and a few other taxpayers, that's the wrong approach. These groups have more control over both the amount and sources of income they recognize in a year. That's especially true of a retiree who has different types of investment and asset accounts. Different types of income are taxed at different rates, and a retiree can have a lot of flexibility over the types of income recognized each year.

The better approach is to focus on your effective tax rate. This is the percentage of all your sources of income that is paid in income taxes. Many retirees can structure their income so that the effective tax rate is much lower than during their working years and the effective tax rate on someone earning the same amount in salary.

A savvy retiree can keep the tax rate around 20 percent without reducing cash flow by managing investments, retirement plan withdrawals, and other income sources.

Take a look at the important factors. For married couples filing jointly, ordinary income is taxed at the 15 percent rate until taxable income exceeds $75,300 in 2016. (For single taxpayers, the ceiling is $37,650.) Qualified dividends and long-term capital gains are taxed at the maximum 20 percent rate, regardless of their amount. (Long-term capital gains on collectibles, including precious metals, are taxed at a maximum 28 percent rate.) For taxpayers in the 15 percent or lower marginal tax bracket, long-term capital gains and dividends are taxed at 0 percent. In the 25 percent and 35 percent tax brackets, long-term capital gains and qualified dividends face only a 15 percent rate.

Social Security benefits are tax free until adjusted gross income reaches $32,000 for a married couple filing jointly or $25,000 for a single taxpayer. Distributions from Roth IRAs and interest from state and local bonds generally are tax free.

Don't forget those rates are on taxable income. Before getting there, you have exclusions, exemptions, and deductions. You reduce gross income by personal and dependent exemptions. Then, you have either the standard deduction amount or your itemized expense deductions, such as state and local property and income taxes, medical expenses, and charitable contributions. You also might qualify for tax credits, such as the foreign tax credit on foreign investments.

The Benefits of Tax Diversification

To manage your cash flow to stay in a low tax bracket, you first need tax diversification. You need to own different types of investment accounts and have different sources of income. If you follow my recommendations, you'll have some guaranteed lifetime income from Social Security, annuities, and perhaps an employer pension. You'll also have your nest egg in taxable investment accounts, traditional IRAs, Roth IRAs, and perhaps other types of accounts.

Some people try to anticipate what future tax law will be like and tilt their assets toward the types of accounts and investments that would benefit in that regime. They might try to own either all Roth IRAs or all traditional IRAs, for example. That's a difficult strategy to get right. It's better to realize that the tax law will change more than once, and you won't be able to anticipate what it will be at any time in the future. If you try to tilt your holdings toward one type of tax regime and are wrong, you could end up paying much higher lifetime income taxes. Instead, try to have tax diversification. You'll have options in any tax environment and won't be hammered in any particular tax regime. You'll also be better able to manage your cash flow to minimize the effective tax rate.

Determining Your Tax Rate

Retirees often can choose how and when they receive income. By carefully paying attention to the sources of income and the amount of AGI, they have more control over their tax burden. In fact, you can almost determine the tax rate you want to pay. Some planners refer to this as tax bracket management.

Here are the tools you can use to manage your tax bracket and minimize your effective tax rate.

Reduce or Convert Traditional IRAs

One of the greatest obstacles to tax-bracket management is having too much of your nest egg in traditional IRAs or 401(k)s. Most people don't realize this until it is too late.

As we discussed in Chapter 8, traditional IRAs (and other forms of tax deferral) are great during the accumulation years. Yet, they create two problems during the distribution years. One problem is that all distributions are taxed as ordinary income, facing your highest tax rate. The other is that after age 70½, minimum distributions are required. As you age, the required distributions increase, and many people in their late 70s and beyond complain that the required distributions far exceed their cash needs and increase taxes.

There are a couple of strategies to consider. One is to take IRA distributions before you need the money. Over time or in a lump sum take money out of the IRA, pay the taxes, and put the rest of the distribution in a taxable account. When you spend the principal in the future it won't be taxed. You'll also be able to invest the money so future income and gains receive favorable tax rates.

The other strategy is to convert all or part of the traditional IRA to a Roth IRA. You pay taxes on the converted amount, but future distributions to you and your heirs are tax free. We discussed this in detail in Chapter 8.

Most people don't want to prepay taxes. It goes against one of the longstanding principles of tax planning. But when taxes will be higher in the future, especially when you'll be faced with an array of stealth taxes, paying taxes now instead of later can make sense. In 2010, favorable tax treatment was offered to those who converted traditional IRAs to Roth IRAs that year. The IRS reported the results and found that conversions increased by nine times over the previous year. Among taxpayers with $1 million or more of income, more than 10 percent did conversions. That means the taxpayers who receive the most sophisticated advice decided paying some taxes early was a good idea when it converted future ordinary income into tax-favored or tax-free income.

An advantage of a Roth IRA is that distributions from it, no matter how large, aren't included in AGI. That is a big help in avoiding the stealth taxes triggered by higher AGI.

More details about these IRA strategies are in Chapter 8.

Time IRA Distributions and Conversions

Consider more than immediate cash needs when deciding how much to distribute from a traditional IRA or 401(k) or how much to convert to a Roth IRA. Consider the rest of your tax picture. Increase distributions or conversions in a year when your tax bracket is lower. Perhaps you have high-deductible medical expenses, a business loss, earned less income, or have other factors that reduce your tax bill. That would be a good year to increase IRA distributions or conversions, because you'll be in a lower tax bracket or have deductions to offset the taxes on the IRA transactions.

Delay Social Security

You need to consider a number of factors before deciding when to take Social Security, as we discussed in Chapter 3. Income taxes are one of the reasons to defer benefits. Social Security benefits are tax free or mostly tax free, unless your AGI is above $44,000. Since delaying benefits increases your retirement benefit, it also increases your potentially tax-advantaged income.

Seek Tax-Advantaged Income

Your taxable accounts should be managed to benefit from tax-exempt income, qualified dividend income, and long-term capital gains. Investments that generate ordinary income, such as interest, should be in other types of accounts or annuities whenever possible. It also is wasteful to take short-term capital gains in taxable accounts without a compelling reason. Hold assets for more than one year to qualify for the long-term capital gains rate.

Use Tax-Wise Investment Strategies

Taxable accounts need to be managed with both taxes and investment returns in mind, resulting in higher after-tax returns. The same strategies we discussed earlier for reducing AGI are good for minimizing taxes on taxable investment accounts.

Manage Your Tax Bracket Annually

When you have tax diversification and the other strategies in place, you are in position to manage your tax bracket, keeping your effective tax rate around 20 percent annually.

You'll have a base of automatic, guaranteed income from Social Security and perhaps some annuities and pensions. After age 70½ you'll also have required minimum distributions from traditional IRAs and 401(k)s. All of that is likely to be taxed as ordinary income. Your taxable accounts might generate qualified dividends, tax-exempt interest, mutual fund distributions, and other income that's outside your control. Much of that should be either tax free (interest on tax-exempt bonds) or tax-advantaged (qualified dividends and long-term capital gains).

When you need cash beyond that to meet your spending needs, you should have flexibility in determining the sources of that cash and how it is taxed. To meet spending needs that exceed the automatic income, carefully choose the sources. You might sell some assets in taxable accounts for long-term capital gains to raise cash. When AGI is nearing the maximum you want, consider Roth IRA distributions to avoid triggering a higher tax bracket or stealth taxes. In a year when AGI is low or you have deductions to offset ordinary income, consider taking extra distributions from traditional IRAs or annuities.

This approach is more work than traditional retirement tax strategies, but the work should pay off by keeping you in a lower tax bracket throughout retirement. With tax diversification and tax bracket management, you can generate substantial cash flow each year while keeping your effective tax rate around 20 percent or even less. Many retirees can maintain their cash flow while avoiding the higher ordinary income tax brackets, the stealth taxes and other burdens Congress aims at you.

The Alternative Minimum Tax

The alternative minimum tax (AMT) is the granddaddy of the stealth taxes. The AMT basically is a separate tax system and is almost a flat tax. A taxpayer computes both the regular tax and the AMT, and then pays the higher of the two. The IRS also computes the AMT for all the returns it processes. If someone didn't compute the AMT who should have, the IRS will send a letter asking for the additional taxes. Many people learn about the AMT for the first time when the IRS or their tax preparers tell them they owe it.

The AMT is computed on Form 6251. The tax starts with regular taxable income. Then a number of adjustments and preferences listed on the form are added back to taxable income. After adding the adjustments and preferences, an exempt amount is subtracted. The AMT is computed on the income remaining after subtracting the exemption. The AMT is close to being a flat tax. The tax rate is 26 percent of AMT income up to $186,300 in 2016. Above that amount a 28 percent rate applies.

Originally, the AMT was designed to ensure that the wealthiest taxpayers did not make generous use of tax breaks to eliminate all income taxes. It was created after IRS data revealed that about 500 taxpayers earned more than $1 million but paid little or no taxes.

Unfortunately, the AMT now traps taxpayers in most income brackets when they have enough tax breaks—even if they have a sizable tax liability under the regular tax. Unexceptional deductions that are added back to taxable income under the AMT include personal and dependent exemptions, state and local taxes, most miscellaneous itemized expenses, and incentive stock option gains.

The reason more and more people became subject to the AMT over the years was that the exemption wasn't adjusted for inflation or income growth. Congress made some partial adjustments in recent years and finally made a permanent "fix" in 2014 that raised the exemption amount and the level at which the 28 percent rate kicks in. But the fix didn't return the exemption to a level equivalent to when the AMT was created. For 2016, the exemption amount is $83,800 for married couples filing jointly and $53,900 for singles taxpayers. The exemption amount is phased out as income rises. For married couples filing jointly, the exemption begins to phase out when income is above $159,700, and for single taxpayers at $119,700.

Under the AMT you're allowed the itemized deductions for charitable contributions and mortgage interest, other than most home equity mortgage interest. You're allowed reduced deductions for some medical and dental expenses. Some business deductions are deferred, such as depreciation and net operating losses.

You're not allowed the itemized deductions for state and local taxes and for miscellaneous expenses. You're also disallowed under the AMT both the standard deduction and personal and dependent exemptions. Tax-exempt bond interest generally is exempt from the AMT, but interest from private-activity bonds is taxed under the AMT.

The full list of tax preferences is in the instructions for Form 6251, available free on the IRS website at www.irs.gov.

There are several ways the AMT can be triggered for retirees and preretirees.

The disallowance of itemized deductions such as state and local taxes and mortgage interest plus the reduction in medical expense deductions can trigger the tax as can the disallowances of the standard deduction for those who don't itemize and personal and dependent exemptions. All these items aren't the exclusive province of the wealthy and can trigger the AMT for others.

Tax items that aren't tax preferences also can interact with the AMT so that they trigger or increase the AMT. Among them are tax-favored items such as long-term capital gains and qualified dividends.

When you have a high amount of capital gains and dividends, you pay a low regular income tax rate. But capital gains and dividends count as income under the AMT, so they can take you above the exemption amount just as quickly as ordinary income does. They also might incur state income taxes, which are deductible under the regular tax but not the AMT. The result of the combination is that you could owe more tax under the AMT than the regular income tax just because you earn a high percentage of your income from capital gains or qualified dividends.

The AMT now applies to eight times as many taxpayers as 20 years ago. Unfortunately, there is no formula that can warn you the AMT might be a problem, because the tax is so complex and has so many moving parts. You have to compute your tax both ways to see if the AMT is a problem.

The AMT can be triggered by taking a large capital gain one year or by having three or more dependents while living in a high tax state. For retirees, required minimum distributions from IRAs can trigger the tax as they increase over the years. Combinations of the different tax preference items or transactions that increase income can unexpectedly make you subject to the AMT. Many people are trapped in a cycle of being subject to the AMT one year but not the next.

Retirees are especially susceptible to a sneak attack from the AMT. A retiree usually receives less taxable income in retirement. Yet, most deductions will remain the same for at least the first few years. Real estate taxes and mortgage interest won't change just because a property owner has retired. Investment advisor fees and other miscellaneous itemized expenses probably will be stable and might even rise. State income taxes will decline a bit with income, but charitable contributions generally stay the same. Even worse, a retiree might have purchased a second home. That increases real estate tax deductions and perhaps mortgage interest expense, and with that comes the risk of paying the AMT.

Most retirees believe that tax-exempt bonds are exempt from all income taxes. They are only partly right. General obligation bonds do not affect the AMT. A number of exempt bonds, however, fund private activities. Interest from these is tax free under the regular tax but is taxed under the AMT. A number of tax-exempt bond mutual funds have about 80 percent of their portfolios in these private activity bonds. A private activity bond is one that is backed not by the general obligation of a government but by an activity that is not considered an essential government function. These activities include airports, stadiums, many commercial properties, and the like.

A retiree also is likely to have more capital gains from the sale of investments than during the working years, and increased capital gains puts the retiree at risk for triggering the AMT. The result for too many retirees is that income declines while tax deductions remain stable and might perhaps increase, which also can trigger the AMT.

Any year you've had changes in any of the items discussed here should cause you to worry about the AMT. Estimate both the AMT and regular income tax both mid-year and close to year-end. If you might be subject to the AMT, there are steps to consider.

When disallowed deductions might trigger the AMT, consider spreading them over two tax years if you can. Otherwise, you receive no tax benefit from the deductions if you're hit by the AMT.

You could defer income. For example, consider spreading a large capital gain over two years instead of one if it is possible. Look for ways to limit distributions from IRAs and annuities. Consider converting a traditional IRA to a Roth. This might make you subject to the AMT in the conversion year but make it less likely in future years. When the law makes the option available, make charitable contributions from a traditional IRA instead of using cash. Or give appreciated stock or other assets to a charity instead of selling the stock and giving cash.

Above all, recognize the potential for the AMT to rear its head when there's a significant new element in your tax picture and estimate your taxes before year-end so you can take action if needed. If you've been preparing your own taxes, a year when the AMT is a possibility is a good time to work with an experienced tax expert.

Taxes on Social Security Benefits

Originally, Social Security benefits were free of income taxes. That went out the door in 1986, when some benefits first were taxed. Taxes were increased on higher income beneficiaries in 1993.

In 1986, taxpayers with adjusted gross incomes above $32,000 began to have up to 50 percent of their benefits included in gross income. In the 1993 tax law, those with an adjusted gross income exceeding $44,000 began to have up to 85 percent of their benefits taxed. Unlike many other provisions of the tax code, these AGI triggers are not indexed for inflation. That means each year more Social Security beneficiaries pay income taxes on some of their benefits simply because inflation increased their nominal incomes.

Suppose Max Profits has adjusted gross income of $31,999. He gets a distribution from a mutual fund that pushes AGI to $32,100. The distribution is taxable. In addition, it triggers taxes on some Social Security benefits that were tax free. Once Max's income exceeds $32,000, each additional dollar of income means more than one dollar is included in gross income—the dollar earned plus up to 50 cents of Social Security benefits. Once Max's adjusted gross income exceeds $44,000, each additional dollar of income could cause up to 85 cents of Social Security benefits to be added to income.

In most states there also are state income taxes on the benefits. That's why those in high-tax states, such as California, who have an AGI above $44,000 can have the marginal tax rate on each additional dollar earned reach 90 percent.

Strategies that Work

Fortunately, there are steps that can reduce the taxes on Social Security benefits, but first, let's throw out a couple of strategies that won't work. Having the higher-income spouse delay Social Security benefits so that only the lower-earning spouse receives them doesn't work. The lower-earning spouse's benefits still might be taxed. The combined joint income of the two spouses is used to determine the amount of benefits included in income. The tax is not computed separately based on the income of each spouse. Married, filing separately also won't help. In fact, it will make the tax worse, because the benefits will be taxed when adjusted gross income of each spouse is above $0.

If adjusted gross income is significantly above the threshold at which benefits are taxed, there probably is not much that can be done to reduce benefits. Taxpayers who are near the threshold for taxing benefits, however, should consider some strategies that can reduce the amount of Social Security benefits taxed. The strategies are the same as those already discussed to reduce AGI.

Itemized Deduction Reduction

The Pease provision (named after the congressman whose idea it was) affects far more taxpayers than the alternative minimum tax. Pease disallows part of a taxpayer's itemized expense deductions when the taxpayer's adjusted gross income (AGI) is too high. The level at which the itemized deduction reduction kicks in (known as the threshold amount) is indexed for inflation, so it changes each year. In 2016, the provision kicked in when adjusted gross income exceeded $311,300 on returns for married couples filing jointly, and $259,400 for an unmarried taxpayer.

Computing the Pease deduction can get complicated. Itemized deductions are reduced by 3 percent of the difference between the threshold amount and AGI. Up to 80 percent of itemized deductions can be eliminated under the Pease provision.

The Pease provision is particularly hard on taxpayers with volatile incomes or who have one-time income boosts. A large capital gain or retirement plan distribution could make a lot of itemized deductions disappear. Someone who has a high income each year knows he or she will be subject to the itemized deduction reduction and can reliably estimate ahead of time the amount of a deduction that would be lost before writing a check for an itemized expense. But someone with a volatile income or one-time change in income is likely to get trapped by the Pease provision and lose the benefit of a lot of tax deductions. Some of those deductions, such as charitable contributions, could have been delayed until the next year.

Since the provision is based on AGI, the strategies already discussed for reducing AGI will help avoid losing the benefit of itemized expense deductions. When it looks like the loss of itemized deductions can't be avoided in a year, consider deferring any large, discretionary itemized expenses until a future year when the Pease provision might not be triggered.

Saving Personal Exemptions

Personal and dependent exemptions also are phased out as income increases under the personal exemption phaseout (PEP) rules. Each taxpayer gets a personal exemption deduction, one for a spouse, and one for each dependent. The exemption amount is indexed for inflation and was $4,050 in 2016. These deductions are allowed whether expenses are itemized or the standard deduction is taken.

The personal and dependent exemptions are reduced when AGI exceeds a threshold amount. That amount in 2016 was $311,300 on a joint return and $259,400 for a single taxpayer. The formula for reducing the exemptions is complicated. It works out to losing 2.25 cents of each exemption for each dollar income rises above the threshold amount. The formula is that exemptions are reduced 2 percent for each $2,500 or part of $2,500 that AGI is above the threshold. For those who don't use computer software or a tax preparer to do their returns, the IRS offers a worksheet along with the instructions to compute the exemption reduction.

As with the other stealth taxes, the strategies for reducing AGI can prevent the loss of personal and dependent exemptions.

The 3.8 Percent Tax on Net Investment Income

The Affordable Care and Patient Protection Act of 2010 included several new taxes. Among them was the 3.8 percent tax on the “unearned” income of single taxpayers with modified adjusted gross incomes exceeding $200,000 and married couples filing jointly with MAGIs above $250,000. The income thresholds aren’t indexed for inflation, so more people will owe them over the years. Though the tax is labeled a Medicare surtax, the proceeds actually will go into general revenues, not the Medicare fund. This tax is separate from all other taxes.

MAGI for this tax is your regular AGI plus any foreign earned income that qualified for the exclusion from gross income.

Unearned income subject to this tax is investment income and includes interest, dividends, capital gains, annuity distributions (taxable distributions only and only when not from a qualified retirement plan), royalties, and passive real estate rental income. Interest income from tax-exempt bonds avoids the tax, though capital gains from sales of the bonds do not.

Taxable distributions from master limited partnerships and real estate investment trusts also count as unearned income. But remember, only taxable distributions are affected. Most distributions from MLPs aren’t taxed. On average, MLP distributions are 15 percent taxable income and 85 percent nontaxable returns of capital. But the return of capital portion reduces your basis in the MLP shares, so it increases the capital gain when you eventually sell the shares. On the other hand, you can hold the MLP shares for life. Whoever inherits the shares will be able to increase the basis to current fair market value and avoid taxes on their sale.

Real estate income can be exempt when earned by a real estate professional. To be a professional you must spend a minimum of 750 hours annually managing real estate. That means being involved in the nuts and bolts of managing properties. Those hours also must be more than half of your working hours for the year.

Income and gains earned through pass-through entities such as S corporations, partnerships, and limited liability companies might be exempt. The activity has to qualify as a business for the individual owner. You must pass one of the active involvement tests under the passive activity regulations. The easiest test to pass is to have the activity be your prime source of income, taking 500 hours or more of your time. When none of the tests is passed, the income is passive and subject to the 3.8 percent tax.

Donations of appreciated assets to charity also avoid the tax. That’s a reason to consider making charitable donations in appreciated property held in taxable accounts instead of cash.

Business owners need to realize that the surtax will apply to the sale of a business. That’s an extra 3.8 percent in addition to the other taxes and the costs of selling.

Unearned income for the tax doesn’t include tax-free interest or distributions from qualified retirement plans, such as 401(k)s, traditional IRAs, Roth IRAs, profit-sharing plans, and defined benefit plans. Social Security benefits and life insurance payouts also aren’t subject to the tax.

But keep in mind the interplay of tax provisions. Distributions from traditional IRAs are included in AGI. So, large IRA distributions could increase AGI and trigger the 3.8 percent tax on your investment income. This is especially likely as you get older and required minimum distributions increase. But Roth IRA distributions aren't included in gross income. Since they aren't taxable, they don't trigger the investment income tax. It's another factor to consider when deciding whether to convert a traditional IRA to a Roth IRA.

The surtax is imposed on the lesser of net investment income and the amount of MAGI above the threshold. Suppose Max and Rosie Profits have investment income of $30,000 and MAGI of $270,000. Their net investment income is $30,000, and the excess of MAGI and the threshold is $20,000, so they pay the tax on $20,000. Multiplied by 3.8 percent brings a tax of $760. If everything else were the same except their MAGI were $290,000, they would owe tax on the net investment income. That tax would be 3.8 percent of $30,000, or $1,140.

Home Sales and the Surtax

When the 3.8 percent net investment income tax was first enacted, there was a lot of speculation about how the IRS would rule on its application to sales of homes. Here is how the tax affects home transactions.

When you sell a home at a gain and the home wasn't your principal residence, such as a vacation home, second home, or rental property, all of the gain potentially is subject to the 3.8 percent tax. You'll have a capital gain from the sale of an investment asset, which is investment income.

When you sell your principal residence, however, the investment income tax applies only to the amount that is included in gross income. On the sale of a principal residence, up to $250,000 of gain is exempt for singles and $500,000 for married couples filing jointly.

Remember that only gain is potentially taxed, not the sale proceeds of the home. First, you subtract from the sale price the basis of the home, which includes the original cost plus the cost of any improvements. Second, you subtract selling costs such as broker's commission and closing costs. Only the sale proceeds above that amount are potentially taxed, and only if they exceed the exempt amount.

For most people, the sale of a principal residence isn't likely to be subject to the 3.8 percent investment income tax. Also, none of the sale proceeds are likely to be included in gross income, increasing your AGI so that it is high enough to trigger or increase the 3.8 percent tax on your net investment income.

Avoiding the Surtax

Of course, as with the stealth taxes, one way to avoid the surtax is to minimize AGI, which we already discussed. There are other strategies unique to the tax:

- *Carefully review major events.* You might think that your income isn't near $250,000, so the tax doesn't affect you. But one-time events could trigger the tax. Suppose you take a large capital gain. That could increase your AGI enough to trigger the tax. Overlooking the potential for the 3.8 percent tax could result in several thousand dollars of additional taxes one year.

- *Know the interplay of tax code sections.* We already discussed several examples of this. Here is another example. When you sell a capital asset at a loss, for the regular income tax the loss is deducted against gains for the year. Any excess loss offsets up to $3,000 of other income, and an additional excess is carried forward to future years. But for the 3.8 percent tax, tax losses offset only gains for the year. Carryforward losses aren't deducted against other investment income to reduce the 3.8 percent tax.
- *Track investment expenses.* The tax is on net investment income. From your gross investment income you are allowed to deduct certain expenses. The deductible expenses include rental and royalty expenses, margin interest to the extent of interest income and short-term gains, investment advice, broker commissions and fees, and state income taxes attributable to investment income.
- *Know what's exempt.* You might be able to restructure things if you're involved in real estate or a small business so that income avoids the 3.8 percent tax. The restructuring would involve your being more actively involved so that the income is business income instead of investment income. Some people will shift from taxable bonds to tax-exempt bonds. Others will carefully plan distributions from annuities.
- *Review trust strategies.* As with other special taxes, the 3.8 percent investment income tax kicks in for trusts at very low levels. For a trust, the 3.8 percent tax kicks in when undistributed investment income exceeds $11,950. Trustees might need to reconsider investment or distribution strategies to reduce or avoid the tax.

RETIREES' SPECIAL TAX PROBLEM

A special tax problem for many retirees, especially new retirees, is the required quarterly payment of estimated income taxes. After decades of having taxes automatically deducted from their paychecks, many have trouble adapting to a system of paying estimated taxes each quarter. Too often, retirees' payments are late or aren't high enough, resulting in unnecessary penalties. Some retirees prepay too much, providing an interest-free loan to the government.

Those who expect to owe more than $1,000 in federal income taxes that are not prepaid through withholding must make quarterly estimated tax payments. The payment for the first quarter of the year is due by April 15. The other three payments are due June 15, September 15, and January 15. If the deadline falls on a weekend or holiday, the deadline is delayed until the next business day.

The penalty for a late or low payment is interest compounded daily at a rate announced by the IRS each month. The interest rate changes with market treasury rates. Interest is charged from the day the payment was due until the earlier of the date the tax return for the year is due and the date the payment actually is made.

Estimated tax payments must cover all types of taxes due: income, self-employment, tax withholding for household workers, and any others that will be reported on Form 1040. Estimated tax payments are determined by projecting the taxes that will be due for the year, dividing the total by four, and paying that amount each quarter. The IRS assumes that income is earned equally through the year, so estimated payments must be equal. You can't bunch the bulk of your estimated taxes in the fourth payment, unless you qualify for the annualization method, which we discuss shortly.

The first goal is to make payments that are high enough to avoid any penalties. Taxpayers can avoid the penalties by qualifying for at least one of three safe harbors. High-income taxpayers must qualify for the third safe harbor to avoid the penalties. The safe harbors are:

- Pay at least 90 percent of the current year's tax liability through timely estimated tax payments.
- Pay an amount equal to at least 100 percent of last year's tax bill through timely estimated tax payments.
- A high-income taxpayer must pay an amount at least equal to either (1) 90 percent of the current year's tax liability or (2) 110 percent of last year's tax liability. A high-income taxpayer is one whose adjusted gross income on the previous year's tax return was over $150,000 ($75,000 for married individuals filing separately). Those AGI levels are not indexed for inflation.

