Guaranteed Retirement Prosperity

Proven Strategies for Surviving the Social Security Doomsday Clock and Boosting Your Income in a Recession

Bob Carlson
Editor, *Retirement Watch*

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Published by:
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The Retirement Dead Zone: How to Survive the Worst Decade for Retirees in American History

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BONUS CHAPTER:

Introduction

First, let's address the *Retirement Bombshell*… why it's so important for retirees to know the facts… and what's coming down the pike.

The *Setting Every Community Up for Retirement Enhancement* (SECURE) Act was signed into law in December 2019.

On its surface, the SECURE Act appears to encourage Americans to save more for retirement.

For example, it aims to increase access to tax-advantaged retirement accounts, like the 401(k).

Additionally, the SECURE Act encourages employers to sign up part-time workers into participating retirement plans.

What Congress won't tell you, however… are the costly side effects of this law.

Ones that threaten to take money – potentially A LOT of it -- away from your heirs.

That's because the SECURE Act has effectively killed a popular retirement strategy called the Stretch IRA.

The Stretch IRA worked like this…

Let's say you have an IRA, and your wish (upon your death) is for your beneficiaries to inherit it.

In addition, you want the distributions of that IRA to "stretch out" for as many years as possible.

This gives beneficiaries distributions (income) that are spread out over time. It also reduces the lifetime taxes paid compared to the higher taxes incurred from a lump sum distribution.

What's more, the extended timeframe of the Stretch IRA strategy allows more time for the IRA to grow tax-free.

Ultimately, the longer a beneficiary can take advantage of the Stretch IRA provisions, the more the IRA will likely be worth when he or she needs it.

Which, of course, means LESS tax revenue for Uncle Sam to take in.

(In past issues of *Retirement Watch* I've discussed the details of the Stretch IRA and how your heirs can ensure they receive all its benefits. As a member, you can review these articles in the Archive on the members' section of the web site at www.RetirementWatch.com.)

And so you can see why elimination of the Stretch IRA is actually one of the chief goals of the SECURE Act.

Under this new legislation, beneficiaries (other than the spouse and a few other select categories of beneficiaries) have to distribute that inherited IRA (including Roth IRAs) within 10 years.

By cutting out the Stretch IRA benefits, Congress has a way to make up for its tax shortfall.

The SECURE Act does that.

It taxes your IRA beneficiaries sooner, rather than over time (as the Stretch IRA allowed all this time.)

So, what are retirees' options for solving this problem?

I identified at least six strategies that run an end-around on the SECURE Act's attack on the Stretch IRA.

I presented them in *Retirement Watch* some time ago, so my members already are working on solutions.

In fact, these strategies are so powerful that I've been recommending most of them for years in appropriate circumstances, even before people heard of the SECURE Act.

You can read all the details on page 68.

One more thing I should point out…

The SECURE Act is just for starters.

It's the first grenade lobbed in a new, orchestrated tax attack on your retirement finances.

IRAs and retirement accounts in the U.S. hold trillions of dollars. Congress wants those assets out of the tax-protected accounts sooner rather than later so it can collect more taxes.

So it's an absolute critical time to ***re-think retirement planning***.

After all, the rules will continue to change, so Americans need to be two, three… even four steps ahead to protect their nest eggs.

And that's why I wrote the **GUARANTEED RETIREMENT PROSPERITY**.

It's an evolving blueprint for making the most of your retirement finances – and always being several steps ahead of Big Changes that can affect your retirement.

I’ve broken the GUARANTEED RETIREMENT PROSPERITY into 4 sections, for easy reference.

SECTION I: Securing Your Retirement Income (Social Security, Investments, Annuities & Other Income Streams)

SECTION II: Your IRA, Taxes & More

SECTION III: Health Care, Long-Term Care (LTC) & Housing

SECTION IV: Your Estate Plan & Your Legacy

Of course, I don’t expect you’ll follow every single one of the retirement strategies I’ve laid out on the following pages.

But you will come to know all the options at your disposal, so you can decide which ones are right for you and your family.

I hope you enjoy reading the *The Retirement Dead Zone: How to Survive the Worst Decade for Retirees in American History*, and I look forward to helping you achieve your financial goals as a new member of *Retirement Watch*.

Kind regards,

Bob Carlson
Editor, *Retirement Watch*

SECTION I: Securing Your Retirement Income (Social Security, Investments, Annuities & Other Income Streams)

Plan Your Retirement Spending Wisely

The traditional retirement plan projects spending to rise steadily each year in line with inflation. That model does not work well for today's retirees.

When retirement lasts 20 or 30 years or longer, a more realistic model of spending and scheduled withdrawals is needed.

Unlike the projections in most models, retirement spending does not increase in a straight line. It varies over time.

In addition, markets also do not move in a straight line. They are volatile and can have extended bear markets and bull markets. These fluctuations in the portfolio value should influence annual spending.

I have found two models that accommodate real-life retirement spending and portfolio fluctuations. They are more realistic than the straight-line models that are generally used.

The first model is to adapt the spending formula used by the Yale University endowment.

The first step is to set the withdrawal percentage for the first year of retirement. Most studies conclude that the maximum safe rate is just over 4% of the portfolio's value.

After the first year, the distribution is determined by using **two separate formulas**.

The first formula is last year's distribution plus the inflation rate for the last year. Multiply that amount by 70%.

The second formula is your initial withdrawal rate multiplied by the fund's value at the start of the second year. Multiply that result by 30%.

Add the two results together to get the distribution for the year.

Under this formula, spending fluctuates with the markets and inflation, but the changes are not as volatile as the markets and inflation are. If the markets experience an extended decline, spending declines gradually.

During bull markets, spending increases faster than inflation. That allows you to enjoy some of the excess gains of the bull market.

But the spending does not rise enough to absorb all the investment gains. The formula leaves a cushion against the inevitable market downturns.

The second model is based on the spending cycles that occur during retirement.

Spending varies by age. Even after retirement there are several cycles. For most people, annual spending peaks around age 50 and then steadily declines, according to the Department of Labor's Consumer Expenditures, which it revises every few years.

There are additional fluctuations after 50. For many people, there is a bump in spending immediately after retirement. There is a burst of spending on pent-up demands such as travel and recreation. After age 75, spending declines somewhat rapidly.

Retirees can plan for a three-stage spending cycle.

The first cycle can be referred to as the honeymoon period of the first few years. This is when the retiree has pent-up demands and also is relatively young and healthy.

After that period, the lifestyle becomes more normal and regular. Spending settles at a level that is lower than during the initial years of retirement.

Sometime after age 75, spending is likely to downshift again. The Department of Labor study indicates that spending by those over age 75 is 25% or more below that of younger retirees. People simply become less active at some point, even when they are healthy.

There might be a fourth spending stage in which major medical expenses or long-term care expenses are incurred. Often when this occurs other living expenses decline. The total expenses incurred by the retiree during that period depend on the extent of insurance coverage.

Under this model, a retiree plans to spend more in the first years of retirement. Perhaps spending could rise to as much as the 8% of the portfolio that many pre-retirees say they are planning.

After a few years, the plan has a spending decline, following by another decline in later years.

A variation of the spending cycle approach is to divide your retirement portfolio into two portions.

One portion is 85% of the portfolio. You plan to spend this amount in roughly equal installments until age 85.

If you retire at 65, you can spend one twentieth the first year, one nineteenth the second year, and so on.

In the meantime, the other 15% is invested in a portfolio designed to grow in value over the 20 years. At age 85, if you are still alive, this second portfolio can be spent over the rest of your life or used to purchase an annuity.

These variable spending models recognize the realities of retirement spending, including that most retirees have flexibility in their budgets.

A number of expenses can be deferred or eliminated, such as travel, auto purchases, and home repairs or remodeling. Other expenses can be increased or reduced from year to year, including dining out and entertainment.

Retirees should plan on flexibility in their spending.

Adjust expenditures for inflation, portfolio volatility, health, and other factors. Varying spending and withdrawals from the portfolio increase the probability of having financial security through retirement and leaving an inheritance for heirs.

The Biggest Mistake in Retirement Planning

What's the #1 mistake in retirement plans?

Failing fully to factor inflation into planning. Make this common mistake and you'll unknowingly drain your IRA and other accounts so fast it will make your head spin.

Retirement these days often lasts 20 years or more. To be safe, you should plan on living to age 90 or older. Over that time, inflation can make a safe, comfortable stream of income uncomfortably tight, even at low inflation rates.

Your purchases almost certainly don't follow the basket of goods in the survey from which the Consumer Price Index is derived. You likely spend more of your income on medical care, and perhaps on eating out, recreation, and other leisure activities.

You also might spend a higher percentage on the necessities, such as food, fuel, housing, and travel. You likely spend less on education, clothing, and work-related expenses, among others.

The ideal option is first to figure out your itemized monthly or annual budget. Then apply an inflation factor to each spending item.

For example, you can inflate your food expenses by the actual food inflation of the last five or 10 years (or your estimate for the future).

Or you can go a step further and separate "food eaten away from home" and "food eaten at home," because restaurant costs have been rising faster than grocery store costs for several years.

How Unforeseen Circumstances Can Negatively Impact your Plans for Retirement

Unfortunately, financial surprises in retirement can blow a hole in your plans. Particularly for early retirees, surprises can be very damaging to their best-laid plans.

The scenario occurs with frequency. A couple diligently worked up a detailed plan that covered all the expenses of their desired lifestyle. They ventured into retirement secure in the belief that they were financially comfortable.

Then, one or more unexpected events happen. Unplanned medical expenses, major home expenses, lower than expected investment returns, and family emergencies are just a few of the major sources of surprise.

When paying for unplanned expenses, retirees lose not only the cash paid for the expenses but all the future income it was expected to generate. Over a retirement of 10 to 30 years, that income is quite a sum. When the unexpected jolt to cash flow arises, retirees need to know how to respond. Here are some key strategies to consider.

Plan for it. Annual spending in a retirement plan should include the irregular and even "unexpected" expenses. The spending plan should provide a place for the irregular cash drains.

I often recommend that the monthly expenses include "sinking fund" expenses. For example, someone who plans to purchase a new car every four years would list a few hundred dollars for automobiles in the monthly spending plan. That amount won’t be spent each month.

The sinking fund, however, ensures that when the spending numbers are run through a computer model the retiree has a better idea of whether enough really has been saved for retirement. Sinking funds can be set up for home repairs and even for unexpected emergencies.

Save more. An alternative to the sinking fund is to establish a cushion in the retirement fund. Don't retire until the fund has $100,000 or so beyond what is needed to generate cash for your planned lifestyle.

Cut spending. Most retirement spending plans are flexible. There are variable expenses that can be cut or delayed. The typical retiree can spend less on travel, dining out, spoiling the grandchildren, and other discretionary items when surprise expenses need to be paid. The reduction does not have to be significant. A cut of 5% or so is enough to get most plans back on track.

Back to work. Those who retired just a few years before the emergency often can return to work, even on a part time basis. They might do something similar to the work they retired from or seek other work to bring in a few dollars until the plan is back on track.

More and more employers are "senior friendly," so returning to work is a more viable option than it used to be. Many retirees who take jobs related to their hobbies instead of their old jobs find that the employment increases their enjoyment of retirement.

Retirees should expect the unexpected in their spending. The best solution is to have built a cushion in the retirement plan that anticipates the occasional unplanned expenses. Even when that isn't done, there still are options that can get the plan back on track.

Stock Market Declines Can Wreak Havoc on Your Retirement

Here’s why. The most dangerous years for a retiree are the five years immediately before and five years immediately after retirement. During that period, the person is most at risk from the negative consequences of a significant market decline.

A person’s retirement nest egg builds during the working years, reaching a peak at retirement. Everything works fine if the investment returns for the next few years equal or exceed the long-term average. But if stocks tumble when the nest egg is near the peak, then there’s a big setback in the retirement plan.

It will take a while for the nest egg to recover to the level on which the retirement plan is based. In addition, instead of spending income and capital gains for the first years of retirement, the retiree is spending principal.

So, it will take that much longer for the nest egg to recover. In fact, the nest egg might never recover to where it needs to be for the retirement plan to succeed, depending on the severity of the market decline and how long it takes for the markets to recover.

This is what economists call the “sequence of returns risk.” You aren’t hurt too badly if a bear market occurs after you’ve been retired for a while. The nest egg has achieved its projected returns for years, and you’re well into the retirement years. But as the studies show, the effects can be very bad if a bear market occurs just before retirement or in the early years of retirement.

That’s why the studies show the best strategy for uncertain economic environments is to reduce holdings of stocks and other risky investments as you approach retirement and then gradually increase them during retirement.

You want to gradually increase stocks and other risky investments during retirement, because you want growth investments in the portfolio. Retirement is likely to last a long time. You need growth in the portfolio to maintain your purchasing power as inflation raises the cost of everything you buy.

How To Maximize Cash Flow — While Preserving Retirement Capital

One strategy we have recommended for some time and that has been adopted by others is the emergency fund or cash reserve fund.

Set aside a portion of your portfolio equal to one to three years of estimated spending. You choose the amount. Invest this part of the portfolio in super-safe assets such as money market funds and certificates of deposit.

The rest of the retirement assets are invested for the long term. Interest, dividends, and sales of shares from the main portfolio are used to pay for living expenses when the portfolio is rising or stable.

But when a bear market knocks down the value of the portfolio, there is no need to sell assets at depressed prices. Instead, use the safety fund to pay for expenses. After the markets recover, profits from the main portfolio can be used to replenish the safety fund and again to pay for expenses.

Not everyone has a large enough retirement fund to set aside several years of expenses in a low-yielding safety fund. An option for them is to put part of the retirement portfolio in immediate annuities paying a fixed amount for life.

Studies show that, on paper at least, immediate annuities extend the life of a retirement portfolio and decrease the risk of outliving one's assets.

Collect Steady Lifetime Income with Inflation Protection

One need of retiring Baby Boomers is for guaranteed lifetime income that replaces old-style defined benefit plans. Another need is for that income to retain its purchasing power. There are several investments and strategies that might accomplish these goals, and more are being developed by insurers.

Buy an immediate annuity and keep saving. A traditional immediate annuity achieves the goal of lifetime income.

The income payments, however, are fixed. Over time inflation erodes the purchasing power of the income. An investor searching for reliable income should consider buying an immediate annuity but not spending all the payouts.

To support purchasing power over time, save and invest some of the distributions.

Buy an inflation-indexed annuity. These annuities make regular payments for either life or a term of years, just like immediate annuities. The payments, however, are adjusted to reflect increases in the CPI. There usually is a maximum one-year increase of 10% or so.

The initial payment, however, generally is 20% to 30% less than that of a standard immediate annuity. The initial reduction is less when there is a lower ceiling on the maximum one-year increase. (Inflation-adjusted annuity payments generally can rise or fall with the CPI.

Payments will not decline below the initial payment amount, but negative CPI changes that are not reflected in the payments will offset future CPI increases.) Unfortunately, only a few insurers offer these annuities, because few people purchase them.

Buy a variable immediate annuity. In variable deferred annuities, the amount accumulated in the annuity account depends on the investment returns earned by the account's investments.

In a variable immediate annuity, the distribution each year depends on the performance of the investments. The VIA is fairly complicated.

The owner selects an Assumed investment return (AIR) from among several choices offered by the insurer.

The higher the AIR, the higher the initial payment will be. Future income payments will vary based on how the investments selected for the account perform relative to the AIR.

If the returns are above the AIR, payments will rise, but if actual returns do not at least equal the AIR, the payments will decline.

You should realize that if the account's return is positive but less than the AIR, the next year's payments will decline.

To avoid an income reduction, select a relatively low AIR of no more than 5%. That reduces your initial payment but makes future reductions less likely. Most VIAs also offer an option that eliminates income reductions, but that costs about 1% in extra annual expenses.

Buy a variable annuity with living benefits. This is a variable annuity with an option often called the guaranteed minimum income benefit (GMIB).

Such annuities provide the opportunity for the income to increase with little risk of reduced income.

No matter which annuity you lean toward, review what the results would be under different circumstances.

Also, realize that the additional features cost money. Review the fees and how much your income is reduced.

Most important is to compare redemption or cancellation fees. Often, it is difficult to exit one of these investments without a steep cost.

Generating Income with REITs

We've owned REITs (Real Estate Investment Trust) in **Retirement Watch** portfolios for decades, and have done very well with them.

We have a long-term position in my buy-and-hold *True Diversification* portfolio. (We add and subtract them from the other portfolios as market conditions warrant.)

And in my own personal portfolio, I've always had at least one REIT Position.

REITs have a low correlation with stock indexes, meaning they don't move automatically up or down with the indexes the way most stocks do.

But REITs are equity investments.

REITs purchase commercial properties around the country. Most REITs specialize in a particular type of property: hotels, apartments, offices, shopping centers, etc.

Some also focus on a particular region or two of the country. By owning REITs you own pieces of commercial real estate around the country. You can own shares of landmark commercial buildings when you own REITs.

Though I haven't yet added global REITs to my portfolios, the REIT concept is spreading around the globe. So, you can own pieces of commercial real estate around the world through a few REITs or a REIT fund.

They're a good source of income. REITs have higher yields than the major stock indexes and most stocks. They're required to distribute at least 90% of their net cash flow.

Good REITs increase their cash distributions most years. So, in addition to probable appreciation in the share price you earn a cash payout that usually increases over time.

REITs are in all sectors of the economy. So, you're diversified across the economy: apartments, office buildings, warehouses, shopping centers, malls, health care, data centers, cell transmission towers, self storage, and more.

REITs are a great way to invest in the coming boom in 5G communications and other parts of the tech boom without the risk and volatility of tech stocks. Don't take the risk of trying to choose the technology providers that are going to dominate the market. Instead, realize that 5G needs communication towers.

Several REITs benefited from the boom in cell phone use by dominating the cell tower business. These businesses will grow more, because 5G uses more communications nodes than regular cell phones.

REITs also are a good way to invest in the growth of cloud computing. You don't have to bet whether Amazon, Google, IBM, or Microsoft dominates the cloud business. They all need data storage buildings and data farms.

There are REITs that specialize in building and running data storage facilities. They've had a lot of growth and strong profits in recent years. They'll continue to benefit no matter which tech firms dominate the cloud.

Preferred Securities: The Investment that Should Be in Every Retirement and Pre-Retirement Portfolio

In this low-yield world, preferred securities provide a higher yield than well-known income investments, such as money market funds, treasury bonds, and CDs.

Preferreds also have lower risk than the high-yielding investments many people promote, such as high-yield bonds and private loans.

Advantages:

Preferreds have higher yield than treasury, investment-grade corporate bonds, and tax-exempt bonds. The yield difference can be 33% or more.

Current yields for individual preferreds are 5% and higher.

Most preferreds have tax advantages. Dividends from most preferreds now are qualified dividend income (QDI) instead of interest. QDI is taxed at maximum 20% rate, instead of the 37% plus 3.8% Medicare surge on interest income.

Preferreds have a higher pre-tax yield than most well-known income alternatives and have a higher after-tax yield than all of them when the income payments are QDI.
Preferreds are issued by many large, well-known companies: Wells Fargo, Prudential, Credit Suisse, JP Morgan, and Met Life are a few examples.

Issuers are companies based in both the U.S. and other countries, so you can put together a global portfolio of high yields. Overseas preferreds generally pay higher yields than U.S. preferreds.

Downsides:

Most issuers are banks, insurance companies, and other financial firms. You won't have full diversification in your preferreds. But in addition to financial firms, major issuers of preferreds are utilities, energy firms, pipelines companies, and telecommunications firms. More than 50% of the market is financial firms.

There are a lot of different types of preferred securities with different tax treatments and other differences. An investor has to really study the market to understand the different types and decide which preferreds he wants to buy. Or you can do what I recommend and buy one of the mutual funds that focus on preferred securities and aims to minimize the tax burdens of its shareholders.

Most preferred dividends aren't guaranteed. The issuer can suspend preferred dividends under certain conditions. That's usually done only in times of extreme financial stress, because the issuers want to be able to issue new securities in the future. That's tough to do if they suspended dividends in the recent past.

Preferred issuers often don't have investment-grade credit ratings.

Preferreds generally lose value when interest rates rise, much like bonds. The sensitivity to interest rates depends on the details of the preferred security.

Unlike bonds, preferreds aren't backed by assets or sources of income. They also don't have an equity interest, like stocks.

Individual preferreds can be difficult to sell. The market isn't as liquid as the markets for stocks or treasury bonds. You need to buy-and-hold or invest through a fund.

Now here's why most investors don't know about preferreds.

Preferreds are a hybrid of stocks and bonds. Most people focus on one or the other. They aren't attractive for many financial services firms to push to individuals. The firms don't want to take the time to explain preferreds.

Plus, preferreds don't trade in the volumes of stocks and bonds, and they don't provide the same level of profit to financial service firms.

Years ago there was a tax incentive for corporations to invest their cash in preferreds, and preferreds were generally only a good idea for corporations to own.

The tax situation has changed. There no longer are special incentives for corporations, and there are tax advantages for individuals to invest in preferreds, as I mentioned earlier. Most people don't know about preferreds, and there are limited incentives for financial services firms to market them.

Even many financial professionals don't know much about preferreds and how to invest in them.

A few mutual fund firms (especially several from Cohen & Steers) realize the value of preferreds and created ways for individuals to benefit from them.

The best way to invest in preferreds is through the two types of mutual funds that I've used frequently over the years.

Avoid the ETFs. That's the way many people who own preferreds invest in them, and that's too risky. Most of the ETFs follow an index. The indexes contain a lot of junk securities in order to reflect the full market. The indexes also have only securities from U.S.-based issuers. You miss a lot of opportunities and higher yields by not going global.

Funds buy preferreds at institutional prices and in large lots. Individuals can get burned on bid and ask spreads if they buy and sell preferreds on their own, because it's not a liquid market.

A mutual fund also can analyze the firms and avoid those with high credit risks.

A mutual fund provides more liquidity than owning individual preferred securities. You can sell your fund shares every day at net asset value, which you might not be able to do with individual securities.

A good fund is Cohen & Steers Preferred Securities and Income fund (CPXCX). (The fund has several share classes with different tickers. The best share class to buy depends on the broker you use or whether you buy directly from Cohen & Steers.) It's an open-end mutual fund. The expenses are on the high side. Recent yield was over 4%. It was over 5% just a couple of years ago. But it's still well above the other safe alternatives, and the distributions have the tax advantages mentioned earlier.

The fund's total return was above 17% in 2019 and over 6% in 2020.

Another good way to invest in preferreds is through one of the closed-end funds that concentrate on preferreds. They use leverage to increase yield and total return. That can be a problem in a falling market or when interest rates are rising. But we will sell the funds when interest rates seem likely to rise, which I did a couple of years ago.

I recommend Cohen & Steers Limited Duration Preferred & Income fund (LDP). The distribution yield in mid-2021 was more than 6.4%. The fund normally sells at a discount to net asset value; don't buy when it's selling at a premium. Here are some recent annual returns for the fund:

2016: 17.94%
2017: 14.58%
2018: -9.68%
2019: 29.44%
2020: 9.46%

I also recommend Cohen & Steers REIT & Preferred Income (RNP) which is invested about half in preferreds and half in REITs. You can combine both these investments in one well-run fund.

For details about preferred securities, a good source is Cohen & Steers web site, especially this link:

https://www.cohenandsteers.com/insights/read/preferred-securities-a-tax-advantaged-complement-ret

The Backdoor That Can Add at least $38,000 to Your Roth IRA Every Year

Higher-income taxpayers often are shut out of the benefits of a Roth IRA. Contributions can be made to a Roth IRA only when your adjusted gross income (AGI) is below a certain level: $198,000 for a married couple filing jointly in 2021 and $124,000 for a single taxpayer.

There's another way to funnel money into a Roth IRA. It allows you to contribute far more than is allowed through regular Roth IRA contributions. It's especially valuable for high-income taxpayers who are still working and for the self-employed.

The strategy is known generally as the Mega Backdoor Roth IRA. It begins with an employer 401(k) plan. If you're self-employed, you can set up a single-member 401(k) plan.

The Mega Backdoor Roth IRA is particularly attractive when you believe tax rates are likely to be higher in the future. You can pay taxes at today’s rates (which were decreased in the Tax Cuts and Jobs Act in 2017) and ensure the money and the earnings on it will be tax free when you take them out of the Roth IRA.

But it’s also a way to ensure you have tax diversification and are prepared for whatever changes occur in the tax law.

Most people are familiar with the annual limit on tax-deferred 401(k) contributions, which is 2021, plus an additional $6,500 for those age 50 or over. You designate a portion of your salary to be deferred into your 401(k) account. The deferred amounts up to the limit are excluded from gross income for income tax purposes, but not for Social Security and Medicare tax purposes. Those are the pre-tax contributions to your 401(k).

Not as many people know the tax code allows additional contributions to the 401(k) account.

These additional contributions are after-tax contributions, because there’s no tax deferral. The additional amounts you defer are included in gross income and are fully taxed. When you eventually withdraw them, the after-tax contributions won’t be taxed. The after-tax contributions are invested in the account, and the income and gains compound tax deferred. The income and gains are taxed as ordinary income when they are distributed.

The tax code allows total 401(k) contributions of $58,000 in 2021, or $64,500 if you're age 50 or over. (The limits are adjusted for inflation each year.) That means you might be able to make more than $38,000 of after-tax contributions.

If your 401(k) plan makes matching contributions, the matching contributions count against your annual limit. So, you might not be able to set aside the full $38,000 of after-tax contributions.

When these two conditions are in place, you make after-tax contributions to the 401(k) and use an in-service distribution to roll it over to a Roth IRA. Once the funds are in the Roth IRA, they are treated the same as other Roth IRA money. Income and gains compound tax-free in the Roth IRA. There are no required minimum distributions (RMDs) during your lifetime. Any beneficiary who inherits the IRA must take RMDs during his or her lifetime.

To use this strategy, see if your 401(k) plan allows after-contributions. If it does, decide how much you want to contribute and set up the additional contributions.

See if your plan allows in-service distributions. If it does and you're eligible to make them without penalties, you can roll over those after-tax contributions to a Roth IRA. An annual rollover should be fine.

If you can't take in-service distributions, the rollover to the Roth IRA can wait until you leave the employer, either for retirement or another job.

Secrets to Boosting Social Security

Social Security retirement benefits are the foundation for post-career income.

They are important to many Americans. Unfortunately, there's a lot of confusion and misunderstanding about the benefits.

It's 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.

The effects of the decisions also can ripple through to your spouse and children. You need to carefully consider Social Security decisions. Ideally, planning about Social Security benefits begins several years before you plan to retire.

Before retirement, most people think Social Security won't be an important part of their retirement cash flow.

Yet, 34% of current retirees estimate that Social Security provides 90% 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 for many people.

It is among the very few guaranteed and inflation-indexed sources of income.

Most people have little idea how much their benefits will be. Social Security used to send annual statements to everyone who was eligible for future benefits. Now it only sends annual statements to people older than a certain age. Others can find that information on the Social Security web site.

The amount of your final income that Social Security will replace depends on your income level throughout your career.

The lower your income, the higher the Social Security replacement ratio is. A lower-income worker could receive 90% of his final income in Social Security retirement benefits.

A very high income worker could receive closer to 10% or less of final income in Social Security benefits.

The average U.S. worker receives about 40% of final salary income in Social Security retirement benefits. The average benefit in 2021 was $1,543 monthly. The amount changes monthly and can be found on the Social Security web site.

The maximum Social Security benefit in 2021 for a worker retiring at full retirement age is $3,148. 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 payable) every year beginning at age 21. Of course, once benefits begin they rise with increases (but don’t fall with decreases) in the Consumer Price Index each year.

Social Security is becoming a more important source of income for many Americans, and many 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 right 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.