Another way to avoid an underpayment penalty is through the annualization method. For example, suppose estimated tax payments for the first three quarters of the year were accurate based on the income to date, but income increased substantially during the last quarter of the year. Then, the taxpayer can make a higher estimated tax payment for the fourth quarter and avoid a penalty. This method is for anyone whose income varied during the year and who made payments based on the income as it actually was received. To use this method, Form 2210 with Schedule AI must be filed as part of the income tax return for the year. This form requires a showing of when income was received during the year and that quarterly estimated payments were sufficient for the income received each quarter.

Penalties for failure to pay estimated taxes cannot be avoided by paying the year's taxes with a big check in the last quarterly payment. The IRS expects estimated taxes to be paid equally throughout the year. When payments are not equal, the only way to avoid penalties is to use the annualization method.

Retirees should choose the payment schedule that allows them to retain money as long as possible and keep it working for them, not the government. If income is likely to stay the same or decline this year, prepay 90 percent of this year's tax liability. That way, 10 percent to 20 percent of the final tax liability can be invested until the tax return for the year is filed. The trick with this approach is to make an accurate estimate of the tax bill for the year. If prepayments are too low, the taxpayer will be hit with a penalty. A taxpayer might want to figure the 90 percent amount, then pay a little extra each quarter to ensure there won't be penalties.

If income is likely to increase this year, make payments based on last year's liability. That way, penalties will be avoided and cash will be conserved for as long as possible.

If income will fluctuate and the taxpayer doesn't mind keeping careful track of the cash flows and related tax liabilities, then the annualized method is best. Taxpayers whose income is primarily from capital gains or retirement plan distributions that are discretionary instead of on a schedule might choose this method. It is too much work for most people, but it can save money when income varies throughout the year. The goal should be to estimate income well enough to hold on to the cash as long as possible without incurring any penalties.

When you must pay estimated taxes, you complete Form 2210 with your Form 1040 each year. That will determine if you owe any penalties for late payments or low payments. There are several ways to make payments, and the IRS regularly updates its payment methods. The IRS has electronic payment systems available over either the telephone or the Internet. These can be made with either a direct transfer from your bank account or charges to payment cards. You also can pay by check accompanied by a voucher Form 1040-ES. Details about the estimated tax are in IRS Publication 505, which is available free through the IRS website at www.irs.gov.

There might be an alternative if you don't want to make estimated tax payments or realized that you made a mistake and didn't make high enough payments earlier in the year. When you prepay taxes through withholding, the IRS assumes the payments were made evenly through the year even if they weren't. You can request that income payments to you have income with held.

An option is to have taxes withheld from payments you receive from pensions, annuities, and IRAs. In most cases you can designate the amount you want withheld. Even if it means having a high amount of the payments withheld, you might find it more convenient to have the taxes prepaid through withholding than having to make estimated tax payments.

The withholding option can be especially helpful when in the last quarter of the year you realized that your estimated tax payments were too low to avoid a penalty. You can request that a distribution from your IRA in the fourth quarter have enough withholding to make up the estimated tax shortfall. The IRS will assume that amount was paid evenly during the year, so it might help you avoid a penalty.

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CHAPTER 9: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following deductions can reduce adjusted gross income (AGI):** **A.** charitable contributions **B.** mortgage interest **C.** health savings account deductions **D.** medical expenses
2.	**Which of the following is one of the greatest obstacles to tax-bracket management:** **A.** having too many stocks in the retirement portfolio **B.** having too large of a nest egg **C.** having too diversified a retirement portfolio **D.** having too much of the nest egg in traditional IRAs or 401(k)s
3.	**For 2016, the alternative minimum tax (AMT) rate is _____________ of AMT income up to $186,300.** **A.** 22 percent **B.** 24 percent **C.** 26 percent **D.** 28 percent

4.	**Which of the following is <u>not</u> considered unearned income subject to the 3.8 percent tax on net investment income:** **A.** interest income from tax-exempt bonds **B.** dividends **C.** capital gains **D.** passive real estate rental income

CHAPTER 9: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Charitable contributions reduce gross income and not AGI. **B.** Incorrect. The mortgage interest deduction has no impact on AGI. **C.** **CORRECT**. Health savings account deductions can be used to lower AGI. **D.** Incorrect. AGI cannot be lowered by deducting medical expenses. *(See pages 210 to 211 of the course material.)*
2.	**A.** Incorrect. Having too many stocks in a retirement portfolio is not an obstacle to tax-bracket management. **B.** Incorrect. Having too much savings is not a big obstacle to tax-bracket management. **C.** Incorrect. Having a diversified a portfolio is not a major obstacle when trying to manage one's tax-bracket. **D.** **CORRECT**. One of the greatest obstacles to tax-bracket management is having too much of a nest egg in traditional IRAs or 401(k)s. Most people do not realize this until it is too late. *(See page 214 of the course material.)*
3.	**A.** Incorrect. The AMT rate is higher than 22 percent for 2016. **B.** Incorrect. For 2016, the AMT rate is higher than 24 percent. **C.** **CORRECT**. The alternative minimum tax rate is 26 percent of AMT income up to $186,300 for 2016. **D.** Incorrect. The alternative minimum tax rate on AMT income above $186,300 is 28 percent. *(See page 217 of the course material.)*

4.	**A.** CORRECT. Interest income from tax-exempt bonds avoids the 3.8 percent tax on net investment income. **B.** Incorrect. Dividends are included when calculating the 3.8 percent tax on net investment income. **C.** Incorrect. When calculating the 3.8 percent tax on net investment income, a taxpayer's capital gains are included. **D.** Incorrect. Passive real estate income is included in the calculation of the tax. *(See page 221 of the course material.)*

CHAPTER 10: HANDLING EMPLOYER RETIREMENT PLANS

Chapter Objective

After completing this chapter, you should be able to:

- Identify best practices for utilizing retirement plans.

Employer retirement plans come in two main types. They are very different types of plans and generate different issues and decisions. (I'm talking only about tax-qualified retirement plans in this chapter.)

One type of qualified retirement plan is the defined benefit plan. This is the old-fashioned pension plan that promises the employee a regular payment after retirement. The employee generally has to work for a minimum period to be vested in any defined benefit and for a longer period to qualify for the full or maximum benefit. The retirement benefit usually is a fixed monthly amount payable for life or for the joint life of the employee and his or her spouse. In some plans the payment is indexed for inflation, but not in most private sector plans.

Fewer and fewer private-sector employers offer defined benefit plans. Decades ago, most large employers and many smaller employers offered defined benefit pensions to employees. But a series of tax and accounting changes caused employers to reduce or eliminate defined benefit plans. Now, defined benefit plans are most likely to be offered to government and union employees. A number of large private-sector employers also offer defined benefit pensions, but these pay relatively small amounts to retirees. Retirees are expected to supplement their retirement income with 401(k) plans and other savings. Also, large employers have been steadily scaling back or eliminating their defined benefit plans.

The other type of plan is the defined contribution plan. The well-known 401(k) plan is the primary defined contribution plan. No specific retirement benefit is promised to the employee. Instead, the employee chooses to have a percentage of salary deferred to a 401(k) account. The employer might make a matching contribution of some or all of the employee's contribution. The employee also chooses how the account is invested from among choices offered by the plan. The employee owns whatever amount the account compounds to over time and chooses how to take money out of the account.

The details of each of these types of plans differ greatly among employers. Yet, there are issues common to the each of the plan types. We cover those key issues in this chapter.

DEFINED BENEFIT PLAN: TAKE AN ANNUITY OR LUMP SUM?

When your employer offers a defined benefit retirement plan and it is time to retire, you generally are offered a choice. You can take the lifetime stream of payments offered by the employer, or you can take the entire lifetime benefit in a lump sum. (You also might have this option with a 401(k) plan.)

The decision is critical. You can't change once a decision is made. Once you begin the lifetime payments (often called an annuity or annuitization), that decision can't be reversed. You're locked in to that stream of payments. When you opt for a lump sum instead, you always can choose to use that lump sum to purchase a commercial annuity. But it might not have the same terms as the one you were offered by the pension plan. The annuity offered by the plan no longer will be available to you.

Yet, this decision rarely receives the level of critical analysis it should.

The decision usually boils down to a choice between control and potential returns on the one hand versus security and risk reduction on the other hand.

When you take a lump sum, you have control over the money. You decide how it is invested and how much to spend each year. The control gives you the potential to earn a higher rate of return than was embedded in the annuity payouts. That could give you more spending money over your lifetime and more to leave to your loved ones. Control also means that if in one year you have a large spending need, you can tap into the lump sum for it. Your annual cash flow isn't limited to the annuity payout.

Another advantage of the lump sum is that there is the potential you won't spend it during your lifetime, so some money will be available for your heirs. The annuity payout usually ends on the passing of you or your spouse. There's nothing left for your children or other heirs or for charity.

With the annuity you have security. You'll receive that fixed payment each month for the rest of your life, no matter how long you live. There won't be anything from the annuity for your heirs, but there probably wouldn't have been anything left of the lump sum if you or your spouse lived to 90 or 100. Plus, the lump sum might have dissipated early through low investment returns or overspending, leaving you to rely on other assets and Social Security to pay your expenses.

Because of the trade-offs, it can be a difficult decision. Yet, it's also a critical decision and one that has to be made.

There are two important steps to take before making a decision.

The first is to determine how good the annuity offer is. The retirement plan should tell you the monthly annuity payment you earned, and it should tell you how much of a lump sum you could receive instead of the annuity. You'd be able to have that lump sum deposited in your retirement account and then roll it over to an IRA. You don't want to take the lump sum as a check or a deposit to a taxable account, because then the entire amount would be taxed in the year you receive it. Once the money is in an IRA, the IRA would be able to buy a commercial annuity.

You want to see the income from a commercial immediate annuity the lump sum would purchase. Follow the instructions for purchasing and comparing immediate annuities in Chapter 3. Contact different insurance agents and brokers to obtain quotes for immediate annuities. This way, you'll learn how much income you can purchase with the lump sum. You'll learn if the annuity is a good deal compared to what is available in the private market or if the lump sum is the better deal. In many cases, the decision is fairly clear at this point. It's obvious that the pension annuity is either a good or bad deal compared to the annuities available elsewhere.

The calculation that pension plans use to determine the lump-sum payment is set by the tax code, and in general it is biased toward a low lump sum. There's a good chance you won't be able to buy a commercial annuity with the lump sum that pays an income comparable to the pension annuity. But don't rely on that general advice. Do the work to determine how much income could be purchased using the lump sum.

There's a second step to take when the lump sum still appears a viable choice. You need to make projections about how long the lump sum would last, or how much you could withdraw from it each year to make it last a long time. You'll have to make estimates about your rate of investment returns, tax bracket, spending rate, and other factors. You need to refer to Chapter 5 for the discussion about tapping your nest egg.

When you believe you'll earn a higher investment return than either an insurance company or than is assumed by the pension plan, you might favor the lump sum. A higher investment return means you're likely to be able to spend more monthly or to have money to leave to loved ones or charity. Or a higher return could mean that you'll earn enough to protect the purchasing power of your income.

To be safe, you should make conservative estimates about your investment returns. Or you should make several projections using different assumptions. That way you'll see what is likely to happen under different scenarios.

The decision really boils down to risk shifting and risk management. By taking the annuity, you transfer to the pension fund the risks that there will be low investment returns or that you'll live beyond life expectancy. You know you won't run out of income during your lifetime, no matter how long you live or how low investment returns are.

You pay for transferring those risks. You have less control over the money and give up the potential of earning a higher return. You also take the risk that you won't live to life expectancy and the pension fund (or its other beneficiaries) will benefit from that. With the annuity, you also might not have any inflation protection. Your other assets will have to provide that.

Choosing Your Annuity

When you decide to choose an annuity over a lump sum from a defined benefit plan, you have another decision to make.

Most pension plans allow you to choose the type of annuity payment you want. Here are the typical annuity payments available:

- *Single life annuity.* The annuity makes payments for the life of the employee. After the employee passes, payments cease.
- *Joint life or joint and survivor annuity.* The annuity makes payments until both the employee and the joint beneficiary pass away. The joint beneficiary usually is a spouse and in most annuities has to be recognized by a state as a spouse. If the employee dies first, the surviving spouse receives payments. Often the amount of the payments to

the surviving spouse can be selected before the annuity begins. A 100 percent joint life annuity pays the same amount to the survivor each month after the employee passes away. There usually are options that reduce the payment to the survivor to either 75 percent or 50 percent of what was paid while the employee was alive.

- *Term of years.* The annuity payments are guaranteed to last a stated number of years. If the employee dies before the period expires, payments continue to a named beneficiary or beneficiaries until the term of years ends. If the employee outlives the term of years, the payments end when the number of years ends.
- *Life annuity with guaranteed term of years.* The annuity payments last for the longer of the term of years or the life of the employee. If the guaranteed term is 10 years and the employee lives 5 years, the payments continue for five more years to a named beneficiary or beneficiaries. If the guaranteed term is 10 years and the employee lives 20 years, the annuity makes payments for 20 years.

The single life annuity usually has the highest monthly payment, though the term of years will be higher if the term is shorter than the life expectancy of the employee. The joint life with 100 percent of the payment continuing to the surviving spouse is likely to have the lowest payment.

The choice often depends on the income and resources that will be available to the surviving spouse. You also need to consider any changes that might be made in a surviving spouse's lifestyle. If the expectation is that the surviving spouse will live in the same house, there might not be a large reduction in the cost of living. There will be a reduction in food, utilities, and some other expenses because there will be only one household member. But many other expenses won't decrease, and there might be increases in other costs, because the deceased spouse won't be available to help with tasks around the house.

If you're married, the tax law says the default payment is a joint and survivor annuity that pays no less than 50 percent of the original amount to the surviving spouse. Your spouse has to agree in writing to any other payment schedule or to a lump sum.

EVALUATING PENSION BUYOUT OFFERS

It's not unusual for corporations to offer a lump sum to employees or retirees in exchange for the employees' relinquishing their pension rights. The number of such offers increased into 2015. Pension buyout offers increased to the point that the IRS issued rules in 2015 that basically prohibit plans from making buyout offers to those already retired and receiving benefits. Offers still can be made to active employees and those who aren't yet receiving their benefits. The offers will continue as long as some plan sponsors believe the offers will benefit the firm financially.

Pension buyout offers generally ask former employees or those nearing retirement if they want to give up the right to receive that monthly check for life in return for one payment that is many times the monthly check.

The law tells pension plans how to compute the lump sums that can be offered. The formula was changed in a 2008 law that phased in the new formula over several years. The new formula in many cases allowed employers to offer lower lump sums than previously were required. Many employers also want to remove the pension obligations from their books. Plus, the quasi-government agency that insures pension benefits raised the premiums it charges employers, making it more expensive to maintain a defined benefit pension plan.

This section discusses the factors to consider when evaluating a pension buyout offer.

Other Benefits

Your pension might have rights and benefits in addition to the monthly annuity. If you're still working, there might be disability benefits or an early retirement subsidy. The pension also might have spousal or survivor benefits. The loss of these benefits often isn't disclosed in the buyout offers, and the lump sum doesn't include money to replace them. It replaces only a single life annuity.

You also should find out if the pension is insured by the Pension Benefit Guaranty Corporation and, if so, the maximum amount of the guarantee. The PBGC guarantees pensions will be paid if the pension fund becomes insolvent, up to a maximum monthly amount that changes each year. If you receive a lump sum, it won't carry a guarantee.

Review any benefit publications or websites available to you, and contact the employee benefits office to see if you are eligible for these and other benefits.

Determining the Value

The lump sum often looks like a good deal compared to the smaller monthly annuity payment. But you need to compare apples to apples by taking a hard look at comparable numbers.

By accepting the lump sum you'd relinquish a guaranteed lifetime income. So, as with the decision of whether to accept an annuity or lump sum at retirement, determine how much it would cost you to replace that guaranteed lifetime income. Most private-sector pensions aren't indexed for inflation. You receive a fixed monthly amount for life. That makes the analysis easy.

Determine the lump sum you would need to buy the same guaranteed lifetime income from a private insurer. We discussed this process earlier in this chapter when discussing whether to take a lump sum or a monthly annuity at retirement and also in Chapter 3 when discussing how to shop for an immediate annuity. The process is the same here. The odds are that to receive the same guaranteed income as your pension, you'll have to pay the insurers more than the lump sum offered.

When you're not already retired or very close to retirement, the inquiry has two parts. Let's say you are 55 and the pension wouldn't begin paying until 65. First, you have to ask the insurers to estimate the lump sum you would need at age 65 to buy an annuity with a monthly payout equivalent to the pension. Second, estimate the rate of return you'd need to earn from investing the lump sum from now to age 65 for it to compound to the amount needed. Another approach is to shop for a longevity annuity. Ask the insurers how much you need to give them today for a monthly payment at age 65 equivalent to what the pension plan would pay.

Another way to evaluate the offer is to calculate how long the lump sum would last. Estimate how much you'd want to withdraw each month for spending. Then, estimate how long the lump sum would last at different investment rates of return at that spending rate. Another approach is to assume you'll spend each month whatever the monthly annuity was going to be. Then, estimate how long the lump sum would last at that spending rate at different investment rates of return.

Conservative investors likely will find that their investment returns won't be enough to allow the account to last for their life expectancies at a spending rate similar to the monthly pension. More aggressive investors might be able to sustain the payouts and even have something left for their heirs, but that assumes the markets cooperate and their actual results match historic returns. Bad markets or investment decisions would leave them worse off than conservative investors.

Taxes

When you receive the monthly pension payments, they likely will be fully taxable as ordinary income. You'll have the after-tax amount to spend. A lump sum can be rolled over into an IRA without incurring immediate taxes. But you'll owe taxes as the money is distributed from the IRA. Or you might convert the IRA to a Roth IRA after the rollover and pay the taxes at that time. In that case, there wouldn't be any taxes on future income and gains earned by the Roth IRA. If you take the lump sum directly instead of having it rollover to an IRA, you'll have to include the entire amount in ordinary income in the year it is received. Those are the most likely tax scenarios. If you have some after-tax contributions in the pension, the results might be a little different for you, because the after-tax contributions won't be taxable when you take them out.

The point is that you need to understand the income taxes that will be owed on whichever option you select. When doing your analysis, be sure you are comparing the after-tax amounts.

Another tax factor is required minimum distributions (RMDs). If you take the lump sum and roll it over to a traditional IRA, after age 70½ you'll have to take the RMDs. This could deplete the account faster than you planned and increase your tax burden. You can read more about RMDs in Chapter 8.

Evaluating the Risk Trade-offs

There's a trade-off of risks and costs in the decision. It is the same as we discussed earlier regarding the decision to choose a lump sum or annuity when retiring and in Chapter 3 when discussing whether to use part of your retirement assets to buy an annuity.

With the pension annuity, the pension plan takes the risks of low investment returns or your living a long life. When you keep those risks with the pension plan, you give up control of the money and the potential to earn higher returns with it. By taking the buyout offer, you would be giving up the lifetime guarantee and taking the investment risk yourself.

The buyout offer assumes you'll live to average life expectancy. The lump sum might be more attractive if there are reasons to believe you will be among those with below-average life expectancy. But if you live beyond life expectancy, you'll need higher-than-average investment returns or lower spending for the lump sum to last.

Evaluating a pension buyout offer requires you to consider a range of issues and take several different steps. The most important issue to keep in mind is that accepting the offer means shifting the risks of a longer life and lower investment returns from the pension plan to you. You'd be taking responsibility for achieving adequate investment returns and managing the spending and also taking the risk you might live a very long life.

401(K) ISSUES AND STRATEGIES

There is a lot more to 401(k) and similar accounts than most people realize. There are strategies that could increase your retirement nest egg. There also are mistakes you need to avoid that could reduce the amount available to fund your retirement. We'll look at the key issues and strategies in the rest of this chapter.

Exiting 401(k)s: Facts and Scandals

When you leave an employer, you have a decision to make with your 401(k). It doesn't matter if you are leaving involuntarily, to take another job, or to retire. The choice is the same. Basically, you can choose to leave your 401(k) account with the plan or you can roll it over to an IRA or to a new employer's plan (if the new plan will accept rollovers). You also can take a distribution of the account in cash, but that's usually not a wise choice, since you'd have to include the entire amount in gross income and pay income taxes on it.

The IRA and 401(k) industries were upended in 2013 by a report from the Government Accountability Office. Investigators concluded that the process often is a mess when individuals are leaving an employer and need to decide how to handle their 401(k) accounts.

The 401(k) rollover process is inefficient, and financial services firms that administer 401(k) plans use their positions to heavily market their own IRAs as the preferred option for departing employees, according to the report. The GAO found that consumers leaving an employer sometimes were given misleading or false information about their choices and the fees involved.

One problem is that the process of rolling over an account from the 401(k) plan of the old employer to a new employer's can be difficult. It often requires submitting a lot of paperwork to both plans and long delays. Each employer wants to be sure that no mistakes are being made and that your money isn't going to the wrong account or being siphoned away in an identity theft scheme. So, they double- and triple-check everything. All that takes time.

Another problem is employers don't want to be in the business of giving financial advice to their employees, especially those who are leaving. They leave the advice and information-giving to the plan administrators, who usually are financial services firms eager to have the 401(k) accounts rolled over into IRAs they administer. The report found that 95 percent of money contributed to IRAs in 2008 came from rollovers.

You need to make a decision about what to do with your account when leaving an employer. Do you roll it over or leave it in the 401(k)? The right answer varies from person to person. Your 401(k) and IRAs are among your most valuable assets and your main retirement planning vehicles, if you're like most people. You need to consider carefully this decision and be sure you are receiving complete and unbiased information.

Below I give a framework for making decisions for handling 401(k) accounts when leaving an employer that will enhance your financial security.

A 401(k) Rollover Framework

Many people automatically roll over their 401(k) accounts in a lump sum when leaving an employer, and the financial services industry certainly encourages that action. It is a good move in many cases, but that might not be the best move for you. Consider all the factors before deciding.

You generally have these options: leave your money in the 401(k) plan (though some employers discourage this), transfer it to the 401(k) plan of a new employer if it allows this, take the distribution in cash, or roll over the account to an IRA.

First, consider any advantages of keeping the money in the current 401(k) plan.

The 401(k) plans maintained by many small and medium-size employers and even some large employers aren't good. They have limited investment options that often aren't among the best funds or asset classes available. The costs can be high. There also might be limits on how often changes can be made in the investments and when money can be taken from the plan.

Some plans, however, especially those at larger employers, can be very good. The employers negotiate low costs and good investment options. For example, you might be able to invest in institutional class funds that have lower expenses than the retail mutual funds available through IRAs and many 401(k) plans. Large employers also pick up some or all of the account expenses instead of passing them through to employees.

An employer that takes its 401(k) seriously also seeks out the better funds in each asset category, offers a wider range of asset categories instead of just the basic five or so, and works with outside firms to design target date plans or similar asset allocation funds that are better than the off-the-shelf products at most fund families. You'll have more investment choices in an IRA, but a well-run 401(k) narrows your choices down to the better ones you'd find yourself and negotiates lower fees.

A 401(k) plan also is likely to have a stable value fund option, which can be a good place to hide while earning a decent yield when you want to be out of the markets or are mapping out your future. The downside to stable value funds is that they aren't good long-term investments, and there can be a high level of fees embedded in them that result in lower interest being credited to your account than you might earn elsewhere. Stable value funds also usually restrict the number of times you can move your money and require advance notice of changes. If you're considering a stable value fund as a longer-term investment, a better idea might be to roll the account over to an IRA and consider annuities or similar products for the IRA.

A major downside to staying with even a good 401(k) plan is that you can't consolidate your assets in one account. Many people find it easier to manage their investments and reduce procrastination when all or most of their money is consolidated at one broker or mutual fund firm. Consolidation avoids spending a lot of time manually consolidating the accounts and determining what the asset allocation is. Consolidation also might earn you lower fees.

You also need to consider the long term. Some 401(k) plans offer good annuity options when it is time to take retirement distributions or are flexible about setting up distribution schedules or allowing periodic distributions. Others effectively discourage people from maintaining their accounts after retiring by not offering annuity options, limiting distribution options, and making changes cumbersome. Check to see what the plan offers retirees and also what it offers to a beneficiary who inherits the account. Some plans require fast payouts to beneficiaries.

When a 401(k) plan has major drawbacks, your best action is rolling over the 401(k) plan to an IRA or a new employer's plan. If you are joining a new employer that will accept rollovers, consider the same factors in the new plan. You're required to put new deferrals into the new employer's 401(k) plan, but you don't have to roll over your old account to it. Decide whether the better choice is to leave the money in the old plan or roll it over to the new plan.

When the new employer's plan is deficient or you're not going to a new employer, shop around for an IRA. Don't assume the IRA offered by the current 401(k) administrator or custodian is best. Consider investment options, fees, and the different ways you can access the account. Take a look at the list of all fees charged for services. Some IRA custodians offer "no-fee" IRAs, because they don't have an annual custodial fee. Then, they charge a fee every time you want to take money out or make any other transaction.

Doing a Rollover Right

Once you decide to roll over an employer plan to an IRA or new employer plan, your work isn't finished. There are different ways to do the rollover, and you need to be sure it's done right.

One way to roll over an account is to have the plan issue a check to you. After the check is issued, you have 60 days to deposit the amount in a qualified IRA or employer retirement plan. Fail to make the deposit within 60 days and the distribution is included in your gross income. You'll owe income taxes, and if you're under age 59½ a 10 percent early distribution penalty in addition.

A lot can go wrong in those 60 days. You could be in an accident, get sick, or lose track of things. Also, you could do everything right only to have the new custodian put the money in the wrong account. All these things and more have happened to people. The IRS allows you to ask for a waiver of the 60-day requirement if you think you have a good excuse. But it's expensive to have a proper waiver filed, and the IRS doesn't waive the requirement very often.

Generally, you'll receive a waiver only if the firm receiving the rollover made a mistake, you were free of fault, and you did everything you could to correct the mistake immediately after you learned or should have learned about it. Other than that, a waiver isn't a sure thing. The IRS has even denied waivers when someone died within the 60-day period.

Another reason not to take the check is that the plan has to withhold 20 percent for income taxes. You have to come up with that 20 percent from other sources and deposit it to the new account to make the rollover completely tax free. You'll get a refund of the withholding after filing your income tax return for the year, but you have to find the cash at the time of the rollover to ensure the entire rollover is tax deferred.