Last decade’s rules of thumb are not ideal for today's retirees.

Taking Social Security benefits often does not involve one decision. For married couples, there are a series of decisions to make. Most of these decisions are irreversible and 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.

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 and inflation protected. These are two qualities many people appreciate only after they've been retired a few years.

There are two other aspects of Social Security benefits that often are misunderstood. For more and more retirees, at least a portion of the benefits are subject to income taxes. Originally, benefits were tax free.

But beginning with the 1986 law, a portion of benefits were taxed. 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.

We won't cover either of these last two issues in this report, but you need to know about taxes on benefits and how benefits are affected when you work while receiving them. You can find information on the members' section of the Retirement Watch web site at www.RetirementWatch.com and in my books *The New Rules of Retirement* and *Personal Finance After 50 for Dummies*.

Why taking Social Security Benefits as Early as Possible May No Longer Guarantee You the Most Money from Uncle Sam

What is the best age to begin taking your Social Security benefits?

The answer might be changing.

As with everything else about retirement, the right decision changes over time and isn’t the same for everyone.

Most people know that the earlier you begin Social Security benefits, the lower the payment will be.

Begin benefits before normal retirement age, and you receive a reduced monthly benefit. The amount the benefit is reduced depends on how long before normal retirement age it begins.

You can begin taking benefits as early as 62. Starting the benefits at age 62 results in a monthly benefit equal to about 75% of the full retirement benefit.

But delaying receipt of benefits increases the monthly benefit. Delay benefits past normal retirement age, and the benefit increases by 6% to 8% per year.

The key is that the increase and decrease rates 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 "breakeven point."

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 increase and decrease rates were set in 1983, the last time Social Security was reformed, using life expectancy tables available at the time.

Life expectancies have increased considerably since then. About half of men currently age 65 will live past age 85.

Another factor is that the annual cost of living increases also increase the initial benefit for those who delay benefits.

If you actually wait until age 70 to begin benefits, you should receive a higher benefit than the one estimated when you were age 62, because of the cost-of-living factor.

Most beneficiaries begin their benefits early, and for many years that made some sense.

But the change 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 might 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, most people will receive a higher lifetime benefit by waiting.

When It's Best To Take Social Security Benefits Early

Delaying Social Security benefits is not for everyone.

Some people simply need the income as soon as they are eligible. They left their employment and are unable or unwilling to seek other work. They also do not have enough savings to wait for benefits.

Another reason not to delay benefits is if there are health or other reasons to doubt a person will reach the breakeven point of normal life expectancy. If that is the case, there is no reason to delay benefits except perhaps to increase benefits for a surviving spouse.

Some people who do not need the benefits still want to begin them early.

Their reasoning is that they can invest the benefits. They believe the return they earn will be high enough to offset the higher benefits they would receive from waiting.

They might be right. But be sure to consider all the factors.

The benefit at age 70 can be twice the age 62 benefit, after considering the age adjustment and inflation increases.

In addition, that higher benefit will continue for life and will increase with inflation. There also will be a benefit for a surviving spouse. It will take some good investment returns to equal that package.

How Married Couples Can Maximize Social Security Benefits

Social Security benefit rules allow some interesting planning strategies beyond simply deciding when to begin benefits.

Most of these strategies involve married couples. We will build on the rules already discussed to develop strategies that might further boost the guaranteed retirement income of you or 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.

(Theoretically the husband can begin receiving retirement benefits while continuing to work. If the husband is under full retirement age, however, the earnings limit will reduce the amount of those benefits and that in turn will reduce the amount received by the wife. If the salary of the husband is high enough, the benefits either spouse is eligible for will be zero.)

The wife, however, 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 full retirement age based on her own earnings. When Max reaches FRA he will be entitled to $1,800 monthly.

Rosie can begin taking $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. That assumes neither of them began receiving benefits until reaching FRA.

Suppose Rosie begins receiving her benefits before her FRA. She will receive a reduced benefit of let's say $400 monthly based on her earnings. When Max retires at FRA, she still will receive the additional $400, bringing her monthly benefit to only $800. By beginning benefits before FRA she permanently reduced her monthly benefit, even after Max retires at FRA.

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, based on a formula. 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 is receiving less than his full benefit. Rosie should receive less than the $800 monthly in the previous example.

As you can see, the rules and scenarios can get complicated. Social Security's web site calculators can help explore results under different scenarios. While the best option depends on the specific details, studies have concluded what's likely to be the optimal strategies for many couples.

Under these studies lifetime payouts are maximized if 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.

The best strategy depends on several variables, such as age differences, earnings differences, and health factors. If you want to establish the optimum strategy, consult with a financial planner who has considerable expertise on the subject.

Maximizing Benefits for the Divorced and Widowed

Divorced and widowed taxpayers have other options and rules to consider.

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

A divorced person can collect 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 and without telling the former spouse. In fact, the ex-spouse doesn't even have to be alive.

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 amount if your ex-spouse is qualified for them, regardless of whether he or she has applied. Your benefit is reduced if you begin it before you are full retirement age.

Divorced spouse benefit can be helpful even when you were the higher earning spouse.

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

The survivor's benefits are a little different for a surviving spouse who was married to the deceased spouse at the time of death. A surviving spouse receives the higher of his or her earned benefit and 100% of the deceased spouse's earned benefit (or what the deceased spouse was receiving at the time of his or her passing).

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 early and will be about 71% of full benefits by taking them at 60. Full benefits can be received if the survivor waits until full retirement age to begin the benefits.

Eligibility for survivor's benefits isn't affected when the survivor remarries after age 60. So, if you are widowed and considering remarrying in your late 50s, consider delaying 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.

How the Federal Reserve Is Changing Our Investment Strategy

The Federal Reserve and other central banks now are actively and preemptively fighting deflation. In the past, central banks were most concerned about containing inflation and they'd tighten monetary policy whenever price increases established some momentum.

In normal times, the Fed would have tightened money before 2020. The economy had been growing for more than 10 years and we had a very long bull market in stocks. The unemployment rate was below 4%, and wage growth was increasing.

Central banks changed their policies in 2019 to fight deflation and changed them even more during the Covid-19 pandemic. So, we should adapt our portfolios. I first explained the changes and how to adjust to them our portfolios for them in the December 2019 issue of *Retirement Watch*. You can read those details at this link: https://www.retirementwatch.com/wp-content/uploads/RW-DEC-19-with-Supplement.pdf

I explained the additional changes and the changes to make in response in later issues of *Retirement Watch* – and through my monthly online seminars I call the *Spotlight Series*. (You can learn more about Spotlight on the web site).

How To Lock in Guaranteed Income with Annuities

Guaranteed lifetime income means financial security like nothing else does. Some people have pensions. For most people, however, after Social Security the most likely source of guaranteed income is annuities.

Many different kinds of annuities are available. The choices generate both confusion and controversy. 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 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 significantly reduce the risk of outliving your money.

You can read about some of the research in the Archive on the members' section of the Retirement Watch web site at www.RetirementWatch.com.
A stream of guaranteed income also allows you to take a bit more risk with the rest of your assets, perhaps leading to higher returns and either a higher standard of living or more assets to leave to loved ones. You don't have to take more risk with the rest of your portfolio just because you purchased an annuity, but it does open up that option.

Even when you decide an annuity allows you to take more risk, you don't have to take a high level of risk. But the security of the annuity income makes it safer to invest for higher returns with your nest egg than you would be comfortable with if you didn't have the guaranteed income.

There are many types of annuities, and not all annuities provide these benefits. The wrong vehicle could result in higher fees, less control, less liquidity, more risk, and fewer benefits.

In this section you learn how to decide the right type of annuity to increase your retirement paycheck and then shop for the best deal.

Most people buy annuities the wrong way. They are presented with a specific investment and try to decide whether or not to put money into it. That's backwards.

The right approach is to decide what you want in your portfolio, or how much guaranteed income you want and look for a vehicle that delivers. Then, shop around to find the best deal on that type of annuity. This section is for investors who take the second approach.

We focus primarily on immediate annuities in this report. Other annuities have their places. But for someone seeking guaranteed lifetime income, the immediate annuity is the prime choice.

An immediate annuity is sort of like 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. The payment amounts don't change, except for two variations of the standard annuity, which we'll discuss later.

In the prototype 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% or 50% 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 period ends.

Some people select a payment for life with a guaranteed term of years. Under this arrangement, 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 reduces the payment further.

Why People Don't Buy Annuities

Economists and most financial advisors believe almost everyone should use immediate annuities to secure part of their retirement paycheck. Yet, very few people purchase annuities to generate guaranteed income for life. Some economists refer to this as The Annuity Puzzle.

People give a lot of reasons for not adding annuities to their financial assets.

- 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 insurer and its other annuity owners' benefit, and the unused portion of the nest egg doesn't go to loved ones or charity.
- Some don't want to give up control of part of their hard-earned nest eggs to an insurer or anyone else.

Similarly, people don't like the inflexibility of 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 buy something.

There are exceptions to this last point; many immediate annuities now will let you take up to 10% 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 in the 1990s 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 aren't 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 with a mutual fund or stock.

Of course, some people fear the insurer could become insolvent and stop making payments.

The fixed amount of the payments also is an issue. People know that inflation will eat away at the purchasing power of that income over the years.

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. The insurer provides you with income security.

The insurer now has to deal with 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 they likely balance each other.

The insurer also has more tools for dealing with low investment returns. 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 and use those profits to 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 wins. 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 above.

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.

The questions you need to ask when considering an annuity are: 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, because of poor investment returns or a long life, consider purchasing an immediate annuity with part of your nest egg. That 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 are overcome when you decide to put only a portion of your nest egg into an immediate annuity. Very few people should put all or most of their assets into annuities, such as people with few assets, relatively low expenses, little comfort with investing, and the potential for long life expectancy.

Most people should consider putting from 10% to 50% 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 invest for growth and purchasing power protection, be available for unexpected spending, and to leave to loved ones or charity.

Remember what we discussed earlier in this report. For most people a good goal is to 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 maximum income security for your post-career period.

The rest of your portfolio can be used to generate additional returns and income to fund non-essential 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 payments will be. The amount of the payments is determined 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 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 extremely low rates 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: They're not easy to buy and 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 report 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 learn how to increase your monthly income for life as much as 20%.

Increasing Annuity Income for Life

After deciding you want a portion of your portfolio in immediate annuities and whether they should be inflation-indexed or not, 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 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 financial advisors believe immediate annuities should be purchased by most people in retirement 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 this and shop for annuities.

Insurers and other annuity payers use different assumptions to determine their payouts. They consider estimated investment returns (and recent investment losses), their own life expectancy tables, and their annual expenses and desired profit margin. Each of these assumptions varies between insurers. Many insurers 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. Often, the highest payouts are offered by insurers with lower financial ratings and more risk.

Each insurance broker and agent usually offer 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 have to meet with several of them.

An easy way to shop is to visit web sites, such as www.immediateannuities.com or www.annuities.direct (Ignore any hyphen.) 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 web sites show the results on the screen. Others mail a package of the proposals to you.

Consider a male aged 60 who wants to put $100,000 in an annuity that will pay monthly income for life with no term certain and no payouts to beneficiaries. From 13 insurers checked by www.immediateannuities.com, the highest monthly payout the last time I checked was $589 monthly from Presidential Life Ins. Co. and the lowest was $533 from Midland National. The $56 difference may not seem like much, but it is 10.51% more per month, every month. It comes to $672 annually — more than one month's payment from either insurer. Over a lifetime, that's a lot of money. (Keep in mind these are only examples. The payouts from annuities change frequently.)

If you are willing to consider insurers with lower financial ratings, the difference is greater. Often there is a payout difference of 20% or more.

I've done this study periodically for over 30 years, and the result always is the same. You risk giving up significant monthly income for the rest of your life by not shopping around. I repeat, however, that 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.

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. I discuss this further later in this report.

Shopping for Higher Income from Annuities

Here's another example of how shopping for annuities increases your post career paycheck. As we discussed, annuity offerings differ significantly among insurers. You can take the search one step further and consider different sources of annuities, or channels as they're known in the business.

There are several sources for annuities, and they earn different commissions from the insurers or obtain different prices for their clients. In general, a higher volume agent or broker can negotiate a better price. That means you can buy the same annuity from the same insurer through different channels and receive different monthly income.

The best work I've seen on this was done by Kerry Pechter in the Retirement Income Journal, a subscription web site. Pechter checked prices at four online sites.

ImmediateAnnuities.com, a website I've used and mentioned, is a broker that represents a large number of insurers. When you ask for a quote, you'll receive data from a dozen or more insurers. The price through the site should be the same or similar to what you would pay through any individual agent or broker representing the same insurer.

IncomeSolutions.com is an institutional channel. It negotiates prices with insurers, and then it says it won't mark those prices up by more than 2%. Standard commissions on immediate annuities, by contrast, usually are 3% to 4%. Many insurers don't participate, and consumers have limited access to the site. To buy from it, you must be a member of one of the pension plans that participate, have a Vanguard account, or use a fee-only advisor belonging to the National Association of Personal Financial Advisors.

Fidelity.com offers annuities from five major insurers and was used as a proxy for several mutual fund companies and discount brokers that offer limited immediate annuity options.

Cannex.com is a database firm available to financial professionals that obtains quotes from a wide range of insurers. It probably is the source with quotes from the highest number of insurers. It's not available to consumers. It isn't an agent or broker and doesn't sell annuities. Financial professionals can use it to determine benchmark prices for an annuity and to locate the insurers with the best prices.

The study confirmed my previous finding, which is that within a sales channel the consumer needs to receive quotes from different insurers. Pechter found payouts from insurers within each source differed by at least 10% for the same client.

As expected, the study also found the payouts differed between the channels for annuities from the same insurer. For those who are interested, the highest payout in the survey was available from Pacific Life. But treat that finding with caution.

Pechter reported only the payouts from insurers that participated in at least two of the channels. So, that doesn't mean Pacific Life was the best quote overall. You might find higher payouts from other financially stable insurers who don't participate in two or more of these channels.

Finding the Best Annuity Source

The best prices in the survey were from IncomeSolutions.com. Its payouts from the same insurer were higher than those through other channels by 4.36% to 2.14%, depending on the insurer. A downside is that IncomeSolutions.com offers annuities from a limited number of insurers.

Companies that offered annuities through each of the other channels but not IncomeSolutions.com included New York Life, John Hancock, MassMutual, and MetLife. But the site did offer the two annuities with the highest payouts among insurers who were available through at least two of the channels: Pacific Life and Integrity Life.

The next best prices were from Fidelity.com, but by a modest margin. This channel was the only one to offer a quote from MassMutual and offered the same prices as ImmediateAnnuities.com for New York Life and MetLife. It offered a 1.63% higher payout than ImmediateAnnuities.com from Principal, but not as good a payout as IncomeSolutions.com.

ImmediateAnnuities.com, as I said, provides the standard deal from each insurer, and its prices matched those quoted by Cannex.com. So it is providing the standard pricing with no additional markups or fees but also isn't negotiating any discounts.

The difference between this source and IncomeSolutions.com, as stated above, varied from 4.36% to 2.14%, depending on the insurer. The biggest difference of 4.36% was on the highest payout annuity from Pacific Life.

You should look at more than price before deciding which channel to use. IncomeSolutions.com doesn't provide much in the way of service and counseling, and neither does Fidelity.com. These two sites primarily are for those who either are using a fee-only advisor or who are comfortable making the choices and decisions themselves.

ImmediateAnnuities.com offers the assistance of a commissioned agent to help you and also offers far more quotes than either of the other two. It's also available to anyone with access to the Internet or a telephone, unlike the other two channels.

The survey also didn't compare the prices with those offered through large employer 401(k) plans. These plans often negotiate prices with insurers, promising them exclusive access and minimal marketing expenses. Be sure to check the option available through your employer when considering an immediate annuity.

Of course, finding the best price for an annuity isn't valuable if you're buying the wrong annuity. You first need to decide whether you want an immediate annuity. Other issues include whether you want a fixed or inflation-indexed annuity; whether it should cover only your life, the joint life of you and your spouse, or include a term of years guarantee; and how much of your portfolio to put in the annuity.

You also need to decide whether you want to buy now when interest rates are low or wait a few years in the hope that interest rates and annuity payouts will be higher. After answering those questions, be sure to shop around for annuities from one or more financially secure insurers that offer competitive payouts.

The Late-in-Life Income Boost

Longevity insurance is the latest tool designed to relieve Baby Boomers' greatest anxiety: Outliving their income. It allows you to spend down your other assets over time, secure in the knowledge that guaranteed fixed income kicks in at age 80 or 85. This innovation is only a few years old, but the number of insurers offering it is growing.

You know the problem. About 10% of all 65-year-olds will live into their 90s. A 65-year-old male has a 50% probability of living to 85, and a 25% probability of living to 90. A 65-year-old female has a 50% probability of living to 88%, and a 25% probability of living to 93. In a married couple when each spouse is 65, there's a 50% probability at least one spouse will live to 91, and a 25% probability at least one spouse will live to 95. Yet, most financial plans do not plan for such long lives.

A financial plan for a married couple should anticipate at least one spouse living to age 100 to be on the safe side. Even those that do plan on long lives and believe they have enough money rely heavily on reality turning out to be similar to their assumptions about factors such as inflation and investment returns. If reality is worse than the assumptions, the retiree could run out of money.

Of course, people who plan for such a long period might realize that there's too high of a probability of running out of money. To deal with this hazard, longevity insurance was developed. Other names for the contracts are deferred income annuities, advanced life deferred annuity, and guaranteed income annuity. The product is simply a deferred annuity with a twist or two.

With longevity insurance, the policy owner deposits a lump sum with an insurer. The marketing is targeted at people ages 60 to 65, but the deposit can be made at almost any age, and the earlier you purchase the better off you probably are. The insurer agrees to begin making regular, fixed payments when the owner turns a certain age, usually 80 or 85, and the payments will continue for life.

Unlike other deferred annuities, when the contract is purchased the insurer tells the owner exactly what the amount of each of the future payments will be. The younger you are when purchasing the policy, the less money you'll pay for a future amount of income.

For example, if a 65-year-old man deposited $10,000 with MetLife in early 2011, the insurer would guarantee to pay $665 monthly beginning in 20 years. That comes to $7,980 annually. The payments are guaranteed to continue for life, no matter how long that is. If the owner lives another five years after 85, the total payouts will be $39,900. If he lives 10 years after the payouts begin, the total received will be $79,800.

That sounds like a good deal. If the owner had invested that $10,000 for 20 years and earned a 7% return annually, he would have a nest egg of $38,670, roughly enough to match five years of payments under the longevity insurance. Yet, there is no guarantee he would earn that 7% return. The payments under the insurance are guaranteed and will continue as long as he lives.

With longevity insurance, an individual can divide a nest egg into two portions. One portion is managed to pay for retirement expenses through age 80 or 85.

A second and likely smaller portion of the portfolio is used to purchase longevity insurance either early in retirement or before retirement that will fund the post-85 period if the owner lives that long. This takes away a lot of the uncertainty in retirement planning.

The individual doesn’t have to wonder how long the nest egg needs to last. He or she knows it needs to last until the longevity insurance kicks in. After that, he’ll receive Social Security plus longevity insurance.
In addition, longevity insurance could allow the rest of the nest egg to be invested for higher returns since the owner knows there will be guaranteed payments after age 85. Or the longevity insurance might allow higher withdrawals from the nest egg, since there will be guaranteed income after age 85.

Many people should be able to purchase this late-life certainty with 10% to 15% of their total portfolio.

Alternatively, while longevity insurance is not a substitute for long-term care insurance, it can provide an extra boost to income at a point in life when there’s a high probability of incurring extra costs because of the need for additional care.

As with all other insurance products, there are trade-offs to consider.

One trade-off is that there are no payments to beneficiaries and no cash value. If the insured does not live to the payout age, the insurer keeps the money. The insurer also profits when the owner lives past 85 but passes away after receiving payments for only a few months or years. The insurer takes the risk that the owner lives to a very old age, while the owner and his heirs take the risk he won't.

In this respect it is like auto, homeowner's, and long-term care insurance. If you never have a claim, the only benefit from the policy is the security of knowing that it is there if you need it.

To counter this drawback, insurers are adding "return of premium" options, but this feature substantially raises the cost by reducing the payout you receive with each dollar invested. I believe the added cost takes away much of the benefit of purchasing the product.

The policies also have no inflation protection. The monthly payout at age 85 might seem like enough money when the policy was purchased, but after 20 years of 2% inflation its purchasing power will be close to half of the initial purchasing power. The policies are starting to offer inflation indexing. Again, that comes at a cost, which can be considerable. It might be cheaper to simply purchase more insurance.

Also, the policy might state that the inflation indexing kicks in only after the payments begin. The erosion of purchasing power during the 20-years of deferral is not covered.
Another disadvantage of longevity insurance is the opportunity foregone. By purchasing a longevity annuity, you lock in today's expected investment returns.

If another long bull market begins in a few years or interest rates rise to historic levels, you might have been better off investing the money on your own than buying the policy. Or at least it might have been better to wait to buy a policy. Of course, an extended bear market means you come out ahead with longevity insurance and the insurer has to worry about how to make up the difference.

Longevity insurance generally requires a lump sum premium instead of payments over time. The policies are starting to offer a multi-year premium option. That also increases the cost, because the insurer does not have your money to invest the entire period.

Because the policies are relatively new and only a few dozen insurers offer them, sales commissions can be higher than for immediate annuiteis. That cost essentially comes out of your future income payments. You can check the latest payouts at www.annuities.direct.

It's likely that the disadvantages will be reduced and longevity insurance will be much more attractive in the next few years. Also, as insurers become more experienced with them, costs might decline.

Longevity insurance is ideal for a middle net-worth investor who is in or near retirement age and has accumulated some savings but is worried about making that savings last. The insurance will ensure that you have income as long as you'll need it and can convert a borderline retirement plan into a secure one.

It would be especially beneficial to a conservative investor. This is the investor who is least likely to take enough risk with his retirement portfolio to beat inflation and wouldn't take advantage of a new bull market even if one were to occur.

That doesn't mean other investors shouldn't use or consider longevity insurance, but the more conservative an investor is, the more longevity insurance makes sense for a part of the portfolio. And the lower the probability of your assets lasting through a long life, the more longevity insurance makes sense.

Other Annuities You Might Hear About

There are many different types of annuities, and each type has at least some people saying they are appropriate for your post-career portfolio. None compares to the simplicity, safety, and low-cost of an immediate annuity. Each of the other types of annuities has its own bells and whistles, each of which carries costs.

I've described the advantages and disadvantages of many of them in Retirement Watch. These articles are available in the Archive on the members' section of the web site at www.RetirementWatch.com. When you are presented with one of these other products and want a guide to analyzing it, take a look through the web site. Some of the more popular ones are reviewed below.

Indexing Annuities to Stock Returns

Investors who are seeking yields higher than those on treasury bonds or certificates of deposit but still want safety are looking to indexed annuities (once known as equity indexed annuities and sometimes known as fixed indexed annuities). These are not retirement income vehicles. They are deferred annuities, a way to earn a return on your money in the accumulation years.

Indexed annuities credit your account with a yield based on the behavior of a stock market index. The specifics of the formulas can get complicated but they've been simplified over the years. Here's an overview of how they work:

You make a lump sum investment. The annuity promises to increase your account by a guaranteed minimum each year. The guarantee these days usually is 1%, though you still might find a higher guarantee. You should know that the guarantee often is not applied to 100% of your investment but only to 87.5%.

You have the potential for a higher yield based on the return of a stock market index. Many annuities now let you select the index you want applied to your account from as many as seven allowed by the insurer, and you might be able to change the index annually. Some insurers are limiting the indexes available and the ability to switch indexes. Some even designate the index that will be used and retain the right to change that index.

What an indexed annuity buyer needs to understand is the formula used to credit the account with income based on a stock index's returns. You won't receive 100% of the return. You'll receive some percentage of the stock index return, called the participation rate. You likely would receive 60% or so of the index return.

In addition, there's an annual limit, or cap, on the return. Most indexed annuities won't allow an account to receive more than 8% to 10% annually, no matter how much the stock index appreciates.

You also want to know the formula used to calculate the index's return for the period. It's rarely the total return you read or hear about.

Many fixed annuities don't include reinvested dividends in the calculated return. The annuity also might not use a straight point-to-point calculation that measures the change in the index from the first day of the period to the last.

The formula might average the index's closing value on all the days of the year, for example, or some other method.

No formula is right or wrong, but you need to understand it before buying an annuity so you'll know what to expect.

An averaging formula, for example, is likely to show a much lower return than a point-to-point formula, because stock index returns tend to be clumped in a relatively few days.

Finally, expenses and fees might be subtracted from the calculated interest rate before the net amount is credited to your account.

Like most other annuities, an indexed annuity usually has a surrender fee when you want your money back before a minimum time passes.

The guaranteed minimum return also usually doesn't apply if you want the money back before the surrender period ends.

So, despite the guarantees, you could receive back less than the initial investment.

Most indexed annuities, however, allow you to withdraw up to 10% of the account during a year without a penalty.
An indexed annuity might offer you bonus interest for buying it. This can range from 5% to 10%.

There's a trade off. An annuity with bonus interest usually has a longer surrender period than one without bonus interest.

I'm also skeptical of insurers offering bonus interest.

In the past bonus interest often is offered by insurers who are trying too hard to increase market share or to raise cash to shore up their balance sheets from losses in other areas. Bonus interest annuities also are likely to have higher fees than others.

Keep in mind that like other annuities, the income distributions from an indexed annuity are taxed as ordinary income.

Though the returns are somewhat based on what happens in the stock market, you aren't investing in stocks and won't have long-term capital gains.

An index annuity also can offer optional bells and whistles similar to those offered with variable annuities.

These bells and whistles increase the expenses deducted from your account and could cause a decline in principal. These features include guaranteed minimum death benefits and guaranteed minimum (or lifetime) withdrawals benefits.

If you choose these riders, an additional fee is charged against your account—not against your earnings but your account balance.

When interest rates are low and the stock market has low or negative returns for the year, there might not be enough income to offset the additional expense of these riders.

That means the value of the annuity account can decline, because principal will be used to pay the expenses. Be sure you fully understand the income crediting and expense rules and whether the account could decline under some circumstances.

There rarely is a reason to add these riders to an indexed annuity. An indexed annuity is for safe accumulation.

When you are ready to begin systematic withdrawals, you can transfer the balance to either an immediate annuity (my recommendation) or a variable annuity with those riders.

Versions of or competitors to index annuities are offered through banks and brokerage firms. You might see them described as principal protected notes, indexed certificates of deposit, and other names.

In most cases they're backed by an insurer, so if you're considering one compare it with available insurance offerings.

An indexed annuity can be considered by someone who wants a steady, safe return but also wants the potential to earn more than is available in treasury bonds and certificates of deposit.

You won't be investing in the stock market, but you'll earn a higher return than bonds when the stock indexes do well. Also, unlike bonds, you'll be protected from having principal decline when interest rates rise.

Building Your Own Annuity

Before considering an indexed annuity, however, consider that you might be able to get a similar or better result by building your own version.

Some investment advisors assert that they achieve safety of principal and the same or a higher return by using properly diversified portfolios.

Others have studied long-term data and believe that most balanced mutual funds earn a better return over most periods. Indexed annuity advocates point out that in recent periods of as long as five years when stocks were down, indexed annuities had positive returns.

You might consider doing something similar to what the insurers will do with your money.

The insurers will put most of the money they receive in bonds and a relatively small amount in futures contracts tracking the stock index you selected to follow.

You could put a large portion of the money you considered for the annuity in zero coupon treasury bonds. These are purchased at a discount from face value and are guaranteed to pay off face value at maturity.

The rest of the money can be invested in a low-cost stock index fund. When the bonds mature, you receive their face value plus whatever the index fund investment is worth.

The fund isn't likely to go to a zero value, so you'll have a positive return.

About 99% of the time, a portfolio 60% in zero coupon treasury bonds and 40% in an index fund returns more than an indexed annuity, according to economic consultant Craig J. McCann, cited in Forbes.

Other advisors assert that putting 70% or so of your money in five-year or 10-year CDs and the rest in an index fund should guarantee the return of your original investment plus whatever the value of the index fund is.

By going the do-it-yourself route you lose the guarantee offered by the insurer. But you gain some benefits that could compensate or more than compensate.
You don't have the sales expenses or annual fees of the annuity. The U.S. government is backing your treasury bonds or certificates of deposit. You receive potentially favorable tax treatment on the index fund investment, and there probably isn't a surrender fee on the index fund.

On the other hand, there likely is the equivalent of a surrender fee on a CD, and if interest rates rise and you try to sell the zero coupon bonds you'll sell at a loss.

These do-it-yourself alternatives are something to consider instead of the variable annuities and indexed annuities. They're not alternatives to immediate annuities as a source of lifetime guaranteed income.

How Safe Are Annuities?

When you buy any type of annuity, bear in mind that though all or some portion of it might be guaranteed, it is guaranteed only by the insurance company.

You are depending on the solvency of the insurance company. 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.

You'll 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 high yields or generous terms from an insurer with a shaky financial foundation.

To be especially safe, limit your exposure to an insurer. Diversify your annuity purchases the same way an investment portfolio is diversified by spreading your annuity purchases among different insurers.

SECTION II: Your IRA, Taxes & More

Can You Spend More in Retirement Than You've Been Told?

Longtime readers know I believe the spending plan is the biggest gap in most retirement plans.

The spending plan ensures you won't run out of money in retirement. It answers the question: What's the maximum amount I can spend each year and not risk running out of money?

The longtime consensus among financial planners is known as the 4% Rule or the Safe Spending Amount.

Under the rule, you can spend about 4.2% of your nest egg in the first year.

The second year you can spend that dollar amount, plus an increase for whatever inflation was the previous year. You continue to increase spending by the inflation rate each subsequent year.

Research indicates that under most investment scenarios, a nest egg would last at least 30 years under the 4% Rule.

I've had criticisms of the 4% Rule for many years. You can read the detailed arguments in the Archive on RetirementWatch.com, or in the revised edition of *The New Rules of Retirement*.

One of my main concerns is that almost no one spends in the pattern envisioned under the 4% Rule.

Spending varies during retirement. Most people spend more money early in retirement, and then spending declines.

It might increase later in retirement to pay for medical and long-term care expenses, or it might continue to decline even after adjusting for inflation.

Another concern is the 4% Rule doesn’t adjust spending for changes in the markets.

If you retire early in a long bull market and follow the 4% Rule, you’d spend far less money over your lifetime than you could have.

But if you retire early in a long bear market, following the 4% Rule could cause you to run out of money fairly early in retirement. The 1960s and early 1970s are a good example of that.

The alternative spending plan I’ve long proposed is a modification of the policy used by the Yale University Endowment to determine how much it will distribute to the university each year.

Under this formula, the first year you spend a percentage of the portfolio you select.

In the past, I’ve used 4% as the initial spending percentage. Each year after that, 70% of the amount you can spend is that same percentage of the portfolio’s value at the start of the year.

The other 30% of the spending is the dollar amount you spent in the previous year, plus the previous year’s inflation.

In the July 2015 issue of Retirement Watch, I used the actual returns of two mutual funds to show how the formula would have worked under real market conditions (that were fairly adverse) using different investment strategies.

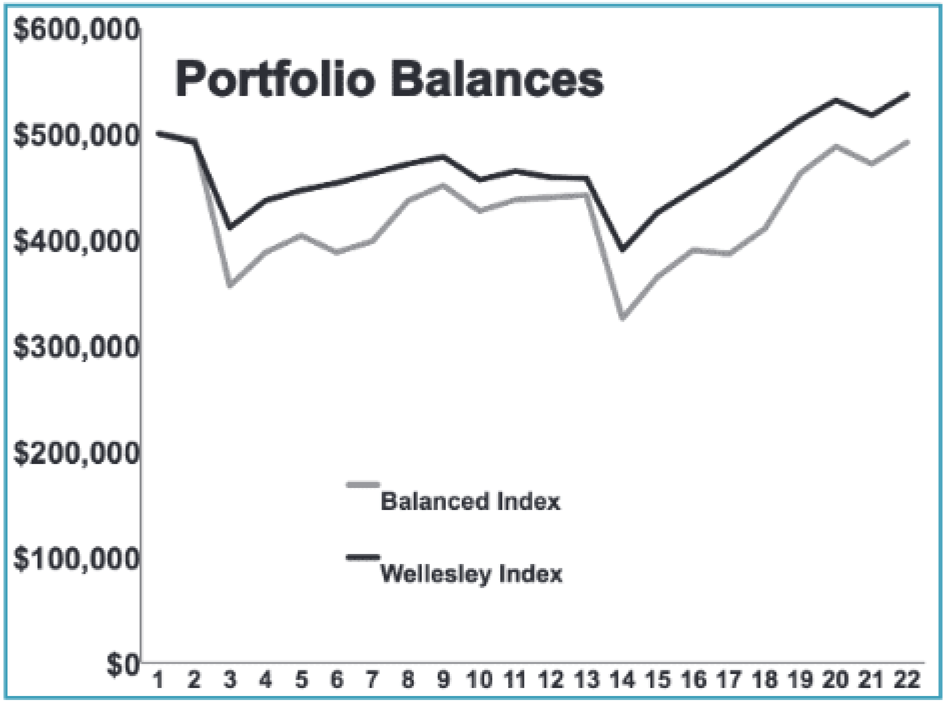
I used 10 years of returns from the mutual funds Vanguard Balanced Index and Vanguard Wellesley Income beginning in 2006.

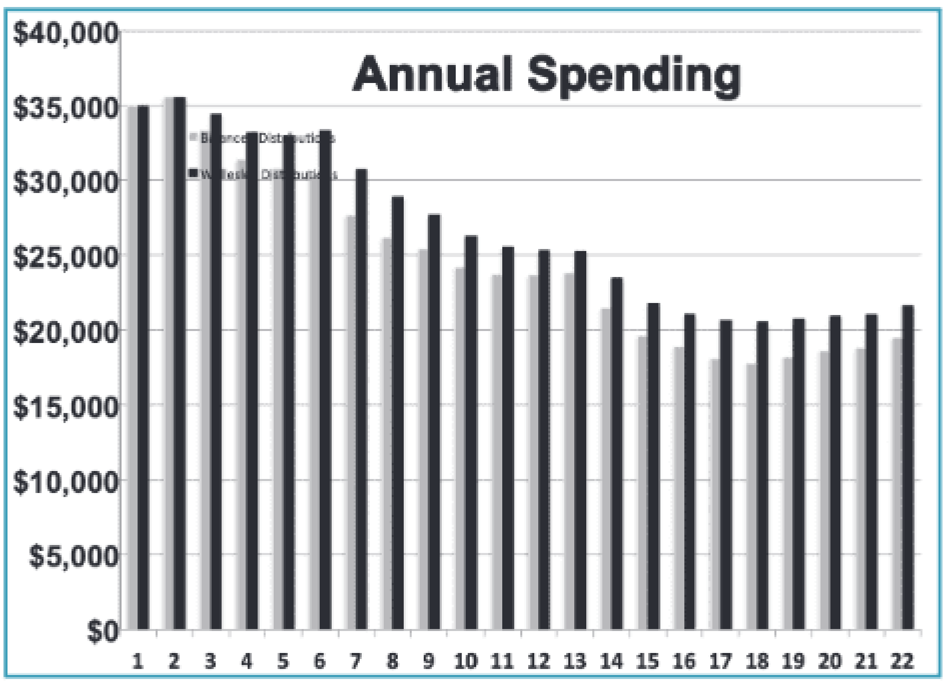
Then, I repeated the returns so that there would be at least 20 years of returns and the returns would reflect two very bad bear markets. You can find the discussion and charts in the Archive on the members’ section of the website.

In my latest research, I modified the policy to better reflect how people really spend in retirement. Instead of using the fixed 4% rate as the base spending percentage throughout retirement, the percentage changes over time.

In the first six years of retirement, 7% is used as the benchmark for spending. It then shifts down to 5% beginning in year seven. Finally, the percentage is reduced to 4% in the 15th year of retirement.

I used the same returns from the two Vanguard funds. You can see the results in the charts below. One chart shows the maximum spending amount each year; the other chart shows the nest egg balance at the end of each year.





Of course, under this formula you spend more in the early years than under the original plan. With a beginning $500,000 portfolio, you spend $35,000 the first year compared to $20,000 in the original plan.

The maximum spending amount declines after the second year, because of the market decline.

The spending never returns to the peak level of the second year because of a combination of the market decline and the reduction in the base spending percentage beginning the seventh year. That’s true for both portfolios.

Spending is higher under the revised formula than under the original each of the first 11 years.

After that, spending under the revised formula declines in a stair-step pattern, partly because of the second bear market and partly because of the second reduction in the spending percentage.

As in the previous research, the Wellesley Income portfolio generates higher returns and has a higher ending balance because it holds up much better in the bear markets.

In the worst years, Wellesley Income lost 9.84% compared to over 22% for the Balanced Index.

Not surprisingly, the values of the nest egg are not as high under the revised formula compared to the original. That’s because you’re spending more money in the early years.

As you can see in the chart, the Balanced Index nest egg only returns to its starting value after year 22. The Wellesley Income nest egg exceeds the original value at the end of year 18 and stays above it.

The revised Yale Endowment spending policy shows that you can develop a spending policy that lets you spend more than 4% in the early years when you’re more active.

It also will adjust spending based on inflation, market returns and changes in your life cycle.

Most retirees spend more in the early years of retirement because they still are active and healthy and have a list of activities they want to accomplish in retirement.

After the first years of retirement, many one-time expenditures have occurred and more of a routine is established. Also, most people slow down after five years or so of retirement, depending on health and age.

There are a few lessons to take from this research.

One lesson is that spending in retirement should be flexible, and you should have a policy that varies spending with your age, the markets and inflation.

Another lesson is that a nest egg can be sustainable with higher spending in the early years of retirement if you spend less in the later years.

To ensure your lifetime financial security with this higher spending in the early years, you should have insurance or other plans to cover any large medical expenses and long-term care in the later years.

Under the revised spending policy, there is about $200,000 less wealth after year 22 than under the original policy.

You also need to decide to what extent you want to leave a legacy for children or others.

Under the revised spending policy, the nest egg doesn’t grow nearly as much as it does under the original spending policy.

So, if you want to leave a significant legacy or simply want your financial security to increase over time, it’s better to stay with something closer to the original spending policy from the July 2015 issue of *Retirement Watch*.

A final lesson is that it’s difficult for investment returns and reduced spending in the later years to make up for high spending in the early years of retirement.

So, while the numbers show that you probably can spend more in the first years of retirement than is allowed under the 4% Rule, there is a limit.

You should be careful not to overspend early in retirement unless you expect a long bull market to bail you out.

A spending plan determines the maximum amount you should spend each year in retirement. The policy also helps you adjust when surprises are delivered by the investment markets or other forces.

The One Simple Move that Can Add $50,000 to your Retirement Account (Without Having To Save Any Extra Money)

Take a look at this chart. It's an example of a retiree's nest egg, valued at $200,000.

To demonstrate how we arrive at this $50,000 in retirement savings, please assume an average annual rate of return of 6% on an initial $200,000 outlay. (6% is the yield I aim for annually in my Retirement Watch "Paycheck Portfolios.")

On the left side is a retirement nest egg based on 10 years of using a financial advisor/retirement planner – and paying a 1.5% fee (which is actually on the low side).

On the right side is the same nest egg, over the same 10-year period. In this case, though, you're following Retirement Watch and the NEW AMERICAN RETIREMENT PLAN.

For this, you're paying as little as $500 for the entire time ($49.95 annually).

That’s a swing of nearly $50,000 MORE in your nest egg… simply by following the NEW AMERICAN RETIREMENT PLAN, and my monthly newsletter, Retirement Watch.

In other words, you don't have to pay gobs of money to retirement and financial planners to get really good advice.

I don’t know about you, but an extra $50k will go a long way in my own retirement plan.

All About Your IRA

Your IRA is the most powerful — if not potentially the largest — tool in your retirement arsenal.

A well-managed IRA can help you achieve every one of your much deserved retirement dreams … and overcome every one of these potential hurdles and challenges you face.

But one simple mistake in saving for, investing in or taking distributions from your IRA could be the difference between a life of constant comfort and peace of mind… or a life of worry, sacrifice and increasing burden on your children.

Managing your IRA in today's more complex world gets tricky. Things change. The law. The economy. The markets. The trends.

And for too many years, we've been told the same old rules over and over again to prepare for retirement … rules that are no longer working.

Most people know the basic rules about IRA rollovers. An account balance can be rolled over tax free from a qualified retirement plan (such as a 401(k) plan) to an IRA or from one IRA to another.

There is no deadline if the balance is rolled over directly from one trustee to another. If the account owner takes the balance from one account, he or she has up to 60 days to get the same amount of money deposited in the same or another retirement account to avoid taxes.

It is best to have rollovers made by the plan administrators or trustees. An unlimited number of these rollovers can be made, and there is no 60-day deadline.

You still have to monitor the transactions to be sure the plan officials don't make a mistake, such as depositing your rollover in a taxable account. But it's less risky than trying a 60-day rollover.

7 Critical Year-End Actions to Take with IRAs and 401(k)s

In the last weeks of every year, I receive a stream of emails from readers asking about transactions they are considering by the end of the year.

In most cases, even if they can analyze the situations and decide on the best course of action by the end of the year, it's too late.

Often, IRA custodians need time to take certain actions, and at the end of the year, they're inundated with requests. Many IRA custodians don't accept requests for certain actions in the last few weeks of the year.

You also might find that any tax or financial advisor you want to consult is booked through the end of the year.

You especially don't want to be in that situation today. People still are adjusting to the 2017 tax law, and the law might change again soon.

Plus, market volatility and uncertainty have increased. Don't wait until later in the year. There are issues you need to consider and act on now.

Make your decisions and take any necessary action well before the end of the year.

Consider a conversion. Every year you should consider whether to convert all or part of a traditional IRA to a Roth IRA. The 2017 tax law changed the rules to make the decision irrevocable.

Before that, you had a limited time to reverse a conversion. You know that the cost of a conversion is that the converted amount is included in gross income as though it were distributed to you. You pay the taxes now and, after a five-year waiting period, future distributions of principal and investment returns from the Roth IRA are tax free.

There are two times to take a hard look at a conversion. One time is near the end of the year.

Because we're no longer allowed to reverse a conversion, it's often best to wait until near the end of the year to decide whether or not to convert all or part of an IRA.

By then, you'll have a good idea of your tax situation for the year and the cost of the conversion.

The other good time is during a stock market dive. The taxes on a conversion are based on the value of the converted amount on the day of the conversion.

If your IRA is primarily in stocks and stocks decline, the taxes on the conversion are less than they would have been before the decline. You can afford to convert more than before the decline.

Plus, after the stocks recover, the payoff for converting will be higher than it would have been before. As we've discussed in past issues of *Retirement Watch*, a number of factors need to be considered before deciding whether to convert an IRA.

The factors include a comparison of your current and likely future income tax rates, how long the money will stay in the Roth IRA to earn compounded returns, your expected investment rate of return, the source of the cash to pay the conversion taxes and more.

Because there are a lot of factors to consider, it's best to use software to make the decision. When you plan to leave the Roth IRA to children or other heirs, a conversion can be a good idea because you're essentially making a tax-free gift to them by paying the income taxes on the conversion.

They will receive tax-free distributions from the Roth IRA instead of taxable distributions from a traditional IRA.

Plan current RMDs. When you're over age 72, it's time to take annual required minimum distributions (RMDs) from IRAs and most 401(k)s. (The beginning age for RMDs was changed from 70½ to 72 for people who weren't taking RMDs before 2020.) Be sure you do this before Dec. 31, which often means putting in the request with your IRA custodian well before that date.

Keep in mind tips for optimizing RMDs, such as carefully considering the IRA that is the source of the RMD, having the distribution made in property instead of cash, and other strategies. See our March 2017 and November 2017 issues for details.

Plan for the SECURE Act and to reduce future RMDs. You can solve two problems with one set of moves.

Many people don't need the RMDs to fund their retirement spending, because they have other assets and income sources that generate sufficient cash flow. They intend to leave the IRAs to their heirs and have the heirs benefit from the IRA over decades through a Stretch IRA.

But they find as they enter their late 70s and beyond, the RMDs trigger higher and higher distributions, which trigger higher income taxes.

On top of the tax issues, the SECURE Act has upset the plan to leave IRAs to heirs. The law, which was enacted in December 2019 has eliminated Stretch IRAs for most heirs.

After being inherited, an IRA will have to be distributed and taxed within 10 years. Fortunately, there are strategies that can increase family after-tax wealth, reduce lifetime RMDs, and create the equivalent of Stretch IRAs.

For details about the SECURE Act and the strategies to consider, review our March and April 2020 issues.

Review charitable contributions. IRA owners older than 72 should consider making their charitable contributions through qualified charitable distributions (QCDs).

You direct the IRA custodian to make a distribution to a charity or issue you a check made payable to the charity. The gift counts as part of your RMD for the year but isn't included in your gross income. You receive no charitable contribution deduction for the gift.

QCDs are limited to $100,000 annually per taxpayer. Only contributions to public charities qualify, not gifts to donor-advised funds or private foundations. See our April 2019 issue for more details.

Have you made maximum contributions? For IRAs, you have until April 15, 2022, to make contributions for 2020. But it’s usually better to make the contributions earlier. The contributions will be invested and earning tax-sheltered returns within the IRA.

Review beneficiary designations. Many people haven’t looked at their retirement plan beneficiary designations in years. The designations should be reviewed every year or so. Are the named beneficiaries still the best choices? Should the choices change in light of the SECURE Act?

When you plan to leave part of your estate to charity, consider making the gift through an IRA by naming the charity as an IRA beneficiary. The other assets in your estate that would have gone to the charity should be left to your loved ones.

The charity won’t owe taxes on the IRA distribution, but your family would if they inherited it.

Do you want taxes withheld? Many retirees don’t pay the proper amount of estimated taxes during the year and owe penalties after the year closes.

Estimated taxes have to be paid as income is earned during the year to avoid penalties. You can’t avoid the penalty by making one large lump sum estimated tax payment late in the year, or after the year closes.

One way you can avoid the penalty is to have income taxes withheld from IRA distributions made late in the year. Withheld taxes are treated as paid evenly during the year, even if the withholding was bunched late in the year.

If you’re taking a large IRA distribution in the last part of the year, consider directing the custodian to withhold for income taxes enough to cover any shortfalls in your estimated taxes.

How will you pay annual fees? Often taxpayers were urged to pay any fees associated with their IRAs separately using non-IRA funds. This created the potential to deduct the fees as miscellaneous itemized expenses on Schedule A of Form 1040.
But the 2017 tax law eliminated the miscellaneous itemized expense deduction for investment fees and expenses.

But few taxpayers were able to deduct their IRA fees as miscellaneous itemized expenses before the law change because their total miscellaneous itemized expenses had to exceed 2% of adjusted gross income to be deductible. Not many taxpayers exceeded that threshold.

Some advisors say it is better to have traditional IRA fees paid directly from the IRA. The payment isn't treated as a distribution. You receive the equivalent of a tax deduction, because pre-tax money in the IRA is used to pay the expense.

I think it's better to pay the fees using money outside of an IRA, whether it's a traditional or Roth IRA. That's because the IRA is tax-advantaged. Let as much money as possible stay invested in the IRA to generate returns that compound free of income taxes. Pay your fees from non-IRA accounts.

The SECURE Act

We're in a critical time for many Individual Retirement Account (IRA) owners. Advance IRA planning is imperative if you want to maximize the after-tax value of your IRA for heirs and avoid the new tax burden Congress has enacted. Again – refer to the March and April issues for more specifics.

Despite the deadlock and division in Washington, the Setting Every Community Up for Retirement Enhancement (SECURE) passed the House and Senate in December 2019.

The SECURE Act and its Senate counterpart have a number of provisions designed to expand retirement savings opportunities and would delay required minimum distributions (RMDs).

To make up for the lost tax revenue, the SECURE Act and the Senate version would end the Stretch IRA.

The Stretch IRA is a strategy in which children who inherit an IRA make maximum use of the tax code to minimize distributions for years. In many cases, the RMDs are less than the investment return of the IRA, so the IRA not only lasts for decades but increases in value.

Under the SECURE Act, beneficiaries (other than minor children and a few other exceptions) would have to distribute and pay taxes on an inherited IRA within 10 years, even Roth IRAs.

There would be no taxes on the Roth IRA distributions.

Both versions would apply to any IRAs inherited after 2019.

Fortunately, there are strategies that will provide the advantages of a Stretch IRA even if Congress passes a version of these bills. These strategies also help you avoid the dreaded RMDs during your lifetime. Some of the strategies are best for people who have enough assets and income outside the IRA that they consider the IRAs to be for emergencies or something to leave their heirs.

To increase your family's after-tax wealth, plan early and find the strategies that best fit your goals and situation.

Empty IRAs early. This is the simplest strategy and provides a lot of variations. This is what I recommended years ago before the other strategies were available.

You can empty the IRA in one lump sum or in installments over the years. You pay income taxes and invest the after-tax money, preferably in tax-advantaged ways.

To protect the money from mistakes and waste by your heirs, you can put it in one or more trusts. The trust agreement and the trustee determine how the money is invested and when it is paid to the beneficiaries.

Convert to a Roth IRA. We discussed many times in *Retirement Watch* how to determine when converting a traditional IRA to a Roth IRA makes sense. In effect, you're paying taxes for your heirs and setting them up for a stream of tax-free income. Unfortunately, the proposed limits on Stretch IRAs would apply to Roth IRAs as well as traditional IRAs. Your heirs still would have to distribute an inherited Roth IRA within 10 years under the SECURE Act.

IRA Leverage Strategy. You can guarantee your heirs will receive the current after-tax value of your IRA, and perhaps more. The guarantee holds regardless of what happens in the investment markets or with the IRA rules.

Suppose Max and Rosie Profits are age 71. Max has a $1 million traditional IRA. He'll soon have to take RMDs though he doesn't need the income.
Max and Rosie form a trust and name their two children as beneficiaries. They transfer the annual RMDs to the trust. There are no gift and estate taxes because of the annual gift tax exclusion, which is $15,000 in 2020.

The trust takes out a joint and survivor life insurance policy on Max and Rosie, naming the trust as beneficiary. Because of their ages and good health, the policy benefit is more than $1.4 million.

Max and Rosie use the RMDs to make gifts to the trust that are used to pay the annual premiums on the policy. After Max and Rosie pass away, no matter when that is, the insurance company will pay more than $1.4 million to the trust, and the trust will use it for the beneficiaries or distribute it to them as called for in the trust agreement.

The insurance benefit will be tax-free to the trust and the beneficiaries. The beneficiaries will receive the face value of the insurance tax free. If they were to inherit a traditional IRA, they'd receive only the after-tax value of the IRA. Of course, if the Profits pass away before the IRA is depleted, the beneficiaries also will inherit what remains in the IRA.

The Family Bank strategy. This is a variation of the IRA Leverage strategy. The main differences are the Profits don't use a trust and buy a different type of permanent life insurance that would have a benefit of more than $1.5 million.

The Profits hold the life insurance in their own names and continue to take the RMDs and use them to pay premiums on the life insurance.

A potential advantage of this strategy is the life insurance policy builds up a cash value over the years. The Profits could tap into this account taxfree when needed to pay for their own expenses, family emergency expenses, or any other cash need that arises. If the cash value earns 6.98% annually, it would be worth almost $264,000 after 10 years.

The Profits could have the life insurance payable to their estate, to the beneficiaries, or to a trust. When paid to a trust, the insurance benefit becomes a family bank. The trustee distributes money to beneficiaries or pays expenses for their benefit as directed in the trust agreement. It also could make loans, such as to buy homes or start businesses. As the loans are repaid, the family bank is replenished and can benefit generations.

Note: The examples in the last two strategies assume the IRA owners are taking RMDs and use those to pay the insurance premiums. But there's no reason to wait. Younger IRA owners can begin the strategies and take annual distributions from the IRAs to pay the premiums. In fact, the strategies provide more benefits the younger you are when they are initiated.

IRA Reboot. The IRA Reboot is an alternative to converting to a Roth IRA. Unlike a conversion, you have no out-of-pocket cost. Instead, you use several tax code provisions and a special type of life insurance policy to avoid paying the taxes out-of-pocket.

The IRA Reboot is best explained through an example with Max Profits. Max is 65, in average health and in the 28% tax bracket. He has a $500,000 traditional IRA that he's considering converting to a Roth IRA in stages over the next five years, which he thinks will keep him in the same tax bracket.

Instead, Max opts to do the IRA Reboot over five years. In the first year, he transfers the IRA to a special qualified account. Then, he transfers $105,732 from the IRA into a Max-Funded Indexed Universal Life Policy with a benefit of more than $1.2 million. He transfers the same amount each of the following four years. The transfers are IRA distributions and taxes are due by April 15 of the next year. At the end of the first year, Max is able to borrow from the insurer about $30,000 to pay the taxes. He does this each year. The loans are secured by the cash value of the policy and remain outstanding until Max passes away. They will be subtracted from the life insurance benefits paid on the policy.

The result is Max converted the IRA to a life insurance policy without using any of his cash to pay taxes on the conversion. The after-tax amount his heirs receive, after paying the outstanding loans, will be higher than the original value of the IRA and will be tax free.

Also, the insurance policy has a cash value account. Max can take money from the cash account to pay expenses or convert it into a guaranteed lifetime tax-free income stream. In fact, his net cash account will top $318,000 in 10 years and $608,000 in 20 years, all net of the loans he used to pay the conversion taxes in years two through six.

Max also can add a long-term care benefit to the insurance policy if he's qualified. The benefit will either increase the premium or reduce the insurance benefit.

The charitable trust bailout. When you want to benefit one or more charities in addition to your loved ones, consider converting your traditional IRA into a charitable remainder trust (CRT).

Under one strategy, your estate planner drafts the CRT as part of your will or estate plan, and you name the CRT as the beneficiary on the beneficiary designation form. After you pass, the entire IRA is distributed to the CRT.

The CRT pays income to a beneficiary or beneficiaries you named in the trust. Typically, a CRT pays a percentage of the trust assets to the beneficiary for life. The annual payouts rise and fall with the value of the trust. An alternative is for the trust to pay a fixed annual amount to the beneficiary. IRS regulations limit the amount of income that can be paid to the beneficiary. After the beneficiary passes away, the remainder of the trust is donated to the charity.

If your estate planner runs the numbers, they should show that your beneficiary receives more after-tax money under the CRT than if the IRA is liquidated within the time frame required by the SECURE Act. You've provided for your loved ones, protected the assets, and also provided for charity.

The conversion to a CRT also can be done during your lifetime. You can take a distribution of all or a large portion of the IRA and immediately transfer the after-tax amount to a CRT. The CRT pays annual income to you (or you and your spouse) for life. Many people then have the remainder in the CRT paid to charity.

To ensure their heirs have an inheritance, they purchase a permanent life insurance policy when the CRT is created and name their children as the beneficiaries.

You include the IRA distribution in gross income. If you itemize expenses on your tax return, you receive a charitable contribution of part of the amount contributed to the trust. The deduction is the present value of the amount the charity is expected to receive in the future. Current interest rates and tables issued by the IRS are used to determine the deduction. The older you are, the larger the percentage of the contribution you can deduct.