My advice: Don't take a check from a retirement plan. You want a trustee-to-trustee transfer. Have the administrator of the plan you're leaving transfer the money directly to the new IRA or employer plan. You'll first have to open the new IRA or other account. With an IRA, you complete a form requesting the IRA custodian to have the funds transferred from the old account. The IRA custodian will contact your 401(k) plan administrator and be sure the account is transferred. There's no 60-day rule with a trustee-to-trustee transfer.

In either case, follow up. Once the account is transferred, be sure it is deposited in an IRA or your new employer's retirement plan. Sometimes firms make a mistake such as depositing transfers into taxable accounts instead of IRAs. You don't want the hassle of correcting this many months after the fact.

A Traditional 401(k) or Roth 401(k)?

Many people know about Roth IRAs, but not many know that Roth 401(k)s have been permitted by the tax law for several years. Employers have been slow to add Roth 401(k) plans, but many larger employers are making them available, and the number of employers offering them is increasing. When an employer offers a Roth 401(k), an employee generally is given a choice between a traditional 401(k) and a Roth 401(k). You also might be able to split contributions between the two. (This doesn't increase your annual contribution limit. You divide the same annual limit between the two accounts.) You also might be permitted to convert a traditional 401(k) to a Roth 401(k), just as is allowed with IRAs.

Like its IRA counterpart, the Roth 401(k) doesn't provide upfront tax benefits. You defer part of your salary into the Roth 401(k), but it still is included in your gross income for tax purposes. The income and gains of the account compound free of income taxes. When you take distributions from the Roth 401(k), they are tax free.

Which type of account is best for you?

The analysis and factors are the same as for an IRA. Generally, the longer the money will compound in the 401(k), the more likely it is that the Roth account will be the better choice. If your tax rate will be the same or higher during retirement as during the working years, the Roth account is likely to be the better choice. See Chapter 8 for more details of the factors to consider and how to make the decision between a traditional and a Roth account.

A general conclusion many make from the factors often is that a Roth 401(k) is the better choice for a younger person. But don't be swayed by a rule of thumb. Middle-aged and older people shouldn't foreclose the idea of electing or switching to a Roth 401(k). The benefits of a Roth 401(k) are so powerful that even older employees should consider the Roth option, according to a study done in 2015 by Stuart Ritter of mutual fund firm T. Rowe Price. This conclusion applies to both annual contributions to accounts and conversions of traditional accounts to Roth versions.

Let's look at a 50-year-old worker who can choose to contribute to either a Roth or traditional 401(k) plan. He contributes $5,000 annually until age 65, and then begins annual withdrawals. He earns a 7 percent annual return and is in the 28 percent tax bracket the whole time. At first glance, it appears he'd have the same account balance in each scenario, which would be $38,061 after 30 years, according to Ritter's assumptions and calculations.

The Roth balance, however, is tax free. The worker or his heirs will benefit from that full amount. The traditional account, however, will be taxed at the 28 percent rate, leaving the worker or his heirs with only $27,404 to spend. Also, higher distributions have to be taken from the traditional account to have the same after-tax spending money as the Roth version.

The worker could select a traditional 401(k) and invest the income tax savings from his contributions in a brokerage account. But that wouldn't be enough to match the after-tax value of the Roth 401(k). That's because the brokerage account earnings would be taxed, so it wouldn't compound at 7 percent annually after taxes.

What if the worker is in a lower tax bracket after retirement? Keep in mind that's less likely these days with only a few tax brackets. But Ritter's numbers show that the Roth 401(k) still is a better deal if the worker's income tax rate drops by as much as 10 percentage points in retirement.

What about an older worker? Ritter's work shows that the Roth 401(k) is the better deal for workers into their early 60s.

Of course, these are hypothetical scenarios. They might not apply to you. The Roth option could be even better for you, or it could be a bad deal, depending on the particulars of your situation and what you assume about retirement tax rates, investment returns, and other factors. The important point is that you shouldn't let rules of thumb and other people's experiences or views determine your strategy. Do a thorough analysis, or have a financial planner do it for you, and take a look at the data.

A Roth account has important advantages over a traditional account that could increase their advantage to you, despite your age, which we discussed elsewhere in this book. I'll summarize the key benefits here.

With the Roth account, you aren't required to take RMDs after age 70½. You can let the account compound longer than a traditional retirement account, increasing its benefits, if you have other sources of income to pay for your expenses.

A Roth account also helps you essentially decide the tax bracket you want to be in during retirement. You'll have other sources of income you can't control, such as Social Security, annuities, distributions from mutual funds or stocks, and required distributions from traditional accounts. When those don't meet your spending needs, you can sell some investments at a long-term capital gains rate of 20 percent and you can tap the Roth account tax free, maintaining your standard of living while controlling your tax bill and rate.

Also, distributions from Roth accounts don't help trigger higher Medicare premiums, taxes on Social Security benefits, and other stealth taxes.

Another advantage of having some money in a Roth account is the flexibility. If you have a large one-time spending need (new car, child's wedding, major home repair), you can take the money from the Roth IRA without pushing yourself into a higher tax bracket or triggering the stealth taxes.

The Advantages of After-Tax 401(k) Contributions

Suppose your 401(k) plans doesn't offer a Roth option. Or suppose you're deferring the maximum amount the tax law allows to the 401(k) plan but want to save more.

You can make after-tax contributions to a traditional 401(k) plan. You're aware that pre-tax contributions can be made to a 401(k) up to $18,000 in 2016 (and an additional $6,000 if you're age 50 or older). Most people aren't aware they can make additional deferrals or contributions. The limit on total 401(k) contributions is $53,000 in 2016, or $59,000 for those making catch-up contributions at age 50 or older. That means if you're 50 or older and maximize pretax contributions at $24,000, you can make up to an additional $35,000 of after-tax contributions. The tax law allows these after-tax contributions, and you can make them if your plan also allows them.

Only the first $24,000 of contributions has upfront tax benefits. The additional contributions up to $35,000 will be included in your gross income and subject to taxes. But once in the 401(k), the income and gains on the contributions compound tax deferred. When you take the contributions out of the 401(k), the after-tax contributions aren't taxed. Only the income and gains on the after-tax contributions are taxed.

Plus, the IRS issued regulations in 2014 that provide an added benefit to making after-tax 401(k) contributions.

For years it wasn't clear how to roll over after-tax 401(k) contributions to a Roth IRA. Under the latest regulations, when you're ready to roll over the 401(k) to an IRA, you can separate the after-tax contributions and roll them directly to a Roth IRA. You can do this even if the after-tax contributions weren't in a separate 401(k) account. At the same time, you move the pretax contributions and all the accumulated income and gains to a traditional IRA.

It can be even better if your 401(k) plan allows in-service withdrawals. These are distributions that the tax code allows after age 59½. Even if you continue to work for the employer, you can roll over the account tax free to an IRA. If you have both pretax and after-tax contributions, you can roll the after-tax contributions to a Roth IRA and the pretax contributions and accumulated returns to a traditional IRA. You then have the 401(k) money in IRAs, giving you complete flexibility in managing them. Yet, you can continue to contribute to the 401(k), making both pretax and after-tax contributions if you want.

Some employers restrict how often in-service withdrawals can be taken, but others allow them as often as you want once you are qualified. In these cases, you can make simple online orders to move your after-tax 401(k) money to a Roth IRA on a regular basis, if you want. To keep things simple, if you're going to make frequent in-service withdrawals have the 401(k) invested only in a money market fund so there won't be much income and gains in the 401(k) to complicate things.

Handling Employer Stock in 401(k)s

Many workers own shares of employer stock or other securities through 401(k) or other retirement plans. Few of these workers know the tax break available to substantially reduce the tax burden from selling those shares. By following a few steps, workers can reduce substantially the taxes from selling the employer stock. The tax break has been available for years.

The tax break is known as *net unrealized appreciation*, or NUA. It works like this.

If you sell the employer stock while it is in your 401(k) or other retirement account, you do not get a tax break. The proceeds from that sale eventually will be distributed to you (from either the 401(k) or an IRA rollover) and taxed as ordinary income.

When you retire or otherwise leave the employer and the account still owns the employer stock, however, you have a choice. You can treat the stock the same as other assets, keeping it in the 401(k) or rolling it to an IRA. As distributions of the stock or its sale proceeds are made, they are taxed as ordinary income.

The other option is to follow the NUA procedure. You distribute the stock to a taxable brokerage account and include in gross income in the year of the distribution only the original value or cost basis of the shares. No other taxes are due at that time, no matter how much the shares appreciated since you acquired them.

As you sell the employer shares, long-term capital gains taxes are due on the appreciation that occurred since you acquired the shares. Long-term gain treatment is allowed regardless of how long the shares have been owned either inside or outside of the 401(k).

To receive the NUA treatment, you have to take a lump-sum distribution from the 401(k) plan. This means that all of the assets must be withdrawn from the account in the same calendar year. The rule is firm. The full account must be distributed within the same year. As part of the distribution, have the employer stock deposited in a taxable brokerage account in your name. The rest of the account can be rolled over to an IRA or treated however else you want. The NUA doesn't change the tax treatment of or options for other assets.

The treatment of the employer stock under this procedure is the same whether you purchased the shares through your 401(k) plan or received them as a matching contribution from the employer.

The NUA tax break is available even if the company's stock is not publicly traded. Many private companies regularly determine a value for their stock. These values can be used to determine your basis in the stock. When the stock is distributed to you, the employer should tell you its basis.

The NUA treatment also is available to heirs who inherit a 401(k) account and take a lump sum distribution after the employee's death. It also is available to divorced spouses if they received part of the retirement account under a qualified domestic relations order.

You don't have to use the NUA treatment for all the stock in the plan. For example, shares that have appreciated a lot can be distributed to the brokerage account and taxes paid today on only the basis. Shares that have not appreciated much can be rolled over to an IRA with other account assets; taxes on those shares are deferred until the shares or proceeds from their sale are distributed.

If a person holds the shares until death in a taxable account, the heirs do not increase the tax basis of the shares. The heirs will owe capital gains on the appreciation when they sell the shares, just as the employee would have.

The 10 percent early distribution penalty applies to distributions of employer shares taken as part of an NUA distribution. But if the employee is at least age 55 and takes the distribution after separating from the employer, the 10 percent penalty usually does not apply.

To qualify for the tax break, you also cannot take any withdrawals from the retirement plan before taking a distribution of the stock, even required minimum distributions after age 70½.

Keep in mind, there might be nontax reasons for selling the stock. If you have doubts about the long-term future for the stock or believe too much of your net worth is in the stock, you might want to sell some or all of it though that means giving up the NUA tax break.

For many people, the traditional strategy still is best. After the top tax rate was increased in 2012, for some other taxpayers at a minimum the strategy isn't as beneficial as before. The top ordinary income tax rate was increased to 39.6 percent from 35 percent. But the top long-term capital gains rate also is increased to 20 percent from 15 percent. In addition, for some people there is the additional 3.8 percent tax on net investment income, which includes sales of employer stock. So, the maximum tax on selling the shares from a brokerage account increased to 23.8 percent from 15 percent.

As I said, for most people NUA treatment still is the best deal. For others, there's less of an advantage of jumping through the hoops for NUA treatment. Still other people will find NUA treatment beneficial but will have to carefully plan future sales of the stock to avoid triggering the 3.8 percent net investment income tax or pushing themselves into the top long-term capital gains tax bracket.

Using a 401(k)'s Brokerage Investment Window

As discussed earlier, the sad fact is that many 401(k) plans aren't very good. They tend to be designed by human resources personnel or business owners, not by investment professionals. They also try to be safe and conventional. The plan might be designed based on what's best for the employer, and that usually means using a single provider for recordkeeping, employee education, and investment options. Or it might be designed primarily for the benefit of the plan administrator.

In short, your choice of investments is limited. You might be limited to investments that aren't particularly good or that charge too much in expenses.

Many 401(k) plans, however, do offer a good alternative. It's known in the business as the brokerage window. Your plan, if it has one, probably uses a different name such as self-directed brokerage account and might even hide the option. But it's a good option for the serious investor with a lot of money in a 401(k) account.

The brokerage window allows plan members to bypass the plan's fund options, open an account through their 401(k) plan at a broker selected by the employer, and invest in most investments that are available in the markets. It's a brokerage account within your 401(k) plan.

Employers generally limit the choices available through the brokerage window, but not nearly as severely as the plan's standard offerings. Most plans allow members in the brokerage window to invest in almost any mutual funds, ETFs, stocks, and bonds available through the broker. Some plans even allow members to invest in options or sell short stocks. The windows usually allow online investing and trading at any time during which other customers of the broker can trade.

Using a brokerage window is not free. There usually is an annual fee of $100 or less. There also are likely to be trading fees on each transaction you make in the portfolio, though there might not be a fee for using no-transaction-fee mutual funds. The funds available through the window also aren't likely to be the institutional share classes available through in-plan funds, so you're likely to pay higher annual expenses in the funds.

Investing your regular contributions also is an issue. Will the plan administrator or broker automatically allocate them in a way you preselect? Or do you have to manually make the investments each month? Are there fees each time you invest the monthly contributions?

Read the 401(k) plan's materials to be sure you know all the fees and restrictions.

Some employers don't want to offer a brokerage window, or they offer one with tight restrictions. They're concerned about legal liability. They don't want employees who make bad investments suing them for making the poor decisions possible. Others are concerned about the government. The Department of Labor in 2012 floated the idea of making employers responsible for any investment selected by 1 percent or more of its plan participants. The proposal was withdrawn but could resurface.

The 401(k) plan brokerage window is not for everyone. If you want a traditional portfolio and your plan offers decent funds, stay within the standard plan. But if you want investments not in the plan offerings or believe the fund choices in the plan are poor, take a look at your plan's brokerage window. When your plan doesn't have a brokerage window, tell the employer you're interested in one.

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CHAPTER 10: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following pension annuity payments lasts for the longer of the term of years or the life of the employee:** **A.** single life annuity **B.** joint life annuity **C.** joint and survivor annuity **D.** life annuity with guaranteed term of years
2.	**When taking a check from a 401(k) account to roll over into a new employer retirement plan, what percentage is withheld for income taxes:** **A.** 10 percent **B.** 15 percent **C.** 20 percent **D.** 25 percent

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CHAPTER 10: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A single life annuity makes payments only for the life of the employee. **B.** Incorrect. A joint life annuity makes payments until both the employee and the joint beneficiary pass away. **C.** Incorrect. A joint and survivor annuity is another name for a joint life annuity. **D.** CORRECT. The life annuity with guaranteed term of years payments last for the longer of the term of years or the life of the employee. *(See pages 233 to 234 of the course material.)*
2.	**A.** Incorrect. The percentage held when a check is issued for the rollover of a 401(k) is more than 10 percent. **B.** Incorrect. Fifteen percent is lower than the amount to be withheld for income taxes. **C.** CORRECT. When a rollover check is issued, the plan has to withhold 20 percent for income taxes. The employee then has to come up with that 20 percent from other sources and deposit it into the new account to make the rollover completely tax free. **D.** Incorrect. The amount withheld for income taxes is lower than 25 percent. *(See page 239 of the course material.)*

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CHAPTER 11: THE GRANDKIDS NEED YOUR HELP MORE THAN EVER

Chapter Objective

After completing this chapter, you should be able to:

- Identify the tax issues involved with donating funds to grandchildren.

One of the prime financial goals of many older Americans is to help their grandchildren. They believe that the grandchildren's generation will have a more difficult time financially than either their parents or grandparents did. The adult children, meanwhile, either have established themselves or shown that they won't make good use of money that is given or left to them.

The grandchildren aren't expected to inherit much from their parents. The cost of college education and the price of the average home continue to climb to levels unimaginable a few decades ago. Many young people enter their twenties with tens of thousands of dollars of higher education debt. The grandchildren also face the prospect of bailing out the failing Social Security and Medicare systems while dealing with the likelihood that those programs won't be nearly as generous to them as they were to previous generations.

Financial services firms are aware of this interest in helping the grandchildren and offer programs to assist. Unfortunately, not all the programs carry strong benefits or are good in all situations. A strategy that benefits one family could be inappropriate for another. There are heavily promoted strategies aimed at grandparents that are more like gimmicks than smart financial planning. In addition, some strategies that were tried and true only a few years ago are no longer the best choices. It takes more knowledge and deliberation to choose the appropriate method for helping the grandchildren.

Consider the following developments in the quest to help grandparents provide for their grandchildren.

A SMALL SUM BUILDS A LARGE LEGACY—THE INSTALLMENT PLAN TO BUILDING A LEGACY

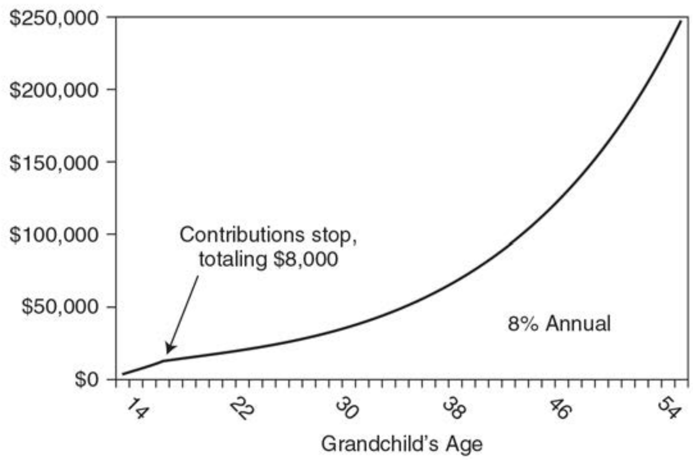
It is remarkably inexpensive and easy to establish a meaningful legacy for a grandchild. Two of the most powerful tools in investing can leverage a small amount into a large sum. Those tools are time and compound returns. You can open a relatively small account today for a grandchild, and when the grandchild really needs the money, the compounded returns over time probably will have greatly increased in value.

Suppose an account is opened with $2,000, and $75 is added to it each month. If the account earns an average return of 8 percent annually, at the end of 20 years it will be worth almost $55,000—though the total contributions were only $20,000. Time and the compounded returns of the investment markets can more than double total wealth. A higher return would, of course, result in more money for the grandchild.

That $55,000 should be enough for the down payment on a new home, to start a business, pay off college loans, or pay for other early-adulthood expenses. See Figure 11.1

Graph of grandchild's age vs. money (in increments of $50,000) displaying an ascending curve at 8% annual earning.

FIGURE 11.1 HOW A SMALL SUM BUILDS A LEGACY



What if the $55,000 is left untouched until the grandchild retires? The grandchild might be disciplined enough not to spend the money, or the account could be created within a trust that limits access to it. If the money compounds at 8 percent annually for another 30 years, the grandchild will have over $500,000—all on the grandparent's $20,000 investment. That's quite a legacy to leave and quite a financial load to take off the grandchild.

Almost any grandparent can use time and compound returns to build a substantial legacy on the installment plan. There is little or no risk that the standard of living of the grandparent will be lowered. This plan also avoids gift taxes, because the annual contributions should qualify for the annual gift tax exemption ($14,000 per recipient in 2016). Estate taxes also can be avoided if the gifts are put in an account that is not in the grandparent's name or legal control. Annual income taxes also should be low. The money can be invested so that there are few taxable capital gains and dividends in most years. Income that is taxable can be taxed at the grandchild's rate.

Table 11.1 shows how the installment plan can work with monthly contributions of $50 and $75. It assumes that the initial investment is $10,000, and the account earns 8 percent annually after taxes. Subsequent monthly investments of $50 and $75 are shown.

TABLE 11.1 MONTHLY DEPOSIT

Years	$50	$75
5	$18,522	$20,334
10	$31,294	$35,842
15	$50,321	$58,947
20	$78,669	$93,370

A strong impediment to this plan in recent years is that many brokers and mutual funds raised their minimum investment requirements. A little over a decade ago, $100 could open an account in a quality no-load mutual fund. Now, the minimum investment at most financial service firms is $2,500 or more. The few firms that allow low initial investments generally impose higher fees and other expenses. Once the hurdle of the initial deposit is cleared, however, small additional investments can be added on a regular schedule or when money is available.

Brokers and mutual fund companies make it easy to set up these plans using their automatic investment programs (AIP). Under an AIP, once an account is set up, the broker or fund company automatically drafts a set amount from a checking account each month and invests it according to preset instructions (which can be changed). The minimum monthly investment usually is between $50 and $100, though some allow monthly investments as small as $25 and some require as much as $250. The regular investments can be stopped, usually with 30 days' notice.

Those are the basics of how to make a small investment become a significant legacy. There are, however, details to consider. Different vehicles can be used to establish this legacy, and the final financial results can vary considerably depending on which vehicle is used. Factors that must be considered are income taxes, estate and gift taxes, control over the account, flexibility, and the effect on financial aid for higher education.

We'll look at how all these factors come together. First, we'll examine the best ways to help fund education expenses for a grandchild. Then, we'll look at establishing a legacy that will cover more.

GUIDE TO HELPING WITH A GRANDCHILD'S EDUCATION

Many grandparents want to help pay for all or some of a grandchild's higher education. So let's look at and compare the different ways available to help fund higher education. A number of these tools also are available to provide wealth in general to a grandchild, so this is a good review even for those who don't want to limit their legacy to higher education. All these strategies, by the way, can be used by parents to help their own children.

The strategies available to help fund college costs—or to provide a legacy in general—have different advantages and disadvantages, which not everyone realizes when choosing a method. Every grandparent needs to carefully consider all the possible effects and choose carefully.

Direct Gifts

The easiest way to help a grandchild is to make a gift of cash or of an investment. The gift later can be used to pay for higher education expenses. Until the expenses are incurred, the gift should be invested to appreciate or compound income.

The benefits of the direct gift are that the money or property is out of the donor's estate, and any income and capital gains earned by the gift are not included on the donor's income tax return and are likely to be taxed at the grandchild's much lower rate. There are no restrictions on the money or how it can be invested or withdrawn.

The disadvantages are that the grandchild has direct control of and unfettered access to the money. It can be invested in whatever strikes the grandchild's fancy. The grandchild may even decide to convert the account to cash and withdraw it.

If the grandchild still is a minor, an account cannot be established solely in the grandchild's name. The assistance of a parent or other adult is required. The easiest approach is for the parent and child to set up a joint account. That arrangement gives either the parent or child the ability to withdraw the money or change how the account is invested. An alternative is to set up a custodial account, such as a UGMA, which is discussed next.

Because of the lack of controls with the direct gift and joint account, they rarely are used to help a grandchild pay for higher education expenses.

The Classic UGMAs

For decades the only vehicle to help fund a minor grandchild's (or child's) education was the Uniform Gift to Minors Act (or Uniform Transfer to Minors Act) accounts, known as UGMA (pronounced ug-ma) or UTMA (pronounced ut-ma). (The name depends on the state in which it is set up.)

These accounts have many advantages. An adult serves as custodian of the account until the child reaches the age of majority. The account is in the minor's name, but the adult controls the investments and withdrawals. Also, a deposit into the account automatically qualifies as present interest under the gift tax law. That means the transfer qualifies for the annual gift tax exclusion, so the transfer is free of gift taxes until all the donor's gifts for the year to that minor exceed the annual limit ($14,000 in 2016). Normally, a gift is not a present interest qualifying for the annual gift tax exclusion unless the recipient has full legal title and control of the property. The tax law carves out a special exception for UGMAs.

Income and capital gains from the account are taxed to the grandchild. That can result in significant income tax savings to the family, because the grandchild is likely to be in a 0 percent or 10 percent income tax bracket, allowing the family to accumulate more after-tax wealth for education.

The disadvantages of UGMAs are less well-known. One disadvantage occurs when the grandchild is ready to attend college and applies for financial aid. Under the formula used to determine financial need at most colleges, a student is expected to spend on college expenses up to 35 percent of assets held in his or her name. The parents are expected to contribute only up to 5.64 percent of their assets each year. (These percentages can vary over time, and different schools can use different percentages.) Grandparents aren't expected to contribute anything.

A UGMA is considered an asset of the grandchild for whom it was established. That means if $20,000 is in the student's name, up to $7,000 must be spent on college during the first year before the student can qualify for financial aid. If the money is in the parents' names, only about $1,000 counts against aid. If the property is in the grandparents' names, none of it is considered during the financial aid qualification process.

If financial aid is a possibility, grandparents and parents should carefully consider whether they want to put assets in the future student's name. Doing so could reduce the amount of financial aid available and require the family to spend more on college expenses than they otherwise would have.

Another disadvantage is that once money or property is placed in a UGMA, the donor cannot get it back. It is important that the donor not contribute money that might at some point be needed to meet emergencies or living expenses. In addition, the UGMA cannot be used to pay expenses that are the legal support obligation of the parents. If the family runs into hard times, the money cannot be used for these legal support items, such as food, clothing, shelter, and medical care.

Also, the youngster gets full legal title to the account immediately upon reaching the age of majority. This is 18 in most states, and 21 in others. There is nothing the parents or grandparents legally can do to keep the youngster from spending the money however he or she wants. Instead of paying for college, the money could be used to purchase a new car, take expensive trips, or on even more alluring items. Because of this feature, many grandparents look for strategies that provide more restrictions on the grandchild's access to and use of the money.

Creating a Trust

The advantages of a UGMA can be obtained without incurring most of the disadvantages by creating an irrevocable trust. A trustee will control and invest the money. Cash will be distributed or used to pay expenses as directed in the trust agreement. Either the trust or the grandchild will be taxed on the income and capital gains, not the parents or grandparents.

Gifts to the trust are present interests and qualify for the annual gift tax exclusion if the trust has a Crummey clause. This clause allows the grandchild to take from the trust any new contribution within a certain time after the contribution was received by the trust. Usually 30 days is the time set. If the money is not taken out within that time, it stays in the trust under the terms of the trust agreement. If the child does demand distribution of the money, the grandparent isn't likely to make future contributions.

The trust agreement, which is written by the grandparent, determines when the money is distributed. There are many options available.

Here's one example. The trust agreement might say that money may be spent only for certain purposes—such as education or emergencies—until the child reaches age 21. After 21, the annual income or a percentage of the trust's value is distributed. At age 25, one-third of the principal is distributed. Additional principal is distributed at ages 30 and 35, after which the trust terminates. Those terms are classics for trusts set up to aid youngsters.

Some trusts provide that money is distributed to pay only for education. Other trusts make distributions as the grandchild achieves certain milestones, such as earning a college degree, holding a job, or reaching a certain age. Trust law is very broad. The standards for distributing and withholding money generally are limited only by your imagination.

Another option is to give the trustee complete discretion over how income and principal will be distributed. The creator of the trust can give the trustee a letter stating the principles to be used, but the trustee is charged with the ultimate decision. That allows the trust to adapt to changing, unplanned circumstances.

An irrevocable trust should contain a clause providing that no distributions will be made when the trustee determines that withholding the money would be in the best interests of the grandchild. This clause protects the money in case the grandchild drifts into substance abuse, gambling, high-risk business ventures, or similar activities. The trustee can resume distributions after determining that doing so again would be in the grandchild's best interest. The trust also should have a clause that allows the trustee to distribute money under special circumstances, such as becoming disabled, needing special medical attention, or wanting extended education.

There are some disadvantages to an irrevocable trust. It costs money to create and maintain the trust. A lawyer must prepare the trust agreement. The trust also has to file separate tax returns and keep separate records. The tax returns can get complicated. In addition, a trustee is needed to manage the trust. To get the maximum tax benefits, an independent trustee is needed. A professional trustee, such as a bank, will do the administrative work, tax returns, and money management for a fee. The administrative and tax work can be split from the investment and distribution management. Whatever the arrangement, creating the trust and having a trustee manage and maintain it will cost money. That's why an irrevocable trust is not a viable option unless a lot of money is involved. Attorney and trustee fees vary around the country, so the advisable minimum size for a trust varies by region.

Another potential disadvantage of a trust is that it reaches the top tax bracket much faster than individuals do. The tax brackets are indexed each year, but a trust paid the top tax rate in 2016 when its taxable income exceeded $12,400. The trustee might be able to manage the investments to avoid the top tax bracket. Otherwise, the family might not get any income tax benefits from setting money aside in a trust for the grandchild.

The trust also might affect the amount of financial aid available. The exact effect will depend on the terms of the trust and whether or not a school chooses to treat the trust as an asset of the grandchild.

Section 529 Savings Plans

A relatively new tool to help fund education expenses is the Section 529 college savings plan. These plans were created by a 1997 amendment to Section 529 of the tax code and have become extremely popular.

The 529 savings plan carries a number of benefits to both the adult who funds it and the future student who is the beneficiary of the account. The plans double as both an education funding tool and an estate planning strategy.

In a 529 plan, a state sets up a college savings trust. An adult opens an account and contributes to it, naming a child or grandchild (or anyone for that matter) as beneficiary. The state invests the money, and the gains earned by the account compound tax-deferred. There are no taxes until money is withdrawn from the account. If distributions are made for qualified education expenses, all compounded income and gains are tax free. If distributions are used for nonqualified purposes, the income and gains are taxed at the beneficiary's tax rate.

Contributions to the trust are considered gifts of present interests, qualifying them for the annual gift tax exclusion. In addition, tax-free gifts can be front-loaded. Up to five years' worth of gift-tax-free contributions can be put into the account in one year and still qualify for the gift tax annual exclusion. When the annual exclusion is $14,000 as in 2016, up to $42,000 per beneficiary can be put into a 529 plan in one year free of gift taxes. A married couple can each put that amount into each account gift tax free in one year.

Front-loading gifts means that the tax-free exclusion for gifts to that beneficiary are exhausted for the five years. In addition, if the donor dies before the five years have ended, a pro rata portion of the gifts will be included in the donor's estate. Otherwise, the money and all its future appreciation are not considered part of the donor's estate.

There are additional benefits to 529 savings plans:

- The donor is considered the account owner and can get the money back when needed under most states' plans. Some states impose an early withdrawal penalty of up to 10 percent of the account's value, some don't.
- The donor can change the beneficiary. If a grandchild decides not to go to college, a new beneficiary can be named.
- The account in one state can be used to pay for education expenses in any state if the state sets up the plan that way.
- Some states give a deduction against state income taxes to their residents who contribute to the 529 plans sponsored by the state.
- There is no preset limit on the earnings under most plans. The money is invested, and most state plans give the donor some ability to choose the investments. If the markets do well, so will the account. On the other hand, there are no guaranteed earnings. An account could lose money, and many have from time to time.
- Some states require that the account be spent by a particular time, usually when the original beneficiary reaches a certain age, such as 30. Others let the account compound indefinitely, changing the beneficiary several times. This type of strategy can substitute as a trust for part of an estate plan.
- The U.S. Department of Education stated that for financial aid purposes, the assets will be considered those of the owner. That means the student will not be considered the owner for financial aid calculations. If the grandparents set up the 529 account, the account will

not count in financial aid considerations. Individual schools, however, can set their own policy on this issue, and some have taken a different position.

These provisions make the 529 plans more attractive in many ways than other investment-oriented plans such as UGMAs, trusts, and direct gifts of money or investment accounts. The donor gets gift and estate tax benefits, yet can get the money back if needed. The donor still has some control over the account and can change the beneficiary. The grandchild does not get legal title to the account after reaching the age of majority.

However, there are three potential disadvantages to 529 plans. One is that the state usually decides how the account will be invested or at least puts limits on the investment options. In most plans, well-known money management companies such as Fidelity, Vanguard, and TIAA-CREFF invest the money. The donor might have some ability to select the initial investment options and might be able to change them periodically. In a few states the state treasurer invests the accounts, and some states have only one investment plan.

To counter this disadvantage, many states offer additional versions of their 529 plans in conjunction with financial services firms. The account is opened through a firm, usually a broker or mutual fund that has established a relationship with the 529 plan. These accounts generally offer more investment options than the state-managed version of the plan, and investments usually can be changed more frequently. These versions of the plans, however, charge higher fees than the state-managed version.

Another potential disadvantage is that Congress could change the rules. There hasn't been a strong movement in this direction, but it's always possible.

The third potential disadvantage is cost. Each state imposes fees and expenses on the accounts in its plan. The level of these costs varies. Some states set the fees at low levels that cover only their costs. Other states try to make a profit from the 529 plans. In addition, a state can have several plans with different levels of fees for each plan. Many states now have plans that can be sold through brokers and financial planners. These professionals get fees from the plans, and the fees under these versions are higher than for the plans purchased directly from the states.

Most states now offer at least one 529 plan. The terms, costs, and fees of the plans vary, though most have modest fees. Most states also now accept contributions from residents of any state and allow the accounts to finance higher education in any state. That enables you to shop around for the state plan that best suits your needs, investment preferences, and fee levels. The main disadvantage to using an out-of-state plan is the potential loss of a state income tax deduction. States that allow residents deductions for their 529 plan contributions generally allow the deductions only for contributions to their own plans. Also, a few states consider distributions to be tax free only if used to pay for education at a college in their state.

Because most states will open accounts for residents of any state, diversification of plans is possible. Rather than settling on one state plan, a grandparent can split contributions among plans from different states with attractive features. A grandparent might, for example, contribute enough to his own state's plan to get the maximum income tax deduction, and then contribute additional amounts to another state's plan with more attractive features.

The details of the available plans are collected online for comparison at www.collegesavings.org. It is important to review all the terms before settling on a plan. For example, not all plans allow the owner to take the contributions back. Some plans allow the return of contributions but only after a penalty is subtracted. Some plans will transfer an account to another state's plan if desired; others won't.

Prepaying College

Before the Section 529 college savings plan was created, section 529 of the tax code provided only for prepaid college savings plans. These plans still are available. They are not as well-known because financial services firms do not have an incentive to promote them. Yet, they do provide significant benefits to grandparents, parents, and grandchildren. In some ways they are more attractive than the savings plans, especially when investment markets aren't doing well.

Under a prepaid college savings plan, the person opening the account names a beneficiary and tells the state the beneficiary's age. The plan determines how much has to be paid in. The plans generally offer payment options ranging from a lump sum to fixed annual payments. When an account is fully funded, the state guarantees it will pay four years of tuition and mandatory fees at public colleges within the state.

There also is a private college version known as the Independent 529 plan. A list of participating institutions and other details are at www.independent529plan.org. Cash put into the plan earns tuition certificates that can be used to buy tuition at the participating schools. How much education each dollar buys depends on the school the child chooses to attend, because tuition and fees vary among the schools. A disadvantage of the plan arises if the child chooses to attend a public university or a private school that does not participate in the plan. In that case, the plan pays back the original investment plus a 2 percent annual return.

The major advantage of prepaid tuition plans is certainty. If the cost of college grows faster than the plan anticipated, the state or the plan makes up the difference. Likewise, if investment returns lag behind expectations, the state or the plan suffers the loss. On the other hand, if the actual results are better than the projections, the state or the plan benefits.

Certainty can be a major advantage, as many have learned through all the volatility of financial markets since 2000. The cost of higher education also is less certain as states reduced their funding for colleges in the wake of budget problems. Buying into a prepaid plan early locks in the current cost and inflation rate and lets the plan take the risk of higher inflation.

A potential disadvantage is that the guarantee covers only the cost at public colleges within the state sponsoring the plan. Private colleges and those in other states aren't guaranteed. If the grandchild does decide to go to an institution that isn't covered, the state will determine a value for the account and transfer that amount to another institution to be applied to costs there.

A prepaid plan also won't cover all the costs of college. Costs that aren't covered include room and board, textbooks, a computer, and expenses other than tuition and fees.

For financial aid purposes, the prepaid plan is considered the student's asset, and generally will reduce the aid available to the student dollar for dollar.

A prepaid tuition plan has less flexibility than a savings plan. Money generally cannot be withdrawn as it can with a savings plan, other than to transfer it to a college to pay expenses. There also might be limits on the ability to change the beneficiary.

Prepaid savings plans ran into problems during the bear market of 2000–2002. When determining how much a parent needs to pay into the prepaid plan, each state estimates the investment return it will earn on that money. The state also estimates the rate at which tuition and fees will increase. Both sets of estimates turned out to be far too optimistic. Of course, the bear market returns were far less than the estimates. The recession caused states to reduce tuition subsidies, so colleges and universities compensated by substantially increasing their fees.

A number of state plans projected deficits for a few years because of the poor returns. Many significantly raised the amounts that must be paid by new enrollees in the plan. A few states stopped accepting new enrollees until they could resolve the financial issues. It is possible that in some cases the plan might not have enough money to pay all the promised expenses at some point, and the state government will have to decide if it is obligated to fund the deficits.

Coverdell Savings Accounts

Coverdell savings accounts initially were called Education IRAs. The name was changed in the 2001 tax law to honor the late U.S. Senator from Georgia, Paul Coverdell. The 2001 tax law also dramatically increased the benefits of these accounts.

Up to $2,000 per child can be put into a Coverdell account each year. There is no deduction for contributions to the account, income and capital gains are tax deferred, and they are tax free when withdrawn, if used for qualified education expenses. The account must be spent by the time the beneficiary is 30.

Qualified education expenses include tuition, fees, books, supplies, and equipment that are required for enrollment or attendance. Room and board are included if the individual is at least a half-time student. The expenses can be incurred for undergraduate or graduate level courses and also can be used to purchase tuition tax credits under a qualified state tuition program. Since 2002, the accounts also can pay for elementary and secondary school expenses.

An account balance can be transferred or rolled over tax free from the account of one beneficiary to another beneficiary in the same family.

The $2,000 annual contribution limit is phased out when the contributor's adjusted gross income is between $190,000 and $220,000 on a joint return.

The nice thing about Coverdell accounts is that virtually any relative can open an account for the benefit of another relative. If a grandparent's income exceeds the limit, he can give money to a parent to contribute to an account for the grandchild.

A problem with the Coverdell accounts is opening one. Many financial services firms do not offer the accounts. They do not foresee there being enough interest to make the accounts profitable. It was hoped that increasing the contribution limit from $500 to $2,000 would help the situation, but that has not been the case so far. Coverdell accounts also have trouble competing with 529 savings plans and even with taxable accounts when all the features and benefits are compared.

U.S. Savings Bonds

Those saving for college education get a special benefit from U.S. Savings Bonds. Normally, interest on the bonds is tax deferred until the bonds are redeemed. Then the interest is taxable. If the interest is used to pay for college expenses, however, the interest is tax free. The tax-free status of the interest is phased out for bond owners whose adjusted gross income for the year exceeds $116,300 on joint returns and $77,550 for all other returns. The exclusion is completely phased out at modified adjusted gross income of $146,300 on joint returns and $92,550 or more for all other returns.

Savings bonds generally offer safe, solid interest rates. The returns won't be spectacular, and higher interest often can be earned on other types of bonds. The safety of the savings bonds, however, cannot be matched, and the tax-free interest feature can make them a good alternative for a conservative investor.

Just-in-Time Gifts

One widely used strategy avoids all the special vehicles. It uses the gift tax exclusion to avoid gift taxes and also to minimize income and capital gains taxes. Yet, the grandparents retain control of the assets as long as possible.

Under this strategy, the grandparents save and invest in their own names in a taxable account. When it comes time to pay for a year of college, the grandparents make a gift of the investments to the grandchild. The grandchild then sells the investments, pays taxes at his or her rate, and uses the after-tax amount to pay for college. The grandchild is likely to be in a lower capital gains tax bracket than the grandparents and might even be in the 0 percent tax bracket.

A disadvantage of this strategy is the property stays in the estates of the grandparents. That's only a problem if the grandparents might be subject to federal estate taxes. Also, while the grandparents own the investments any income and gains are on their income tax returns. The strategy does, however, avoid the problem of searching for a vehicle that helps the grandkids but doesn't give them too much control, reduce financial aid, or create other problems.

A key advantage of this strategy is that the grandparent retains control of the account. The account also can be set up at any mutual fund or broker the grandparent wants. In addition, the account can be invested in a tax-wise fashion so that the after-tax returns will be competitive with the tax-favored vehicles such as 529 savings plans.

By paying the expenses, the grandchildren also might qualify for tax breaks such as the Hope or Lifetime Learning tax credits for education expenses. Applying those credits to the grandchild's income could make the gains tax free.

An option that builds on this strategy is to have the children pay at least half their living expenses for the year. That makes them independent. They claim their own personal exemptions, the credits for college expenses, and deductions for any loan interest. They aren't likely to hit the income limits at which those tax breaks are phased out. Be sure to keep track of their annual living expenses and be able to show that the children paid at least half their expenses.

The grandchildren's living and college expenses could be paid with gifts received from the grandparents, and the grandchildren still would qualify for the tax breaks. The key is that the gifts must be unrestricted. The grandparents must take the risk that the money will be spent on something else.

BRINGING IT ALL TOGETHER

You can see that there are many ways grandparents can help pay for a grandchild's education. There is no one right vehicle. A number of factors must be balanced before making a decision. Here are some general rules to consider:

- When money will be invested in the markets to be used years from now, a section 529 savings plan can be the best choice. For a relatively low cost it provides tax advantages and estate planning benefits. The 529 plan also makes it unlikely that the grandchild will spend the money on something more alluring than college. It has minimal impact on eligibility for financial aid and has a great deal of flexibility.
- When the child can be trusted or the grandparent is willing to assume the risk, a good choice is to invest in a taxable account in the grandchild's name. Once the child turns 19, all income and gains are taxed at the grandchild's tax rate unless the grandchild is a full-time student under age 24. The grandparent can invest in his or her own name until sometime after the child turns 19, then give the account to the grandchild. There would have to be a joint account or a custodial account. This approach could severely reduce available financial aid, because the assets are in the student's name.
- If financial aid is a possibility, the grandparents might want to consider investing in their own names. Saving in either the grandchild's name or even in the parents' names could reduce financial aid. Investments could be given directly to the grandchild when college expenses are due. The grandchild could sell the investments, incurring taxes at his or her own rate. A disadvantage is that the grandparents would pay taxes on the investment income at their rates in other years. Another disadvantage is that the property would be included in their estates if they pass away before the money is spent.
- Investing in the grandparent's name keeps many options open. The education expenses can be paid as they are incurred by making gifts of appreciated investments to the grandchild. The taxes on gains are paid at the grandchild's tax rate. In addition, the grandchild might qualify for the Hope and Lifetime Learning tax credits. Saving in the grandparent's name also keeps the grandchild eligible for the maximum financial aid.

- A prepaid tuition plan provides the most certainty. The payment of tuition and fees is guaranteed in return for fixed payments from the parent or grandparent. Additional expenses, such as room and board, can be funded through the other strategies.

HELPING BEYOND COLLEGE

Helping to pay for education expenses is not the only way to help grandchildren. Most grandkids can use help beyond education, and many won't even attend college. A grandchild could use assistance to buy the first home, start a business, or even prepare for retirement decades away. Some of the strategies that help save for college also could be used to establish a general legacy for grandchildren. Prepaid college savings plans aren't useful for saving beyond college, and neither are Coverdell Savings Accounts. UGMAs can provide wealth beyond college, though whether or not that happens is completely at the discretion of the grandchild. He or she gets full legal control at the age of majority. Good uses can be made of direct gifts, trusts, and even 529 savings plans. Most of the 529 savings plans don't require the money to be spent until the original beneficiary is age 30; some allow accumulations even longer.

Let's look at how some other ways to help establish a legacy for a grandchild.

Best Way to Help a Grandchild

Perhaps the best tool for providing financial help to a grandchild is a Roth IRA. They were created as retirement accounts, but it is tough to beat the Roth IRA for estate planning and transferring wealth.

The advantages of the Roth IRA are that income and capital gains earned by the account are not taxed. Also, neither the owner nor the subsequent beneficiary pays income taxes on distributions in most cases. These advantages mean investment earnings compound tax free, and then the accumulated amount can be withdrawn without incurring income taxes.

A Roth IRA's advantages are back-end loaded. There is no benefit for creating a Roth IRA, such as a deduction for contributions. There is no age limit on contributions to a Roth and no required minimum distributions (RMDs) for the original owner. With a regular IRA, contributions cannot be made after age 70½, and required distributions must begin after that age. A beneficiary inheriting a Roth must begin RMDs, but they can be made over the beneficiary's life expectancy. That means for a grandchild, the required annual distributions would be small, usually much smaller than the earnings and the appreciation of the Roth IRA. So the account's value can appreciate for many years until the beneficiary really needs the money.

Those are powerful advantages that cannot be found in any other vehicle. There are several ways the Roth IRA can be used to help loved ones.

Start a new Roth IRA for yourself. A new Roth IRA can be started with annual contributions of up to the annual limit. You might not be eligible to contribute to your own IRA, because the right is phased out as adjusted gross income increases. The limit is indexed for inflation and depends on your filing status.

The owner also must have earned income for the year at least equal to the amount contributed to the Roth IRA. Earned income is salary and wages, not investment income. A contribution also can be made to a Roth IRA for a nonworking spouse as long as the working spouse has earned income at least equal to the total contributions. The earned income requirement keeps a completely retired person from pursuing this strategy.

A grandparent can begin a Roth IRA, name the grandchild as beneficiary, and make regular contributions. After the grandparent passes away, the grandchild becomes the owner. The grandchild must begin taking minimum annual distributions from the Roth and can take additional amounts when desired. Instead of taking additional distributions, the grandchild can let the account continue to compound tax free. If the investment returns exceed the required annual distributions, by the time the grandchild is ready to retire the Roth IRA should provide a meaningful source of tax-free income.

Also, a grandparent who already has a traditional IRA can convert all or part of it into a Roth IRA, naming a grandchild as the beneficiary. This would generate all the Roth IRA benefits for both the grandparent and grandchild. There is a cost to converting a regular IRA to a Roth IRA: The amount converted must be treated as though it were distributed. That means the converted amount must be included in the grandparent's income and taxes paid on it. In Chapter 8 we discussed the circumstances in which it might make sense to convert a traditional IRA to a Roth IRA.

Grandparents also can help set up a grandchild's IRA. There is no minimum age for setting up a Roth IRA. All the taxpayer needs is earned income. It doesn't even have to be enough income to incur taxes. Suppose a grandchild earns a bit of money from babysitting, mowing lawns, or a part-time job. The grandchild naturally wants to spend most of that money. The grandparent can match the earnings with a cash gift that is used to set up a Roth IRA or can make the deposit directly to the IRA. The youngster then lets the income and capital gains compound tax free in the Roth IRA and is still able to spend the money he or she earned.

This can be the best deal for the grandchild. Because the grandchild is setting up the IRA and not inheriting it, there are no required minimum distributions at any time during the grandchild's life. The income and gains can compound for as long as the grandchild lets them. In addition, the money does not have to be left in the IRA until retirement. Distributions from a Roth IRA are tax free if the money has been in the Roth IRA for at least five years and it is withdrawn for one of the following reasons: death, disability, after reaching age 59½, or to pay first-time home buying expenses of up to $10,000. A grandchild can take a tax-free withdrawal to help buy his or her first home. Or the money can compound until after the grandchild reaches age 59½. After that, all distributions are tax free. Money can be withdrawn for other reasons as needed. The gains and income would be taxable, but it would have benefited from tax-deferred compounding over the years.

Don't overlook Roth IRAs just because they don't fit into your retirement plan. Roth IRAs are extremely powerful estate planning tools and can be used by individuals of almost any income level to enhance the future of their loved ones.

NO-TAX, LOW-COST WAY TO HELP A GRANDCHILD

A grandparent doesn't need to give away money or property to help a grandchild. Money can be lent to a grandchild.

Here's one plan. Lend $50,000 to a grandchild for five years. The grandchild invests the money and earns 10 percent annually. At the end of five years, the grandchild has accumulated over $80,000 before taxes. The grandchild can repay the $50,000 and still have about $30,000, minus taxes, left as a nest egg. Taxes should be quite low, because the grandchild should be in the lowest tax bracket and the gains should be long-term capital gains. The grandparent's only cost is the earnings from the $50,000 for five years, and the grandchild has accumulated a nice starter fund after only five years.

This is such an attractive deal for taxpayers at any income level that the tax code has imposed a number of hurdles.

A lender is required to charge a minimum interest rate on most loans. If the minimum isn't charged, then it is a below market loan on which a minimum interest rate based on current market rates is imputed. We'll discuss the effects of imputed interest shortly.

There are several key exceptions to the requirement of a minimum interest rate. The first is that a gift loan between individuals, which is what is described here, does not have interest imputed when loans between the individuals do not exceed $10,000, and the loan is not used to purchase or carry income-producing investments.

Another important exception provides no imputed interest on gift loans between individuals when the loans do not exceed $100,000 and the borrower's investment income for the year does not exceed $1,000. If the borrower's net investment income does exceed $1,000, interest will be imputed but only in the amount of the borrower's net investment income for the year.

This obviously is an important exception for loans to grandchildren. A grandparent can lend up to $100,000 to a grandchild interest free, if it is invested primarily for long-term capital gains so that there is little or no taxable annual income. If there is annual investment income, the grandchild should be sure to keep track of investment expenses such as broker's commissions. Those expenses are subtracted from investment income to arrive at net investment income. After five years, the grandchild sells enough of the investments to pay back the loan. There are no tax consequences to anyone, except taxes when the grandchild sells the investment.

Suppose a loan doesn't meet one of the exceptions and has interest imputed. Even then, the results are not bad.

When interest is imputed, the grandparent will be treated as having made a gift to the grandchild equal to the interest that should have been charged but wasn't. Then the grandparent will be treated as having received a payment of that amount of interest income from the grandchild. Because the grandparent can give the grandchild up to $14,000 annually free of gift taxes, gift taxes aren't a problem until the imputed interest is over $14,000.

The grandparent will have interest income equal to the amount of the imputed interest, though it won't be paid in cash. Suppose the imputed interest is $2,000 and the grandparent is in the 40 percent tax bracket. The cost of making the loan will be $800 in taxes on phantom interest income each year.

If a gift loan is made to a grandchild (or any other relative), there must be appropriate paperwork. The

IRS doesn't like loans between related parties and tries to treat them as gifts. There must be a real expectation of repayment and the intent to enforce collection. The note should spell out an interest rate and repayment schedule and contain an unconditional promise to repay. The repayment schedule, which can be a balloon payment at the end, must be followed as much as finances permit. There also must be a reasonable expectation that the loan could be repaid. For example, a loan made to a relative with a failing business that is unlikely to recover might be treated as a gift rather than a loan.

One word of caution is that the assets the grandchild purchases might decline in value. I know one wealthy individual who lent money to an adult child and suggested the purchase of a stock he knew well. Unfortunately, the market did not agree with his assessment of the stock. The child soon owned a stock worth half its previous value and still owed the father the full amount of the loan.

SIMPLE, LOW-COST WAYS TO HELP

A grandparent doesn't need to be a multimillionaire to help the grandchildren. The grandparent doesn't even need to be wealthy. There are many simple, low-cost ways to help, and they are tax free. With many of these strategies, the grandparent can see the benefits now instead of imagining how the wealth will be used in the future.

The use of property is a great way to help future generations. For example, a grandparent might have a vacation property or recreational vehicle. The adult children (the grandchildren's parents) might save significant expenses if these assets can be used for family vacations. That savings can be used to help pay for the grandchildren's education or other future needs. Letting others use property costs the grandparents very little, and it usually has no tax consequences.

An increasingly popular strategy is to pay for family vacations. Travel can be fairly expensive, and many families with children have to stretch for or cannot afford a nice trip. A family trip paid by the grandparents can give the family an experience they never would have had or save them thousands of dollars. Grandparents who cannot afford to pay for an entire trip might be able to pay for a portion. Sometimes grandparents will pay for a cruise or a stay at a resort. All the children and grandchildren have to do is get to and from the location and pay for their food.

Technically, paying a share of someone's vacation costs is a gift to them and counts against the annual tax-free gift amount. But the IRS to date has looked only at gifts of money and property. It has not tried to add up holiday gifts, meals, and travel.

Another way grandparents can help loved ones is to have their financial advisors help the grandchildren. Suppose a grandparent gets professional advice on an estate plan, financial plan, or investments. The advice can be tailored to ensure that the needs of the children and grandchildren are considered in the plan. The grandparents also can pass on any advice received.

A further step is for the grandparent to offer to pay the advisors to work with the children or grandchildren. The loved ones would meet with the advisor, and all the information would be confidential between them. But the grandparent will have rendered a valuable benefit, and the advisor can ensure that what the children are doing is consistent with what the grandparent is doing and that the plans are coordinated.

The grandparent also should be able to get a break on fees. Even if the grandparent doesn't pay for everything, the family should get a break by using the same advisor. A family buying as a group probably can negotiate a lower fee than could each individual family member.