There are other ways to structure the conversion of an IRA to a CRT. These are the most frequently used strategies. If any sound appealing, discuss the alternatives with your estate planner.

Most large charities have offices that will manage and administer a CRT for little or no money when they are named as a beneficiary.

Charity as IRA beneficiary. The simplest strategy is to make post-mortem charitable gifts through an IRA. You can set up a separate IRA that has roughly the amount you want the charity to receive and name the charity as the beneficiary. Or you can name the charity as one of several beneficiaries for an IRA, noting either the dollar amount or the percentage of the IRA you want the charity to receive.

After you pass, the charity takes a distribution of its share of the IRA. Since the charity is tax-exempt, it doesn't owe any income taxes and receives the full benefit of the distribution. When your children or other loved ones inherit an IRA, they include the distributions in gross income and owe income taxes on them. They really inherit only the after-tax value. But when they inherit non-IRA assets, they increase the tax basis to the current fair market value. They can sell the assets right away and won't owe any capital gains taxes on the appreciation that occurred while you owned the property.

If you're going to make a straightforward charitable contribution through your estate, it's better to make them through an IRA than the rest of the estate.

Most of these are not do-it-yourself strategies. You need to work with a financial advisor who knows the strategies, especially those involving life insurance. There is more information, along with detailed examples of several of these strategies, in the report The Bombshell Battle Plan: How to Defend Against the IRS' Secret Weapon by David Phillips and Todd Phillips. You can receive it for only $5.95 by calling 888-892-1102 and identifying yourself as a Retirement Watch reader.

Investing in your IRA

The traditional retirement portfolio is mostly stocks and bonds, with an overweight to bonds and other income investments.

Retirees need to move away from the traditional stock and bond portfolio. The retirement portfolio should have assets that earn equity-like returns over the long term but that are not tied closely to the returns of the major stock and bond indexes.

Real estate, privately issued company stock, hedge funds, separately managed accounts, timber, gold, commodities, and other fast-rising assets will help diversify your portfolio.

A portfolio that is more diversified than traditional portfolios and that adjusts its allocation based on extreme market valuations will avoid the worst effects of sustained bear markets in stocks.

By considering the entire toolbox and using those tools that are appropriate for him or her, the retiree greatly increases the likelihood that the portfolio will last through retirement.

The One and Only Time It Makes Sense To Hold Stocks in an IRA (Plus, When to place an equity mutual fund into an IRA & when not to)

Most investors own both taxable and tax-deferred accounts.

Some also own tax-free accounts, such as Roth IRAs.

Few investors consider which investments are best held in these different accounts.

Yet, properly allocating the investments between the accounts can change the amount of after-tax income available for retirement.

A typical investor will hold stocks and equity mutual funds for the long term. The mutual funds will have low annual distributions that are subject to taxes.

For this investor, the best advice is the conventional advice. Hold in a taxable account investments that already are tax-advantaged, such as stocks, equity mutual funds and real estate.

Gains from these investments will be taxed at the long-term capital gains rate. If the investor incurs losses in the taxable account, these can offset gains from other investments in the account or other income.

If these tax-advantaged investments instead were in a tax-deferred account, the investor would be converting tax-advantaged income into ordinary income.

That is because distributions from an IRA are taxed as ordinary income.

Long-term capital gains earned in the IRA would be taxed at the ordinary income tax rate instead of the long-term capital gains rate.

The conventional advice does not work for every investor.

Suppose an investor owns stocks and equity mutual funds but rarely holds them for more than one year. Or the mutual funds do a lot of trading and distribute a lot of taxable gains each year.

The gains earned by this type of investor would be taxed at ordinary income rates in a taxable account because they would be short-term gains.

The investor could be better off holding those investments in tax-deferred accounts.

Why You Should Consider Paying your IRA Taxes NOW Instead of LATER

Some of you could substantially lower your tax bill in retirement by doing so.

In fact, you could avoid paying tens of thousands of dollars in needless taxes!

Here's what you must consider in order to carry out this strategy.

One of the most powerful tax-saving retirement weapons that should be in every retiree's arsenal is the Roth IRA.

Their unique benefits are tremendous! No age limit on contributions. No required minimum distribution at age 72.

And the best reason ever to open a Roth IRA: not one dime you withdraw from it in retirement is ever taxed. No matter how much your money has grown over the years!

Many of my readers cannot open contributory Roth IRAs, because their incomes are too high. Currently Roth IRAs are unavailable to higher income taxpayers.

This means any couple with an adjusted gross income of $198,000 or more ($124,000 for singles) is not allowed to make a contribution. (The limits are adjusted for inflation annually.)

But since 2010 taxpayers of any income legal have been allowed to convert a traditional IRA to a Roth IRA. They are able to take advantage of the significant tax savings Roth IRAs offer.

Taking advantage of this is easy. Simply build up your traditional IRA and other tax-deferred accounts as much as possible.

Then, convert your regular IRA to a Roth IRA (and consider doing the same with your 401(k) as well if you can roll it over to an IRA).

You will pay taxes on the conversion, but it could be considerably less in taxes then you'd be forced to shell out in the future.

Many people aren't excited about paying taxes before they have to. But, unless your income tax rate is going to be lower in the future than it is now, it can make a lot of sense to pay taxes now and shelter all the future gains and income from taxes.

I've explained the rationale for this in some detail in my books and in articles in *Retirement Watch* that are available in the Archive in the members' section of the web site.

How To Buy Your Dream Vacation Home Using Your IRA

While the list of prohibited transactions for IRAs is extensive, it is not absolute.

The law requires the Department of Labor to create a procedure for obtaining exemptions from the prohibited transactions rule.

This has been done, and the Department grants a number of exemptions each year.

Here is a sample of exemptions granted over the years:

- An IRA owner sold real estate to his IRA.
- An IRA owner sold stock to his IRA.
- An IRA owner purchased stock from his IRA.
- An IRA owner purchased real estate from his IRA.
- An IRA owner lent money to a corporation of which he was the sole owner.

That means when the loan was repaid, the corporation paid tax deductible interest to the IRA.

The Department of Labor, through its Employee Benefits Security Agency, reviews applications for exemptions. The office also grants "class exemptions."

These are available to anyone meeting the qualifications stated in the class exemption.

To be granted an exemption, you have to show the office that a transaction is administratively feasible, is in the interest of the plan and its participants and beneficiaries, and that it protects the rights of plan participants and beneficiaries.

An individual exemption is put on a fast track to approval if you show that the transaction is substantially similar to two or more exemptions granted in the last five years.

The web site is revised regularly, but at the time of this writing, here's how you can get full details of past exemptions at the web site www.dol.gov/ebsa/.

In the right column, click on "EXPRO Exemptions," "Individual Exemptions," and "Class Exemptions."

For full details about exemptions and procedures, get the booklet "Exemption Procedures Under Federal Pension Law," available at www.dol.gov/ebsa/publications/-exemption_procedures.html

The possibility of an exemption widens your financial options.

For example, your IRA might be able to write the mortgage on your next home or vacation home.

Instead of writing mortgage checks and paying interest to a bank or other lender, you will be making the payments to your IRA.

And the interest likely will be deductible. That's a pretty good deal.

When in doubt, work with a tax advisor who is well-versed in the rules for making nontraditional investments in IRAs.

Avoid These Frequent Rollover Mistakes

The rollover is the most frequent IRA transaction. Yet, it is fraught with traps and is the source of many expensive mistakes.

You want to avoid the two nasty consequences of rollovers that don't comply with the fine points of the tax law.

An improper rollover usually is included in gross income and taxed as ordinary income, except for any portion that was after-tax or nondeductible money. In addition, you're likely to be hit with a 6% penalty for making excess contributions to an IRA.

There are many types of rollovers, more than 30, according to Ed Slott, a certified public accountant (CPA), though taxpayers often know them by different names. A conversion of a traditional IRA to a Roth IRA, for example, is a rollover.

Fortunately, we know the most likely rollover mistakes and how you can avoid the hit they make to your family's after-tax wealth.

RMDs. Many people are annoyed that they are required to take distributions from their retirement plans after age 72 and look for ways to reduce the required minimum distributions (RMDs) and the taxes on them. Often, the strategies they develop don't comply with the tax law.

You can't roll over an RMD to another qualified retirement plan. First, trying to roll over an RMD isn't going to save you any taxes. You still must include the RMD in gross income, except any portion that already is after-tax money. Second, any amount rolled over to an IRA or other qualified retirement plan usually is treated as an excess contribution to the plan, subject to a 6% penalty for each year you leave it in the plan.

Remember I said an IRA conversion technically is a rollover. So, you can't deposit your RMD in a Roth IRA and call it a conversion. It can be a contribution to the Roth IRA, if you're eligible to make one. But the RMD still must be included in gross income. If you aren't eligible to make a Roth IRA contribution for the year, it's an excess contribution and you owe the 6% penalty.

When you're over age 72, you first must take your RMD for the year from a traditional IRA. You can convert any amount that is left in the traditional IRA after you take the RMD.

After-tax funds. You might have after-tax funds in either an IRA or 401(k). After-tax money is money on which you paid taxes before it was contributed. It could be an IRA contribution that you couldn't deduct because your income was too high. Most 401(k) plans allow you to contribute money above the amount that can be excluded from gross income for income tax purposes ($19,500 in 2021). You pay income taxes on those contributions, so they after-tax money.

After-tax funds are tax-free when you withdraw them from the plan. But there are some limits on other actions you can take with after-tax money.

You can't rollover after-tax IRA money to an employer retirement plan. If you join an employer whose plan accepts rollovers from other plans, you can roll over pre-tax money in the IRA or 401(k), but any after-tax money can't be rolled over to an employer plan.

This rule can be an advantage. Suppose you have after-tax money in a traditional IRA and work for an employer whose plan accepts rollovers. You can roll over the after-tax money to the employer plan and leave all the after-tax money in the IRA. Then, you can roll over the after-tax money to a Roth IRA and not owe any taxes on that conversion. The IRS issued rules in 2014 that make it easy for taxpayers to execute a tax-free IRA conversion in this way.

Or you can keep the after-tax money in the IRA and in the future, most of the distributions will be tax free. Only the portion that represents future investment returns would be taxable.

Roth IRA contributions are after-tax money. Roth IRA money can't be rolled over to an employer plan, even if the employer has a Roth 401(k).

You might want to do this rollover in the other direction. Suppose you have after-tax contributions in a 401(k) plan. When you decide to roll over your 401(k) to an IRA, you can separate the pre-tax and after-tax contributions. The pre-tax contributions can be rolled over to a traditional IRA tax-free as is usually done. The after-tax contributions can be rolled directly to a Roth IRA, and there are no additional taxes paid.

To receive this treatment, you must roll over the entire IRA in the same year. These rollovers also must be done trustee-to-trustee. You can't receive the funds personally and then try to roll them over. This strategy makes it easier for higher-income employees to eventually have Roth IRAs.

The **60-day** rollover trap. You know that you can take a distribution from an IRA. If you return the same amount to the IRA within 60 days (a rollover), the distributed amount is not included in gross income.

Here's the trick. You MUST return, or roll over, the same property that was distributed. If cash was distributed, then the rollover must be in cash. If you were distributed shares of stock or a mutual fund, then you have to roll over the same number of shares of the same stock or mutual fund.

There is one loophole. Suppose you receive a distribution of property from an employer retirement plan, such as stock of the employer. You can sell the stock and roll over the cash proceeds to an IRA. That would be a tax-free rollover.

A few years ago, I reported how the IRS changed its policy and decided the 60-day rollover can be done only once every 12 months (not every calendar year) per taxpayer (not per IRA). Many people still fall into that trap by trying the 60-day rollover more than once every 12 months.

Divorce distributions. In many divorces, a 401(k) plan or IRA is divided. To defer taxes, it's important to follow 5 key steps. Just to make divorce even more difficult, the tax code has slightly different rules for IRAs and 401(k)s.

Suppose an IRA owner takes an IRA distribution and hands a check for that amount to the other spouse. The receiving spouse deposits it in his or her IRA. The spouse who owned the IRA will be treated as taking a distribution and will have to include it in gross income. If under age 59½, the spouse also might owe a 10% early distribution penalty. The other spouse will be penalized for making an excess IRA contribution.

To avoid this result (and a similar result with a 401(k) plan), you need a court document. With an IRA, a standard divorce decree is sufficient. But with a 401(k), you need a document known in the tax code as a qualified domestic relations order (QDRO). You need a separate QDRO for each 401(k) account involved.

Then, the legal document is presented to the IRA custodian or 401(k) administrator along with details about which account is to receive the settlement amount. The custodian or administrator makes the transfer directly to the other account. To avoid taxes on the rollover, it must be executed from one trustee or administrator to the other.

Why You Should Make Charitable Contributions from Your IRA

Congress finally delivered good news to individual retirement account (IRA) owners late in 2015. The Protecting Americans from Tax Hikes Act of 2015 (PATH) made permanent the qualified charitable distribution (QCD) from IRAs for taxpayers ages 70½ and older. The QCD, one of the best ways to make charitable gifts, has been in and out of the law since 2006. Now, taxpayers can reap the benefits of adding it to their regular tax planning, including planning QCDs early in the year.

When the QCD rules don't apply, a charitable contribution made with IRA funds is first treated as a distribution to the owner. It doesn't matter if the contribution is made by a direct transfer from the custodian to the charity, or if a distribution is made to the IRA owner who then makes a charitable contribution. In either case, the amount is included in the gross income of the owner as a distribution.

The owner might be entitled to a charitable contribution deduction as an itemized expense on Schedule A to offset the income. Many people over age 70½ don't deduct charitable contributions, because they don't itemize deductions. They no longer have mortgages, so their itemized expenses don't exceed the standard deduction.

Even when you can deduct the charitable contribution, there still are negative tax effects from making a charitable contribution from an IRA when the QCD isn't available. Including the distribution in gross income increases adjusted gross income. That could increase or trigger the stealth taxes. Among the stealth taxes are the inclusion of Social Security benefits in gross income, the Medicare premium surtax, the phaseout of personal and dependent exemptions, reduced itemized expense deductions, the alternative minimum tax and the 3.8% surtax on net investment income. There are other tax breaks that are lost or reduced as income rises.

So, even when a charitable contribution deduction offsets the amount of the IRA distribution included in gross income, there can be other negative tax effects from having to include the amount in gross income.

The QCD avoids those potential problems and provides other benefits to eligible taxpayers.

Under a QCD, the charitable contribution made from the IRA isn’t included in the gross income of the IRA owner. Excluding the charitable contribution from gross income means there is no risk it will trigger any of the stealth taxes. The owner also doesn’t take a deduction for the contribution.

In addition, the QCD counts toward the required minimum distribution (RMD) for the year. RMDs increase gross income and can by themselves increase income taxes and the stealth taxes. Instead, a charitably minded taxpayer can take care of the RMD and charitable contributions with the same move. Suppose your RMD for the year is $17,000. Make at least $17,000 of QCDs and you’ve satisfied both your RMD and $17,000 of your charitable giving for the year. There’s no gross income on your tax return from the RMD. You don’t deduct the QCDs as charitable contributions.

A QCD can be a good strategy during a year when a traditional IRA is being converted to a Roth IRA. In the year of the conversion, you still are required to take your RMD for the year, regardless of when during the year the conversion is done. You won’t be able to convert the RMD amount. Without the QCD, you’d have to include the RMD in gross income along with the converted amount. The alternative is to make a QCD with the RMD amount. That keeps the RMD amount from your gross income.

You have to meet certain requirements to take advantage of the QCD.

The charitable contribution must be made directly from the IRA custodian or trustee to the charity. If you receive a distribution from the IRA and later make a contribution to charity, that doesn’t count as a QCD. The distribution will be included in gross income.

The IRA custodian can give you a check that is payable to the charity, and you can deliver that check to the charity. That will count as a QCD.

You must be at least age 70½ by the date of the charitable contribution. If you turn 70½ during the calendar year, transfers made from the IRA to a charity before that date don't count as QCDs. You have to wait until reaching the milestone for the charitable transfers to count.

QCDs are limited to no more than $100,000 annually per taxpayer. No matter the amount of your RMD for the year, you can give up to $100,000 to charities from your IRA. The $100,000 will receive QCD treatment when all the requirements are met (and reduce future RMDs by trimming your IRA balance). If your charitable giving from the IRA for the year exceeds $100,000, there is no carryover of the excess amount to future tax years. Instead, the contributions from the IRA above $100,000 are treated as non-QCDs as described early in this article. The contributions from the IRA above $100,000 are included in the gross income of the IRA owner as a distribution, and the owner might be able to take a charitable contribution deduction.

The $100,000 annual limit is per taxpayer. There is no sharing of the limit between taxpayers. For a married couple to have $200,000 of QCDs for the year, each spouse must have IRAs worth at least $100,000 and give $100,000 from his or her IRAs. If only one spouse has IRAs, he or she has only the $100,000 QCD limit and the other spouse's QCD limit can't be used.

A QCD can be made only from an IRA. Employer retirement plans aren't eligible for QCDs. Also, QCDs can be made from simplified employee pensions (SEPs) and Simple IRAs only when the plan hasn't received an employer contribution for the plan year that ends with or during the calendar year in which the IRA owner plans to make the charitable contribution from the IRA.

Roth IRAs technically are eligible for QCDs, but not as a practical matter. That's because after-tax money can't be used to make a QCD. All or most of the money in a Roth IRA is after-tax money. Also, there is no benefit to making a QCD from a Roth IRA, because the distribution is likely to be tax-free anyway.

Likewise, after-tax contributions in a traditional IRA can't be used to make a QCD. Only pre-tax money in the traditional IRA can be used to make a QCD. Unlike in other situations, the after-tax and pre-tax money in the traditional IRA can be segregated and designated. In other situations, taking money out of the traditional IRA would be automatically pro-rated between pre-tax and after-tax money.

When your IRA has a mix of pre-tax and after-tax money and you use the pre-tax money to make a QCD, that leaves less pre-tax money in the IRA to be taxed in future years to be distributed or converted to a Roth IRA.

The IRA owner can't receive any benefit from the charitable contribution. Any small gift or reward from the charity could make the entire contribution ineligible for QCD treatment. A QCD, however, can be used to satisfy a pledge the IRA owner made to the charity.

All the regular rules for substantiating charitable contributions must be followed. That means the IRA owner should have documentation in writing from the charity acknowledging the amount and date of the contribution.

QCDs can be made only to public charities that are eligible for charitable contribution deductions under the regular IRS rules. Not eligible for QCD treatment are gifts made to private foundations, donor-advised funds, and charitable gift annuities.

How To Have The Penalty For RMD Mistakes Waived

One of the stiffest penalties in the tax code is the one for not taking the correct required minimum distribution (RMD) from an IRA or other qualified retirement plan.

You pay a whopping 50% of the amount that was supposed to be distributed but wasn't. This penalty is in addition to paying income taxes on the distribution. The penalty is called the "excess accumulations tax."

You probably know the basics of the RMD rules. A review of the rules and key strategies for RMDs was in our February 2017 issue. Remember that the starting age for RMDs was changed to 72 for taxpayers who weren't taking RMDs before 2020.

The IRS is on the hunt for RMD mistakes. It realized a few years ago that many people take the wrong RMD or none at all. The IRS adjusted its computer systems, and the information retirement plan custodians have to report to make it easier to identify RMD mistakes.

Yet, the IRS can waive the penalty and readily does so. The process for having the penalty waived is relatively easy.

The important step is to review your RMDs to determine if you made a mistake. Don’t wait for the IRS to find the mistake and contact you. It will be difficult to have the penalty waived at that point unless you qualify for a few narrow exceptions. If you’re uncertain about the RMD rules, have a tax advisor review your RMDs.

Once you discover you didn’t take an RMD or didn’t distribute the correct amount, the first step is to have the correct amount distributed. The IRS will waive the penalty when the distribution shortfall was “due to reasonable error” and “reasonable steps are being taken to remedy the shortfall.” So, the first step is to remedy the shortfall by having the correct amount distributed. You’ll include it in gross income in the year in which it was actually distributed, not the year it was supposed to be distributed.

It is best to receive the distribution in the form of a check so you can make a copy of the check and submit that with your penalty waiver request. If the distribution is made in another form, be sure to have documentation proving the distribution was made.

Don’t combine this distribution with any other distribution or shortfall. You want to clearly show the IRS the amount was distributed. When the shortfalls were made over more than one year, make separate distributions for each year so that you’ll have clean, clear documentation.

You ask for the penalty to be waived by filing Form 5329, using Part VIII. If you haven’t already filed your income tax return for the year the mistake was made, you can include Form 5329 as part of your return for that year. Otherwise, you separately file 5329. File a separate 5329 for each year there was a mistake.

Enter on line 52 the amount of the RMD that was supposed to be taken. On line 53, enter the RMD actually taken. On line 54, enter zero, not the difference between lines 52 and 53. You enter the zero because you’re requesting a waiver of the penalty. Also, if you can, write “RC” in the margin next to line 54. These are the line numbers for the current version of the form. The numbers are different for previous years.

Finally, attach to Form 5329 a statement describing your reasonable cause and proof that the shortfall has been distributed.

The difficulty is that the IRS hasn’t issued regulations or other guidance stating what it considers to be reasonable cause for not initially distributing the correct amount the first time.

Tax professionals who’ve handled a number of RMD penalty waiver requests say a request is most likely to be granted when the mistake was due to an error by a financial institution or the serious illness or mental incapacity of the taxpayer. It also is likely that a penalty will be waived if a third party, such as a court or financial institution, has tied up the IRA. Another good reason is your IRA owns hard-to-value assets and you didn’t receive a valuation in time or the valuation later was revised.

In cases for other types of penalties, waivers sometimes are granted when someone for whom the taxpayer was a caretaker had a serious illness. That reason might work for the RMD penalty.

Other than that, we have no guidance. If you believe there’s a reasonable cause, you might as well file a penalty waiver request. The worst that can happen is the IRS denies the waiver and you have to pay the penalty.

The IRS won’t acknowledge initial receipt of your request and will take at least a few months to respond. You’ll receive either a notice that the return was accepted as filed or a bill for the penalty. If Form 5329 is included with your regular tax return, you won’t receive an acceptance notice. You’ll receive either a bill for the penalty or nothing.

Don’t include a check for the penalty with your return. Older versions of the instructions to Form 5329 say to do that, but recent versions don’t. Details about the penalty are in IRS Publication 590-B and the instructions to Form 5329. Or you can read the IRS regulations for tax code §4974(d).

The Most-Asked Roth IRA Question

We're going to look at what lately has been the question I'm asked the most about Roth IRAs. I don't know why there's increased concern about this question. It's probably because the new tax law makes it more attractive for most people to convert a traditional IRA into a Roth IRA. Whatever the reason, there's a lot of interest in "the five-year rule" for Roth IRAs, which is one of the more confusing rules in the tax code.

The five-year rule frequently is summarized something like this: A distribution from a Roth IRA isn't tax free until at least five years have passed. Longtime readers know I believe rules of thumb and shortcuts are dangerous, and this is a good example.

The summary stimulates a lot of questions. Do I have to wait five years each time I make a contribution to a Roth IRA or do a conversion? Does the five-year period restart if I rollover the Roth IRA to a new custodian or another Roth IRA? If I pass away does the five-year period restart for my beneficiary? Those are just a few questions that arise.

One reason there's a lot of confusion is most people don't realize there are two separate five-year Roth IRA rules that have to be considered separately.

The Five-Year Rule for Contributions The first five-year rule applies to contributions to Roth IRAs and controls whether distributions of earnings will be tax free.

Only "qualified distributions" from a Roth IRA are tax free. Two tests must be met for a distribution to be qualified. One test is that five tax years must have passed since the first contribution was made to any Roth IRA by the taxpayer.

This is a broad rule, according to the Treasury regulations. The five-year period starts whenever the IRA owner puts money into any Roth IRA. Under this rule, contributions include both direct contributions and converted amounts.

Some people have thought this five-year rule applies separately to each Roth IRA. That's not the case. Others have thought the five-year rule is applied separately to each Roth IRA conversion. That's also not the case. There have been worries that rolling over the Roth IRA to another might restart the five-year period. Again, that's not the rule.

The Roth IRAs of the taxpayer and the money flowing into Roth IRAs are aggregated to come up with one five-year period. Essentially, once you've satisfied the five-year rule, you've satisfied it for life. That's a reason that some advisors say if you're interested in a Roth IRA in the future, you should convert or contribute a small amount to a Roth IRA now, so the five-year clock will start running.

The second test for qualified distributions is broader. The distribution must be made on or after at least one of the following events: the owner turned age 59½; the IRA owner passed away, so the distribution is made to the estate or a beneficiary; the distribution is made for first-time qualified home-buyer expenses of up to $10,000.

You must satisfy both tests for a Roth IRA distribution to be tax free. For example, you must be at least age 59½ and must have had a Roth IRA for at least five years for the distribution to be tax free.

The Five-Year Rule for Conversions The second five-year rule determines whether a distribution of principal from a converted IRA is subject to the 10% early distribution penalty. The rule applies only to the penalty. The other rule determines whether the distribution is taxable.

This second rule states that the early distribution penalty isn't imposed if at least five tax years have passed since the principal was converted to a Roth IRA. There are a couple of important points with this rule. One point is that it applies separately to each IRA conversion. That means if you're doing conversions over a period of years, you have to track the amount of principal converted each year.

The second point negates the importance of this rule for most of my readers and most people who convert traditional IRAs to Roth IRAs. This point is that there are other ways to avoid the 10% penalty and the most commonly used one is for the IRA owner to be at least age 59½. Once you've hit that age, a distribution no longer is considered early, so the early distribution penalty doesn't apply.

As an example, suppose Max Profits is 45 years old and converts a traditional IRA to a Roth IRA. At age 51, he needs the money from the Roth IRA and distributes the full account. The early distribution penalty doesn't apply, because more than five years have passed since the conversion. But the distribution of the earnings of the Roth IRA is taxable, because Max hasn't met any of the requirements for a qualified distribution under the first five-year rule. The distribution of the principal, or converted amount, isn't taxable, because the taxes on that were paid when the conversion was done.

Some Other Important Points The five-year rules aren't nearly as onerous or even as important as many people suppose for a couple of reasons. The first reason is that each rule talks about tax years, not calendar years. A tax year starts on the first day of the year, so you really don't have to wait five full calendar years before qualifying under either five-year rule.

For example, you can make a contribution to a Roth IRA for tax year 2018 as late as April 15, 2019 (even later if the 15th falls on a weekend or holiday). Or you can convert an IRA as late as December 31, 2018. In either case, the five-year clock starts running on the first day of the tax year, January 1, 2018. So, the five-year period is less than 60 months from the date of your action.

A second point is that many people overlook what are known as the ordering rules for Roth IRAs. When you take a distribution from a Roth IRA that is less than the full IRA value, the ordering rules determine whether the distribution is of principal or earnings.

The ordering rules state that distributions are first considered to be of principal. Only after all principal is distributed are earnings distributed. Distributions of principal from the Roth IRA aren't taxable, because you already paid taxes on them. So, even if you're within the five-year period, income taxes aren't an issue until all the principal is distributed and earnings are being distributed.

The ordering rules also state that contributions are distributed first, then converted amounts and finally earnings are distributed. A final point in the ordering rules is when there were conversions in different years, the conversions are considered to be distributed on a first-in, first-out basis. So, the first conversions are distributed first, and the most recent conversion is distributed last.

A third point is that the details of the five-year rules are a bit different for Roth 401(k)s. I won't go into those details now.

While the five-year rules are complicated and confusing, they don't matter to most people taking money out of Roth IRAs during retirement. You'll be older than age 59½, so the early distribution penalty won't apply.