Another benefit is that together the younger members of the family learn more about money and sees how finances work. That's a big improvement over leaving your loved ones your assets and expecting them to know how to manage them. Often, being unprepared to handle the family's assets can do more damage than taxes or probate costs.

A grandparent who is in business or is an investor can help family members by letting them benefit from opportunities that come the grandparent's way. When family members are in the same or related businesses, the grandparent can send some potential business or clients to other family members instead of keeping the opportunities for themselves.

TEACHING GRANDKIDS WEALTH MANAGEMENT

It is nice to give wealth to grandchildren. But an even better gift can be to teach them how to multiply and manage wealth for the rest of their lives.

Young people today are more financially savvy than any prior generation. They own investments, have such high discretionary income that retailers make pitches to them, and even financial services firms are catering to the younger generation. Despite this attention, money, and information, most grandchildren know just enough about money management to be dangerous. That's where grandparents come in. Grandparents can help subsequent generations become better, shrewder financial managers. An additional benefit is that by managing their own funds, the grandchildren will learn to be more responsible people in general.

To help grandchildren on their way, consider these steps:

- Open basic accounts for them. Start with a savings account. It could be an account at a local bank or a money market fund that is easy to access. The grandparent can put in the start-up capital to meet the minimum investment amount, but can tell the grandchild that the startup money is either the grandparent's or is available only for college. Review the account statements with the grandchild from time to time, so that he or she can see how the money grows just by being left alone in the account.
- Use the account to teach the grandchild to save for the long term. For example, the grandparent could say that only up to 20 percent of the balance can be spent, and the rest is being saved for college or some other future need. Also, instead of depositing gifts to the account that the grandchild doesn't know about, give money directly and encourage him or her to save all or most of it. Some people prefer separate accounts—one for spending money, one for long-term expenses such as college, and maybe another for other expenses. Each time the child receives money, a portion is put into each account.

- Give simple lessons to the grandchild. Explain how compound interest and regular savings work, using examples and explanations that the child can understand. Some brokers and mutual funds have education materials to help explain a point. A good book is The Richest Man in Babylon by George Clayson, a classic that explains savings and compounding of wealth.
- Encourage the grandchild to save by offering to match new savings with additional gifts to the account.
- Help the grandchild pick stocks for a hypothetical portfolio. It can be a game, but the child will learn and might become interested. Over time, review the selections and how they performed.
- Buy mutual funds in the investment account. Teach the grandchild how to check prices in the newspaper or on the Internet. When the reports from the mutual fund arrive, use these to show the grandchild which companies the fund owns and how they have affected the price.
- Buy a few stocks with the grandchild. This is how a child learns to think like a business owner. When the company reports arrive, the grandchild won't be able to understand most of them. But the grandparent can point out some highlights, such as descriptions of the company's activities and how a few key numbers changed over time.

A grandchild needs to save and invest for a lifetime. Grandparents can get them off to a good start with a few easy steps and some early lessons on how wealth works. With any luck, the grandchild will be able to benefit from a grandparent's wisdom long after the grandparent is gone.

CHAPTER 11: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following is a strong impediment to an installment plan for a grandchild's legacy where a grandparent wants to set up an account with $2,000 and adds $75 per month to it:** **A.** the payment of gift taxes **B.** income is taxed at the higher rate of the grandparent **C.** risk to the standard of living of the grandparent **D.** many brokers and mutual funds raised their minimum investment requirements
2.	**Which of the following is a disadvantage of a direct gift to an adult grandchild to use for higher education expenses:** **A.** the account is in the grandchild's name but the adult controls the investments and withdrawals **B.** the grandchild has direct control of and unfettered access to the money **C.** there are very tight restrictions on how the money can be invested or withdrawn **D.** the gift cannot be invested once given
3.	**Which of the following is correct regarding a Uniform Gift to Minors Act (UGMA) account:** **A.** UGMA accounts have only been around since 2012 **B.** the account is in the minor's name, but an adult actually controls the investments and withdrawals **C.** income and capital gains from the account are taxed to the grandparent **D.** money placed in a UGMA account can be taken back if requested within 30 days

4.	**Which account used for planning for a person's education expenses doubles as both an education funding tool and an estate planning strategy:** **A.** a direct gift **B.** a Uniform Gift to Minors Act (UGMA) account **C.** a Section 529 college savings plan **D.** a prepaid college account

CHAPTER 11: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The plan avoids gift taxes, because the annual contributions should qualify for the annual gift tax exemption ($14,000 per recipient in 2016). **B.** Incorrect. Income that is taxable can be taxed at the grandchild's rate, so this is usually a benefit, not an impredIment. **C.** Incorrect. There is little or no risk that the standard of living of the grandparent will be changed. **D.** CORRECT. A strong impediment to the plan in recent years is that many brokers and mutual funds have raised their minimum investment requirements to $2,500 or more. *(See pages 252 to 253 of the course material.)*
2.	**A.** Incorrect. The account being in the grandchild's name while the adult controls the investments and withdrawals is an advantage of a UGMA account. **B.** CORRECT. Once the gift is given, the grandchild has complete control over it and can spend the money however they choose, regardless of the grandparent's intentions. **C.** Incorrect. There are no restrictions on how the money can be invested or withdrawn. **D.** Incorrect. Once the gift is given, if it is not being used immediately for education expenses, then it should be invested to appreciate or compound income. *(See page 254 of the course material.)*
3.	**A.** Incorrect. For decades, the only vehicle to help fund a minor grandchild's education was a UGMA account. **B.** CORRECT. An advantage of a UGMA account is that the account is in the minor's name, but the adult controls the investments and withdrawals. **C.** Incorrect. Income and capital gains from the account are taxed to the grandchild which can result in significant income tax savings to the family. **D.** Incorrect. Once money or property is placed in a UGMA, the donor cannot get it back. *(See pages 254 to 255 of the course material.)*

4.	**A.** Incorrect. A direct gift is not an effective estate planning strategy. **B.** Incorrect. A UGMA account is a useful education funding tool, but not a versatile estate planning strategy. **C.** **CORRECT**. A Section 529 college savings plan is both an excellent education funding tool, as well as a useful estate planning strategy. **D.** Incorrect. A prepaid college account is not effective as an estate planning strategy. *(See page 257 of the course material.)*

CHAPTER 12: ESTATE PLANNING IS MORE THAN TAXES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the importance of estate and succession planning.

A revolution occurred in estate planning.

Estate planning was in turmoil for more than a decade, but the tax law now is settled. The new rules and strategies are set, and for many people the best strategies are very different from those before the changes began.

The turmoil began with the 2001 tax law that made multiple changes over 10 years and then scheduled a reversion to the 2000 law. A 2010 deal in Washington prevented the reversion and temporarily eliminated the estate tax for most people. The 2010 law, with some modifications, became permanent in 2012. The turmoil in the law is over for at least a while, and with it the major excuse to procrastinate about estate planning.

Less than half of 1 percent of estates of adults who passed away in 2014 incurred the federal estate tax, estimated the Tax Policy Center. That's because each person has a lifetime $5 million lifetime estate and gift tax exemption that increases with inflation each year. The exemption for 2016 was $5.45 million. In addition, the new "portability rules" allow married couples a true doubling of the individual exclusion. A married couple can pass $10 million (indexed for inflation) to future generations free of estate and gift taxes.

Don't conclude from all this, as many have, that because you no longer have to worry about the federal estate tax, you don't have to worry about estate planning. Also, don't conclude that you don't have to consider taxes at all in your estate planning.

You still need a complete, up-to-date estate plan. Everyone does, regardless of the value of your estate. There are many nontax factors that always were an important part of each estate plan but were given less attention in the past because of the importance of estate taxes. Now, those other issues can receive the attention they should. Also, taxes other than the federal estate tax should be an important part of most plans, and you have to look at taxes differently.

A consequence of the 2012 law for most people is that income taxes are a higher burden than federal estate and gift taxes.

Because few estates will face a federal tax burden, now we can focus on the real issues of estate planning. Failure to have a plan or to have a quality, updated plan likely will lead to dissipation of much of your lifetime's wealth by forces other than federal estate taxes. A nonexistent or inadequate plan is an impediment to achieving your plans and goals for the wealth and often leads to family disputes and disharmony.

First, we'll discuss the nontax aspects of estate planning. Then, we'll review the estate tax and basic tax planning strategies to consider as part of your estate plan.

ESTATE PLANNING ESSENTIALS FOR EVERYONE

Tom Carvel and his 800 ice cream stores once were familiar to many Americans, especially those in the northeast region where Carvel's gravelly voice was featured in radio and television ads for the stores. In 1989, ill health forced Carvel to sell the business, and in 1990 he died. Carvel's estimated $200 million estate should have been as simple as a $200,000 estate. He wanted his widow taken care of, then the bulk of the estate donated to charity (they had no children).

Instead, Carvel made almost every possible estate planning mistake. The result was a disaster. Over a dozen lawyers representing many different interests kept the estate tied up in court. The estate dwindled to $60 million or less because of legal fees and other consequences of the litigation. Family members and business associates became estranged and accused each other of various dishonest acts. The whole mess should have ended in 1998 when Carvel's widow, living as a recluse in England, passed away. But her cremation was stopped by an attorney who wanted an autopsy to determine if she was mentally competent at the time of her death, and the disputes continued.

You don't have to be rich to make the mistakes Carvel made. For example, a copy of the will could not be found at the time of his death, and there were reports that the document shredder in Carvel's old office was very busy in the months after his death. The will mysteriously appeared about two years later, after an expensive lost-will court proceeding was concluded.

The problems with Carvel's estate, and thousands of other estates, weren't related to the tax law. There are many essential parts of an estate plan that need to be in place even when taxes aren't a factor. To avoid Carvel-like problems, there are key rules that should be followed in every estate plan.

Best Gift to Leave Your Heirs

When Tom Carvel died, his will was not in the filing cabinet that should have contained it. No one had a copy. In addition, his affairs were a web of corporations and other entities through which property frequently was passed. Paperwork for many of the transactions was incomplete. Carvel apparently kept everything straight in his head, but no one else could figure it out.

The best thing one can do for one's heirs is to organize your estate and leave a clear guide to the estate. The guide has two purposes. One purpose is to make things much easier and less expensive for loved ones. The other purpose is to avoid mistakes, such as overlooked or mismanaged assets.

The ideal way to provide this information is to fill a three-ring notebook with key documents. Yes, even in today's digital word, hard copy documentation is important. The first document would be an instruction letter that gives an overview of the estate and the steps that the executor or heirs should take right away. The alternative is to have survivors spend weeks or months pulling things together, or perhaps paying a lawyer to do so. At a minimum, the letter should identify who should be contacted, give the location of the will and other important documents, and describe funeral preferences.

The letter should be accompanied by copies of key estate and financial documents. Important documents in this package include:

- A list of legal and financial advisors, including the attorney, executor, accountant, insurance agent, bank, broker or financial planner, and financial institutions at which there are accounts.
- An inventory of assets, including a description of what is owned, where it is located, an estimate of its value, approximately when it was acquired, and its tax basis.
- Recommendations for the management or disposition of special property should be stated somewhere in the notebook. Items that warrant this treatment include business interests, real estate, art and collectibles, and any investments about which there is a strong personal attachment.
- Current tax returns plus regularly updated copies of the will, personal financial statements, and details of debts. Estimates of estate taxes and cash flow would be helpful.
- Details of financial accounts including Social Security, insurance, pensions, bank accounts, brokerage accounts, mutual funds, and any other assets. In most cases, a copy of a recent account statement is sufficient. Another option is to identify where the files for each of the accounts are located.

The notebook should be revised at least annually. The estate executor and at least one other person should be aware of the notebook and where it can be located. Remember that no matter how simple and straightforward things appear to an owner, they often are murky to someone who walks right into the situation and has to begin managing the estate. Make things easier for everyone by getting organized. Most people are surprised by what they learn through this organizing process, and it makes them better at managing their wealth.

ENSURING YOUR ESTATE PLAN ESSENTIALS

Every estate has a host of significant issues other than federal taxes that need to be addressed. To prepare you, here's a roadmap of the key issues for every estate plan. You'll be looking for solutions to each of them that meet your goals, resources, and other factors.

Medical Care

That's right. Medical care is a vital part of a good estate plan. The plan should define how your medical care and needs will be addressed in different circumstances.

First, you'll need documents that provide which decisions will be made and who will make them in case you aren't able to. That means you need a medical power of attorney or medical care directive and perhaps a living will. You also should consider if you want documents such as do-not-resuscitate and do-not-hospitalize orders. You need to focus on both the terms and scope of the documents and, especially with the power of attorney, selecting the person or people to make decisions.

The financial aspect of your medical care also should be covered. Be sure you have adequate insurance or resources to cover most types of medical care. This is discussed in detail in Chapters 6 and 7. Be sure your executor, your spouse, and perhaps others know about your insurance and where to find the details.

Avoiding Disputes

It doesn't matter how much or how little wealth you have. When an estate owner doesn't develop a plan, conflict and chaos often follow. Children, even adult children, can fight over how assets are divided and managed. The presence of a second spouse or other players can make the conflicts worse.

You shouldn't be content with thinking "the kids can work it out." Any estate planner will tell you they often don't. Even when an estate doesn't seem to be worth much, there's a need to clearly state how you want it divided and handled. In most families, there's usually at least one person who'll look for something to fight about with the others if you leave an opening. Almost every estate planner can tell you stories of families spending far more on legal fees than an item or estate was worth.

Consider the possible sources of conflict in your estate. Then, work with your estate planner to develop strategies to minimize or eliminate the conflicts.

Probate

You might not be worried about estate taxes, but the probate process can cost a lot of money and delay settlement of your estate. Probate is the system that ensures your debts are paid, your assets are distributed how you intended, and heirs have clear legal title to assets. Some states have a streamlined and less expensive process, at least for smaller estates, under the Uniform Probate Code. But a number of states still use an older, expensive, cumbersome process. You need to find out which type of state you live in and what would be involved in probating your estate.

When the state has an unattractive probate process, consider avoiding the probate process and how to do it. You can use a living trust, partnerships, limited liability companies, joint title, and other tools. Each has advantages and disadvantages. Discuss them with an estate planner to select the best tools for you.

When you live in or have property in more than one state, the processes of both states must be considered. The bulk of your estate will be governed by the state in which you are resident or domiciled, and any real estate will be controlled by the state where it's located. To avoid probate in two states, you might want out-of-state real estate owned through a trust or limited liability company instead of in your name.

Beneficiary Forms

IRAs, annuities, employer retirement plans, life insurance, and some other assets aren't affected by your will. They are inherited by whoever's named in the beneficiary designation forms. Be sure these forms in both your records and those of the firm sponsoring the asset reflect your current wishes. If you don't do anything else toward estate planning, take this easy step.

Care of Others

You might be helping or anticipate having to help a relative or other person. It might be an elderly parent or other relative. It could be a child or grandchild that has needs. If so, you probably want to develop a plan to ensure he or she has help when it's needed. That might mean buying life insurance or establishing a trust for their benefit.

Asset Management

You're probably managing your investments and other assets well. You're following good advice. You probably also determined who you want to inherit and benefit from the investment portfolio and other assets next. But who will manage the portfolio? Is your surviving spouse or other member of your family capable? Do they have the knowledge and skills to manage your assets and make them last a long time? Have you even discussed this with them?

If not, you need a plan.

One option is to lift the burden from the loved ones, just as you have for years. Plan to have one or more money managers invest the assets.

If that's your plan, find an investment manager now. Don't expect loved ones who don't know how to manage money to be able to select a good money manager.

You can test drive managers by giving one or more managers a portion of your portfolio to manage now. That lets you see not only how they perform but how well they communicate and provide customer service. They'll be in place for you to examine, and over time you can let your spouse or other heirs know that you believe the manager is good and that they should continue to use the firm's services when they inherit the portfolio. If it's the wrong manager, you'll find out soon and be able to make another choice.

Succession

When you own business interests, real estate, or complicated assets such as a collection, succession planning is a must. Look for someone in your family who's able and interested in continuing management of the assets. Then, plan the transition in management and ownership. Don't wait. With businesses and complicated assets, it often takes five years or more of planning for a succession to be successful.

When there's no suitable management successor in the family, you might look for one or more associates who can continue management. They might want to buy the business from the estate or be willing to manage it while family members continue ownership. Or you should develop a plan for how the asset will be sold and the proceeds distributed to your loved ones.

You need to develop a plan of succession or sale now. Too often, when a plan isn't in place the value of the asset isn't maintained during the transition. The estate doesn't receive the full value the business once had. Sometimes the entire value of the asset dissipates.

You might have other issues to address, but these are the most common nontax estate planning issues. Some of these you might be able to resolve on your own. But it's best to meet with an experienced estate planner and discuss the goals and ambitions for your wealth, family, and the rest of your life. Then, you can identify the issues and develop a plan.

WRITING A BETTER WILL

A will is not an estate plan, but your estate plan should include a will. Here are some key provisions of wills and the planning process that often are overlooked and can make a big difference in the results of an estate plan.

Estate Liquidity

Estate liquidity is often overlooked but vital. An estate might be valuable, but it also needs cash to pay taxes, debts, and other expenses. If there will be a cash shortage, the owner needs to provide life insurance or a schedule of which assets are to be sold first to raise cash. In some wills, the executor is empowered to take out a mortgage on one or more properties to raise cash.

Specific Bequests

Avoid specific bequests in a will. A specific bequest is when a certain amount of money or particular assets are designated for an individual. Specific bequests can complicate the estate and cause unintended problems. In Tom Carvel's will, 83 people were left relatively small cash gifts. Most of these were former employees who could have been given bonuses after the business was sold. Instead, the gifts increased the size of the will and the cost of administering the estate. They also greatly increased the number of people involved in the will contest and the amount of cash the estate needed.

Specific bequests can create other problems. A specific dollar amount might seem small when the will is written. But the value of other assets might fall in a market decline, or there might be unexpected taxes and other expenses. That cash gift suddenly is a bigger part of the estate than was intended. The gift also might use up scarce cash that is needed for taxes and debts.

A specific property bequest also can have unintended consequences. Suppose a few hundred shares of stock are left to an individual. Over time, however, the market likes the stock and it soars in value. This small gift becomes a meaningful part of the estate, and it is going to someone who was supposed to be a minor beneficiary. Or the stock could drop in value, leaving the beneficiary feeling slighted and with less than intended. Or the owner might sell the stock after the will is written. Then, the will has to be rewritten or amended, or the executor can be left to figure out what was intended for the beneficiary. Of course, an asset left in a specific bequest might disappear, creating a number of problems.

Small gifts generally should be made during the owner's lifetime. If they are made in a will, there should be some limits. For example, a cash gift can be made through a formula, such as for a specific amount but only up to a certain percentage of the estate's value or its liquid assets. Likewise, a gift of specific property should be limited to a ceiling value or percentage of the estate and only for assets that you're sure you won't sell. But the best bet is to make specific bequests only of unique items, and specify that they be part of the residual estate so they won't come out of the estate first.

Debts and Taxes

Debts and taxes require careful consideration. Without the correct, technical wording, some beneficiaries of an estate might receive their bequests without making any contribution to the estate's taxes and debts. The main beneficiaries shoulder the tax and debt burden through their shares. It is a technical issue, but the owner should be aware of who will bear the burden of the taxes and debts.

Personal Property

Distributing personal property can be the most difficult part of a will. Oddly enough, it is the personal items, even seemingly insignificant ones, which bring out rivalries among the survivors and cause the most disagreements. There should be a plan in the will for dividing the personal property. There are several tried and true methods for doing this with a minimum of distress among heirs.

One option is to have the executor divide the property. A non-family member should be executor for this to work. Or the executor can be directed to sell everything and distribute the cash. Another option is to set up a lottery. The oldest child (or the one who picks the lowest number out of a hat) picks an item first. Then the others pick one item in order. For the next round of picks, the order is reversed. Another method is to have the children pick the items they would like while the parents are alive. The children attach their names to the items. These are just a few ideas.

Changing Circumstances

A final point in estate planning is to expect change. An estate plan is not a one-time event. It needs to be updated whenever there is a change in the personal or family situation. A marriage, divorce, or birth in the family should trigger an appointment with the estate planning lawyer. Significant changes in the estate's property or value also should cause reconsideration of the plan. Even when there are no obvious changes, a lawyer should be contacted for a review every 18 months to three years.

THE ESTATE TAX

The basic outline and computation of the federal estate tax is fairly simple. Your executor compiles a list of all your assets and their values. That is your gross estate. Then a few deductions might be subtracted to arrive at your taxable estate. Your lifetime taxable gifts are added to the taxable estate, because the estate and gift taxes are considered a uniform wealth transfer tax. In other words, you should pay the same tax whether you give property away during your lifetime or after your death. Then the tentative tax on both your final estate and your lifetime gifts is computed. After computing the tentative tax, gift taxes paid during your lifetime are subtracted.

Next, the remaining tax is reduced by the amount of your lifetime estate and gift tax credit. Everyone gets an estate and gift tax credit. The current level of the credit is what exempts most estates from the federal estate tax. Note that since the estate and gift tax are unified, you can use all or part of the credit during your lifetime to make tax-free gifts, and that reduces the amount of credit available to your estate. If you used all or part of the credit to reduce lifetime gift taxes, the amount of the credit that was used is not available to reduce estate taxes.

As I said, in the 2012 law, the lifetime estate tax credit was raised so it shelters an estate worth up to $5 million per person. That amount is indexed for inflation and was set at $5.45 million for 2016. The maximum estate tax rate is 40 percent. There also is generation skipping transfer tax imposed on transfers directly from grandparents to grandchildren or later generations, and it has the same exemption and tax rate as the estate tax.

You can see in the outline of the estate tax in the paragraphs above how the estate and gift taxes are unified. Your lifetime taxable gifts are added to the gross estate to determine the estate tax. Then, the gift taxes you actually paid during your lifetime are subtracted from the tax payable. Finally, the remaining amount of your estate and gift tax credit is used to reduce the tax payable.

This computation should reveal several basic ways to reduce estate taxes. All estate tax reduction planning falls into one or more of these strategies:

- Remove assets from the gross estate or reduce the value placed on assets in the estate.
- Maximize use of the marital deduction and charitable contribution deduction.
- Use the lifetime estate and gift tax credit.
- Don't reduce taxes. Instead, buy life insurance to pay the taxes or provide an inheritance.

Understanding the New Portability

A new feature was introduced in the estate tax in 2010 and remained in the 2012 law. Estate planners call this feature portability or portable credits. It allows married couples to have a joint lifetime exemption equal to two individual lifetime exemptions, because any unused lifetime estate and gift tax credit of the first spouse to pass away can be transferred to the surviving spouse.

Previously, the lifetime estate tax exemption was available only to the individual. It had a use-it-or-lose-it feature. Any exemption amount not used by your estate and your lifetime gifts was lost. To maximize tax savings and avoid losing a credit, it was important for married couples with substantial assets to split title to their assets so that each had an estate of roughly equal value—or at least equal to the lifetime exemption.

Now, a surviving spouse may take the unused exemption amount of the first spouse that passed away and add it to his or her own. It works like this. The estate of the first spouse to pass away is exempt from estate taxes up to $5.45 million in 2016. If that spouse's taxable estate was worth less than $5.45 million, the unused exemption amount transfers to the surviving spouse. When the survivor eventually passes away, he or she can exempt more than $5.45 million of assets by using his or her own exemption plus the unused exemption of the deceased spouse. Together they're sure of exempting up to $10.9 million in 2016.

Consider Max and Rosie Profits with a net worth of $8 million, $6 million in Max's name and $2 million in Rosie's name. Rosie passes away in 2016. Before 2010, her estate would be exempt from taxes, but her unused exempt amount would be lost. Max and Rosie would have been advised to ensure Rosie had legal title to at least the lifetime exempt amount or equal to what Max owned.

Under current law, however, Rosie's estate still is exempt, but that unused estate tax exemption of $3.45 million ($5.45 million [the maximum allowable asset exemption] minus the $2 million that is Rosie's actual net worth) can be transferred to Max. His estate will have both his own exemption of $5.45 million in 2016 plus Rosie's unused $3.45 million exemption, for a total of $8.9 million. Max's exempt amount is increased for inflation each year he lives after 2016, but Rosie's unused amount that carried over to Max is fixed at $3.45 million. It doesn't increase for inflation after Rosie passes away.

To secure the portability of the first spouse's unused exemption, the estate executor must follow IRS rules. In particular, the estate of the first spouse to pass away must file an estate tax return, even if the estate is exempt from filing a return because no tax is due. The return must be filed within nine months of the date of death, though a six-month extension is available. If the executor fails to file a return or misses the deadline, there is no portability and the unused exemption is lost. The executor when filing the return can elect not to allow portability if for some reason you want that or he decides that's best. If an estate tax return is filed but doesn't take a position on the transfer of the unused credit, then it is treated as though the executor elected to transfer the unused credit.

It's important that you name an executor who knows to file an estate tax return, even when one is not required in order for your unused exemption to be portable for your surviving spouse. Filing an estate tax return should be automatic now for someone who was married, regardless of the estate's value. (Some advisors say that couples should consider forgoing the exemption in order to avoid filing an estate tax return. If a return is filed, the IRS might audit it and find some estate or gift taxes are due.)

When the surviving spouse had more than one deceased spouse over his or her lifetime, only the exemption of the last deceased spouse can be used. Here's how that rule works.

Example

Rosie Profits dies, leaving her surviving husband, Max. Rosie had a previous husband who passed away and his estate used only $3 million of his exemption. So, Rosie's estate can exempt $7 million (her $5 million exclusion amount plus the unused $2 million exclusion amount from her first husband). Rosie didn't make any taxable gifts during her lifetime and has a taxable estate of $3 million. Rosie's estate elects to let Max use Rosie's unused exclusion amount, which is $4 million (Rosie's $7 million exemption less her $3 million taxable estate). So, Max's exclusion is increased by $4 million and is $9 million if none of his exclusion was used by taxable gifts. (All these numbers use the basic $5 million exemption without inflation indexing, to keep the example simple.)

A price of portability for the estate of the first spouse to pass away is subject to audit until the audit period for the second spouse to pass away has closed. Also, the carried-over exempt amount from the first spouse to pass away is not indexed for inflation. It's a fixed dollar amount, regardless of how long the surviving spouse lives.

It's a good idea for most estates to take the election, even when the surviving spouse's exemption seems more than sufficient, because the surviving spouse could receive a windfall at some point or could live a long time and have assets appreciate.

THE 20-MINUTE ESTATE PLAN

For most of us, estate planning still should be a key part of our financial planning. We must continue to plan our estates even when there is little risk of owing the federal estate tax.

Estate planning is easier than most people believe. That's because most estate planning experts shroud the topic in complex tax, legal, and insurance jargon. Most people can't get interested in discussions of probate, reversionary interests, split interest trusts, and related topics. Maybe the experts want to add some mystery to the process, or perhaps they don't know how to communicate in plain English. The reasons don't really matter. What matters is that most presentations on estate planning cause people either to avoid planning their estates or to put together hurried, inadequate estate plans.

That's why I've put together this simple guide I call the 20-Minute Estate Plan. It builds on what I already presented and provides straightforward, practical steps that will help an individual put together an estate plan. This isn't a complete self-help guide. Meetings with an estate planner still are essential. The guide makes it easier to work intelligently and economically with an estate planner and to make informed decisions about the various options. That will save time, money, and frustration, and also result in a superior estate plan.

Estate Planning Basics

What is estate planning? It's not simply avoiding taxes or probate. Estate planning is deciding how wealth should be transferred to the next generation (or other recipients of the owner's choice), then determining which legal tools to use to transfer that wealth. Only after establishing how the assets should be distributed does the focus move to considering ways to reduce taxes, avoid probate, and other goals. Lawyers and other professionals like to call the process estate planning, but it really is best to think of it as inheritance planning. That puts the true purpose of the process in the forefront.

To begin the inheritance planning process, take the following steps.

Make a List of All Assets and Liabilities

An effective inheritance plan cannot be prepared without this information. And a professional, no matter how skilled, can't do anything without this starting point. Frequently overlooked assets include pension plans, life insurance policies, trusts of which the estate owner is a beneficiary, and inheritances that are likely to be received. Heirs will inherit only net assets, so a list of all debts needs to be compiled, including whether the debts are secured by certain property.

Decide the Desired Distribution of the Assets in the Future

The traditional goal is for major assets to be inherited first by the spouse if he or she still is alive, then by the children, usually in equal shares. Smaller amounts or specific items might be designated for special friends, other relatives, and charities. Of course, no one has to follow the traditional route. An owner might want to favor one child over others or want the bulk of the estate to go directly to the children instead of his or her spouse. Many people decide to give a portion of their estates to charity. The only major limits are that a spouse cannot be completely disinherited in most states (unless there is a valid prenuptial or postnuptial agreement) and children can be completely disinherited if the intention is made clear in the will. In addition, an inheritance cannot violate law or public policy.

As part of this step, secondary goals also should be considered. For example, should a spouse inherit everything but only in a way that prevents the property from being subsequently inherited by a second spouse or family (or previous family) instead of by your children? Should property be left to children and grandchildren but with strings attached so that they don't waste the property or so they have to reach certain goals before getting the property? There often are ways of accomplishing both main and secondary goals, as long as the goals are clear.

Decide How Much Property Should Be Given Now, and How Much Later

People often prefer to give some of their wealth while they are alive. There are several potential benefits. If estate taxes are an issue, giving early ensures the assets are out of the gross estate. You also have the benefit of seeing how the wealth is used and benefits the lives of loved ones. Some people use early gifts as a way of testing how their loved ones will handle the wealth. If they believe the wealth is wasted or not used well, they will consider changing either how much they leave someone in the will or give it but with some controls or limits.

Work with One or More Estate Planning Professionals to Develop an Estate Plan

The plan should achieve the desired goals and also take into account estate taxes, probate, and other concerns. An average middle class individual might need to work only with an estate planning attorney. Wealthier individuals and those with businesses or other complicated assets might need to add an accountant, life insurance agent, business appraiser, trustees, and other professionals.

Implement the Estate Plan after It Is Fully Understood

That sounds obvious, but apparently it isn't. Many people have great estate plans designed by skilled professionals, but then they fail to fully implement the plans. They don't set up trusts recommended by their planners or fail to transfer assets to the trusts. Maybe life insurance is not purchased as planned, annual gifts to children are not made, or other steps aren't taken. The result is a lot of time and money spent on estate planning but no effective estate plan in place.

Let Heirs Know in General What Is Decided and How Things Are Set Up

An estate owner also should draft a letter of instructions as described earlier that lists basic information such as where copies of the will are kept, who the financial advisers are, and a summary of assets and liabilities. This document should be updated at least annually and be accompanied by recent tax returns and an outline of your estate plan, at the minimum. The letter should be given to the executor of the estate and to any other key people.

An inheritance plan really involves people more than law, life insurance, trusts, and other legal tools. The focus should be on how to provide for people both now and in the future, and also how one wants to be remembered.

Cutting Off the IRS

I previously listed the four basic strategies for reducing estate taxes: reducing asset from the gross estate, removing future appreciation from the gross estate, increasing deductions, and buying life insurance. Within those four strategies are many options. Not all will be appropriate for you. You decide which are best for you by working with your estate planner.

If your estate plan was in place before 2013, and certainly if it was created before 2010, you need to revise it or at least have an estate planner review it carefully. Here are a few of the more important potential changes:

- *Wills with bypass trusts need to be reconsidered.* Fewer families will need them now, because of the higher estate tax exemption. There still are cases when a bypass trust should be considered as part of an estate plan, but in many cases, the bypass trust could produce results you don't want under the current law.
- *Formulas in wills need to be rewritten when they determine the amount of an estate transferred to a bypass trust or when for any reason they refer to the estate tax exemption amount.* Under traditional formulas, the $5 million exemption will use all or the bulk of most estates. Many surviving spouses will be impoverished under wills in place before the law changed. If your estate plan has a bypass trust or formula clause, you need to visit an estate planner soon.
- *Don't forget state levies.* About 20 states have some form of estate or inheritance tax or both. Often these have much lower exemptions than federal law and will be a more significant burden on your heirs. You might want to revise your will primarily to avoid these taxes. Residents of the states with estate or inheritance taxes might need to do significant estate tax planning even when they will owe no federal estate taxes.
- *Make tax-free gifts.* The wealthy or near-wealthy who have enough assets to pay for retirement should consider removing appreciating assets from their estates. You want to remove future appreciation from your estate, especially when the assets are appreciating faster than the Consumer Price Index. Otherwise, you take the risk your future estate will be taxable or more of it would be taxable than would be now. You transfer more wealth tax free to heirs when you give property before it appreciates, especially when you can make those transfers free of gift taxes. Even those with modest estates might want to make gifts when they live in states with high estate or inheritance taxes and they have enough to maintain their standard of living.

- *Income shifting is back.* With the higher lifetime exemption, you can transfer a lot of income-generating assets or property with large capital gains free of gift taxes to family members. When they family members are in a lower tax bracket than you, this keeps more after-tax wealth in the family.

- *Use irrevocable trusts.* Property that is transferred during life to an irrevocable trust is excluded from the gross estate. The transferor cannot be a beneficiary of the trust or be able to get the property back. There might be gift taxes owed when the trust is set up, but that should be cheaper than paying estate taxes down the road. If a goal is to avoid gift taxes, just enough property can be put in the trust each year to take advantage of the annual gift tax exemption. An irrevocable trust has the additional benefit of allowing the donor to make the gifts with strings attached. Those strings might protect heirs from themselves and also from being spoiled or otherwise damaged by an inheritance.

- *Buy life insurance to pay taxes or provide an inheritance.* Life insurance is a way to leave an inheritance without altering the ownership of other assets. It is possible that the insurance can provide a larger inheritance than otherwise would be available, especially if a married couple takes out a joint life or survivorship life insurance policy. Life insurance benefits are included in an estate only if the insured had any ownership interests in the policy. Life insurance can be excluded from an estate if the policy is owned either by an irrevocable trust, a limited partnership, or another individual, such as the children.

- *Give to both charity and heirs.* There are various strategies, such as charitable remainder trusts and charitable lead trusts, which allow an estate or a property owner to take advantage of the charitable contribution deduction while providing income or property to heirs for a period of years.

- *Use gift tax discounts.* There are strategies that allow you to give all or part of a property away but also pay gift taxes on only a portion of the value. This is known as a discount gift tax strategy, and discounts of 20 percent and higher are available. Discounts might be possible using family limited partnerships, split interest trusts and a few other strategies for reducing gift taxes.

THE TURNABOUT IN TAX PLANNING

Most of us don't have to worry about federal estate taxes. Yet, taxes still should figure in your estate plan as much as ever. Instead of focusing primarily on federal estate taxes, your tax planning should focus on two other areas. First, you need to focus on reducing federal capital gains and income taxes over the long term. Second, you also need to focus on reducing state taxes on income, capital gains, estates, and inheritances.

Here's the key issue now. When property is included in your estate, most of the time the tax basis of the property is increased to its current fair market value. For example, let's say you purchased mutual fund shares for $10,000 years ago and they now are worth $20,000. If you sell today, you'll pay capital gains taxes on that $10,000 gain. If you give the property to your children to remove it from your estate, which used to be the recommended strategy, they'll take the same $10,000 tax basis you had and eventually have to pay capital gains taxes on that gain and any additional gain when they sell.

Continue to hold the fund shares, however, and they'll be included in your estate. The tax basis will increase to their fair market value at that time. The estate or your heirs who inherit can sell the shares immediately and owe no capital gains taxes. Your loved ones will receive the full value of the shares, not an after-tax value. Or they can continue to hold the shares. Eventually when they sell, they'll owe capital gains taxes only on the appreciation that occurred while they owned the shares.

Bottom line: The longtime rule to remove assets from the estate through direct gifts or transfers to trusts might not be the best advice today. It might be better to hold appreciated and appreciating assets. You'll avoid federal estate taxes unless your estate is very valuable, and you and your heirs will avoid capital gains taxes on the appreciation.

That's why your estate's tax planning strategy should consider all the taxes that might be imposed on an asset. There is the federal capital gains tax, plus any similar tax your state imposes. There also are the stealth and add-on taxes that increase as income rises, including the 3.8 percent net investment income tax and Medicare premium surtax, taxation of Social Security benefits, reductions in itemized deductions and personal exemptions, and the alternative minimum tax. All of these might be avoided by your family when you hold appreciated assets and have them included in your estate. Then, the heirs can sell them at no tax cost.

Even wealthy people who might have part of their estates subject to the federal estate tax should reconsider the extent to which they want to remove assets from their estates. These other taxes cumulatively could total more than the maximum 40 percent federal estate tax, especially if your state doesn't have its own version of the estate tax.

Holding assets in the estate isn't the ideal strategy in every case. If your state is one of the 20 or so plus the District of Columbia (as of 2015) that has some form of estate or inheritance tax or both, you need to compare the tax from holding the asset in your estate to the income tax that would be owed if you transferred the asset now to a loved one. Remember to consider the income tax rate your beneficiary would pay, not that you would pay. For example, if you live in a state with an estate or inheritance tax but your children live in a state without an income or capital gains tax, your family might save money by giving appreciated property to them now instead of holding it in your estate.

You can see that tax planning is more complicated now. Sometimes the right move is intuitive or obvious. Other times, some careful calculations need to be made. You need to evaluate each of the potential taxes that would fall on each asset before deciding whether or not to give property now or hold it.

Here are some general rules:

- Prime candidates to be held in your estate are appreciated investments and your personal residence.
- Depreciated investment properties and business real estate also would avoid income and capital gains taxes by remaining in your estate.

- Appreciated art, gold, and collectibles are likely to be worth holding in the estate because they are subject to a higher maximum capital gains rate—28 percent—than most other assets.
- Any patents, trademarks, and copyrights created by you also are good to hold in the estate, because your tax basis is likely to be zero but a beneficiary of the estate can increase the basis.

On the other hand, there's no tax reason to hold cash. Also, variable annuities and qualified retirement plans (including IRAs and 401(k)s) don't receive an increased basis after the owner's death. All the distributions will be treated as ordinary income whether taken by you or your beneficiary. You might save money by paying those taxes now instead of later.

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CHAPTER 12: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Married couples are allowed to pass ___________ (indexed for inflation) to future generations free of estate and gift taxes.** **A.** \$5 million **B.** \$10 million **C.** \$15 million **D.** \$20 million
2.	**Which of the following is the best option when the person that an individual wants to leave their estate to might not be up to the task of managing the assets properly:** **A.** leave everything to charity **B.** let the survivors figure it out **C.** test out investment managers before the individual passes **D.** assign an investment manager randomly
3.	**Which of the following is <u>not</u> a recommendation for writing a strong will:** **A.** be aware of who will shoulder the tax burden **B.** have a plan in place to provide for estate liquidity if needed **C.** include specific bequests in the will **D.** revisit the will periodically to see if circumstances have changed

4.	**Which of the following is an estate tax reduction strategy:** **A.** remove assets from the gross estate **B.** use the lifetime estate and gift tax credit **C.** maximize use of the marital deduction **D.** all of the above

CHAPTER 12: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. For a single person, the amount is \$5 million (indexed for inflation). **B.** CORRECT. The new "portability rules" allow married couples a true doubling of the individual exclusion. A married couple can pass \$10 million (indexed for inflation) to future generations free of estate and gift taxes. **C.** Incorrect. The amount is less than \$15 million. **D.** Incorrect. \$20 million is twice the amount of the allowable exclusion for married couples. *(See page 273 of the course material.)*
2.	**A.** Incorrect. If the goal is leaving the assets to a specific individual, then changing the will to give everything to charity does not accomplish that goal. **B.** Incorrect. Letting the survivors figure things out on their own is not sound estate planning advice. More often than not, this leads to problems that could have been easily avoided if the individual had a plan in place before they passed. **C.** CORRECT. If an individual feels that the heirs may not be up to handling the assets properly, the best solution is to test out managers while they are living. Managers can be given a portion of the portfolio to manage to see how they do. This way the heirs do not have the added pressure of having to manage assets that they are unprepared for. **D.** Incorrect. Although assigning a manager at random may work out, it is equally likely that it won't. The better option is to test the managers prior to passing. *(See page 277 of the course material.)*
3.	**A.** Incorrect. Without the correct, technical wording, some beneficiaries of an estate might receive their bequests without making any contribution to the estate's taxes and debts. The main beneficiaries should shoulder the tax and debt burden through their shares. **B.** Incorrect. Estate liquidity is often overlooked but vital. The estate should have a plan detailing the steps that an executor should take if liquidity is required for the estate. **C.** CORRECT. Avoid specific bequests in a will. Specific bequests can complicate the estate and cause unintended problems. **D.** Incorrect. Even when there are no obvious changes, and especially when there are obvious changes, a lawyer should be contacted for a review every 18 months to 3 years. *(See pages 278 to 279 of the course material.)*

4.	**A.** Incorrect. Although not the only correct selection, removing assets from the gross estate or reducing the value placed on assets in the estate is a good estate tax reduction strategy. **B.** Incorrect. Using the lifetime estate and gift tax credit is an estate tax reduction strategy. However, it is not the only correct option. **C.** Incorrect. Maximizing use of the marital deduction and charitable contribution deduction is an effective estate tax reduction strategy, but it is not the only correct selection. **D.** **CORRECT**. An effective estate tax reduction strategy includes removing assets from the gross estate, using the lifetime estate and gift tax credit, and maximizing the use of the marital deduction. *(See page 280 of the course material.)*

CHAPTER 13: AVOIDING FINANCIAL SCAMS AND ABUSE

Chapter Objective

After completing this chapter, you should be able to:

- Recognize red flags that can lead to financial abuse.

The world is rife with financial scams and abuse, and you're a target. Those are facts we all need to acknowledge. Unfortunately, many people don't know enough about the world of financial scams, to their detriment. Even people who think they know the facts of financial fraud and abuse don't, especially those most likely to be targets. You need to understand financial fraud and abuse and take precautions before it is a problem for you or those you care about.

Most people don't even realize when they've been targeted for or subjected to fraud and abuse, according to a 2015 survey done for FINRA, the Financial Industry Regulatory Authority. The survey asked people if they'd ever been defrauded or targeted for fraud, and most answered in the negative. But the survey also asked people if they'd ever been approached about or participated in certain types of financial transactions, and 84 percent said they had. The financial transactions described in the questions were classic and widespread scams and frauds. That means most people, 84 percent, were targeted for fraud or abuse and didn't realize it.

Several key factors make a person more likely to be a target of fraud and abuse.

Age, of course, makes one a target. That's partly because as people age they tend to become more trusting and optimistic. They're more likely to believe the best results will occur from actions, and that makes them vulnerable to sales pitches.

In addition, cognitive skills diminish as we age. Our "executive thinking" skills peak as early as age 35 or 40 according to some research. After that, we're less effective at critical thinking and cognitive reasoning, or at least when trying to exercise those tasks quickly. Having diminished cognitive skills doesn't mean someone is suffering from dementia or other illnesses. It means they don't analyze and reason as well as they once did, especially when they try to make decisions quickly. Other research shows older people actually make better financial decisions but only when they use wisdom and experience to make good decisions by taking the time to analyze a question in detail.

That's why it is important to take the time to carefully and thoroughly consider important financial and nonfinancial decisions and seek input and opinions from others. You should assume you might be missing one or two things on the first review and "sleep on it." You also should encourage friends and relatives to make decisions more deliberately, so they aren't defrauded.

As you might guess from the FINRA survey, most fraud victims aren't aware of what are known as the badges of fraud. These are the factors that indicate a proposal is likely to be a scam or fraud. For example, most people don't know the levels of investment returns that are realistic or that very few investments are guaranteed. Those are just a couple of the badges of fraud most people can't identify.

Other traits are common among fraud victims. They are likely to believe they can tolerate more risk than others (a trait more common among males and higher educated people). They also are less likely to seek advice from friends and family, often because they're afraid asking for input will make them appear unable to make decisions or handle their finances. In fact, seeking advice from people who care about you is a sign of good decision making.

Of course, having some money also makes one a target, but you don't have to be wealthy. Anyone who has a few thousand dollars or more in liquid assets is an attractive target to many crooks.

COMPARING FRAUD AND ABUSE

You need to understand financial abuse is different from fraud, and people are more likely to suffer financial abuse than fraud. Though a somewhat nebulous concept, financial abuse is when someone makes improper or illegal use of your property, money, or assets. It can include identity theft, using checks or credit cards without permission, and misusing or stealing property. It also can include inducing someone to sign a document as well as improperly using a power of attorney, guardianship, or conservatorship.

The key mistake many people make is not realizing perpetrators of financial abuse are highly likely to be people known to and trusted by the victim. When asked about financial abuse, most people say it is likely to be committed by strangers and the greatest threats are from Internet and mail scams or telephone solicitations. In fact, family members or professional advisors are believed to commit about 90 percent of cases of financial abuse.

Financial abuse is most likely to occur when two factors are present. One factor is disability or cognitive decline. The other factor is social isolation. This doesn't mean someone is physically isolated. It means they have significant contact with fewer people and don't spend as much time as they used to with family, neighbors, church members, or whoever else was in their social network for years. It also could mean they never did have much of a social network and have a smaller one now. The abusers tend to isolate people so that others can't learn what is happening to or influence the victims.

Of course, not everyone who is disabled or has cognitive decline is abused. But they are common factors in abuse cases.

Also, an abuser often has some kind of mental or emotional problem. It might be as simple as someone being overwhelmed at being a caregiver or who feels entitled to take advantage of the person. For example, a family member caregiver might conclude that performing the care entitles him or her to make personal use of the victim's car or other possessions without asking or paying for them.

Often, the only help for a victim of abuse is someone else noticing a problem. That's why it is important for all of us to know the factors that can lead to financial fraud or abuse and the signs abuse might be occurring.

You should keep track of friends, family members, and others you know for the warning signs of cognitive decline and social isolation. Social isolation is easy to identify and try to correct. When someone appears to drop out of the social network, try to call or visit the person. If a caregiver or other person acts as a gatekeeper and appears to be isolating the person, there could be a problem.

Also, be alert for changes in spending or investment patterns, erratic or unusual transactions (such as large cash withdrawals), lack of knowledge about personal financial matters or a reluctance to discuss them, and giving a power of attorney to a new person. Unusual fear of or submission to a caregiver also is a warning sign. You can find a checklist of these and other red flags of financial abuse at www.allianzlife.com/sos.

After seeing one or more warning signs, you don't have to investigate or solve the problem. Instead, if you know one or more family members who have been close to the person, you can contact them and express your concerns. Even better, you can report a concern anonymously to local Adult Protective Services, or the long-term care ombudsman if the person is in a nursing home or assisted living. In most states, the report is anonymous by law. The state will look into the details and there won't be consequences to you if it's a false alarm. People are encouraged to report potential abuse if they have only a suspicion. There's no downside to reporting a suspicion, and you could save someone from abuse.

PROTECTING YOURSELF FROM SCAMS AND ABUSE

Fortunately, you can take steps to reduce your risk, and many of these steps are very easy to do and cost little or no money.

One easy step is to be alert for key promises and actions that are markers of scams and abuse.

Guaranteed high returns are a definite red flag. It is rare that a legitimate investment offers a guaranteed return. Legitimate guaranteed returns are low. An investment doesn't need to be guaranteed to be suspicious. When the seller says the investment has high potential returns with very low risk, he's likely not being honest. You should be aware of the level of current interest rates on Treasury bonds. All others investment returns spring from the return on these riskless investments. It isn't likely that a legitimate investment can offer substantially higher returns and still be guaranteed or low risk.

Complicated investments or presentations also are warning signs. If you're a sophisticated investor who's using a team to evaluate investments with high minimum investment levels, you might expect to see some complicated deals. Otherwise, complicated strategies, terms, or presentations most likely are used to hide problems with investments. Con artists know that many people, especially as they get older, are embarrassed to admit they don't understand something and are more likely to go along with it.

Someone presenting a legitimate complicated financial offer will know that it is complicated and be prepared to take the time and effort to explain it in detail. When someone presenting a complicated investment isn't willing to answer clearly all your questions and provide the details, that's a red flag.

Urgency is another red flag. There are very few legitimate financial transactions or investments with short deadlines to act. Often, pressure to act quickly is a tool to prevent you from considering all aspects or reviewing it with others.

Don't invest in or buy anything with inadequate disclosure. Anything that meets the legal definition of a security must have a detailed prospectus. Insurance products also are required to provide significant details under state laws. When all you're given are a few brochures and flyers, you should be suspicious. The less information you're given, the more likely it is that the proposal isn't legitimate.

The fastest and easiest way to avoid fraud and abuse is to add more people to your financial team. One simple, effective step is to have more people regularly see your financial statements. There's usually little or no cost to having others mailed copies of your statements or given online access to the statements.

Good candidates for seeing your statements include responsible adult children or siblings, close friends, and professional advisors, such as accountants and estate planners. Their job is to look for unusual transactions, such as large expenditures, new investments, a new pattern of expenses, and similar suspicious activities.

One really good use of a financial team member is as a reviewer and sounding board for making decisions.

For example, an easy, effective way to avoid scams and abuse is to tell anyone who asks for money or proposes an investment to make their case to your advisor or advisors. It might be an accountant, attorney, money manager, or broker. The professional likely will charge an hourly rate for this, but scamsters usually reveal themselves by not following up with your advisor. You even can use a friend or relative who's fairly sophisticated financially and is willing to play the role.

The team approach also is a good way to avoid having one financial advisor take advantage of you through bad deals or excess fees. Make sure all your advisors know who your other advisors are and let each of them know whenever you're contemplating a significant move.

Regular reviews of your finances with each of your advisors or even with a trusted confidante or friend also prevent problems. A team approach also tips you off to someone whose motives are not the best. If someone who's giving you financial advice objects to sharing information or including others in meetings, you should be concerned.

Trusts and powers of attorney also can avoid a lot of problems when the right people are in charge. Likewise, having someone manage or co-manage your money can prevent a lot of problems.

Another way to avoid scams is to minimize what security experts call *pocket litter*, the items you carry around that give valuable information to crooks.

Many people keep significant personal information in their wallets, purses, cell phones, computers, and elsewhere. Experienced criminals who gain access to these items, even if for only a short time, can learn enough to commit identity fraud or set you up for a con.

Take a hard look at what you carry around. At a minimum, use a meaningful password to open electronic devices. Even better is to avoid taking out of your house information that can be useful to criminals such as Social Security numbers, bank and credit card numbers, birthdates, and the like. Carry only what you need.

MAKING IDENTITY THEFT LESS LIKELY

Identity theft isn't making the headlines it did a few years ago. Yet, it's still a major problem. The FTC still estimates that millions of Americans have their identities stolen, and this costs consumers about $5 billion. In 2014, the FTC said fixing credit after a theft took about 175 hours and cost $1,173. In addition, a bad credit report can cause you to be denied a mortgage or auto loan or even a job.

The baby boomers and those who are older are big targets for identity theft. They tend to have money and good credit ratings. Plus, they're vulnerable from a number of sides, such as anyone who helps around the home.

Credit card companies have tightened their protections for customers. Their computers are programmed to identify unusual transactions, and the companies quickly contact the cardholder or freeze an account. But that doesn't stop people from applying for new cards or loans in your name or taking other actions.

If you really want to prevent identity theft, consider these steps.

Check Credit Reports

You're entitled to an annual free copy of your credit report from each credit reporting firm and can obtain it at www.annualcreditreport.com. You should exercise this option annually to see if there are any errors or any activity you didn't initiate. Though you should do it, this is a weak step and only a first step. You would be learning about unauthorized credit applications well after the fact. The real benefit of this step is to correct any mistakes in the report, such as having someone else's history incorrectly applied to your report.

Note that obtaining your credit report is not the same as seeing your credit score. The details of credit scores are considered proprietary, and apparently each lender can determine how the score is computed for them.

Destroy All Debit Cards

Many people like debit cards because, unlike credit cards, they draft the amount directly from your checking or other account. You aren't borrowing money, so interest and finance charges aren't imposed.

The downside is that you don't have all the protections of credit cards. Losses from improper use of your credit card are limited to $50 by law. There's no limit on debit card losses, unless the card issuer voluntarily establishes one. If someone gets your debit card and PIN, they quickly can drain your account.

Debit cards also are less attractive after the Dodd–Frank financial regulation law. The law reduced the fees card processors can charge retailers on each transaction. As a result, the card issuers generally eliminated rewards programs and other bonuses. Because of the identity theft potential and lack of benefits, it might be better to switch from debit cards to credit cards.