You’re also likely to be withdrawing money gradually over time. That means you will withdraw principal first, and that’s not taxable. Only after all your principal has been withdrawn do you have to worry about some of the distribution being taxable. Most likely, five years will have passed by then, so the distributions will be tax free.

How To Avoid (More) Taxes by Converting to a Roth IRA

Many people aren’t excited about paying taxes before they have to.

But, unless your income tax rate is going to be lower in the future than it is now, it can make a lot of sense to pay taxes now and shelter all the future gains and income from taxes.

You could avoid paying tens of thousands of dollars in needless taxes!

Here's what you must consider in order to carry out this strategy.

One of the most powerful tax-saving retirement weapons that should be in every retiree's arsenal is the Roth IRA.

Their unique benefits are tremendous!

- No age limit on contributions.
- No required minimum distribution at age 70½.
- And the best reason ever to open a Roth IRA: not one dime you withdraw from it in retirement is ever taxed. (No matter how much your money has grown over the years!)

Taking advantage of this is easy. Simply build up your traditional IRA and other tax-deferred accounts as much as possible.

Then, convert your regular IRA to a Roth IRA (and consider doing the same with your 401(k) as well if you can roll it over to an IRA).

You will pay taxes on the conversion, but it could be considerably less in taxes then you'd be forced to shell out in the future.

A conversion is best when the taxpayer has cash from other sources that can be used to pay the income taxes, so that the entire IRA can remain intact and maximize the income and gains that will compound.

In addition, the IRA should be left alone for 10 years or longer so that the compounding can make up for the taxes paid on the conversion, assuming an 8% rate of return.

A higher return means a lower payback period, and a lower return means a longer payback period.

If money has to be distributed from the IRA to pay taxes on the conversion, then the Roth IRA should be left undisturbed for a longer period for the conversion to reach the break-even point.

There are other strategies that will reduce taxes on taxable investment accounts.

They could save each retiree thousands of dollars in taxes each year, and make the retirement fund last that much longer.

For example, in the taxable account you want to minimize the number of trades made each year. Numerous trades mean short-term gains, taxable at the top tax rate. Sell investments only when one of these conditions is met:

The prospects for the investment are poor or mediocre. A higher return in another investment can make up for the taxes you will pay to sell the first investment.

The investments are high risk. Your nest egg should primarily have investments that have margins of safety. Most retirees cannot afford to see a large portion of their nest eggs decline in value.

There will be low taxes on the trade. The best way to meet this requirement is to hold a security for more than one year before selling, qualifying for the long-term capital gains rate.

Your IRAs & Your Beneficiaries

I always advise people not to either name their estates as the IRA beneficiary or fail to name a beneficiary.

Doing so can require the IRA to be distributed quickly, causing your beneficiaries to lose the tax deferral.

If the estate is beneficiary or there is no named beneficiary and you had not reached age 72 and were not taking required minimum distributions, the IRA must be distributed within five years after your passing.

The heirs are not allowed to stretch the distributions over the 10 years allowed by the SECURE Act or the longer period that is allowed if the beneficiary is a surviving spouse or one of the other categories of beneficiaries exempt from the SECURE Act’s 10-year rule.

In the second case, some custodians make the problem worse. They will not make distributions to the individual beneficiaries. They will insist on paying the estate and let the estate distribute the money to beneficiaries.

This requires the estate to remain open until the IRA is empty. These custodians do not understand that the IRA legally can be assigned by the estate to the beneficiaries named in the will or other documents. There is no reason to require the estate to be kept open for the stretch-out period.

IRS beneficiary designation forms decide who inherits your IRA. Your will and other documents don’t matter. If a custodian loses the form, it will consider the estate to be the beneficiary unless the estate or beneficiary provides a copy of the form.

Lost forms are not unusual especially after a firm undergoes several mergers or restructurings. If you amend the beneficiary designation, ask the custodian if it will return to you the old forms so that it won't have an out-of-date designation on file.

One of the easiest things you can do to ensure your IRA custodian follows your wishes is to scrap their standard beneficiary forms. Most of the mistakes made by IRA custodians are tied to this beneficiary form, which IRA owners often spend a minute or less filling out.

But a little bit more careful planning can save a large portion of your wealth for your heirs and keep it out of the greedy hands of the IRS.

That's why I recommend you submit your own customized beneficiary forms with detailed instructions. This simple step can prevent a lot of headaches and needless taxes.

It can also help you take advantage of opportunities you might not be able to otherwise.

Most estate planners have experience drafting customized beneficiary forms and working with custodians to accept the forms.

Customized forms should be considered seriously when an IRA is large, there are multiple beneficiaries, or it is not desired to split the IRA equally among the heirs.

This also is a good reason to use a customized beneficiary form instead of the form provided by the IRA custodian.

An estate planner can draft a custom beneficiary designation form that directs the custodian to do exactly what you want. Not all custodians will accept such forms.

But they are more likely to if the form includes a clause relieving the custodian of any liability if it follows the form.

The lesson is to be sure to designate one or more individuals as primary beneficiary of the IRA and also to name contingent beneficiaries in case the primary beneficiary is not able to inherit the IRA.

What Every Spouse Needs to Know About Inheriting an IRA (4 Options)

Many mistakes are made with inherited individual retirement accounts (IRAs).

The rules aren’t straightforward or intuitive, so people often make the wrong decisions, resulting in thousands of dollars of taxes unnecessarily paid to the Internal Revenue Service (IRS).

Bottom line: Your loved ones need to know what to do when they inherit an IRA.

Knowing the rules is especially important for spouses. Most IRAs name the spouse as the primary beneficiary.

A surviving spouse has more options than other IRA beneficiaries. That provides more opportunities to maximize the after-tax value of the IRA, but it also increases the potential for choosing a bad option.

A surviving spouse who is named the beneficiary of his or her deceased spouse's traditional IRA isn't subject to the 10-year distribution period of the SECURE Act and has other choices not available to any other IRA beneficiary.

Option #1 is to distribute all of the IRA assets within five years of the original IRA owner's death.

Of course, that eliminates the potential for tax-deferred compounding of the IRA. All the distributions will be included in gross income and taxed in the same way they would have been to the original owner.

That's the least attractive tax option but might be considered when the cash is needed. One positive aspect of this option is that the 10% tax on distributions made before age 59½ don't apply to distributions from Inherited IRAs.

The penalty won't be imposed, regardless of how young the surviving spouse is.

Option #2 is to establish an inherited IRA.

This involves changing the title of the IRA to reflect that it is an inherited IRA held for the benefit of the surviving spouse.

Each IRA custodian uses its own particular wording, but the title of an inherited IRA is typically similar to this:

Max Profits, deceased, IRA FBO Rosie Profits. ("FBO" means "for the benefit of.")

Here's one area in which the surviving spouse has a distinct advantage over a non-spouse beneficiary.

When non-spouse beneficiaries establish an inherited IRA, they are required to distribute the entire IRA within 10 years of the original IRA owner’s death. There are a few exceptions, such as when the beneficiary is a minor or is disabled. But in general, a non-spouse beneficiary must distribute the IRA within 10 years.

When a surviving spouse inherits a traditional IRA and the original owner was already taking RMDs, the surviving spouse can begin taking RMDs over his or her life expectancy.

The rule is the same for a surviving spouse if the deceased spouse already reached the age for required minimum distributions.

But the surviving spouse has an option when the other spouse passed away before reaching the required minimum distribution age.

The surviving spouse doesn’t have to begin required minimum distributions from the inherited IRA until after the deceased spouse would have been age 72.

When the required minimum distributions begin, they are based on the surviving spouse’s life expectancy, not the deceased spouse’s — unless the surviving spouse wants to use the deceased spouse’s age.

Yet, the surviving spouse is permitted to take distributions from the IRA whenever money is needed before the RMDs begin.

The distributions will be taxed the same as they would have been for the original owner, but, because this is an inherited IRA, the 10% early distribution penalty doesn’t apply.

The options above are available only if the surviving spouse is the sole primary beneficiary of the IRA.

If others share as primary beneficiaries, then all are treated as non-spousal beneficiaries.

Option #3 (one that’s unique for surviving spouses) is the spousal rollover, or fresh start, IRA.

The surviving spouse can use this option for his or her share of an IRA even when there are other primary beneficiaries.

Under this option, the surviving spouse moves the assets to his or her own IRA.

The move can be done by the IRA custodians, or the surviving spouse can take a distribution and deposit that amount into his or her own IRA within 60 days.

The spousal IRA can be a new IRA set up for this purpose, or an existing IRA. The assets also can be moved tax-free to any other qualified retirement plan, such as a 401(k) account.

Once a spousal IRA is created, it is treated as though it has always been the surviving spouse's IRA. No reference is made again to the inherited IRA.

The surviving spouse names new beneficiaries. The required minimum distributions schedule is determined solely by the surviving spouse's age, not by the deceased spouse's age. That's why it's also called a fresh start IRA.

Option #4 is very similar to the third option. The surviving spouse simply treats the inherited IRA as his or her own IRA.

This has the same effects as the spousal IRA, but it is rarely done this way. Usually, the spousal rollover is used.

That avoids any misunderstanding about the surviving spouse's intentions. Once executed, a spousal rollover is irrevocable.

Which Option Is Best for the Inheriting Spouse?

Those options for a spouse inheriting an IRA can seem complicated.

What's the best option?

It usually depends on the spouse's age. Here's why.

When the surviving spouse is under age 59½, the 10% penalty on early distributions applies to any money taken from a spousal rollover IRA.

Remember that after a spousal rollover, the IRA is treated exactly as any IRA owned by a surviving spouse, with no reference to the Inherited IRA.

That means any distributions before age 59½ are included in gross income, and subject to the 10% early distribution penalty.

(That is, unless the spouse qualifies for one of the exceptions to the penalty other than that the assets that were inherited.)

However, the 10% early distribution doesn't apply to any distributions from an inherited IRA.

If the surviving spouse is less than age 59½ and might need to take a distribution some time before that age, the inherited IRA likely is the best option.

When the surviving spouse is older than age 59½, then the spousal rollover is the preferred option.

Another benefit of the inherited IRA option is that a spousal rollover can always be executed later without penalty.

So, a younger spouse can select the inherited IRA option first, and then do the spousal rollover after turning age 59½ or at any other time.

The choice is more difficult when the surviving spouse is substantially younger than the deceased spouse.

In that case, under the inherited IRA, the surviving spouse might be forced to begin required minimum distributions (RMDs) at an early age, even before turning age 59½, depending on the age difference between the spouses.

Yet, the required minimum distributions at that point are likely to be fairly low.

It might be worth the cost of the RMDs to preserve the ability to take a larger penalty-free distribution at any time in case the cash is needed.

There's one other angle to consider.

I regularly advise people not to name their estates as IRA beneficiaries, or not to fail to name an IRA beneficiary.

That's because the potential for deferral is lost when an entity other than a natural person is the beneficiary.

The IRA must be distributed within five years. But there's a narrow exception when the surviving spouse is the sole executor of the estate, and also the sole beneficiary of the IRA proceeds that pass through the estate.

In that case, the surviving spouse still can execute a spousal rollover within 60 days, after proceeds are received from the IRA. But the surviving spouse can't treat the IRA as an inherited IRA. (IRS Private Letter Ruling 201618011)

That's a narrow exception and not one that you should rely on.

If you want your spouse to inherit your IRA, you should name him or her as the primary beneficiary.

Then, be sure your spouse will be informed of the options for handling the IRA and how to choose the better option.

Tax Secrets of Mutual Funds

Many mutual fund investors focus on the fees they pay but don't pay enough attention to the taxes on their investment returns.

Taxes are a greater drag on net investment returns than expenses and fees, according to a study by Rob Arnott of Research Affiliates.

Most investors leave a lot of money on the table by overlooking important tax tricks of funds and focusing on taxes only near the end of the year.

Don't let that happen to you. Review these simple rules about mutual fund taxes and keep them in mind all year.

As markets change, consider tax-wise actions to take with your funds. You want to own the right assets in the right accounts when possible.

Owning the right investments for you comes first. To the extent you can, own the assets in the most tax efficient accounts for them.

If most of your money is in an IRA or 401(k), you might not be able to have all the right assets in the right accounts.

That’s one reason I recommend tax diversification.

It’s a good idea to have taxable accounts, tax-deferred accounts and tax-free accounts. A good general rule for putting the right assets in the right accounts is to hold assets that already receive tax advantages in taxable accounts.

Stocks, mutual funds and other assets you’ll hold for more than a year should be in taxable accounts to take advantage of long-term capital gains.

Stocks that pay qualified dividends usually should be in taxable accounts.

Tax-deferred accounts should hold assets that earn short-term capital gains and taxable interest.

Tax-free accounts, such as Roth IRAs, also should own these types of assets.

Real estate investment trusts (REITs) are a hybrid but generally should be held in tax-deferred or tax-free accounts.

You might also want to hold treasury bonds or treasury-only mutual funds in taxable accounts, because their interest is exempt from state income taxes.

Those are general rules. Let’s move beyond those basics to a higher level of mutual fund tax planning.

You know that a mutual fund avoids income taxes by distributing to shareholders most of its net interest, dividends and capital gains.

Only the shareholders are taxed on the income. Shareholders on the date of the distribution pay the taxes.

If you buy shares in a taxable account the day before a distribution, the distribution will be included in your income for the year, though it really is a return of your investment.

The net asset value of the shares is reduced by the amount of the distribution.

When you're investing or considering an investment in a mutual fund, know its regular distribution dates. You want to make new investments just after, not before, a distribution.

When you made an investment shortly before a relatively large distribution, there's a strategy you might want to use to reduce the tax burden on the distribution.

Suppose Max Profits invests in a fund with a $15 net asset value per share.

The fund distributes $5 per share the next day. Max now has $5 of income and shares with a net asset value of $10 and a basis of $15.

Max can have the shares redeemed for $10, realizing a $5 short-term capital loss that offsets the distribution.

The strategy might not be worth doing if the fund has a redemption fee on short-term holdings or if Max invests through a broker who charges transaction fees on the trades.

In addition, to be able to deduct the loss, Max has to wait more than 30 days to re-invest in the fund.

It is best to know a fund's distribution schedule and avoid buying new shares shortly before a redemption. You don't want to own mutual funds in a taxable account that distribute a lot of gains and income each year.

The taxable account should be for investments that let gains compound for years with minimal annual distributions.

If a fund has a total return of $8 per share during the year, you don't want it to distribute $4 of that return so that you have to pay taxes on them.

You want the gains to stay in the fund and compound over time. You want to be able to control when most of the taxes are incurred, and you want them to be long-term capital gains.

To decide which funds to own in taxable accounts, study a fund's turnover ratio and distribution history.

The turnover ratio is a measure of the frequency of a fund’s trading. A fund that trades frequently has a high turnover ratio and usually is generating a lot of gains, especially short-term gains, that will be distributed to shareholders by the end of the year.

You can find a fund’s turnover ratio in its prospectus and in many of the online data sources of mutual funds.

The turnover ratio is a rough measure of a fund’s likely annual distributions. A more precise measure is a fund’s distribution history. The fund’s prospectus and many online sources list the amount of the distributions made in recent years.

You can see if the fund regularly has high distributions, periodically makes high distributions, or keeps its annual distributions low.

The prospectus and many online sources also provide a table that compares the total return of the fund to its after-tax return for a hypothetical shareholder.

Two funds can have identical total returns over time. Yet, their shareholders can have dramatically different after-tax returns because of differences in annual distributions.

It also is a good move to check the types of distributions a fund has made.

When a fund owns an investment for more than one year before selling, any gain produced is a long-term capital gain. When the gain is distributed to shareholders, they report it on their returns as long-term capital gains.

The shareholders retain the tax advantages of the long-term gains. But when a fund sells a winning investment after owning it for less than one year, it distributes short-term gains that shareholders must report as ordinary income to be taxed at their regular rate.

When a mutual fund has a high turnover ratio or a history of large distributions, try to own that fund in a tax-deferred or tax-free account instead of a taxable account.

A little-known trick is to check a fund’s prospectus or the online data sources for the amount of its loss carryforwards and unrealized gains before deciding which fund to buy.

When a mutual fund has net losses from its transactions for the year, it doesn't distribute those losses to shareholders. Only net gains and income are distributed.

The losses are kept on the fund's books and can be used to offset future gains. If a fund had a poor year or stretch of bad years, it might have loss carryforwards on its books.

Those carryforwards will shelter future gains from taxes. You don't want to buy a dog of a fund simply because it has loss carryforwards.

But when you're considering funds with similar long-term records, one with high loss carryforwards might generate higher after-tax returns than one with few or no carryforwards.

You might want to search for loss carryforwards when an investment sector has been down for a couple of years and you're thinking it's ready to turn around.

Another time to examine carryforwards is when a fund had a rough couple of years because a small number of its investments did poorly, but you think the fund is ready to turn around. Investors buy index funds partly because of their tax efficiency.

Index funds usually make fewer trades than most active funds, so they have lower distributions.

That's the general rule, but it doesn't apply to all index funds. Some fund companies manage their index funds with more tax efficiency than others.

The money managers at those fund companies work hard to offset gains with losses. Others are much more passive and have higher taxable distributions.

The taxable distributions also vary because funds have different ways of tracking an index.

Some funds buy the individual stocks in the index. But others use futures, options and other tools for at least part of their portfolios.

These positions trigger gains as they mature, which happens frequently, and the gains usually are short-term.

These situations are especially likely for funds that track an index other than a large-company stock index. The less liquid the index tracked by a fund, the more likely it is that the fund will deviate from the index, will use methods other than direct ownership of the stocks and will have higher taxable distributions.

Any mutual fund can lose control of its tax situation when it experiences a large amount of redemptions.

A redemption run can occur when investors lose interest in the sector the fund invests in or decides better funds are available.

As investors redeem their shares, the fund has to sell investments to meet the redemptions. If the sales result in gains, the shareholders who remain in the fund pay taxes on the distributions of the gains.

Some investors refer to this as the death spiral or tax spiral. The longer you stay in a fund that is losing shareholders, the larger your annual tax bill is likely to become.

Index investors should compare open-end mutual funds to exchange-traded funds (ETFs).

ETFs have some tax tricks and strategies available that open-end funds cannot offer investors.

Any fee you pay to buy the ETF through a broker might be negligible compared to the tax savings over time, though many ETFs now can be purchased without commissions or trading fees.

Mutual funds encourage investors to automatically reinvest distributions. There are some good reasons to do that.

But over the long run, when the fund is held in a taxable account, reinvestment of distributions results in more headaches and tax issues.

Each time a distribution is reinvested, your basis in the new shares is their value on that date.

Most people go for years holding a fund and reinvesting distributions. They have a bunch of shares bought at different times and different prices.

When they're ready to make partial sales of their holdings to fund retirement, they have a complicated tax picture.

They have to determine the tax basis and holding period of each share sold. It is better to avoid automatic reinvestment of distributions.

Instead, let distributions accumulate in a money market fund. Then, use the account to rebalance your portfolio by purchasing new shares in funds that have lagged the others.

SECTION III: Health Care and Long-Term Care (LTC)

8 Ways To Curb the High Cost of Retirement Medical Care

The cost of medical care continues to rise and to be the wild card in retirement plans.

Reports and studies update their estimates of the cost of retirement medical care each year. They show the cost to be high and also very unpredictable for individual retirees and couples. The studies focus on average or median costs.

You have to be aware that individual costs vary greatly because of differences in personal health, geography, and insurance coverage. Your retirement medical costs can be substantially higher or lower than the forecasts.

We're talking about out-of-pocket costs, those expenses that aren't covered by Medicare or other insurance. People on average incur higher medical costs than these estimates, but Medicare picks up some of the costs and insurance might cover other costs.

A couple retiring in 2019 and incurring median drug expenses during retirement would need to save $174,000 to have a 50% chance of covering their lifetime costs for medical expenses only, according to a study from the Employee Benefit Research Institute.

Those who incur among the highest medicine expenses are likely to need over $399,000. The good news in the report is that the prescription drug expense estimates are lower than in the past because of a reduction in the rate of growth of medical and drug costs.

How will these costs be paid?

EBRI estimates that Medicare covers about 62% of medical costs for beneficiaries. (I've seen other reports estimate that Medicare pays only about 50% of costs.)

Another 13% comes from private insurance and about 12% is paid by the retirees. The rest is paid by state programs, employer retirement benefits, and other sources.

There are steps you can take to reduce both the out-of-pocket medical costs and the uncertainty of your exposure to the medical costs.

• **Those not already retired should establish good health habits**, including participating in any employment or community wellness programs.

• **When you're eligible for a health savings account, take advantage of the option and fund it with the maximum amount each year**. Contributions to HSAs are deductible if made by you and excluded from gross income if made by your employer. Earnings on the account compound without taxes, and all amounts withdrawn from the account are tax-free when withdrawn to pay for qualified medical expenses. It's a good way to build a tax-advantaged retirement fund for medical expenses.

• **Enroll in Medicare when first eligible**. You pay a penalty for life if you decide later to sign up for Medicare Part B or Part D Prescription Drug Coverage after your initial enrollment period expires.

• **Sign up for Part D Prescription Drug Coverage**. This is private insurance that is partially subsidized by the government. Prescription drugs are the largest medical expense for most of those age 65 and older. A good policy reduces your out-of-pocket costs and the uncertainty of how much you'll pay should you have an above-average or catastrophic need for medicine. When you don't have much need for prescription drugs at the start of retirement, sign up for a barebones, low cost policy. You always can switch to a more robust policy during a future open enrollment period if you need it and will avoid the premium penalty for signing up for Part D late.

• **Consider a Medicare Supplement policy**. When you're in traditional Medicare (not Medicare Advantage), there are a number of deductibles, copayments, and coverage gaps. A Medigap policy will cover some of them and reduce your uncertainty. There are 10 different Medigap policies to choose from, so you can look for the right trade off for you between premiums and better coverage.

• **Shop around**. I can't stress this enough. Recent studies have found that premiums for identical coverage for the same person can vary by 100%. There are people paying twice as much for Part D and Medigap policies than they should because they didn't shop around. The insurance industry counts on a combination of inertia and people disliking insurance shopping. It costs people a lot of money.

• **Have flexibility**. A retirement plan needs a cushion and some flexibility because of the uncertainty of medical expenses. You should minimize fixed expenses so that spending changes can be made in case uncovered medical expenses arise.

• **Plan for long-term care**. Medicare won't cover much of any long-term expenses you incur, and most of you won't qualify for Medicaid. You probably don't want to rely on Medicaid for long-term coverage anyway, because the level of care by facilities accepting Medicaid usually is considered to be of lower quality than at others.

I recommend most people plan on using several sources to pay for LTC. Part of the cost can be funded from savings. There probably are expenses you incur now that you won't if you need LTC, and that money can be used to help pay for LTC.

To pay for the bulk of the coverage, you should consider obtaining either a standalone LTC policy or an annuity or life insurance policy with a long-term care rider. Or you can combine both types of coverage.

Tapping the equity in your home through either a reverse mortgage or a sale can be a good way to plan for extended long-term care expenses. By using all these tools, you'll have a solid plan to cover any LTC you need.

What You Need To Do NOW To Avoid Higher Medicare Premiums

You could pay almost four times the regular Medicare premium in two years if you don't take action soon.

Back in 2003, Congress began means-testing Medicare by putting in place the Medicare premium surtax or surcharge.

It’s known formally as IRMAA, Income-Related Monthly Adjustment Amount. IRMAA is one of the Stealth Taxes I warn retirees about.

At first the surtax covered only Part B of Medicare. In 2011, it was expanded to include the Part D Prescription Drug program.

The surcharge now kicks in at lower income levels than in the past and has a higher rate for people with the highest incomes.

Under IRMAA, you pay higher Medicare premiums as your modified adjusted gross income (MAGI) increases. The amount of the premium increase depends on your income level.

There are six premium brackets. The nasty trick is that a $1.00 increase in MAGI can push you into the next bracket and increase your premiums by thousands of dollars for the year, especially if you’re a married couple and both spouses are in Medicare.

Premiums increased about 6% from 2019 to 2020. Medicare uses income tax returns from two years earlier to determine the surtax.

Returns for tax year 2020 are used to determine 2022 Medicare premiums. Beneficiaries will receive letters in late 2021 telling them what their 2022 premiums will be, based on their 2020 tax returns.

You can have the additional premium withheld from your Social Security benefits or have Medicare bill you.

To compute MAGI, you start with AGI on your form 1040. You add to it tax-exempt interest income, EE savings bond interest used for education expenses and income excluded under the foreign earned income exclusion.

You reduce IRMAA by reducing MAGI. Increasing itemized expense deductions won’t help. But deductions against business and self-employment income will reduce MAGI, and so could loss deductions from businesses and investments.

People often stumble into higher premiums because of a one-time income event. Many people don’t realize that a one-time income boost will trigger not only taxes on the income but also the Medicare premium surtax.

One-time income events that can trigger IRMAA include selling a business or real estate, selling a residence if the gain is high enough to be taxable, taking a larger IRA distribution, taking a large capital gain and similar events.

There’s a tradeoff to some events, such as converting a traditional IRA to a Roth IRA. The future distributions from the Roth IRA will be tax free and won’t be included in MAGI. They won’t trigger the premium surtax.

But in the year of the conversion, MAGI will spike higher. It’s likely to trigger higher Medicare premiums in two years.

You might trade higher Medicare premiums one year for lower premiums the rest of your years by converting all or part of a traditional IRA. Once you’re on Medicare or even within two years of being on Medicare, you should consider the Medicare premium surtax before making any transactions that will increase MAGI.

The premium surtax can be waived or reduced when it is the result of one-time life events that are out of your control. Events that will result in waiver of the surtax include marriage, divorce, death, a reduction in work hours, ceasing work and a pension default.

Other events also might qualify as reasonable causes to reduce the premium surtax, but these are the only ones Medicare indicates clearly qualify. The key is the event must have been generally out of your control.

A surge in income from selling an asset or a similar event isn’t going to result in a waiver.

You file Form SSA-44 from Social Security to ask for a waiver of the surtax.

Be aware of the IRMAA brackets and where you fall in them. If you are below the surtax trigger level, recognize that a one-time increase in MAGI could trigger the surtax in two years.

Consider whether the transaction can be avoided or restructured to avoid IRMAA. If you're already in one of the surtax brackets, try to avoid events that will push you into a higher surtax bracket.

You also want to look for opportunities to decrease income or increase deductions that will reduce MAGI and lower the Medicare premiums for at least one year.

If you aren't yet retired, factor IRMAA into your plans. For example, you might want to convert small amounts of an IRA each year in the years preceding retirement to ensure you aren't hit with IRMAA in the future when you're forced to take required minimum distributions.

If you're already retired, know where you are in the IRMAA brackets and take care to avoid actions that will increase your surtax in two years.

The Retirement Watch "Family Caregiver Planning Guide"

Family caregiver planning has some simple rules…

And some not-so-simple rules.

For starters, any caregiver agreements involving family members should be in writing.

That is, unless the person providing the care is being altruistic (being a friend), and expects nothing in return now or in the future.

Often when one family member provides care for another, there usually is some agreement about compensation.

Sometimes the caregiver is paid directly and on a regular basis.

Other times there is an agreement that the caregiver will receive an increased share of the estate, some property, or a lump sum.
In these situations, a written caregiver agreement ensures there are no misunderstandings, everyone in the family knows the terms, and tax benefits are maximized.

An agreement is important in every case but is especially important when the caregiver has siblings.

When a family member cares for another and there is a financial payment of any sort, the payments are not tax-free gifts.

Any payments are compensation for services and must be included in the gross income of the recipient.

This is true whether the payments are made periodically like a salary, in a lump sum, or as an additional inheritance.