Freeze Your Credit Identity

Probably the most effective way to avoid identity theft is to freeze your credit reports. You can contact each of the three major credit reporting firms and direct them to freeze your credit status. Then, they won't be allowed to release your information to anyone. With your credit status frozen, even someone who obtained all the details of your identity won't be able to receive approval for new loans or credit cards.

You periodically might want someone to have access to your credit reports. You might apply for a new job or seek a mortgage or auto loan. In that case, you can ask the services to unlock your account for a set time period. Usually, each time you do this costs $5. Unfortunately, you can't authorize release of your credit report only to certain people or firms. You have to freeze or unfreeze your information to everyone.

When you freeze your credit status, you establish a password or PIN. You need this to unfreeze the account. If you lose the PIN, a process that can take months is needed to verify your identity and unfreeze the credit.

Secure Your Information

Identity usually is stolen through unsophisticated methods. Thieves can enter a home or steal a wallet, cellphone, or personal computer and find all the information they need. In general, someone who has your name, address, birth date, and Social Security number can cause a lot of damage.

People often leave access to this information exposed. They enter key information in their smartphones or computers. They leave sensitive documents accessible in their homes. Even if there are no valuable objects in your home, it pays a thief to break in and grab blank checks, old financial statements, and your passport or birth certificate. You can go on a short vacation and have all this information stolen while you're gone. Documents with this information should be shredded and thrown away or securely locked.

This step is especially important for snowbirds or other second home owners.

Consider Credit Monitoring Services

There are a number of services that track the activity on credit reports by one or more of the credit reporting firms.

Each of the free services generally monitors only one credit reporting firm, usually is owned by the credit reporting firm, and tells you which reports it covers. They also want to upgrade you to a fee-paying service. Usually the free reports are issued at a fixed date, so activity could occur in your account some time before you know about it.

There are other services that will monitor your credit for a fee. These firms say they are proactive and will know as soon as there is new activity in your account. They also look for a wider range of activity, such as requests to change your address and let you know immediately of any changes. This proactive approach can stop someone who's stolen your identity from receiving loans or other credit in your name. Most of these firms also will help you restore your credit record and reclaim your identity if it's stolen.

I'm not convinced these services are worth the cost. Many of the services they offer you can obtain free. For example, you can sign up for a Do Not Mail list at www.dmachoice.org and can opt out of prescreened credit card and insurance offerings at www.optoutprescreen.com. This is in addition to www.

annualcreditreport.com. Also, there have been problems at some of the firms. Lifelock, for example, reached a settlement with the Federal Trade Commission in 2010. The FTC alleged that Lifelock used deceptive advertising and that its computer security was lacking. Then, in 2015 the FTC filed a complaint alleging that Lifelock violated terms of the 2010 settlement. You receive more protection at lower cost by freezing your credit reports.

These steps won't completely eliminate vulnerability. There are other ways your Social Security number can be obtained, and a thief can use that to file a false tax return in your name and claim a refund, among other things. But the IRS doesn't hold individuals liable for false refunds (though it isn't as generous with employers who are victims of identity theft). These are the strongest measures you can take and will greatly reduce your risk.

CLOSING THE DOOR TO YOUR GREATEST FRAUD RISK

Your greatest risk of being scammed or having your identity stolen might be one you don't suspect. The big headlines are generated when information thieves access the databases of major retailers or other well-known businesses. But the headlines are behind the times.

Information thieves have moved on to medical records.

A medical record often has all the information an identity thief needs in one convenient place: birth date, full name, Social Security number, and often insurance and financial account information. All this information is more convenient and accessible to thieves than ever as medical providers comply with the federal mandate to make medical records digital. Paper records are supposed to disappear or be supplemented by digital versions stored on a hard drive.

An entire medical record often sells for $50 on the black market, according to a 2015 article in The Wall Street Journal. A crook can do a lot with a medical record. It can be used in the typical identity theft activities of obtaining loans or credit cards, opening new bank accounts, or filing false income tax returns to claim refunds.

Medical records also can be used to obtain medical care, leaving you stuck with copayments and deductibles on that care. You also might face a canceled plan and errors in your medical history that can take a year or longer to correct.

Digital medical records often are shared quite rapidly among insurers and medical providers, making it hard to correct errors. Unlike credit cards and other financial records, there aren't yet standard procedures in place to correct medical records and reduce the consequences of record theft.

Children and the elderly are the usual targets of medical record theft, a crime that victimized about 1.8 million Americans in 2013 and has increased almost 20 percent annually the last couple of years through 2015.

Medical records are sought by overseas crooks who use their digital expertise to probe the databases of medical providers just as they try to infiltrate major corporations and government agencies. Security from these types of attacks is not high on the priority list of most medical providers. Unlike a lot of other large organizations, a medical provider might not even know its database was breached or probed.

Consumers also are behind in protecting themselves, because medical record theft doesn't receive much publicity. Here are a few steps you can take:

- *Avoid providing Social Security and driver's license numbers to medical providers.* They don't need them, except in rare instances.
- *Ask medical providers to remove these numbers from their existing records.* You have the right to have personal information removed from medical records.
- *Treat old medical documents you possess the same way as financial records.* Shred them instead of throwing them away. Any records you retain should be stored securely. This includes bills, receipts, and diagnosis information.
- *You have the right to review and receive a copy of most of your records from medical providers.* The rights are spelled out in the federal regulations at 45 CFR 164.524. Just as you should with credit reports, it's a good idea to take advantage of this right and review your records for incorrect information, fraudulent charges, treatments you didn't receive, and personal information you want removed.
- *Carefully review the "Explanation of Benefits" you receive periodically from your insurer or Medicare.* These statements often are difficult to decipher, but they can reveal whether someone is using your insurance to obtain treatment under your name or a medical provider is submitting improper charges to the insurer. If you don't understand the treatment code listed, call the provider's billing staff for an explanation.

CHAPTER 13: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is not a component of financial abuse:**

- **A.** identity theft
- **B.** misusing property
- **C.** insider trading
- **D.** improperly using a power of attorney

2. **Which of the following is a warning sign that financial abuse may be occurring:**

- **A.** unusual financial transactions
- **B.** power of attorney given to a new person
- **C.** unusual fear of a caregiver
- **D.** all of the above

3. **Which of the following is a step to take to prevent identity theft:**

- **A.** wait for creditors to notify you of an issue
- **B.** use debit cards exclusively
- **C.** freeze your credit status
- **D.** keep all financial information in one location, like a desk drawer

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CHAPTER 13: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Identity theft is a component of financial abuse. **B.** Incorrect. The umbrella of financial abuse includes misusing property. **C.** CORRECT. Financial abuse does not include the crime of insider trading. **D.** Incorrect. Improperly using a power of attorney is a component of financial abuse. *(See page 294 of the course material.)*
2.	**A.** Incorrect. Unusual financial transactions are a red flag that financial abuse may be occurring, but it is not the only correct selection. **B.** Incorrect. A warning sign that financial abuse may be occurring is when an individual gives power of attorney to a new person. However, this is not the only good option. **C.** Incorrect. Unusual fear of a caregiver is an indicator that financial abuse may be occurring, but the other options are valid as well. **D.** CORRECT. Warning signs that financial abuse may be occurring are seeing unusual financial transactions or fear of a caregiver, as well as giving power of attorney to a new person. *(See page 295 of the course material.)*
3.	**A.** Incorrect. Credit reports should be checked annually, rather than waiting for creditors to notify you of a problem. **B.** Incorrect. Credit cards should be used rather than debit cards. **C.** CORRECT. Freezing your credit status is a good way to prevent identity theft. **D.** Incorrect. Keeping financial information together in an unsecured location can actually increase the chances of experiencing identity theft. *(See pages 297 to 298 of the course material.)*

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CHAPTER 14: CHOOSING THE RIGHT RETIREMENT LOCATION

Chapter Objective

After completing this chapter, you should be able to:

- Identify the key factors involved in a successful move after retirement.

The image of the ideal retirement ingrained in the imaginations of most Americans includes a home in a sun-drenched retirement community.

Reality often doesn't match the ideal. Not every retiree moves to a Sun Belt state. Not every retiree who moves to a Sun Belt state enjoys the experience. Some studies show that 25 percent or more of those who retire to Florida leave the state within five years. I've met retirees who admit to choosing the wrong place to retire. Many people don't realize that despite the publicized exodus of seniors to Florida, Arizona, and other states, most retirees never move from their longtime residences.

Only about 37 percent of retirees have moved in retirement, according to a survey taken in 2015 for Merrill Lynch Bank of America by Age Wave. Another 27 percent say they anticipate moving, but it's not clear they actually will move, when, or where. Many say they anticipate they'll have to move some day for health or medical reasons. A hefty 36 percent say they don't anticipate moving in retirement. So, close to 60 percent of retirees didn't move after retiring, and it wasn't clear they ever will, at least not because they want to.

The biggest reason people give for moving or anticipating a move in retirement is to be closer to family, not to be in a warmer climate or near more golf courses.

Another widespread belief is that when most people move in retirement, they downsize. That is, they move into a smaller, less costly home. Yet, about half of retirees who move in retirement don't downsize, according to the survey. They move into a home that is the same size or even larger than the one they lived in before retirement. The main reason for not downsizing is so there will be room for family and friends to be comfortable during extended visits. Some even say they want enough room so adult children can live with them if they need to.

The top reasons for downsizing are economic. Most want to lower their monthly housing costs or reduce the burden of maintaining the larger home.

Another stereotype is that most retirees move into an age-restricted community, an enclave restricted to those ages 55 and over. In fact, only 7 percent of retirees say they moved into an age-restricted retirement community.

Even when people move in retirement, most don't move far. About 83 percent of those over age 65 who moved in the year before the survey stayed in the same state. Only about 17 percent of those over age

65 who moved the previous year relocated to a different state. Other surveys over the years found that many in move in retirement stay in the same ZIP code.

One of the most important decisions regarding retirement is where to live. Even someone who gets all the retirement financial decisions right will be unhappy if he or she settles in the wrong place. I know, because I've talked to and counseled retirees. Retirement location questions are among the most common, right after questions about investments and estate planning. Complaints and second thoughts about the chosen retirement location also are very common.

The choice of where to live in retirement also is a very personal one. There are numerous surveys and ratings of various retirement locations. I advise prospective retirees not to take these too seriously. Research can't be very thorough when a survey claims to investigate and rank hundreds of locations each year. I also find it a bit curious that the rankings change drastically from year to year. More importantly, a generic ranking system of locations cannot determine the best location for you. The preferences and priorities of a person or group that's compiling a survey aren't likely to be the same as yours.

There are some real secrets to finding the right retirement location. Unless you want to move a lot, follow my guidelines to finding your happy retirement home. With my recommendations you can use the published retirement location guides, but use them in a different way. It is not important which areas are ranked best by any particular guide. What is important is why a location received a particular rating and the details about the area that are described in the survey. What is most important is what your values are and how you rank a location. You very likely will put a different priority on some qualities of a location than the publishers of the various guides.

START WITH YOU

To start, ignore all the guides and descriptions of retirement locations. Start with you. Make a list of your interests, hobbies, favorite things to do, and things you dislike. Then list the things you expect to do in retirement. I think it is best if you start with a general list of activities. Then try to make it more specific by focusing on what you expect the typical day, week, or month to be like, and on what you would like to do at certain times of the year.

This exercise is very similar to the one we conducted in Chapter 2 to develop an estimate of your retirement spending. In fact, ideally you should consider where you want to live when developing your retirement spending estimates.

Next, use these interests to compile a list of qualities that are important for the community in which you would like to live. Do you want to live within a certain distance of a golf course, church, shopping, hiking trails, beaches, fishing, or other activities? Or perhaps you want easy access to libraries, museums, theaters, or racetracks. Most people also have a preference about whether to live in a city, suburb, or rural area.

Consider more than "what." Consider "who." Which people or types of people do you want to be around? If you want to spend a lot of time with the friends you have now or with children and grandchildren, that will greatly influence your decision. Keep in mind that one of the keys to a successful retirement is social contact. People who have a lot of contact with friends and family tend to be happier in retirement than others.

Someone who makes friends easily and who looks forward to socializing might consider the whole country. Also consider your neighbors when looking at individual communities. I find that some retirees don't like living in a community that is full of other retirees. They'd rather be in a community of various age groups. Some prefer to be around people of similar education, profession, or intellectual interests. Others like to be around people of varied backgrounds and interests. Which do you prefer?

There also are other characteristics of the area to consider: Climate, terrain, traffic, crime, taxes, job opportunities, and recreational opportunities. Some people have special interests, such as museums or the opera. Some want to be near first-class medical facilities. Make your list as comprehensive as possible before considering even one location.

SURVEY THE COUNTRY

Using your list of interests and preferences, you can start with the big picture and knock out large portions of the country. If you want to golf in the winter, you won't be living in the northern parts of the country. If you like to ski or hike in the mountains, you probably don't want to live in Florida. The list will help even those who plan to split time between two or more retirement homes, because it will help narrow down where those homes should or should not be.

Refine Your Search

After having narrowed it down to a few regions in the country, it is time to turn to the websites, glossy magazines, books, and friends for ideas on places that are worth examining. When considering each possible location, in addition to the list of qualities already described, consider the following factors that I've found often loom large in a retiree's daily life but are too often overlooked.

Look at All the Costs

Sometimes an inexpensive area is not as inexpensive as it seems, at least not for every lifestyle. Every area seems to have its hidden costs. For example, I met a couple who wanted to reduce their expenses in retirement. So they sold their home in a metropolitan suburban area and used about half the sale price to buy a similar-sized home in a low-cost, less-populated area. They pocketed the rest of the sale price and thought they were on easy street.

However, they found many of their routine activities cost more than they expected. Their new area also did not have the discount superstores or the variety of shopping they were used to, so they would drive for an hour or so to find the shopping they wanted. Basic utilities also cost more in the new location. The list of these little costs and inconveniences went on until they realized the true cost of the location wasn't as low as they expected.

It is important to look at the big costs, such as housing, but it is the little daily costs that often surprise retirees. Health insurance and other health care costs vary significantly around the country. There are no reliable rules of thumb, such as "rural areas are always more expensive than urban areas." You have to verify the cost in each specific location. Once a specific location is under consideration, ask an insurer what the cost would be for you in that location.

Food, utilities, and services also can be eye-openers. I once looked at homes in a community and found that two electric utilities reached the end of their service areas in the middle of the community. One serviced half the community, while the other serviced the other half. Residents said that service and prices differed significantly between the two utilities. The cost of water also varies greatly and shouldn't be taken for granted.

The tighter your budget, the more important all these costs become. Once an area is under serious consideration, take your list of proposed retirement activities and budget and see what each item would cost in the new area. To avoid surprises later, actually take a trip to the grocery store and contact the local utilities to find out what they charge.

Make Sure Low Taxes Are for Real

There's nothing better for an area's image than to be considered low tax. The label often sticks for decades, even after residents are paying higher taxes. Unfortunately, it often is a false label. For example, many people consider an area to be low tax if it doesn't have an income tax. But the lack of an income tax often is offset by high sales taxes, real estate taxes, personal property taxes, and intangibles tax (which is imposed on investment portfolios). There also can be stuff taxes added by the locality that that greatly increase phone and electric bills.

There also are hidden taxes. Some localities have low property taxes, but they don't provide services that are routinely provided in high tax areas. This fools people who come from areas where, for example, trash collection and other services are included in their property taxes. Only after moving do people find out that in addition to property taxes, they must pay separate fees for these other services.

Another tax trap is that there often are high-tax localities within low-tax states. Localities often set their own rates for property taxes and can impose their own sales taxes. Sometimes a locality can add its own income tax. In these cases, a difference of only a few miles can make a big difference in tax bills.

Contact the local and state tax departments for details about all the local taxes. The Chamber of Commerce might also have good information that summarizes all taxes. Someone who can afford it should meet with a local CPA for details about the taxes and fees. In many areas, real estate agents are required to disclose additional fees imposed on homeowners or they will do so if asked.

Be sure you get information on state and local income taxes, sales taxes, real estate and personal property taxes, and intangibles taxes. Also, take a good look at estate taxes. Sometimes higher inheritance taxes imposed by a retirement relocation can cost your heirs a bundle.

Consider Year-Round Climate and Lifestyle

Once I was golfing in South Carolina. The starter on the course revealed that he was a retiree from New Jersey who had moved south to avoid snow in the winter. But he found he disliked the South Carolina summers even more than winters in New Jersey. "If I had known about the mosquitoes," he said, "I never would have moved here."

One classic mistake is to retire to an area because of a good vacation or short trip there. Soon after moving, the retiree learns that the daily life in the area is not as enjoyable as a short vacation. Another mistake is to move to a warm area to get a break from dealing with winters. A substantial minority of people who do this eventually change their minds. Sometimes people learn that they really like having four seasons, or at least three. Maybe they don't want to move back to where it is cold six months of the year, but they also don't want year-round summer. Or they find that while winters can be pleasant in a warm climate, the summers can be unbearably hot.

Find Your Community

By now, your choice probably has been narrowed down to a few areas. Now it is time to consider individual communities or subdivisions in these areas. It is possible to pick the perfect area in which to live but to choose a neighborhood or community that causes unhappiness or at least reduces the pleasure of living in the area. Here are a few things to consider when searching for a community.

Demographics

Florida became a magnet for retirees starting in the 1960s. Now I hear from many near-retirees and new retirees that they don't like Florida and even Arizona retirement communities because the populations are so old. They want to live with a younger, more active group. In addition to age, try to learn about the interests and activities of the community. Some communities have a range of clubs, sports leagues, and social activities. Other communities have more limited activities or have attracted residents who basically stay at home and have a few close friends.

Some people want a leisure-minded retirement community, where the focus is on golf, tennis, and card playing. Others want a learning-oriented atmosphere with a college nearby or with classes, speeches, and lectures. Don't assume every community has all types of activities. Many tend to emphasize some over others.

Security

Americans of all ages seem more interested in secure communities each year. Do you want a gated community with its own security patrol? Do you want an active neighborhood watch? Some communities also have security measures built into individual living units.

Associations

In the last few decades, homeowners' and community associations have become another branch of government. State laws usually let an association do pretty much whatever a majority of its members want. That can be good or bad.

An effective association maintains property values and quality of life. But some associations pass detailed, restrictive rules and enforce them to the letter. Rules might encompass the size and design of mailboxes, lawn and patio furniture, and decks. One community association in my area once ordered an entire block of homes to take down their decks because the builder made each one six inches wider than allowed. It is not a bad idea to get a feel for the power and activities of the local association. Some retirement location experts advise you to review association and board meeting minutes for the last year or two to see what the current controversies are and how the group works.

Perhaps more important than the rules and regulations is the financial condition of the community. A homeowners' or community association usually is responsible for the maintenance of common areas and perhaps some other assets. Some HOAs keep dues low by not investing in maintenance or setting aside funds for the inevitable time when assets will need major repair or replacements. Instead, the unfortunate people who are homeowners when those times come must pay special assessments. Check the financial condition of the HOA, especially its level of reserves and how it calculates how much to put in the reserves.

TYPES OF RETIREMENT HOUSING

Housing for older Americans is a booming industry. There now are many different types of housing available to seniors. There are variations of each type, and some types are common only to some areas of the country. Let's take a brief course in the senior housing options.

Traditional Housing

Of course, a retiree can go into any community and rent or buy an apartment, condo, townhouse, or house just as any adult can. In fact, more seniors probably live in traditional housing rather than any special senior housing.

Planned Communities

Some of these are specifically restricted to seniors, while others use pricing and marketing to ensure that residents primarily will be seniors. These communities tend to differ from regular subdivisions and developments primarily because they have amenities that are especially desirable to active retirees. Golf and other recreation facilities often are prime features. A community center with an active agenda usually is an important element. Housing usually is single family homes or condominiums or both, with design features that are attractive to seniors (examples include one floor level, door handles instead of knobs, and security). The HOA might be responsible for maintenance of all yards and sometimes the outside of all housing units. Usually there is no medical care element to these communities. They are for independent, active people who happen to be retired.

Independent Living

In some places this is called congregate care. These facilities are for seniors who need a little bit of help for activities such as cooking, cleaning, and driving or who anticipate needing some help in the near future. Housing usually is in apartments or condominiums but can be single family homes. Onsite amenities usually include recreation facilities, a convenience store, dining rooms, meeting rooms, a library, social areas, and television rooms. Often there is a shuttle service to local shopping and medical offices, and regular outings are organized. For many, independent living is like being at college.

The buildings usually feature extra-wide hallways and doorways to accommodate walkers, wheelchairs, and motorized scooters, along with other senior-friendly features. Housecleaning and other services usually are available. But, again, onsite medical facilities are limited. Usually the housing unit is purchased or a large deposit is made, and a monthly fee is paid. Additional fees might be paid based on other services used.

Assisted Living Facilities

This often is described as an alternative to nursing homes, but it really is not. Limited medical care is provided at assisted living facilities (which is one reason their basic daily room rate is considerably less than a nursing home rate). Assisted living facilities are for someone who needs help in one or two daily living activities (dressing, bathing, eating, housekeeping, walking, etc.) or perhaps wants help with cooking, cleaning, and similar activities. It is not for someone who needs physical rehabilitation or skilled nursing care. Residents generally live in dormitory-style rooms and have common dining and social areas.

Assisted living facilities generally have to comply with far fewer regulations than nursing homes. Many have a nurse or other licensed medical personnel on site for only part of the day and there are few or no medical facilities on site.

Group homes usually offer assisted living services in townhomes or single-family homes with 15 or fewer residents. These might be subject to less regulation than larger assisted living facilities.

Nursing Homes

These are for individuals who need physical therapy or skilled nursing care on a regular basis. Usually, the care is provided by nurses and other medical professionals under the direction of a physician. Nurses usually are on duty 24 hours a day.

Continuing Care Retirement Communities

The CCRC is a relatively new but fast-growing type of senior housing. CCRCs attempt to put the main types of senior housing in one community: independent living, assisted living, and a nursing home. Some CCRCs also have townhomes and detached homes in the community.

A resident initially moves to a CCRC when healthy and starts in an independent living apartment, townhome, or detached home. After that, a resident or spouse can move into assisted living and the nursing home as needs require. If a resident never needs either specialized facility, that’s fine. But as one ages, there might be the need to move into one of the other facilities. The independent living, assisted living, and nursing home usually are in one building or are connected by walkways so that residents do not need to go outside to visit someone. The community also usually includes the types of amenities found in independent living.

Methods of financing a residence in a CCRC vary. Most often, a large lump sum is paid up front to live in the CCRC. This sum usually is fully or partially refundable to the resident’s heirs, though the refund right might disappear after 10 years or so. (In some CCRCs the housing unit is purchased outright. The owner or heirs can sell it.) There also is a monthly fee, which might be the same for everyone or might depend on the services received. In return for these payments, the resident is guaranteed care in the appropriate facility for life.

In recent years, the communities have offered other options. The other options generally require you to pay a lower fee when entering the CCRC, but the fees you pay cover less of the assisted living and nursing home care when you need it. You might have to pay for the services when needed at the market rate.

There are two factors you need to review carefully before deciding on a CCRC. One factor is fee increases. Often there are few or no restrictions on the CCRC's right to increase the monthly fees. Monthly fee increases of 4 percent to 6 percent annually compounded over 10 or more years really add up. Ask about the CCRC's right to raise fees and its history of fee increases. Additional fees are another factor. Ask what services aren't included in the basic fee and what the fees are for those other services. You might find that you're likely to be charged more than the basic fee.

Planned communities generally are suitable for any active retiree. Most senior citizens don't start seeking out the other facilities until their mid-seventies, unless there is a medical problem. So someone younger than 75 who lives in an independent living community or a CCRC might be one of the youngest residents. But some people decide they want to move only once in retirement, so they move to a CCRC or similar community early in retirement.

Someone considering a move into a planned community or CCRC should be aware that the financial strength of the community is very important. You should do all you can to check the financial stability of the firm that will provide the services and lifetime guarantees. In the 1980s, there was some overbuilding in senior housing, and the developers of some communities went bankrupt. It also is important to look at the bylaws, covenants, and other regulations of the community, and know who determines what level of care is needed and when a move into a different level of care can be made.

CCRCs often aren't required to provide the same level of disclosure as HOAs and some other types of communities. They also aren't as subject to as much regulation as some other options. You should gather whatever information you can about the financial condition of the community and any entities related to it before making a decision.

To learn more about CCRCs, consult the websites of AARP and LeadingAge (formerly the American Association of Homes and Services for the Aging). Also check with your local Area Office on Aging and the Long-Term Care Ombudsman for help selecting the right place for you.

AVOIDING THE BOOMERANG

The boomerang is when someone retires to a location, decides it was a mistake, and moves back to the original location or somewhere else. It occurs when the original decision was made in haste or without considering all the factors. Here is how to avoid the boomerang:

- *Start the retirement location decision making process about two years before a move might actually happen.* That allows enough time to take all the steps recommended.
- *Don't commit right away.* It is a good idea to rent a place in a new location before buying. Ideally, the rental should be for at least a year in order to get familiar with year-round weather and activities. It also provides time to locate the most convenient and desirable

community in the area. An alternative is to rent for a few months at a time each year for a few years before moving. That might provide enough exposure to the area to make a good final decision and also might make for a smoother transition between the old home and the new one.

- *Get involved in the community.* Though renting, act like a permanent member of the community. Get involved in your activities of interest, meet people, and learn about the area. Try to develop the kind of routine that is anticipated for the retirement years.
- *Decide what size home to have after the move.* Be sure to consider factors such as how often family or others will visit, whether an office area is needed, and how many belongings will be in the home.
- *Check financial statements before buying.* Many seniors buy in new communities. It is important to be assured that the community and its amenities will be finished as planned. That means checking out the financial condition of the developer. Also check on the condition of the community association. On the financial statement, see if the fund balance is positive or negative. Look to see if there is a reserve for future obligations and maintenance; if there isn't, then the current fees probably are too low. Ask about the current level of dues and about past fee increases. Check the current occupancy or sales rates of units. If things are slow, financial trouble could be ahead. Be sure there isn't any outstanding litigation listed in the footnotes to the financial statements. You also might want to review the minutes of board and association meetings for the last year or two to see if maintenance, improvements, or the level of dues have been major issues.
- *Finally, determine the full cost of a move and be sure it is acceptable.* Moving a household full of goods plus cars and other items can cost tens of thousands of dollars. That expense, plus buying and selling costs, can add up to a stiff price for the relocation.