It is also true if the payments are in cash or some other form.

The agreement is also especially important if the person cared for hopes to qualify for Medicaid nursing home coverage someday.

Medicaid is available only to people with incomes and assets below certain levels.

Gifts made in the five years before the Medicaid application are added to the person's net worth to determine if the asset limit is reached.

But compensation for personal care paid to a relative is not considered a gift by Medicaid if the payments are made under a caregiver agreement that was written in advance and the compensation amounts are reasonable and at arm's length.

The written agreement also helps avoid IRS finding that the transfers were gifts.

Gifts above the annual exclusion amount are taxable or reduce the lifetime gift and estate tax credit.

A caregiver agreement, also known as a personal service or personal care contract, should have a number of elements.

The duties of the caregiver should be specified. Spelling out the details is a way of proving the compensation is reasonable and reducing misunderstandings over services to be performed.

Typical services include preparing and serving meals, making sure medication is taken, keeping the house clean and maintained, paying bills and running errands.

There needs to be an agreement over which tasks will be personally performed by the caregiver and which will be performed by others but arranged and supervised by the caregiver.

It must be clear who will pay for third party services.

The amount of compensation must be stated, as well as the frequency and form of payment.

The compensation should be reasonable and based on the average hourly rate charged by others in the locality for similar services.

There can be a family discount from the market rate but not a premium. Some family members want only to be aid for their out-of-pocket costs plus a small amount for their time. That is fine but should be stated clearly.

The compensation has to be reasonable based on the caregiver's skills. The hourly rate for a registered nurse, for example, cannot be used for someone without the credentials.

Many states assume that services performed by a family member are gratuitous.

Without the writing, the family might not be able to obtain reimbursement from some government programs and, in the worst case, the person providing care and receiving compensation might be accused of stealing or financial abuse.

The payer of the compensation might be required to withhold and report Social Security and other taxes.

Additional Family Caregiver Planning Rules

The recipient should report compensation as gross income. The details of the agreement will determine if the caregiver is an employee or independent contractor for tax withholding and reporting purposes.

The agreement should be discussed with other family members for input and to avoid misunderstandings.

Putting the agreement in writing and making sure it has the essential elements reduces the tax and family problems that frequently arise from haphazard and informal agreements.

How To Build Your Own Long-Term Care (LTC) Plan

The cost of long-term care is one of the major retirement financial worries. Survey after survey confirms that.

The data also confirms that few people do anything about long-term care, other than worry.

One survey even found that many people would rather go to the dentist than talk to someone about long-term care.

That needn't be the case. You can put together a plan to pay for long term care, in case you need it.

There's no magic bullet to long-term care planning. Instead, set your goals and consider all the tools available. Then, you're likely to have a plan that both meets your needs and is affordable.

Remember, long-term care is more than nursing home care. Long-term care (LTC) can be any type of assistance with the activities of daily living.

Adult day care and someone to help clean and cook are LTC. Home health care is LTC.

So is some physical therapy, as well as residing in an assisted living facility and parts of a continuing care retirement community.
Of course, a nursing home or other full-time custodial care is LTC.

Most people want to stay in their own homes for as long as they can. That becomes easier each year. More and more long-term care is given in residences, though it might have to be given by a professional.

Some people want or assume that when they need help they'll be assisted by family members.

Other people favor professional caregivers and don't want to burden family members, yet some of those people don't want strangers in their homes.

You need to decide your preferences and be sure they're realistic, then consider the options available.

Most people understand that a majority of older people need long-term care at some point in their lives, but also believe that they won't be among those who need it.

Most people also greatly underestimate the cost of long-term care, even home assistance.

I urge you to visit the websites of John Hancock Insurance and Genworth and review their cost estimates for different types of long-term care in your area of the country.

Now, let's consider the elements of your Long-term Care (LTC) plan.

Family and friends. Family and perhaps some close friends are the likely sources of long-term care to many people.

We all know people who spent considerable time helping a parent or other relative who couldn't fully take care of themselves. Yet, that isn't always a good or viable option.

Is a family member even available? Family members might live too far away or have families, jobs, and other obligations.

Family care-giving might work in the short-term, but is it viable for an indefinite, extended period?
Studies also show family caregiving is burdensome, having negative long-term effects on the finances and health of the caregivers.

Qualifications are also an issue. A family member can help with cooking, cleaning, and other household chores. But other help you need might require training.

On the positive side, some long-term care insurance policies and other payors of long-term care expenses will reimburse family members for helping, under some circumstances.

Medicare. Despite what many people believe, Medicare isn't likely to meet your long-term care needs.

While Medicare does pay a lot of money to long-term care facilities and professionals, the covered care is only for up to 100 days of long-term care following a hospital stay of at least three days.

In other words, it is for rehabilitation after an illness, surgery, or injury.

Medicaid. A high percentage of nursing home expenses in this country are paid by Medicaid. Yet, to qualify for Medicaid you have to meet the program's definition of being impoverished.

The exact standards vary among the states. Generally, you have to give away most of your assets five years before applying for Medicaid or spend down your assets for at least five years of care before applying.

Also, Medicaid pays for nursing home care but not for assisted living and many other types of long-term care.

The #1 Way To Multiply the Money Available for Long-Term Care

Traditional long-term care insurance might be dying, but there are other, and probably better, ways to protect your family and assets from the potentially onerous costs of long-term care.

In 2020, only 58,000 traditional long-term care (LTC policies) were sold. That's 10% of the number sold 20 years earlier.

Steep premium increases on existing policies are the main reason traditional LTC insurance is in decline. In August 2019, regulators in 22 states approved another 58% increase in premiums on some existing Genworth policies. That follows 28% increases in each of the last two previous years.

Other insurers have had significant increases approved in recent years.

Insurers say buyers of new policies aren't likely to face such premium increases in the future, but there's no assurance. Potential buyers are understandably skeptical.

Also, traditional LTC policies still have the longstanding use-it-or-lose-it feature. If you don't need much long-term care during your life, all you receive for paying premiums through the years is peace of mind. Yet, you still need to prepare for long-term care.

About 25% of Americans who will turn age 65 between 2021 and 2025 will need up to two years of LTC during their lifetimes, according to a federal government report. Two to five years of care will be needed by 12%, and 14% will need more than five years of care.

The cost varies by location and the level of care needed. Home care provided by aides generally costs $15 to $20 per hour. Assisted living is more expensive (often $4,000 or more per month), and nursing home care is the most expensive, costing more than $100,000 per year in most places. You can find data on the cost of different kinds of care around the country on the Genworth website.

Unless you're able and willing to pay such costs yourself, you need a plan to protect your wealth and estate. The best option often is a Hybrid LTC policy, also known as an Asset Based Care Plan, or The Leveraged Care Solution. These are life insurance policies or annuities with LTC benefits.

The policies give you the certainty of receiving a particular benefit payment for a fixed period if you need LTC. They also multiply your savings. The amount you deposit in a policy automatically becomes two times, three times or more in LTC benefits.

In addition, if you don't need LTC or need only a small amount, there are life insurance benefits or an annuity balance payable to your beneficiaries. You aren't subject to the use-it-or-lose-it rule.

That's why the hybrid policies gradually have been replacing traditional LTC policies, with almost 500,000 hybrid policies acquired last year.

I'm pleased to report that one of the best hybrid policies became even better in 2019 and its advantages continue into 2021.

The 844 Long-Term Care Plan					
Male					*Assumes initial $100,000 deposit.*
Age at Contribution	Inflation Provision	Age	Legacy Benefit	Monthly Care Benefit	Total Cash Pool
55	None	55	$201,000	$7,700	$551,000
		85	$184,000		
	5% compound	55	$104,000	$4,000	$324,000
		85	$100,000	$17,000	$1,396,000
65	None	65	$145,000	$5,800	$419,000
		85	$139,700		
	5% compound	65	$97,800	$4,000	$321,000
		85	$100,000	$10,400	$852,000
70	None	70	$120,000	$4,700	$339,000
		85	$113,000		
	5% compound	70	$98,900	$3,900	$317,000
		85	$100,000	$8,000	$658,000

Female					*Assumes initial $100,000 deposit.*
Age at Contribution	Inflation Provision	Age	Legacy Benefit	Monthly Care Benefit	Total Cash Pool
55	None	55	$203,400	$7,800	$567,000
		85	$189,000		
	5% compound	55	$80,000	$2,700	$220,000
		85	$100,000	$11,700	$952,000
65	None	65	$147,100	$6,000	$432,000
		85	$144,000		
	5% compound	65	$80,000	$3,000	$241,000
		85	$100,000	$8,000	$639,000
70	None	70	$114,500	$4,800	$343,000
		85	$114,300		
	5% compound	70	$98,900	$2,900	$230,000
		85	$100,000	$5,900	$479,000

* data from 2019 and the numbers change over time and depending on the individual

This LTC/Life hybrid from an A+ rated carrier is referred to as the 844 Plan. You buy a universal life policy and an LTC rider. Immediately, you have the life insurance benefit and a cash value account plus the LTC benefits.

The LTC benefits will always be significantly more than your deposit. Exactly how much more depends on your age, sex, the deposit schedule you choose and some other factors. You also can select inflation protection for your LTC benefit.

You can see from the accompanying table examples of coverage at different ages with and without inflation protection, assuming a deposit of $100,000. The numbers are from mid-2019 and can change over time. They also can vary based on your health and where you live.

Benefits begin 90 days after a certified caregiver verifies that you need help with at least two of the six activities of daily living or you have cognitive impairment. You choose in advance to have benefits paid over a period from 48 to 84 months. LTC benefits received under the policy are tax free.

Another important feature of the 844 LTC Plan is that it provides indemnity benefits instead of reimbursement benefits. Traditional LTC policies and many hybrid policies provide reimbursement benefits. You first incur the LTC expenses. Then, you submit receipts and other documentation to the insurer and wait for reimbursement. Also, the policy will reimburse only covered expenses.

Not all the LTC expenses incurred will be reimbursed. Try doing all that paperwork when you need LTC. An indemnity policy, on the other hand, begins monthly payments after the 90-day waiting period. No receipts are required, and you don’t have to wait for reimbursement.

Also, you can spend the money on anything. You don’t even have to be in a facility or use licensed care providers. You can be receiving care at home informally from a family member. In other words, this isn’t “nursing home insurance.” You decide how to receive the LTC you need.

Unlike traditional LTC policies, with the 844 LTC plan you can choose after five years to cancel the policy and have your full deposit returned.

Here’s how the policy recently was enhanced. Hybrid policies require a lump sum premium, and the minimum usually is $50,000 to $100,000. To receive higher LTC benefits, you deposit a larger amount.

Many people are hesitant to take out the coverage, because they aren’t comfortable transferring so much of their liquid assets at one time. Others don’t want to sell investments or draw down IRAs because of the taxes that would trigger in one year.

Now, you don’t have to worry about that. The 844 LTC Plan can now be paid with multiple deposits over several years. You can choose a lump sum or payments over one, five, seven, ten, or 15 years.

If you are under age 71 you can obtain coverage without having to deposit a significant sum at one time. The minimum deposit is one that will produce at least a $50,000 life insurance benefit. Depending on your age and other factors, it could be as low as $5,000. The maximum deposit is $500,000.

You obtain more coverage and life insurance by using the single-premium option. You need to examine the effects of the different payment options and determine which trade-offs you prefer. The 844 LTC Plan is available to people between ages 40 and 75. There's no medical exam. You answer some questions about your medical history and take a cognitive impairment test, which can be taken over the telephone.

The insurer is a solid A+ rated carrier that has been in business for about 130 years.

Don't Be Scared By Those Estimates of Retirement Medical Spending

The biggest financial worry of retirement happens to be among the most manageable and easiest to conquer.

Surveys routinely show that Americans are most concerned about retirement medical expenses.

Even high net worth individuals say they're worried post-career medical care will deplete their assets.

It's no wonder. Every year we're faced with fresh estimates of total out-of-pocket retirement medical costs and the media hype the estimates. The Employee Benefit Research Institute (EBRI) estimates a couple aged 65 in 2019 will need about $301,000 to have a 90% probability of covering their out-of-pocket retirement medical expenses, excluding long-term care.

The latest estimate from Fidelity Investments for the same couple is $285,000.

Those numbers can seem overwhelming. But when we learn how they're compiled and the resources available to retirees to manage them, out-of-pocket expenses are likely to fall much lower on your list of financial worries.

Now is the time to take a hard look at retirement medical expenses and be sure the right plan for you is in place.

If you're new to Medicare or looking forward to retirement in a few years, go through the same process when it's time for you to enroll in Medicare.

Let’s first break down those big numbers of lifetime spending estimates.

The lifetime estimates are for expenses over 20 to 30 years, depending on the estimate. An estimate of $300,000 over 20 years is $15,000 annually. That’s for two people, or $7,500 each. The estimates also are adjusted for inflation, so they aren’t in 2021 dollars.

If you make the same estimate with your cable television bill, you’ll probably estimate you’ll pay about $100,000 for cable over the next 20 years. It looks much more daunting when presented that way.

Like your cable bill and other expenses, the medical expenses will be paid gradually over the years. You’ll pay them using Social Security benefits (which are indexed for inflation), investment income and gains, and the principal in your nest egg.

To be sure, medical expenses will be one of your most significant retirement expenses. They’re also likely to increase over time.

Most importantly, there can be a great deal of uncertainty about the level of retirement medical expenses.

The estimates are of median or average spending for retirees. There’s a wide variation in individual spending. The EBRI estimates the range of spending among retirees and those in the highest 10% of spending, pay quite a lot.

Fortunately, you can reduce the uncertainty significantly and also reduce your out-of-pocket medical expense spending. Medicare Open Season is the latest opportunity to do that.

Most people think their retirement medical expenses depend on their health, and their future health is unpredictable. But other factors are more important in determining your out-of-pocket spending.

We need to understand some details of Medicare and the way the estimates of lifetime spending are compiled.

Traditional Medicare has a lot of coverage gaps. Most vision, dental and prescription drug costs aren’t covered. Neither are hearing aids. Over-the-counter medicines also generally aren’t covered.

Most importantly, there’s 20% coinsurance for most covered care. A beneficiary in traditional Medicare is on the hook for 20% of most covered medical care, no matter how high the bill.

A major surgery or illness or a chronic condition can trigger thousands, or tens of thousands, of dollars in out-of-pocket costs rapidly.

But you don’t have to be at risk for all those costs.

When you are in original Medicare, you need additional coverage.

Buy a comprehensive Medicare supplement, or Medigap, policy. There are 10 different types of policies available.

Each type covers a different amount of Medicare’s gaps. The more gaps that are covered, the higher the policy’s premium. We’ll discuss this in more detail in future issues of Retirement Watch.

When you’re first eligible for Medicare, insurers must issue you a policy without regard to your health.

I recommend that original Medicare beneficiaries purchase the broadest Medicare supplement policy they can afford. The broadest type of policy now is known as Plan G.

Prescription drugs are the other major gap in Medicare. They also aren’t covered by Medicare supplement policies. But you can buy separate coverage through a Part D Prescription Drug policy. We’ll also discuss these policies in more detail later.

With these two policies plus original Medicare, the only major medical expenses that won’t be covered are vision and dental care and hearing aids. You’ll generally have to plan on paying these expenses out of income and savings, though you might find vision and dental insurance or discount plans in your area that are attractive to you.

When you’re in original Medicare, you should plan to maximize insurance premiums in order to minimize uncertainty and out-of-pocket costs.

A study by T. Rowe Price found that about 75% of out-of-pocket medical costs for most retirees were insurance premiums, including Medicare premiums.

About 25% of retirees paid less than $2,000 annually in premiums. Other out-of-pocket spending varied considerably, and a major cause of the variation is the amount of insurance coverage.

A married couple in original Medicare can obtain broad coverage in most areas of the country for less than $3,000 each. That includes monthly Medicare premiums.

There’s an alternative to this package of traditional Medicare, plus additional insurance coverage. You can join a Medicare Advantage plan.

These plans, which now cover about one-third of Medicare enrollees, have all the original Medicare coverage. They also provide additional benefits for prescription drugs, vision and dental care.

They might include additional coverage. The Advantage plans also have a cap on your annual out-of-pocket expenditures for covered care.

Most areas of the country have several Advantage plans available. They’re not all the same, so compare details. Focus on the providers that are in the network.

If you take prescriptions drugs, check the coverage for those drugs.

In *Retirement Watch*, I discuss the important differences between original Medicare and Medicare Advantage.

With either of these approaches, uncertainty about your lifetime medical expenses is greatly reduced.

You can take an ax to retirement medical expenses. You should be able to pay premiums and many of the copayments and deductibles from monthly income.

Other out-of-pocket expenses might be paid from savings or by reducing other expenses.

How To Save Money on High Prescription Drug Costs in Retirement

As you might expect, medical care will be one of your highest expenses during retirement.

And prescription drugs will be among your highest medical expenses.

Now consider this…

A 65-year-old couple today that has median prescription drug expenses for the rest of their lives will need $165,000 of savings to have a 50% chance of covering their health expenses in retirement, according to the Employee Benefits Research Institute.

To have a 90% chance of having enough savings, they'll need $265,000.

To protect your financial security, you need a plan for controlling prescription drug expenses. Traditional Medicare doesn't cover most drug expenses.

The best strategy is to buy a Part D prescription drug policy if you're in traditional Medicare or participate in a Medicare Advantage plan with prescription drug coverage.

I'll talk about Part D plans but be sure to look at the same factors when considering an Advantage plan.

The most important rule is: Shop around.

If you take nothing else away from this discussion, it should be the importance of shopping around.

Studies of Part D plans found that premiums can vary by as much as 100% for plans available in the same area with identical or very similar coverage.

People don't like to shop for insurance, and many don't know what to look for, so they pay higher premiums than they need to.

Shopping around is relatively easy, especially if you have Internet access. The Medicare website has summaries of all the plans available in your area with links to details at the insurers' websites.

You also can talk with someone at 800-MEDICARE to discuss the plans available in your area.

In many areas, help is available through the local Area Office on Aging or non-profit groups. There also are financial advisors who specialize in helping to choose Medicare plans for a fee.

Understand How Premiums Work

Of course, you start with the monthly premium, but don’t end there.

The plan with the lowest premium might offer coverage that is inappropriate for you and costs more in the long run.

A plan with a higher premium might offer advantages such as a lower deductible and broader coverage.

Covered Medications

Perhaps the most important feature of a Part D plan is the drugs covered, also known as the formulary.

Insurers choose which drugs they cover and the extent of the coverage. Determine a plan’s coverage for medications you already use or believe are likely to need in the future because of personal or family medical history.

A plan might cover only generic drugs when they’re available for a condition. Usually, you have to try the generic first and determine either that it isn’t effective or has side effects before a brand name will be covered.

When several different drugs are available for a condition, a plan might not cover all of them.

New or experimental drugs usually aren’t covered at all, and off-label use of a drug might not be covered.

When a drug is available in different forms, such as a tablet, capsule, lotion, or gel, a plan might not cover all the forms.

Each year, as Part D open season approaches, review your plan’s revised formulary for any changes.

A plan can change its details each year. Drugs that are covered one year might not be covered the next.

Deductibles and Co-payments

Each plan sets its annual deductible, the amount you have to spend before the plan covers any medications.

It can’t be more than $360, adjusted for inflation each year. Some Part D plans have no annual deductible.

After the annual deductible is met, you’ll have a copayment or coinsurance on each prescription. A copayment is a dollar amount while coinsurance is a percentage of each prescription’s cost.

Each policy has its own copayments or coinsurance. In most policies, they vary in what are called tiers.

Usually Tier 1 has a low copayment or coinsurance and is mostly generic drugs, and Tier 2 is mostly brand name drugs and carries a higher copayment or coinsurance.

The Coverage Gap

The most confusing aspect of Part D is the coverage gap, also known as the donut hole or doughnut hole. The gap has changed over the years. Most seniors don’t understand the coverage gap, according to a survey by Blink Health. Initially, your covered prescription drugs cost you only the policy’s co-payments. Once you meet the policy’s deductible (if it has one; the deductible can’t exceed $445 in 2021), you pay a higher percentage of the drug costs until your out-of-pocket spending reaches the annual limit.

For 2021, the out-of-pocket limit was $4,130. You’re in the coverage gap, or the donut hole, when your spending for the year is between the deductible limit and the annual spending limit.

In the coverage gap in 2019, you paid 25% of the cost of all brand-name drugs and 37% of the cost of all generic drugs. In 2020, you paid 25% of the cost of both types of drugs when you’re in the cover-age gap and this will continue in 2021.

Once your out-of-pocket medicine spending exceeds the year’s limit, you receive what Medicare calls catastrophic coverage. You’ll pay only a small coinsurance or copayment for covered medicines for the rest of the year. The next year, you start over.

It is tempting to select the Part D plan with the lowest premium, but that might not leave you with the lowest out-of-pocket costs at the end of the year. You want to look at the deductible, copayments and whether the policy provides additional benefits while you’re in the coverage gap.

Though the coverage gap can be complicated, you need to understand how much you might pay for prescriptions while you're in the gap before selecting a plan.

Pharmacy Restrictions

To obtain coverage, you might be required to use only certain pharmacies. Often, continuing prescriptions must be refilled through a mail order pharmacy selected by the insurer.

It is important to enroll in a Part D plan or a Medicare Advantage plan when you're first eligible.

If you don't and enroll later, you'll pay a higher premium every month for the rest of your life. The amount of the higher premium will depend on how long you waited before enrolling in Part D.

If you don't need coverage when you're first eligible, sign up for the cheapest Part D policy available. You can switch to a different policy during the annual open enrollment period in the future when you have different prescription drug needs.

Reevaluate your choice each year as open enrollment approaches.

Plans change their terms each year, and your needs might change. A plan that worked well for you in the past year might not in the next year.

Making the Best Use of Home Equity in Retirement Income

The residence usually is one of the most valuable assets retirees own.

It also is one of the worst-managed assets.

Few people realize the home can be used to increase retirement cash flow or know how to do so efficiently.

In past issues of *Retirement Watch*, we've gone over reverse mortgages and issues related to moving in retirement. You can find these articles in the Archive on the members' section of the web site.

Let's put these topics together to consider how to make the best use of home equity in retirement income.

While your house is your home, it also is both one of your most valuable assets and your highest expense.

Most people consider their home equity primarily to be left for their children or to be used in a pinch to pay for long-term care or high medical expenses.

Instead, consider how it can be used for your financial benefit.

The first strategy to consider is downsizing.

Downsizing is moving from your current home to one that costs less and is less expensive to own.

To many people, downsizing is moving to a smaller home, but that’s not necessarily the case.

If you move to a less expensive area, you can purchase a home that costs less to buy and own without being smaller than the old home.

Downsizing can have two benefits.

First, downsizing creates additional liquid assets. You sell the old home and purchase a new home that is less valuable than the old home.

The difference is cash in hand for you that can be invested to generate additional retirement cash flow.

Or you can use it to pay debt. Either way, eventually it increases retirement cash flow.

The trick is to not overestimate the amount of cash downsizing will create.

It costs money to buy and sell homes and move your goods to the new home (or acquire new furnishings and accessories).

Many people overestimate the cash they’ll net from selling their old homes, so they “downsize” to a home that’s more expensive than they really should have purchased.

The result is a lot of real estate activity without increasing their nest eggs by much.

A good rule of thumb in most areas is that the costs of buying, selling, and moving will cost about 10% of the value of your current home.

Second, downsizing should decrease your monthly expenses.

You've moved into a home that's less expensive to own, so your monthly cash flow available to pay for expenses other than housing should increase.

Downsizing also could have nonfinancial benefits by making your life easier and less stressful.

You'll have less home to clean and maintain. It also might be easier for you to move around the home, and the neighborhood might be more suitable to this stage of your life.

The second strategy to consider is a reverse mortgage, also known as a home equity conversion mortgage (HECM).

A HECM is a loan backed by the equity in your home. You don't make loan repayments during your lifetime.

The loan is paid from the sale proceeds after the home no longer is your primary residence.

If you live a long time and the interest compounds to a large number, you won't owe more than the equity in your home. The lender or the federal government will take the loss.

You can take the HECM as a lump sum, line of credit, or an annuity.

For example, you can arrange for a monthly annuity that will last as long as you live.

You still have to pay taxes and insurance on the home, and you'll be responsible for maintaining it. But you receive part of your home equity in cash without having to move.

The major disadvantage of a HECM is that it is a relatively expensive way to borrow. Because of the costs, you'll be able to borrow much less than the full equity of your home.

The percentage of the home's value you can borrow will depend on your age and the level of interest rates when you borrow.

Here are the key points when planning how to use these strategies to benefit from your home equity.

Downsizing is best done sooner rather than later.

There are social and emotional aspects to leaving a long-time home, so the longer you wait the more difficult the move and subsequent readjustment will be.

Age, of course, makes the physical act of moving more difficult. Physical limitations could make the move more expensive because you have to hire people to do things you would have done a few years earlier.

Also, the lifetime benefits of downsizing are greater when you act sooner.

The financial goals of downsizing are to increase your nest egg (resulting in higher income) and decrease monthly expenses. The sooner you make the change, the greater the lifetime financial benefits.

Downsizing also should occur before using a reverse mortgage.

If you take out a reverse mortgage and decide to downsize later, you have to pay the reverse mortgage and all its accumulated interest and fees from the sale proceeds. Taking out a reverse mortgage will foreclose downsizing in the future for many people.

A reverse mortgage is very flexible. Traditionally a HECM was used to pay for medical expenses or home maintenance late in life when other cash sources were exhausted or to set up an annuity to supplement Social Security and any other income. Those uses still are available.

Another option is to create a reverse mortgage line of credit. You can use the line of credit to avoid reducing your nest egg when markets are down or unexpected major expenses arise. Then, pay down the line of credit from future investment returns.

A HECM also can be used before age 70 if you retired but want to maximize Social Security benefits. You can supplement nest egg withdrawals and any other income with cash from either a HECM line of credit or monthly payments for a set period of years.

After Social Security benefits begin at 70, you can choose to repay the reverse mortgage over time or wait to have the loan paid from a future sale of the home.

I don’t want to downplay the practical and emotional aspects of your home. Too many people, however, overlook the options for managing their home equity. There are ways you can turn your largest expense into a source of extra cash flow.

The earlier you incorporate these ideas in your retirement plan and ensure you are in the right home for the long term, the more financially secure you’ll be through retirement.

Deducting Mortgage Interest after Tax Reform

The Tax Cuts and Jobs Act (TCJA) of 2017 made far-reaching changes to the mortgage interest deduction.

While many changes in the law simplified the tax code, this is one that complicated things for some people. The changes also mean that about 14 million people deducted mortgage interest in 2018, down from 32 million in 2017.

One change that will have a major effect is the increase in the standard deduction. It was doubled almost to $12,000 for single taxpayers and $24,000 for married taxpayers filing jointly ($26,000 for couples 65 and older).

The higher deduction means fewer people will itemize deductions on Schedule A. You either take the standard deduction or deduct itemized expenses on Schedule A, whichever has the higher deduction. If you’re married and filing jointly, you don’t deduct itemized expenses unless the total of your Schedule A expenses (mostly mortgage interest, state and local property taxes, medical expenses and charitable contributions) exceeds the standard deduction, which was set at $24,000 for 2018 and indexed for inflation each year. .

In addition to the higher standard deduction, another factor that will reduce the number of people deducting itemized expenses is that state and local property tax deductions are limited to $10,000 per tax return and miscellaneous itemized expenses are eliminated.

The TCJA imposed new limits on the mortgage interest deduction itself.

First, it is important to understand the distinction between acquisition mortgage debt and home equity debt. The distinction has been in the tax code for a while, but it is more important to many people now.

Acquisition debt is any debt used to acquire, build or substantially improve a primary residence or a second residence. The loan must be secured by the residence. Home equity debt is any other debt secured by a residence.

Notice that it doesn't matter what the lender calls the loan. A home equity loan or line of credit can be acquisition debt under the tax law when you used the loan proceeds to substantially improve the home.

Under the old law, you could deduct interest on acquisition debt up to $1 million and interest on home equity debt up to $100,000.

Under the new law, interest on home equity debt isn't deductible at all, and there's no grandfather rule. Interest you deducted in the past on a home equity loan or line of credit isn't deductible in 2018 and later years.

For acquisition debt, interest is deductible only on loan principal up to $750,000.

But there are grandfather rules for acquisition debt. If your acquisition mortgage interest was deductible in 2017, it probably still is deductible in 2018. The new limits apply only to mortgages taken out after December 15, 2017.

In addition, if you refinance a grandfathered mortgage, the $1 million limit still applies but only to the extent of the debt that was remaining on the refinanced loan. For example, if you deducted interest on a $800,000 loan in 2017 and refinanced it in 2018 with a new $900,000 mortgage, only $800,000 of the mortgage principal is grandfathered.

Another grandfather rule applies the old limit when there was a binding written contract in place by December 15, 2017, and the transaction was closed before January 1, 2018.

It is important to note that the $750,000 mortgage limit applies per tax return, not per home, and only mortgages on up to two homes qualify for deductible interest.

For loans incurred after December 15, 2017, you can deduct interest attributable to principal of up to $750,000. The principal can be on up to two homes, your primary residence and one other home. If the mortgages on the two homes total more than $750,000, you can deduct interest attributable to only $750,000. If you have more than two homes, you can deduct interest on only two of them, even if the mortgages are less than $750,000.

One result of the changes is that it's more important to maintain good records for any mortgage when you plan to deduct the interest. To deduct interest on more than $750,000 of principal, you have to show the mortgages apply for the grandfather rules.

You also need to show the interest is on an acquisition mortgage. That means in case of an audit you should have paperwork that proves you used the mortgage proceeds to buy, build, or substantially improve the home. That's particularly important if the loan was considered a home equity loan by the lender, since traditional home equity loan interest isn't deductible.

As of 2019, the IRS hasn't required lenders to report on Form 1098 whether interest paid is on a home equity mortgage or some other type of mortgage. But it might do that in the future and use it to determine which taxpayers to audit.

For some taxpayers, the new rules cause a re-evaluation of whether they should continue to carry a mortgage or pay off their debt.

The analysis still is the same as discussed in our June 2018 issue. The first step is the mathematical analysis. When the after-tax return on your cash exceeds the after-tax cost of the debt, it makes sense to keep your money invested and maintain the debt.

The second step is to consider the subjective factors. Do you sleep better knowing you don't have debt? If you pay the mortgage do you have enough liquid assets to handle any emergency expenses that come up?

With the new rules, it might cost more after taxes to have a mortgage than in the past. If you have the cash to pay off the mortgage, you should re-evaluate whether it still makes sense to have a mortgage.

The $125,000 Solution: The Tax-Free Lifetime Income Stream

Perhaps one of the most misunderstood and under-utilized financial strategies available today is what I call the ***$125,000 Solution***.

Since 1980, more than a million Americans have used this strategy to:

- Pay for living expenses from an (optional) lump sum, instead of their retirement nest egg…
- Pay off their home mortgages, or even purchase second homes…
- Fund their golden years and have the retirement they deserve…

However, one million Americans who know about this strategy doesn't seem like nearly enough, especially when you consider that the current population of the U.S.A. is more than 300 million.

The solution I'm talking about is a **Reverse Mortgage** (also known as a home equity conversion mortgage, or HECM).

Most folks who have heard of reverse mortgages probably have a lot of preconceptions about them – and how they work. I'm also going to bet that most of them are dead wrong.

So, in the following pages, I'm going to attempt to set the record straight. Hopefully, the information found below will help you decide if getting a reverse mortgage is a smart decision for you, your family, and your house.

What Exactly Is a Reverse Mortgage?

In short, a reverse mortgage is a type of home loan that allows homeowners to convert a portion of the equity in their home into cash, which they can then withdraw and use for whatever purpose they desire.

Available through an FHA-approved lender, reverse mortgages are increasingly used by seniors to supplement Social Security, or to pay for unexpected medical expenses and home improvements.

Because this type of loan is often misunderstood, though, it's important to first sort through the clutter and distinguish fact from fiction.

Here's how HUD (the agency that regulates and guarantees the loans) describes reverse mortgages:

> *"The equity that you built up over years of making mortgage payments can be paid to you. However, unlike a traditional home equity loan or second mortgage, reverse mortgage borrowers do not have to repay the loan until the borrowers no longer use the home as their principal residence or fail to meet the obligations of the mortgage."*

In a reverse mortgage, a lender makes a loan to the homeowner. Neither principal nor interest on the loan needs to be paid until the homeowner dies, moves, or sells the home. The loan and interest are paid off from proceeds of the sale of the home. The loan proceeds are tax free and do not affect eligibility for other benefits.

Here's an example to help you picture this better. The median home price in America today is about $200,000. For the sake of this argument, let's assume your home's value is at least 25% higher than that – $250,000.

Even if you haven't entirely paid of the mortgage on your current house, you could get a reverse mortgage loan equal to 50% of the home's value, or $125,000. Actually, that estimate may be on the conservative side.

Note: Before you go thinking about getting a 50% loan on your multi-million-dollar mansion, know that the government put a cap on how big a reverse mortgage could be. The maximum equity value that will be considered for 2021 was $822,375.

Reverse mortgage proceeds can be received in a lump sum, fixed monthly payments (for your lifetime or a set number of years), or a line of credit to be tapped as needed. Taken as a line of credit, interest accrues only on the amount actually borrowed, not on the entire amount authorized.

In general, reverse mortgages are guaranteed by the Federal Housing Administration. That means the lender is guaranteed to receive payment of the principal and interest, even if they exceed the final value of the home.

Disadvantages of Reverse Mortgages

So far, I've explained briefly how a reverse mortgage works and what to expect. Doesn't sound so dangerous, right? Here are some more things you should know about them, though:

1) You cannot borrow the entire value of the home. The lender for a reverse mortgage wants to make a profit on the loan, so the eventual sale price of the home must cover the loan principal, accrued interest, and perhaps the upfront costs of the loan.

As a result, you will only be able to borrow a portion of your home's value.

2) The amount of the loan can vary. The amount depends on current interest rates, the borrower's age, and the value of the home in question.

Lower interest rates mean a potential increase in the value of the loan, whereas higher rates can possibly lower the value. Also, be aware of your age, as the older you are, the higher the maximum loan amount can be.

3) Associated costs. This is the major disadvantage of a reverse mortgages, especially when the upfront costs and fees are factored in.

Associated costs can include:

- An origination fee. FHA-guaranteed loans can charge up to the greater of $2,500 or 2% of the first $200,000 of the home's value, plus 1% of the value over $200,000 up to a maximum fee of $6,000.
- An initial mortgage insurance premium, which is a flat 2% of the loan amount.
- Closing costs and costs associated with other mortgages (such as appraisal fees and surveys), which can be 1% to 2% of the loan amount. The closing costs depend on the lender and the prevailing practices in your area.
- Monthly loan servicing fee. After the loan closes, most lenders charge a monthly servicing fee of about $35. There can also be an annual mortgage insurance premium of 0.5% to the interest rate

If you factor all these costs together, they amount to about 6%, or more, of the total FHA loan amount. That's potentially tens of thousands of dollars in fees.

Thankfully, these upfront costs don't have to be paid in cash and can become part of the loan, but again, doing that will reduce the amount of cash you can borrow, and you will be accruing interest on those costs since they become part of the loan.

Alternatives to Reverse Mortgages

Because of the pricey additional costs, and other factors, a potential reverse mortgage borrower should **first** consider other alternatives. For example:

- Many areas allow senior citizens either to reduce real estate taxes or defer payment until the home is sold. Taking advantage of this break can increase cash flow.

- Consider other loans. Regular home equity loans usually have much lower upfront costs and lower interest rates. The disadvantage is that repayment must begin right after the loan is made.
- Consider selling the current home and move into a lower-cost home. The excess proceeds from the sale of the first home can be used to pay bills or be invested, with the income used to pay for living expenses.

Also, consider that some lenders offer reverse mortgages that are not FHA-guaranteed. These loans have no maximum amount, so they are appropriate for those whose home values exceed the FHA lending limit. Additionally, they might have lower costs because borrowers aren't paying for the FHA insurance.

My bottom line: Do your research. The benefits and risks of a reverse mortgage should be carefully weighed against each other and viewed in light of your own situation.

Why a Reverse Mortgage May Make Sense for You

Okay, now let's cover why reverse mortgages are something more people need to learn about. We've covered the basics of a reverse mortgage and covered some reasons to stay away from them, but it's time to leave the negativity behind.

1) A homeowner can be allowed to "age in place." This is the single biggest benefit of reverse mortgages.

More specifically, a reverse mortgages lets the person who took out the loan remain in their family home for as long as they wish. As the loan money can be used for whatever purpose the homeowner desires, this can be for house repairs or upgrades to the existing structure, such as handicap access. Older generations are often quite attached to the spot they lived in, often for decades, and the ability to repair and upgrade the house as one ages can go a long ways in providing peace of mind and a sense of belonging.

2) The homeowner can meet the soaring costs of getting older. We already mentioned the ability to conduct major repairs and upgrades to the house, but the cash from the reverse mortgage can also help cover medical expenses, vehicle costs, and other related things.

To put it simply, the extra income you receive from this solution could mean the difference between living out your golden years to the full and working until you're 80 to make ends meet.

3) Reduce risk while maximizing income. A reverse mortgage moves more of your tax-advantaged dollars into your later years, which is when you need it.

These days, there are ways, but also more laws, to take into account when planning for retirement. While this strategy isn't right for everyone, there is clear demand among U.S. homeowners approaching or at retirement age.

For example, many widows and divorcees can benefit financially from a reverse mortgage if they have lower Social Security, 401(k) or IRA benefits.

Again, **do your research**. Carefully consider your own present (and future) situation to see if a reverse mortgage could help you.

What Are the Qualifications to Take out a Reverse Mortgage?

To take on a reverse mortgage, you must:

- Be at least 62 years of age.
- Own your home outright, or have a low mortgage balance that can be paid off at closing with proceeds from the reverse mortgage.
- Live in the home (primary residence).
- Have the financial resources to pay ongoing property charges (including taxes and insurance).
- Receive free or low-cost consumer information from an approved counselor before obtaining the reverse mortgage loan.

The 2 Steps That Can Generate up to 76% MORE Than Social Security Each Month

This is a simple, yet effective, strategy that can be broken down into only 2 steps.

Step #1:

Delay Social Security payments. This step is often lost on a majority of retiree-age Americans, but it can really pay off.

Simply put, by waiting longer, you get MORE.

For each year that you delay payments, instead of receiving Social Security at age 62, you'll get a higher amount. Actually, your benefit increases by 8% for every year that you delay receiving benefits.

If you wait to receive benefits until age 70, eight years of compounded payment increases means you net 76% more money each month (than if you started at age 62). In other words, you receive the *maximum allowable benefit*.

Step #2:

The "Social Security Swap-Out."

By taking out a reverse mortgage, you can use the extra cash as a powerful money machine in place of normal Social Security payments.

So, delay Social Security benefits instead of starting them at age 62 and let the money compound by 8% each year.

Meanwhile, take out a reverse mortgage and use that tax-free money to pay your monthly living expenses.

Once you're ready to start receiving Social Security payments, you can even stop the reverse mortgage payments and have significantly higher income due to all the years you waited.

That's all there is to it. Simple and effective.

The Social Security "Mulligan"… How to Get a "Bonus" Income Stream (Even If You're Already Getting Social Security)

If you have been receiving Social Security payments for LESS than 12 months, you can essentially cancel your Social Security and pay it back to Uncle Sam. This money will come back to you later, but at higher monthly payments since you'll be older.

Alternatively, if you have been getting Social Security for MORE than 12 months, you can suspend your Social Security benefits for the time being and receive credit for this period of delay. For example, if you're 68 and wish to suspend your SS payments until age 70, you'll get a higher benefit at that time.

Some Facts About Reverse Mortgages

- The average reverse mortgage borrower is a single woman age 75 or older.
- For a married couple, the age of the youngest borrower determines how much you can borrow.
- For homes worth more than $625,500, the reverse mortgage premiums and principal limit factors apply only to the first $625,500. (This limit is indexed for inflation and is $822,375 for 2021.)
- It is still possible for reverse mortgage borrowers to foreclose on their homes (you must continue to use it as your principal residence, pay property taxes or insurance, and keep your home in good repair).
- As of 2015, new rules require applicants to complete a lender financial assessment (to include credit reports, mortgage payment history and household debt).
- It's often a good idea to hire a reverse mortgage counselor to help review the short- and long-term benefits, the potential downsides, and the loan itself (in the context of your financial situation).
- Be cautious of reverse mortgage scams and unsolicited offers, and contact HUD at 1-800-347-3735 if you wish to file a complaint.

A List of Reverse Mortgage Lenders

Here are some reputable reverse mortgage lenders for your consideration:

(Keep in mind that not all of these lenders do business nationwide, and also note that I receive no financial compensation from any of the following).

All Reverse: https://reverse.mortgage/

Signet Mortgage: http://www.signetmortgage.com/

First Bank: https://firstbankreversemortgage.com/

Retire Secure: http://retiresecurenow.net/

Goldwater Bank: https://www.goldwaterbank.com/

Longbridge Financial: https://longbridge-financial.com/

Centennial Home Mortgage: http://www.centennialmtg.com/

Additional Resources

For more information on reverse mortgages, consider these sources:

AARP (800-687-2277 or www.aarp.org/revmort) for its booklet *Home Made Money: A Consumer's Guide to Reverse Mortgages*.

National Council on Aging: 202-479-1200 or www.ncoa.org

Fannie Mae (800-732-6643) and its Home Keeper loans

National Reverse Mortgage Lenders Association at 866-264-4466 or www.reversemortgage.org

www.ltccounselor.org

How To Downsize in Retirement: The Financial Impact

Let's continue the downsizing theme by taking a deep dive into its financial impact.

I've learned over the years that people often downsize only to find that it doesn't generate the cash flow they expected.

Consider, for starters, what you expect to have left over from selling the old house.

I'm not referring to the gross selling price, but rather the net price. You'll probably have to put some money into the house to prepare it for a sale, and you need to be realistic about the work that needs to be done and what it will cost.

Of course, you need a good idea of what a buyer is likely to pay. Get the opinions of several real estate agents before making estimates.

It is best to have a range of probable prices, from best case to worst case.

Determine the selling price at which downsizing doesn't make sense, and how likely the house will fetch more than that price.

Remember, there will be selling costs, such as the real estate agent's commission and other costs.

For example, does your locality have a sales tax or other transfer tax that applies to home sales?

Of course, even after paring your possessions, there's a cost to moving everything remaining to the new residence.

That cost is going to depend on how many things you plan to move and how far you move.

Another cost of downsizing is setting up the new home.

People often find that furniture that was fine in the larger home doesn't work in the new home.

Or perhaps the old stuff now seems too old, in the wrong color, or style for the new place.

In other words, carefully consider how much of your current stuff you'll be able to take to the new home and how much you'll have to pay to outfit the new home.

The final piece of the puzzle is the monthly cost of the downsized home.

Will you really save a lot on utilities and other regular expenses? Some people find that amenities or services they had in their long-time homes cost extra in their new homes, or they find the utilities and other ongoing expenses aren't as low as they anticipated.

Some people find they're traveling to visit family and friends more, or dining out more, because the downsized home isn't suitable for hosting or entertaining.

Don't take any of these details for granted. Develop realistic estimates of your new lifestyle and living expenses.

Sometimes downsizing is essential, because the house is simply too big, or too much work at this stage of life.

But when downsizing is optional, and you're doing it primarily in expectation of financial benefits, take the time to objectively assess the likely results.

SECTION IV: Your Estate Plan & Your Legacy

Why Bother with Estate Planning?

- Estate planning and estate taxes are something only the very rich worry about.
- I want everything to go to my spouse, so I don't need to worry about estate taxes or planning.
- Congress repealed the estate tax for middle income Americans.
- I don't have many assets, so I don't have estate planning issues.
- I bought life insurance so I wouldn't have to worry about estate planning.
- My living trust solves all my estate planning problems.
- My spouse and I own everything jointly; that's all the estate planning I need.
- My assets are worth less than $10 million, so I won't have estate problems.

These are the explanations people give most frequently for ignoring estate planning or putting it on the backburner. Unfortunately, these comments are myths, half-truths, or are based on misinformation. The truth is more like this:

- Everyone needs an estate plan—no matter the value of the estate.
- An estate plan is about much more than taxes.
- One goal of an estate plan is to ensure your comfort, care, and financial security for life.
- Without an estate plan, it could take a long time and cost a lot of money before your heirs receive anything from your estate.
- A will or a life insurance policy by itself is not an estate plan.
- A living trust solves only a few estate planning issues but not all of them.
- Many Americans have more valuable estates than they realize.
- When your estate is valuable enough to be taxable, leaving everything to your spouse might increase over-all taxes and cause other problems.

The Real Goals of Estate Planning

There was a time when tax reduction was the main focus of most estate plans, even for middle class families.

Back then, the estate tax was imposed on estates worth more than $600,000.

Even then, a host of other issues were covered in good estate plans. Now, with all but a few estates exempt from the federal estate tax, those other issues are, or should be, at the forefront of estate planning.

That’s a good thing for many people. Too often the other issues didn’t receive enough attention. Now, estate planners are making sure they are fully addressed.

The first step in developing an estate plan is to define your goals. Every person and family is unique and has some unique goals that need to be identified. Yet, there are common traits that lead to common goals.

The first step is to consider the broad goals that are common to most estate plans.

After thinking about them, other goals and wishes are likely to occur to you, and that will help the estate planner flesh out the details of your plan. The common, broad goals of estate planning are:

- Transfer your assets quickly and efficiently to the next owners
- Ensure your comfort, care, and security for the rest of your life (and the same for your spouse)
- Minimize the costs and delays that often are part of the estate settlement process
- Enhance family harmony, or at least avoid increasing family disharmony
- Ensure wealth reaches the intended beneficiaries
- Preserve the wealth, which could mean protecting it from costs, delays, and taxes.
- It also could mean protecting the wealth from mismanagement, fraud, waste, and other events that often prevent family wealth from surviving.
- Ensure that your financial and medical matters are managed if you aren’t able to manage them.

You can see that estate taxes aren’t the main obstacle to leaving the legacy you want. You worked a long time to build your estate. Be sure that it supports you for the rest of your life and, if possible, provides a meaningful legacy for your family, charity, or other objects of your affection.

12 Basic Rules for Every Estate Plan

Despite the importance of estate planning and the new stability in taxes, too many people aren’t doing anything about their plans. They’ve fallen into the habit of procrastination.

That’s a mistake. You don’t know when your estate plan will be needed, and for most people the non-tax elements of a plan are more important than the tax issues.

Another problem is that an estate plan should be tailored for the individual.

Contrary to what you'll hear in some estate planning seminars and from some advisors, there aren't many strategies that should be in every estate plan.

But there are some basic rules and guidelines that apply to every estate plan, whether it is worth $500,000 or $500 million. If you don't follow these rules you likely will do damage to your heirs and perhaps leave them believing you weren't fair.

For procrastinators and those who simply don’t know how to begin the estate planning process, here’s a checklist of the essential first steps and principles.

Regardless of the value of your estate or your age, these basic rules and guidelines should apply. You and your attorney will draft an effective plan by paying attention to these guidelines, regardless of what the tax law is or might become.

1. Do something.

Too many people use uncertainty or tough decisions as an excuse not to have a plan. Some people can’t resolve issues such as who should be the executor or trustee or the guardian of their children.

Some can’t decide how much to leave to charity, or perhaps the estate planner is proposing a tool they don't quite understand or aren't comfortable with yet.

Don't let these issues leave you with no estate plan or an out-of-date plan. If you can’t pull a complete plan together, at least do the minimum necessary, such as having a basic will and powers of attorney.

You can do an estate plan in installments. Or you can do most of the plan but defer a decision on one or two difficult issues.

Assemble a plan now that at least covers the essentials. Then, work toward a more robust plan as you learn more about the tools available, refine your goals, and resolve disagreements.

2. Keep track of your estate.

There's a story that legendary comedian W.C. Fields didn’t think banks were safe, so he diversified by stashing his money in relatively small amounts in banks all over the country.

He didn't keep a master list of the banks, and his heirs never were sure they found all the money, though they spent resources trying to track down all the accounts. Fields probably knew how to find everything, but he didn't give anyone else all the information.

Different variations of this story occur remarkably frequently in estates of all sizes. The estate owner doesn’t have a master list or file of all the property and debts, and the files aren’t in great shape, at least not for someone who doesn’t know the filing system.

In those cases, all the property might not be located or the estate spends a lot of time and money trying to locate it. Your estate planner also can’t deliver the best advice without an accurate list of your assets and liabilities.

At a minimum, you should update a complete list of your assets and liabilities once a year and share this with the person (or persons) named as executor in your will as well as your estate planner.

And make sure your executor knows where to find all the documents to back up the financial statement. Even better is a complete list of all your key financial items, including online accounts.

For help compiling a list, use my report, To My Heirs, available for purchase through the Bob’s Library tab on www.RetirementWatch.com.

3. Estimate cash flow.

Many people overlook cash flow when developing an estate plan. But the cash flow and sources of cash are important. Debts must be paid. Lawyer's fees and other expenses will be incurred.

The expenses of running and maintaining the estate's property must be paid, and the dependent survivors have their regular living expenses to pay.

Unfortunately, a good estate plan can be ruined if the wrong people implement it.

Of course, if taxes are due they must be paid with cash.

4. Estimate how much cash the estate will need and where it will come from.

If the estate won't have enough cash, reconsider the plan. You can sell some assets now, provide that some people will get property instead of cash, buy life insurance, or give the executor instructions on how to sell property.

Many estate planners advise limiting specific cash bequests to only a few special cases to avoid leaving the estate with a cash flow problem.

5. Choose executors and trustees.

Most people spend a lot of time on their plans, and then select the executors and trustees as an afterthought, often automatically choosing the estate planning lawyer as executor and the bank recommended by the lawyer as trustee.

Those might or might not be the best choices for you. Unfortunately, a good estate plan can be ruined if the wrong people implement it.

Give a lot of thought to who should execute your plan. We’ll cover this issue in more detail later in this book.

6. Anticipate conflicts and try to reduce them.

Many estates have built-in conflicts that could have been resolved.

For example, if kids don't get along now, if you are always mediating their disputes, then they aren't likely to amicably manage assets or decide how to divide them.

Perhaps they should be given separate ownership of assets, different voting rights, or someone else should help make decisions about the property. You probably shouldn’t have will provisions that requires them to share assets or agree on how things are to be managed.

Other times the different roles of an individual create conflicts. A classic conflict is when a spouse is made trustee, receives income from the trust, and the children receive the trust property that remains after the spouse dies.

Often, the children end up believing that the spouse invested for maximum current income at the expense of earning capital gains for the future.

Your estate plan should avoid such built-in conflicts. At best they lead to hard feelings and at worst lead to expensive litigation.

7. Don't search for a perfect solution.

An estate plan is a balancing act. An estate plan strikes a balance between your goals, the needs of your family, the tax law, and perhaps other factors.

For example, reducing taxes often means either giving up control of property now or leaving everything to your spouse. So, there is a tradeoff between taxes, control, and distribution.

You also have to decide whether to leave assets to your heirs directly or with some restrictions, such as through trusts.

A good estate planner will present you with several alternative plans to meet your goals. Each will handle the tradeoffs in different ways. You choose the alternative that strikes the balance you prefer.

8. Don't be a control freak.

Some controls can be a good idea, such as when a beneficiary is young, doesn't have good judgment, or lacks experience handling a meaningful amount of money.

In such cases, property should be put in a trust that restricts distributions for a while.

But some people go further and dictate in detail how wealth is and is not to be invested and distributed. There are trusts saddled with restrictions that require them to be invested in Treasury bills, gold stocks, or the stock of certain companies, to name just a few examples.

Trustees, executors, and heirs need to be able to adapt to changing circumstances, including events you never anticipated.

9. Make your general plan known.

If you don't tell heirs your plans, they will develop expectations. Feelings can be hurt when they are surprised after your death. That can lead to anger or bitterness that will be taken out on others in the family.

Also, heirs might plan their finances with certain expectations about your estate plan and be in difficulty when their expectations aren’t realized.

You should let people know generally how they’re affected by your plan. For example, if you aren't going to treat heirs equally, will leave money to charity, or know that someone is expecting certain property, it is important to let the affected people know ahead of time.

Likely heirs also should have a rough idea of the value of your estate and how much will be passed to them.

10. Don't circulate your will.

While you want the general outline of your plan known among those affected, don't circulate the will or other documents. You likely will need to update it every few years, and any change in the details gives someone a reason to be upset.

Also, having different versions of a will circulating over the years makes an expensive will contest more likely.

11. Keep it as simple as possible.

Some people and their attorneys get so wrapped up with the latest estate planning tools that they overlook simpler strategies that will accomplish their goals. Be sure complications are necessary to meet your goals before putting them in your plan.

12. Things change. Your estate plan is never final.

The property you own and the values change. The members of your family change through births, deaths, marriages, and divorces. Your goals might change. You might be inclined to leave more or less to charity or specific heirs over time.

Bottom line: You need to meet with your planner at least every two or three years to review changes in your financial picture, family, and goals as well as the tax law and other laws.

Remember that any mistakes in your estate plan will live long after you. Follow these rules and you'll end up with an estate plan that works well for you and your heirs.

Reviewing Your Estate Plan Essentials

You need a complete, up-to-date estate plan now more than ever, regardless of the value of your estate. Every estate has a host of significant issues other than federal taxes that need to be addressed. We'll be diving into details throughout this book. To prepare you, here's a roadmap of the key issues of 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 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 a do- not-resuscitate order. 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. You can find details about these documents later in this book.

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.

Do you have or should you buy long-term care insurance? If not, are you planning to qualify for Medicaid for any long-term care needs, or do you plan to meet the costs from your assets and income? Have you looked at policies that combine life insurance or an annuity with long-term care benefits? Neglecting this issue too often leads to a burden on loved ones, an estate being depleted to pay for care, and sometimes the next generation's nest eggs being depleted.

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.

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 the 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, 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 they have 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 a money 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 businesses, 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 or 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 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 succession or sale plan 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 non-tax 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.

The Turnabout in Tax Planning

Most of us don't have to worry about taxes in estate planning because of the estate tax break. (For those who do, we'll discuss estate taxes and planning to reduce them later in this book.)

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.

Rethinking Trusts

The 2017 law created some unexpected costs for people who executed estate plans that included trusts under the old law.

Suppose your estate will be less than the lifetime exempt amount but is valuable enough to be subject to estate taxes under the old law. Under the old law you transferred assets to a trust to remove them from your estate, because that made a lot of sense under the old law.

The trust and beneficiaries have the same tax basis in the transferred assets that you had. Capital gains taxes will be due when the assets are sold. That was fine under the old law, because the potential estate taxes were higher than capital gains taxes.

Under the current law, however, your estate isn’t subject to federal estate taxes. The assets still will be subject to capital gains taxes when the trust or the beneficiaries sell them. Now, the trust might be an unnecessary expense. It doesn’t save estate taxes any- more. If you had held the assets, there wouldn’t be a federal estate tax, and the capital gains taxes could be avoided when your estate or heirs sold the assets.