Most people want to make their retirement location decision only once. To make the right decision, get a head start and be sure to consider all the angles. Finally, consider this option. If there is an area you like for a special reason—say, Florida sunshine for the winter—consider becoming a snowbird. You can rent in that location for a few months during the year and stay in your current home the rest of the year.

NEW WORLD OF ADULT LIVING CHOICES

Traditional retirement living and housing choices are on the way out. The new generation of retirees is looking for new living experiences. Developers are obliging, giving older Americans more choices than ever. These new choices include building communities outside the traditional retirement havens of Florida and Arizona, but they involve much more than that. The new choices include different types of housing and living arrangements and various types of activities within the communities themselves.

One reason for the new senior living choices is that retirees are relatively young. In many adult communities, about a third of the residents are under age 65. Those under age 55 can amount to 10 percent or more of the residents.

Another reason for the changes is that today’s retirements are longer and have more stages than in the past, generally up to three stages. In the first stage of retirement, often at least one spouse continues to work at least part-time. In this stage, the retirees might move to a smaller home but want to stay in the same general area to maintain personal and business relationships and living patterns. In the next stage, retirees might move to a completely different area, perhaps somewhere with warmer weather. In the third stage, retirees move closer to family and friends. Each stage has a range of living choices.

CHAPTER 14: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is <u>not</u> a good basis for determining a location to retire to:**

A. picking a place where you had a nice vacation

B. picking a place where you have friends and family that are important to you

C. picking a place where there are plenty of activities that are of interest to you

D. picking a place with an agreeable climate

2. **Which of the following is true regarding retiring and moving to a low tax area:**

A. a low tax area means that there is no income tax

B. many low tax areas have high sales taxes or real estate taxes

C. low tax states contain only low tax localities

D. some localities impose an intangibles tax, which is a tax based on the school district

3. **Which of the following is a consideration to keep in mind when selecting a community to retire to:**

A. the demographics of the new community

B. whether the community is part of an association

C. the security of the community

D. all of the above

4.	**Which of the following is correct regarding assisted living facilities:** **A.** more seniors live in assisted living facilities than any other type of housing **B.** assisted living facilities are an alternative to nursing homes **C.** residents generally live in dormitory-style rooms and have common dining and social areas **D.** assisted living facilities generally have to comply with more regulations than nursing homes
5.	**Which type of retirement housing attempts to put the main types of senior housing in one community:** **A.** continuing care retirement communities (CCRCs) **B.** assisted living facilities **C.** planned communities **D.** congregate care facilities

CHAPTER 14: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. Choosing a location to retire to should not be based on the fact that you had a good vacation there. Many people find that a vacation destination is a better place to visit than to live. **B.** Incorrect. An individual thinking of retiring to a new location should consider moving to a location that is near important friends and family. **C.** Incorrect. Choosing to retire to a new location with activities that are of interest is a good planning strategy. **D.** Incorrect. Selecting a retirement locale based on an agreeable climate is a good planning strategy. *(See pages 306 to 307 of the course material.)*
2.	**A.** Incorrect. A low tax area does not mean that the area does not have any income tax. Sometimes areas with no income tax have many other taxes that offset that income tax savings. **B.** CORRECT. Many so called “low tax areas” have higher sales or real estate taxes, which offset the savings from a lack of an income tax. **C.** Incorrect. Many low tax states have high tax localities within the state. **D.** Incorrect. Some localities do impose an intangibles tax, but it is a tax imposed on investment portfolios. *(See page 308 of the course material.)*
3.	**A.** Incorrect. The demographics of an area is a consideration that should play an important part in determining a new community to retire to. However, this is not the only correct selection. **B.** Incorrect. Whether the community is part of an association, like a homeowners’ or community association, is an important characteristic of a potentially new community to bear in mind, but it is not the only problematic issue. **C.** Incorrect. A retiree contemplating moving to a new community should consider the level of security in the new community, but the other options are also valid. **D.** CORRECT. Considering moving to a new community should include the retiree considering the demographics of the area, the level of security offered, and whether the new community belongs to any associations that the retiree would have to comply with. *(See page 311 of the course material.)*

4.	**A.** Incorrect. More seniors probably live in traditional housing rather than any special senior housing. **B.** Incorrect. Assisted living facilities are often described as an alternative to nursing homes, but they really are not. **C.** CORRECT. In assisted living facilities, residents typically live in dormitory-style rooms and utilize common dining and social areas. **D.** Incorrect. Assisted living facilities generally have to comply with far fewer regulations than nursing homes do. *(See page 311 of the course material.)*
5.	**A.** CORRECT. The continuing care retirement community (CCRC) is a relatively new but fast-growing type of senior housing that attempts to put the main types of senior housing in one community: independent living, assisted living, and a nursing home. **B.** Incorrect. Assisted living facilities are for someone that needs help in one or two daily living activities. They do not incorporate other senior housing into their facility. **C.** Incorrect. Planned communities are not a type of senior housing that incorporate several types of senior housing. **D.** Incorrect. A congregate care facility, or independent living facility, is just a component of a CCRC. *(See page 311 of the course material.)*

CHAPTER 15: KEYS TO A SUCCESSFUL RETIREMENT

Chapter Objective

After completing this chapter, you should be able to:

- Identify how to plan for a productive retirement.

People often tell me that they failed at retirement the first time. And the second. And the third.

These aren't people with serious financial problems. They didn't cut short retirement because they needed the money. Instead, they devoted their retirement planning time and resources to the financial aspects. They neglected the other elements of retirement planning, and those often are the more important parts.

Most retirement planning focuses on the financial side of retirement, which we also can call the hard side of retirement planning. Finances certainly are important to a happy and successful retirement. Yet, they aren't the end of the story or even the most important contributors to retirement success.

The most difficult parts of retirement planning usually are what can be called the soft side of planning. You need to decide how to spend all that time you used to spend working. You need activities that fulfill you and give you a sense of purpose. There's a lot of time to fill, and the amount of time only grows as people live longer and are retired longer. The biggest nonfinancial mistake people make in their retirement planning is neglecting the soft side of planning, and it is the source of many unsuccessful retirements.

The problem is so widespread that in recent years many professional advisors adopted an approach that sometimes is called life planning. Instead of diving directly into a client's finances, the advisor instead gets to know the client. A proper plan can't be developed until the advisor knows a client's likes and dislikes, hobbies, family, goals, and other interests. In other words, what is important to the person and what does the person enjoy doing? How will that change in retirement? Only after obtaining such knowledge can the financial planning process begin.

That's why we started this journey in Chapter 2 by having you envision the regular activities you want to do in retirement. Only after that could an estimate of your retirement spending be made. Retirement planning begins with deciding how you plan to spend your time. Knowing you is the start of retirement planning. It is the essential first step to both the hard side and soft side of planning.

The first step in retirement planning should be to imagine the life you want after your current career. Determine how you'd like to spend your time for at least the first few years and then how that might change in the following years. Where will you live? How do you want to live day to day, month to month, and over the course of a year? Do you know people who already are living that way? Set your life goals first, not your income or asset accumulation goals.

As more than one retiree has told me, retirement can be hard work. The failure of many people to do this work is why people fail at retirement and why some studies indicate that the over-60 age group has higher-than-average rates of depression, substance abuse, and suicide.

The point of saving and investing for retirement is so you can spend time doing things you really want to do. The nest egg sometimes is called walk away money or freedom money. Being financially secure is helpful to a successful and happy retirement, but it doesn't ensure one. You need more than money.

Many of those who took one or more tries at retirement didn't have a vision of what retirement would be like and how they would be active and fulfilled. They had to try one or more times before they figured out how to be successful at retirement.

THE VACATION RETIREMENT

There's a lot of confusion these days about what retirement is or should be.

We all know the stereotypical retirement popularized by those who retired in the 1950s through the 1980s, now known as the vacation retirement. Retired people would spend their time in leisure activities, essentially doing whatever they wanted. It is almost like a second childhood.

When I started advising people about retirement some years ago, it was clear I was helping people reach a point when they would stop working. They looked forward to the vacation retirement. The question I received most often was, "How soon can I retire?" Ceasing work as soon as possible was the goal.

Of course, that was a manufactured image and lifestyle. The surveys indicate only a minority of U.S. retirees pursued that lifestyle. Some believe insurance companies and others in the financial services industry created the image to give people an incentive to save and invest. Others think real estate and travel interests were the creators. I'm not one who believes people can be so easily manipulated by commercial interests. The early generations of retirees probably wanted the vacation retirement after decades of working and the prospect retirement wouldn't last too many years. At this point, it doesn't matter what the origins of the vacation retirement were. While the vacation retirement is what most people associated with the word retirement, it certainly wasn't retirement for everyone and probably will apply to fewer people going forward.

It might still be the retirement for you. Now, however, many people say they want to work after age 65. About 70 percent of baby boomers say so, according to AARP surveys. A growing (but still minority) of those over 40 say they won't ever retire.

Though it's a big change, it's not surprising. People are healthier and living longer. Many want to continue contributing and to have meaning in their lives. Others need the money.

Many people need and want the experiences that come with a job and work. Foremost is a sense of purpose and achievement. Many people also benefit from the structure of work. The "every day is Saturday" model of retirement is not for everyone, especially those who still are fairly healthy and active. They don't want to plan each day from a blank slate. They want the structure a job provides for at least part of each week. Being in the workplace also provides regular exposure to new things and people.

With the vacation retirement, you wake up one day and all those things are gone. You have to recreate them.

For most of us, the first thing we need to do is drop the assumption of "retirement." We'll be retiring from a particular job or career. But we'll be moving on to other activities, and it's likely those activities will change over the next two or three decades. We might take different jobs, start new careers, or engage in volunteer activities. Many people probably won't actually "retire" until sometime in their 70s or later. Very early in your retirement planning you need to consider the lifestyle you want in retirement. Are you looking forward to the vacation retirement, or are you hoping for something with more structure and purpose?

TWO IMPORTANT, OVERLOOKED ISSUES

Throughout this book I indicated that many retirement plans overlook key issues. Some don't factor inflation in their spending plans. Others don't pay enough attention to medical expenses and long-term care. Those are two examples of frequent oversights. There are also a couple of soft issues that frequently are neglected in planning.

Where Your Spouse Fits

A few years back, an organization I was associated with had a few high-level tasks that needed to be done. No one at the top executive levels had time to take on the additional work.

The solution was to bring back on a temporary basis a former senior executive.

It worked out well. He had retired recently, so he was current on the issues and had not committed his time elsewhere. He stayed for about six months, completed the projects, and solved the problems. Then, he went back to retirement.

A few months later, he and his wife were invited to the organization's holiday party. During the party, his wife pulled aside the senior executives and asked, "Can't you find him something else to do? He's getting in my way at home."

Common failures of the retirement plans of many married people are they don't realize how retirement will affect the other spouse, and the spouses don't coordinate their plans. Each spouse makes many assumptions about the other during the planning, but they often don't check with each other to be sure the assumptions agree.

One set of problems centers around the daily or weekly routines. Spouses often have trouble harmonizing these activities. One spouse often expected they would spend most of their time together, while the other complains that spouse is in the way or expects to be entertained all day.

This problem largely can be resolved by beginning retirement planning the way I suggest. Imagine your day-to-day retirement life. Each spouse should do this. Give the daily and weekly routines some thought and discuss the ideas with your spouse. If your ideas match up, that's great. Otherwise, it's another part of the retirement plan you'll have to work on.

The day-to-day issues are not the only potential problems between spouses. Big-picture retirement issues also have to be coordinated, which many couples don't do. Fidelity Investments periodically has a survey conducted on the issues. The 2007 version found that 61 percent of spouses disagreed on what the primary source of retirement income would be; 41 percent disagreed on whether at least one spouse would work during "retirement"; and more than 33 percent of couples disagreed about their amount of their life insurance coverage and expected retirement ages. Finances are only part of a retirement plan. Couples need to discuss and decide the other issues.

Caring for Your Mind and Spirit

A very important factor in establishing a successful post-career period is social interaction or human connectivity. Your social relationships are more important to your well-being than money is. More and more research makes this clear.

The relationships could be with family, friends, co-workers, and others in your community. It's not clear why this matters, but regular and close interaction with others is important to maintaining health and a positive outlook. An important point is that the number of relationships or contacts isn't key. What really matters is the depth or closeness of relationships.

You can read some details in two books with similar titles.

The Longevity Project by Howard S. Friedman and Leslie R. Martin analyzed data accumulated from 1,500 individuals over 80 years. The Project periodically interviewed the participants and had them complete questionnaires. Among its findings are that close involvement with friends and communities improves health and longevity and is more important as we age.

The Longevity Prescription by Dr. Robert Butler appears at first to be the latest in a long line of books by doctors in their 80s giving their personal prescriptions for a long life. Butler died in 2010 at age 83. In fact, Butler devoted much of his life to research on aging in the United States and offers much more than his personal experience and reflections.

Reviewing his research and that of others, Butler identified eight keys to a long, healthy life. Two of them are nurturing your relationships and connecting with your community. Butler said social connectivity is so important that, rather than struggling to stay in their homes, most Americans around 80 should seek to move into senior living communities.

KEY RETIREMENT MISTAKES TO AVOID

Most of this book is focused on actions you should take toward a successful retirement. Sometimes, however, the best way to have good results is to avoid mistakes. We have enough experience with retirement to know the major events and actions that are likely to lead to unsuccessful retirements. Avoid these and you're well on the way to a successful retirement. Some of these we discussed earlier in the book, but they bear repeating here.

Debt

Once it was rare for someone to retire with debt, even a home mortgage. Now, the number of retirement-age Americans with substantial debt is increasing. In retirement you have reduced flexibility and substantially less potential to earn a higher income. At the same time, negative financial surprises are more likely, especially high medical or long-term care costs. The combination of high debt and large surprise expenses can be financially devastating in retirement. You can control your level of debt. Less debt means you have more flexibility and a larger cushion against surprises. For most people, it's better to eliminate debt in retirement.

Spending Too Rapidly

Surveys of retirees and preretirees indicate consistently that many believe they can safely spend 7 percent or more of their assets each year without the risk of running out of money. As we discussed, financial planners and academics who studied retirement spending believe the safe spending rate is much lower. Many say the safe spending rate is around 4 percent of the retirement nest egg. In Chapter 4, we discussed reasons why the safe spending rate might be even lower. Be sure to carefully consider the rate at which you safely can spend your nest egg.

Uncovered Major Medical Expenses

Medicare doesn't cover all your medical expenses, as we discussed in Chapter 6. Realize the potential risk from high medical expenses and use the strategies we discussed to avoid spending too much out of pocket on medical expenses and how to protect yourself from high medical expenses through insurance.

Helping Others

These days, many retirees are overextending themselves to help their younger loved ones. That's understandable, but it's dangerous. You're likely to spend down your nest egg too fast, and ultimately that will leave both you and the younger generation without any financial support. Help for younger generations must be affordable for you and shouldn't be open-ended or without expectations of progress by the younger generation.

Flying Solo

The data are clear that married couples do better financially in retirement than singles. That's partly because too many retirement plans don't include the contingency that one spouse will pass away, costing the household Social Security and other income sources. A solid plan includes financial security for a surviving spouse.

Failing to Adapt

A retirement plan is important. Equally important is to realize it is only a plan. It shouldn't be treated as a one-time exercise that serves as a roadmap to be followed without deviation. A plan is based on a large number of assumptions. It also is based on current laws and circumstances. Actual results are likely to vary quite a bit from the assumptions built into the plan over time. You need to review the plan regularly.

Determine where the plan assumptions no longer are valid. Then, revise the plan as needed to stay on course. Don't wait too long to review the plan and consider the changes that need to be made. An annual review means relatively small adjustments each year. Waiting longer to review could mean substantial adjustments will be needed.

KEEPING UP WITH CHANGES

As just stated, things change. Sometimes circumstances change. Sometimes we learn something new or realize that what we thought we knew wasn't true. That's a theme of this book and the previous version. You can't assume that what you knew or what worked for you years ago still is valid today.

Here are a couple of good examples from the nonfinancial world.

It's widely accepted that people experience cognitive decline as they age. It happens at different rates for different people, but it's been widely accepted that after around age 30, memory and certain mental abilities decline.

Newer research, however, adds to our knowledge and refines that information. The new information calls into question a lot of the conclusions from the early research and shows how we can use our aging minds to our advantage.

It turns out the cognitive tests that are the basis for what most people believe about aging minds were biased in favor of younger people. First, they were biased because of the way the tests were conducted. Younger people were used to taking those types of tests in those types of environments, so they were likely to score somewhat better than older people.

More importantly, the tests were biased because they were carefully structured to minimize the influence of experience on the results. The scientists wanted to measure only raw cognitive ability.

In other words, the tests tested artificial things. In most real-world decision making, experience and knowledge are important. Experience and knowledge become wisdom, and wisdom leads to better decisions.

The bottom line is that older people may process things a bit slower than younger people, but when they take the time to make decisions, older people often make better decisions.

It's important that you know this, because studies also show that people's beliefs about aging influence their behavior. For example, people who have negative stereotypes about aging tend to show greater memory decline than those with positive views of aging.

More importantly, you also can use this new information to improve your cognitive ability and keep your brain young. The best way to do that is to learn new things. Most people believe the way to prevent cognitive decline is to keep the brain working. That's what the first wave of research on brain health indicated. That spawned a wave of older people carrying around crossword puzzle and Sudoku books.

The latest research indicates that learning new things from time to time is better than doing puzzles and games. The brain seems to be more flexible and resilient when it is forced to learn new tasks and information instead of applying or remembering things already known.

Stay abreast of what's new, and your mind will stay fresh.

Another fact everyone knows is that exercise improves health and longevity. The standard advice is to engage in at least a minimum amount of physical activity, but that more is better for most people.

The advice changes and is refined, however, as more data are compiled and analyzed.

Data from the Copenhagen City Heart Study, which has been conducted since 1976, found that male runners lived on average 6.2 years longer than the nonjoggers, and for females the benefit was 5.6 years.

But more exercise apparently is better only to a point. Deeper analysis found those who ran more than four hours a week at 7 miles per hour or faster lost most or all of the benefits of exercise. The greatest health and longevity benefits went to those who ran 1.0 to 2.4 miles per week at a rate of 5 to 7 miles per hour. This group also abstained from vigorous exercise at least two days a week.

This study and others support the notion that too much and too strenuous exercise can damage the heart and other parts of the body. While exercise is better for health and longevity than no exercise, too much exercise can have the same effects as no exercise.

These are two examples of how something many people believe, that seems intuitive, and that becomes a rule of thumb turns out to be not quite true as we learn more and analyze the data in more detail.

THINGS THAT REALLY MATTER

We focused most of *The New Rules of Retirement* on your personal finances. We strove to cover all the key financial aspects of retirement and retirement planning.

But the point of this chapter is that there's a heck of a lot more to a successful retirement than money, and a substantial amount of money won't necessarily make your retirement happy or successful. Many people retire once, and then go back to work. A substantial minority of people "retire" several times before it sticks. Lack of satisfaction is what drives them back to work.

Periodically, I review the latest studies of the relationship between money and happiness. By and large, the studies show that once the basic needs of life are met, more money doesn't lead to more happiness. This is true across many different countries, cultures, and demographic groups. Other things lead to happiness and satisfaction, and you have to include these in your retirement plan.

In recent years, the money and happiness studies have tried to dive deeper into the issue.

In 2013, Emily Esfahani Smith wrote a couple of articles in The Atlantic discussing the deeper studies. The research indicates that happiness is different from purpose or meaning. People tend to report being happy when their lives are easy and they can have or do what they want. But happiness is fleeting. More lasting satisfaction comes from lives with purpose, even if that makes life difficult for a while. In fact, striving for happiness, wanting to be happy, and planning for happiness don't increase happiness and could contribute to unhappiness.

Most studies of happiness indicate that happy people tend to have a lot of social interaction, are optimistic, and are physically active, among other attributes. Yet, not all people who report being happy are satisfied. Having a purpose makes people more satisfied and, more importantly, makes them feel their lives are meaningful.

That's why many people become somewhat depressed after retiring or losing their jobs. They've lost a lot of their purpose in life, and their lives start to lack meaning.

In your retirement planning, be sure to include one or more things that will give you purpose and a feeling of being meaningful. You don't have to strive to do great things to have a purpose. Volunteering, working part-time, or helping family members or neighbors provide many people enough purpose to give their daily lives meaning.

You still need to plan your finances to be sure you have the time to seek happiness and purpose. But be aware that financial planning isn't the end of retirement planning and won't lead to a successful retirement by itself.

CHAPTER 15: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Neglecting the soft side of retirement planning is so widespread that in recent years many professional advisors adopted an approach that is sometimes referred to as ___________________.**

A. total financial planning

B. life planning

C. total retirement planning

D. comprehensive retirement planning

2. **Which of the following is <u>not</u> a reason given by people that say they want to work past age 65:**

A. many people want the experiences that come with working

B. many people benefit from the structure of work

C. people are healthier and living longer

D. fewer younger people are working so job openings remain unfilled

3. **According to the most recent Fidelity Investments survey, which percentage of spouses of retirees disagreed on what the primary source of income would be:**

A. 10 percent

B. 33 percent

C. 41 percent

D. 61 percent

4.	**Which of the following is correct regarding debt and retirement:** **A.** it is rare today for an individual to retire with substantial debt **B.** retirement typically means an individual has more flexibility in his or her spending **C.** high debt and large surprise expenses can be financially devastating in retirement **D.** most retirees should plan on taking on more debt during retirement

CHAPTER 15: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Total financial planning does not incorporate the soft side of retirement planning. **B.** CORRECT. Many professional advisors offer life planning, which allows the advisor to get to know the client personally and to make a retirement plan that suits the individual and his or her interests (the soft side). **C.** Incorrect. The term that professional advisors use for a comprehensive retirement plan is not total retirement planning. **D.** Incorrect. Comprehensive retirement planning is not the term used by financial advisors when devising a retirement plan that incorporates the soft side of retirement planning as well as the financial side. *(See page 319 of the course material.)*
2.	**A.** Incorrect. Many workers that say they plan to work past 65 want to do so because they want the experiences that come with working. **B.** Incorrect. Many people feel that the benefit received from the structure of work makes them more likely to want to stay employed past 65. **C.** Incorrect. Because people, in general, are healthier and living longer, they want to stay employed longer as well. **D.** CORRECT. The lack of replacement employees is not a reason given for wanting to work past the age of 65. *(See page 320 of the course material.)*
3.	**A.** Incorrect. The percentage of spouses that disagreed about the primary source of retirement income was much higher than 10 percent. **B.** Incorrect. Thirty-three percent of those surveyed disagreed about the amount of their life insurance coverage and expected retirement ages, not about the source of income. **C.** Incorrect. Forty-one percent of those surveyed disagreed on whether at least one spouse would work during “retirement,” but more disagreed about the income source. **D.** CORRECT. Sixty-one percent of spouses disagreed on what the primary source of retirement income would be. *(See page 322 of the course material.)*

4.	**A.** Incorrect. While it used to be rare for someone to retire with debt, the number of retirement-age Americans with substantial debt is increasing. **B.** Incorrect. Retirees typically have reduced spending flexibility and substantially less potential to earn a high income. **C.** CORRECT. High debt and large surprise expenses, such as unplanned medical expenses, can be financially devastating in retirement. **D.** Incorrect. For most people, it is better to eliminate debt in retirement. *(See page 323 of the course material.)*

GLOSSARY

Crummey Clause: A provision contained in certain irrevocable trusts that permits specified trust beneficiaries to withdraw gifts you make to the trust for a limited period of time. The provision allows gifts to the trust to qualify for the federal annual gift tax exclusion.

Defined benefit plan: A company pension plan in which an employee's pension payments are calculated according to length of service and the salary they earned at the time of retirement.

Dynamic asset allocation: A portfolio management strategy that involves rebalancing a portfolio so as to bring the asset mix back to its long-term target.

Effective tax rate: The average rate at which an individual or corporation is taxed. The effective tax rate for individuals is the average rate at which their earned income is taxed. The effective tax rate for a corporation is the average rate at which its pre-tax profits are taxed.

Health savings accounts (HSA): A savings account used in conjunction with a high-deductible health insurance policy that allows users to save money tax-free against medical expenses.

Long-term care: A variety of services which help meet both the medical and non-medical needs of people with a chronic illness or disability who cannot care for themselves for long periods.

Long-term care insurance: Insurance that helps provide for the cost of long-term care beyond a predetermined period. Long-term care insurance covers care generally not covered by health insurance, Medicare, or Medicaid.

Long-term legacy spending: Type of spending that involves conserving part of the retiree's estate so it can be left to family members.

Medicaid: A health care program that assists low-income families or individuals in paying for long-term medical and custodial care costs. Medicaid is a joint program, funded primarily by the federal government and run at the state level, where coverage may vary.

Medicare: The federal health insurance program for people who are 65 or older, certain younger people with disabilities, and people with End-Stage Renal Disease (permanent kidney failure requiring dialysis or a transplant, sometimes called ESRD).

Pease tax: Reduces the amount of itemized deductions that certain taxpayers are allowed.

Replacement ratio: A person's gross income after retirement, divided by his or her gross income before retirement.

Required minimum distributions: The minimum amount you must withdraw from your account each year. You generally have to start taking withdrawals from your IRA, SEP IRA, SIMPLE IRA, or retirement plan account when you reach age 70½. Roth IRAs do not require withdrawals until after the death of the owner.

Section 529 plan: A tax-advantaged method of saving for future college expenses that is authorized by Section 529 of the Internal Revenue Code.

Uniform Gift to Minors Act (UGMA) account: An act in some states that allows assets such as securities, where the donor has given up all possession and control, to be held in the custodian's name for the benefit of the minor without an attorney needing to set up a special trust fund.

Vacation retirement: A term used for the idealized retirement of the 1950s through 1980s where people were believed to spend their time in leisure activities.

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About the Author

Robert C. Carlson is editor of the monthly newsletter *Retirement Watch*. He is also the managing member of Carlson Wealth Advisors, L.L.C. Mr. Carlson is chairman of the board of trustees of the Fairfax County Employees' Retirement System, which has over $3 billion in assets, and was a member of the board of trustees of the Virginia Retirement System from 2000 to 2005, which oversaw $42 billion in assets at the time.

Mr. Carlson was trained as an attorney and accountant, passing the CPA exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument-rated private pilot. He is listed in several editions of *Who's Who in America* and *Who's Who in the World*.

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