Of course, there are non-tax reasons for creating trusts, and we’ll discuss those in detail later. But there are many times when tax avoidance was a prime reason to create trusts under the old estate tax law but trusts don’t provide a tax advantage under the new law.

If you set up trusts under the old law that don’t make as much sense now, you might be able to take actions to adapt to the new law, if the trust terms allow it. One strategy is to exchange assets with the trust. Take highly appreciated assets out of the trust and replace them with other assets of equal value that don’t have as much built-in gain.

It also might be possible to change the trust terms so that you are considered the owner and the assets are included in your estate for tax purposes only. That would cause the assets to be included in your estate and receive the increase in basis for those who inherit them.

Your estate planner will have to review the trust to see if such steps are possible. Today’s estate tax law requires a different approach to planning. Strategies that once were cutting edge now might be unnecessary or costly. Review your existing plan and meet with your planner to adjust it for the latest law.

Cutting Major Cash Drains From Your Estate

An estate plan should be designed to protect your assets from taxes, creditors, waste, and other cash drains both during your life and when it is time for your heirs to take over.

Here are some essential tools every estate should consider for conserving your estate's cash.

Two Key Documents

An estate plan might contain many documents. Estate plans that fail, however, often do so because of two key and usually overlooked documents. Take care that these documents are in your estate plan and meet your needs.

The first document to consider is the durable power of attorney. Most of us won’t ever use this document, and all of us hope it won't ever be needed. Accidents and illnesses happen, unfortunately, and the power of attorney acts as an insurance policy when they do. As with other forms of insurance, the document must be prepared in advance or it won't be available when it is needed.

Too often, a person has plans for managing assets during his or her lifetime and has a will and estate plan that take care of wealth after his or her death.

Yet, no provision is made for managing the assets if the individual were to become incapacitated. This gap can be expensive, embarrassing, and expensive.

Insurance statistics indicate that at most ages an individual is more likely to become disabled for a few months than to die. What happens to your money and other property if you are disabled?

If you have not made any provisions, often nothing can happen. Any property that is solely in your name, including your business, legally cannot be sold or managed by anyone other than you.

Your family can’t tap your checking or investment accounts. Investments can’t be bought or sold, even if some people know you would have wanted those actions taken. The employees of your business are limited in the actions they can take. Your family can’t even borrow against the equity in your home to raise cash for any medical care you might need.

Joint ownership eliminates some, but not all, of these problems. With joint ownership, your joint owner usually can write checks but cannot sell assets or borrow against them, though the rules vary from state to state and also can be altered by a joint ownership agreement.

In case you become incapacitated and unable to manage affairs, someone needs to step in to pay bills and manage assets. Many people assume a spouse can take these actions.

Unfortunately, a spouse can manage only joint accounts. Otherwise, the spouse has no more rights to handle your accounts or business than a stranger does. For some types of property, such as real estate, the signature of each spouse might be required before any action can be taken.

Without a power of attorney, in order to manage your assets your family would have to go to court and get an order that you are incompetent. Someone would have to be appointed to manage your affairs. This procedure is costly, time-consuming, and potentially embarrassing. In addition, the court often appoints your closest relative and that might not be the person you would want handling your financial affairs.

A power of attorney gives a named person or persons, known as an attorney-in-fact or agent, the legal right to act for the person who signed the document, known as the principal.

A general power of attorney grants the agent the authority to act for the principal in all matters. A limited power of attorney, as the name implies, grants the power to act on certain specified matters, such as financial affairs, that are named specifically in the document.

A power of attorney can be revoked at any time. The standard power of attorney expires automatically when the person signing the document is incapacitated. Unfortunately, that is the time you most need someone to act for you. That's why the durable power of attorney was developed.

When the proper language is in the document, the power of attorney continues in effect after the person signing it becomes incapacitated. All states now recognize the durable power. With it, the attorney-in-fact will be able to act when the principal is unable to.

A potential drawback to the durable power of attorney is that it is valid when you sign it, even when you are not incapacitated. That means there is a possibility that the person named as attorney-in-fact is not trustworthy and could take actions with your assets right away. There are very few instances of someone abusing this power, probably because the principal still is around and mentally capable.

Most people and financial institutions will double check to ensure that you really authorized the document and aren't able to act. An approach that gives you protection is to execute a durable power of attorney but have your estate planning attorney or other trusted advisor retain all documents until your family tells the attorney that there is a need.

Some states recognize an alternative document, the springing power of attorney. This power takes effect only after a disability occurs. Some people are more comfortable with this approach, because they aren't turning over power when they are healthy.

There are disadvantages to the springing power of attorney. First, not all states recognize it. Second, for it to take effect there must be a definition of disability and a process for having you declared incapacitated. That could make the document less effective than the durable power, and disagreements could lead to court action that the power of attorney was partly created to avoid.

Perhaps the best protection is careful selection of the attorney-in-fact. You are giving very broad powers to this person. While the immediate concern after a disability is ensuring that bills are paid and other routine matters are handled, the attorney-in-fact will have the ability to sell assets and re-invest or distribute the proceeds unless you prohibit that.

It is tempting to name a spouse or adult child as the power holder, and that might work well in many cases. Be sure to name someone whose judgment you can trust.

For example, if there is a sharp market decline while you are incapacitated, do you want someone who is going to sell all your equities or do you want someone who will adhere to the long-term plan? Is there someone who can judge when to change a long-term plan and when to stick with it?

Another protection is to name more than one attorney-in-fact. That can protect against both fraud and bad judgment. On the other hand, that means two signatures are required for everything. The two individuals have to be near each other and able to meet regularly. A compromise arrangement is to require two people to act on significant actions such as the sale of assets but allow one person to be attorney-in-fact for routine matters.
Be sure to name at least one alternate attorney-in-fact, because something might happen to the original.

It is not enough to sign one document. Most financial services companies have their own forms and will accept only those forms when someone asserts a power of attorney. You need to contact each financial service company at which you have an account, own a safe deposit box, or have a relationship. Ask for copies of their forms, how many copies they will want on file, and how old a copy can be before they want a fresh one on file.

Unfortunately, your attorney can draft the best power of attorney form and have it be almost useless because your financial institutions insist on their own forms. When you change financial institutions, be sure to ask for new power of attorney forms as part of the process.

People who live in more than one state—such as those who live in colder climate states most of the year but spend the winter in warm weather states—need to be sure that their documents are effective in each state. It might be necessary to have one document executed for each state.

You decide how much power to give the attorney-in-fact. You might want to grant a general power of attorney that covers all matters. A broad power such as that is a hedge against a long disability. Another option is to limit the power to financial matters or to matters named in the document.

Estate planning also is a consideration. A power holder can make gifts or other transfers of assets under a general grant of power of attorney. The IRS, however, will not recognize the tax effects of gifts made by a power holder unless the document specifically states that the holder is authorized to make gifts of property. Be sure this language is in your power of attorney.

If you are considering a limited power of attorney, keep in mind there could be disputes. Something might come up that you didn’t foresee or that someone argues is not covered by the powers listed in the document. That always is the risk of giving a limited power of attorney. You also should have protections against abuse. For example, in 2007 New York philanthropist and heir Brooke Astor was in the headlines with lurid allegations that her son and lawyer were using a power of attorney to subject her to a substandard lifestyle, conserving her wealth for themselves instead of spending it on their needs.

After she died, criminal charges were filed alleging that the two stole her money. Her son eventually was convicted and served three months in prison before being released for medical reasons. He died in 2014.

The case highlights the importance of selecting the right person to name as your agent. In addition, you can add protection against an agent gone wild. Keep in mind that despite the potential problems, you should still want the POA. Someone needs to manage your affairs if you aren't able to, and it should be someone you selected and under terms you set. The key is to establish a balance between those goals and security.

Another protection is to name more than one attorney-in-fact. That can protect against both fraud and bad judgment.

Someone needs to manage your affairs if you aren't able to, and it should be someone you selected and under terms you set.

Worthwhile Protections To Consider for Your Estate

Require regular accounting. Most agents holding POAs are responsible only to themselves. A layer of oversight can dissuade an agent who is tempted to abuse his position.

The oversight can be simple. Require that copies of monthly statements of your accounts be sent to one or more other people. The recipients can be relatives or professionals, such as your attorney or accountant. The recipients can review them to see that no suspicious transactions are taking place and also that adequate amounts are being spent for your upkeep.

Obviously you want to pick someone you think isn't likely to collude with the agent.

Appoint multiple agents. Appointing two or more agents makes malfeasance less likely, though two agents wasn't enough protection in Mrs. Astor's case. The downside is that multiple agents can complicate matters, because two or more people have to approve everything and might be required to sign every check.

Appoint a protector. A solution I have recommended regarding trusts is known as a protector or supervisory agent. This is someone who has the right to review everything done by the agent and can replace the agent at any time for any reason.

Again, collusion always is possible but having additional oversight reduces the probability of malfeasance.

Put details in the document. Mischief also can be reduced with a careful delineation of the agent's powers. As discussed above, consider specific details in the POA. Attorneys generally discourage putting too much detail in the document, because each item you put in can be subject to interpretation and dispute. But you might want to include some clear limits.

Name the people who can receive gifts and, if you want, put annual and aggregate limits on the gifts. Some people prohibit the agent from receiving gifts or other payments, or they limit the amounts and circum- stances of such gifts. In some estates, specific items of property are precluded from being given away.

Have a side agreement. Some estate planners recommend the principal draft a separate letter of understanding that both the principal and agent sign. In this letter, the principal clearly states his or her intentions and desires about how the agent will manage the assets. The document has no legal effect. But it can be consulted by the agent and could have an effect on an agent's actions. It also clearly expresses your intentions, in case there is a dispute.

Lawyers have other terms and tools to increase the protections. Remember to balance these protections with the goal of enabling an agent to manage your affairs. The protections might make the agent's job more difficult and prevent someone from accepting the position.

The bottom line is that there is no substitute for carefully selecting the agent or agents. The POA should be given to someone who is both trustworthy and capable of handling the estate. One never can be certain how someone will act when faced with the temptations and responsibilities of the position, so some protections are in order. But the best protection is to carefully select the agent.

The power of attorney can be revoked or modified any time while you are legally competent. It should be reviewed every few years as part of a regular estate plan review. Consider the individual appointed, the powers granted, and whether all appropriate financial institutions have current forms.

You also might want to talk with the attorney-in-fact periodically to ensure that your goals and desires for the assets are clear and that the person or people still are able and willing to serve.

An alternative to the durable power of attorney is the living trust. I will cover this in more detail later in this chapter, and many of you are familiar with the living trust.

One little-known use of the trust is in disability planning. You are trustee or co-trustee when the trust is created. The trust should contain a succession clause which states who will take over as trustee should you die or become disabled. The provision also should define disability. This has all the advantages of the durable power of attorney.

The main difference is that you must have all your assets legally owned by the trust for the succession clause to accomplish its purposes. That means transferring the titles to your home, cars, investment accounts, and other assets to the trust.

Even if you have a living trust, you also should have a power of attorney. No matter how diligent you are, there likely are assets that aren’t part of the living trust. These assets can’t be managed by someone without either a power of attorney or a court order.

A related document and the second key document is the health care durable power of attorney. This allows someone to make health care decisions when you are incapacitated.

For the last few decades, the living will has received a lot of attention. This document states the types of life-saving care that you want or don't want. Often it states general principles to guide doctors and might state preferences for a few situations. A common choice of language is that medical personnel should not use measures that would maintain the principal in “a persistent vegetative state.”

Living wills are easy to execute. Most states now have standard forms that can be located on the Internet or obtained from various organizations.

The problems with living wills are that they are vague, do not cover all circumstances, and cannot keep up with changing medical technology and treatments. Also, surveys show that most living wills don't make their way into the medical charts and have no effect on treatment. Doctors either don’t know about them, ignore them, or aren’t sure how they apply the situation they face. That's why a health care power of attorney is a better choice.

Instead of trying to draft general principles to cover all situations, appoint someone who knows you to listen to the medical options and make decisions when you are incapacitated. These documents are recognized in all states and can be written to survive your incapacity. The durable power of attorney for health care can be personalized and keeps the courts from getting involved.

The power of attorney can be supplemented with a living will or other document that expresses your philosophy and wishes under at least some circumstances. The combination of a power of attorney and living will often is called an advanced health care directive.

Do not resuscitate/hospitalize. DNR and DNH orders for older patients are quite common, especially for those who are frail. Research indicates CPR rarely helps these individuals recover and instead makes their passings violent rather than peaceful. The reasoning for the DNH is that at some point people do not benefit from hospitalization for every new ailment or development. Instead, they should be kept comfortable wherever they are residing.

Someone who agrees with those sentiments can decline in advance CPR or hospitalization

The problems with living wills are that they are vague, do not cover all circumstances, and cannot keep up with changing medical technology and treatments.

HIPAA Authorization. This simple document authorizes medical providers to release medical information about you to the named persons without violating the privacy provisions of the Health Insurance Portability and Accountability Act of 1996. It can be incorporated into the other forms. Many medical providers won't even give details to spouses and family members now without the express authorization.

If you spend time in more than one state, check with an attorney to be sure that your documents will be effective in all states involved.

Your documents also can include non-medical instructions. You can give instructions regarding music, grooming, fresh flowers, and other aspects of your environment you'd like when you are receiving care.

Of course, all of your doctors should have a copy of any documents you execute and know how to get in touch with the agents named. Each of the agents should have a copy. Some family members also should have copies.

How To Plug the Leaks In Your Estate

You need a will, even if all your assets are owned by a living trust or held in joint title.

Why do you need a will? It is unlikely that even if you have a living trust or other arrangement, all your assets will be covered by it.

Any other assets will be covered by your will or disposed of according to state law. A will also can cover other issues such as guardians for children and small symbolic gifts to special individuals.

And the will can have several provisions in it to protect your heirs and your wealth. Here are some key will provisions that everyone should have or at least consider. Estate liquidity is remarkably overlooked in estate planning.

It is not enough to reduce taxes and probate. You must be sure the estate will have enough cash or liquid assets to pay the expenses it will face. These cash transfers include paying your debts, estate expenses, and for the management of property while the estate is processed.

You might have a surviving spouse or other dependents who need help with their living expenses until the estate is settled. All of your planning could be for nought if the estate has to sell assets to raise cash for basic expenses.

In your planning, be sure to estimate estate liquidity. If there might be a cash shortage, consider buying life insurance or designating which assets should be sold first to raise cash for expenses. When the estate has a lot of non-liquid assets, consider selling some of them now to ensure the estate will have enough cash to meet its needs and obligations.

A related issue is specific dollar bequests. Often a will states that someone is bequeathed a specific dollar amount. At the time the will is written, this bequest is a certain percentage of the estate and the intent was to give that person that percentage of the estate.

But the size of an estate can change. Suppose an estate had a lot of common stocks or mutual funds. The owner wrote a will in the spring leaving specific dollar bequests to certain individuals and charities. The owner dies, however, and about the same time the stock market suffers a steep decline. Suddenly, the specific dollar bequests are a much larger portion of the estate because of the sharp decline of the value of the estate assets.

Despite this, the specific dollar bequests would be paid first. The other heirs would receive whatever was left, which would be less than was intended. The same result could occur in an estate that holds real estate, collectables, a business, or any other substantial assets that fluctuate in value.

Your heirs often are better off if you limit specific dollar bequests. Except for fairly nominal bequests, most bequests should be made either by naming specific assets, by stating a specific percentage of the estate's value, or by a formula that states a specific dollar amount or a certain percentage of the estate, which is smaller.

Another key clause is the tax apportionment clause. This clause states whether the death and income taxes related to a particular asset will be paid by the individual inheriting that asset or by the residuary estate (the estate left over after specific bequests). It can be an important clause. If you do not state how the taxes will be computed, they will be paid out of the residuary estate. That means less for whoever gets the residuary estate, and that usually is your spouse or children.

Make sure you go over the consequences of the tax payment clause thoroughly with your estate planner.

The same philosophy applies to the payment of debts clause.

Will each heir in effect pay a share of the estate debts, or will they be paid out of the residuary estate? Perhaps whoever inherits each asset will be responsible for debts related to it. Or will you buy enough life insurance to cover the debt payments? Do not overlook this issue, or your residuary beneficiary could end up with far less than you intended.
A simultaneous death clause is standard in most wills but be sure yours has one. This clause states that if you and your spouse die within a certain time of each other, then each spouse will be treated as having predeceased the other. This is important for avoiding multiple estate taxes and costs.

Without this clause, if you and your spouse are in a common accident many state laws say to assume that each survived the other. That means all your assets go through your estate, then go through your spouse's estate before they go to your children or other heirs. That could mean double taxes and double fees.

You probably want to set the time period in the simultaneous death clause at 90 days. Some state laws put the period at 24 hours or 72 hours. This means if you and your spouse are in a common accident but one of you dies a week after the other, your assets will be hit with double estate costs. Most estate planners find that 90 days is a better time period for the simultaneous death clause.

Picking the Right Trustee (Don't Let Them Break Your Estate Plan)

What's the biggest problem with most estate plans? Often it is not taxes or cash flow.

Many times, the biggest problem is the trustee or executor that was appointed to carry out the estate plan.

Trusts are a key part of many estate plans. Later, we'll learn many situations in which one or more trusts could be beneficial. How the trustee administers the trust determines the quality of the estate plan. Unfortunately, there are many ways a trustee can destroy a solid plan.

A perennial problem is fees. Often no fee limits are placed in the trust agreement or contract with the trustee, allowing the trustee to increase fees at will, which some have done.

Investment performance also can be a problem. A bank trustee might feel obligated to hire the bank's mutual funds or asset managers to handle the trust's investments. At some trust companies, this results in high fees for mediocre performance. Also, there can be overnight changes in the trustee.

In the rapidly changing financial services industry, your local bank can be swallowed up by a series of larger banks. Soon, someone who never knew you and doesn't know anything about your family is managing the trust along with 250 others. There's no way that trustee (who probably won't stay in the job more than two years) can know your preferences or what is best for the family. The trustee also probably lives and works hundreds of miles from your home.

Let's look at a common situation that starts out right but ends up with very bad consequences.

Often a person wants to provide adequate assets and income for the surviving spouse but is concerned about the spouse's ability to manage property or wants to ensure that a potential second spouse does not get the property.

The solution is to write the will so that the property is put into a trust for the surviving spouse's benefit. The trust states that after the surviving spouse dies, the assets go to the couple's children. The will names a trustee to manage the property and dispense income and principal to the surviving spouse at the trustee's discretion.

These arrangements work fine for a while, and often work well for many years. But some trustees tend to invest very conservatively while some widows outlive their husbands by many years. The result after a decade or so of conservative investing coupled with inflation is that income payments from the trust no longer match the widow's standard of living.

Some trustees compound this problem by arguing that one of their duties is to preserve assets for the children to eventually inherit, so they will not dip into principal to pay more money to the widow.

This problem is fairly common and becomes more common as life expectancies increase. An additional problem is that in many states trust beneficiaries do not have the power to change trustees unless that power is in the trust agreement, and some estate planners don’t think to put that provision in the trust. This is a problem for children who are beneficiaries of trusts as well as for surviving spouses. Once you are gone, your family might have no say in how the trust is managed.

After all, that is one of the reasons trusts are created in the first place. The beneficiaries aren't supposed to have discretion. But the beneficiaries also have few options if the trustee performs poorly. Courts generally aren't willing to change a trustee unless the trust agreement specifically allows it.

Also, the trustee can use trust assets to pay for its defense against a suit. Some legal reforms are under way, but they aren't in place yet in most states.

For the trust to work, you have to set things up right in the first place. Here's what to do:

Don't make the trustee choice an after-thought. Usually, at the end of the estate planning process, the attorney asks who should be trustee. The trust creator hasn't thought about it. Then the nod goes to a bank suggested by the attorney or one that has the creator's accounts.

Give the trustee as much thought as the rest of your plan. Interview several trust companies. Ask how they communicate with beneficiaries, how they make decisions about distributions, what kind of personnel turnover you can expect, and, of course, what the fee schedule is. Also check into how they will invest the trust. Look beyond traditional trust companies during the search. Major brokerage firms and some mutual funds now actively seek this business and have active trust subsidiaries.

Consider appointing co-trustees. Corporate and bank trustees have many advantages. They have the infrastructure to efficiently administer the trust and do the taxes. But they might not know what is best for your family or know your preferences. You can appoint a co-trustee who is a family member, friend, or professional advisor. The co-trustee can have the power to prevent expenditures and investments. You also can empower the co-trustee to approve fee changes or even change the corporate trustee. You can appoint one or more co-trustees.

Split trustee duties. You can hire a corporate trustee to handle administration and taxes. Then provide for someone else to handle the investments. You can pick a firm or adviser you like. Or you can appoint a co-trustee or committee to handle the investments. Be sure fees are separated for the different functions.

Limit fees. There's no reason for your trust not to put some kind of limit on fees. Some trust companies that won't want the work under that condition, but enough will. A good option is to have someone other than the corporate trustee, such as a co-trustee or a committee, approve fee increases.

Provide for removal of a trustee. Amazingly, most trusts don't give anyone the power to remove trustees. That was partly due to IRS rules, but the rules were changed in 1995.

You probably don't want beneficiaries having the power to change trustees, especially if a point of the trust was to limit the beneficiary’s access to the property so it would not be wasted. The original purpose of the trust might be voided if the beneficiary could shop for a friendly trustee.

If you do give the beneficiary the power to change trustees, limit the power so it cannot be exercised more than, say, once every five years, and the new trustee has to be the same size or larger than the current trustee. You can put in other conditions if you want.

By the way...

In the rapidly- changing financial services industry, your local bank can be swallowed up by a series of larger banks.

Soon, someone who never knew you and doesn't know anything about your family is the trustee. Consider this as well.

But you might allow the trustee to be changed and have the corporate trustee chosen by a co-trustee or a committee. If these people are familiar with both your wishes and the beneficiaries' needs, an appropriate trustee is more likely to be selected.

Write a letter. A trust agreement cannot cover all circumstances, because you cannot foresee everything. If a trustee has some discretion in handling the trust and making distributions, you might want to leave a letter that outlines what your intentions were and the actions you would prefer the trustee to take in certain circumstances. Those instructions might be helpful to the trustee when hard decisions or unexpected circumstances arise.

All About Living Trusts

The living trust is perhaps the most frequently used way to avoid probate.

The living trust is very popular in some states, and rightly so. But in some cases, it is overhyped. Plus, many individuals are not aware of some of the drawbacks and technicalities of living trusts.

A fourth advantage of a living trust is that it often is more difficult to contest than a will. The rules for will contests are rather well-established. But there are not many cases of someone successfully challenging the terms of a living trust. If you are excluding some- one from your estate who might feel a right to part of it, you might find that a living trust provides better protection than a will.

A disadvantage of the living trust is that it is more involved than most people realize. You must do more than simply draw up the trust document. Legal title to all the assets you want covered by the trust must be transferred to the trust's name. This means changing the title on your homes, cars, financial accounts, and anything else that you want covered. This process is known as "retitling."

Too often people do not go through the retitling process. Part of the reason is that retitling might cost money when real estate and automobiles are involved, depending on local law. Another reason is that retitling is inconvenient and time-consuming. There are many living trusts around that are useless because the individuals involved never retitled their assets.

A living trust also might make it more difficult to undertake some routine transactions, especially after the original trustee dies and the trustee must be changed. Banks, brokers and other financial institutions have very firm rules about their getting all the proper documentation after the death of the original trustee before anything is done with an account by a subsequent trustee.

It can be time-consuming to change trustees, buy or sell investments, or undertake similar transactions when a living trust is involved. If you set one up, you should learn your financial institutions’ paperwork requirements.

Remember that a living trust does not avoid estate or income taxes. It also doesn’t eliminate the need for a will. You aren't likely to have all your assets covered by the living trust. So, you still need a will to handle the assets that aren't under the living trust.

The living trust avoids probate, helps in disability planning, and provides some privacy. But it creates some of its own problems.

Should You Avoid Probate?

A question that is rarely raised but should be is whether or not you really want to avoid probate.

Whether you want to avoid probate depends largely on your privacy concerns, disability planning, and where you live.

The traditional reasons for avoiding probate are that it is a very expensive, time-consuming process. Lawyers take a percentage of the estate off the top, often for simply having paralegals do some paperwork. Then, the courts and lawyers can take many months, sometimes years, to get the paperwork done and the assets distributed according to the will.

But some states have changed much of that. The required fee schedules for probate are gone in some states. So, the lawyers bill by the hour for work actually done. Your executor can negotiate rates plus do some of the legwork personally to further cut costs.

For small and medium sized estates, some states have created a streamlined probate process. The executor has nine months to file the federal estate tax return, and the streamlined pro- bate process is designed to have the entire estate cleared up in that time.

Probate isn’t all bad. Some people believe it is an advantage to have everything about the estate and how it is distributed in the public record and reviewed by the court. There's less of a chance for shenanigans by the executor or others. Anyone who disagrees with how things are being handled can file a complaint with the court. The probate process also certifies title to the assets, making it more difficult for someone to challenge the ownership.

You should discuss both the advantages and the potential costs and delays of probate as part of the estate planning process. Have a full discussion with your planner to determine how much of your estate should go through probate. Probate is not an all-or-nothing choice. Most estates are partly subject to probate and partly avoid probate. Some widely owned assets, such as IRAs and annuities, pass to their next owners automatically and without probate.

The question for you is how much of your estate you want to avoid probate. When you spend time in more than one state, especially when you own real estate in two or more states, consider the probate situation in each state. Generally, the bulk of your estate is subject to probate in the state where you were a resident or domiciled. But real estate is probated in the estate where it is located. So, your estate might be subject to probate in more than one state without proper planning.

Whether you want to avoid probate depends largely on your privacy concerns, disability planning, and where you live. If you want privacy for your wealth, a living trust is preferable to the probate process. But if privacy is not a concern and you live in a state with modern probate processes, a living trust might not be worth your while. California, for example, still sticks by the old probate rules.

Living trusts are very popular in California, and rightly so. But that is not the case in every state.

Avoiding probate is not an automatic decision these days. You should discuss the pros and cons with your estate planner and see what is best for your situation.

A good estate planner will ask your goals and philosophy of money, show you different ways of trying to meet those goals, explain the tradeoffs in each method, and let you choose which route to take.

Crafting The Perfect Will

It doesn't take much to tarnish a gem of an estate plan, and with it your legacy. A misplaced word, missing clause, or miscommunication between lawyer and client can send your ordered plan spinning into chaos.

You can avoid such a fate. Follow these guidelines and you'll be well on the way to establishing the perfect will as the foundation for your estate plan.

Observe your lawyer work. A good estate planner wants to know about everything you own or have an interest in before beginning.

If the lawyer doesn't ask for details, you probably need another lawyer.

A good estate planner also will ask your goals and philosophy of money, show you different ways of trying to meet those goals, explain the tradeoffs in each method, and let you choose which route to take.

Unless your estate is very simple, be wary of a lawyer who has only one solution or quickly determines what to propose.

Write it in English. Lawyers and clients don't always speak the same language. And too often clients aren't willing to make their lawyers explain enough. The result can be unintended consequences in the will.

You can avoid this fate by writing in your own words what you want to accomplish and what you think the estate plan accomplishes. You should do this before you talk to the lawyer and give the lawyer a copy.

Then as you and the lawyer develop a plan, update your statement to include the changes you believe have been made. Show each revision to your lawyer. This method reduces the room for error, and you'll find out quickly if you and the lawyer miscommunicate in your discussions.

Get a second opinion. You do it with almost every significant thing in your life, and probably with some things that aren't very important.

Spend a little extra money to get a second opinion on the will and any other estate plan documents. Take your statement of goals and the documents to another estate planning lawyer for a review and comment.

Estate planning is fairly complicated and gets more complicated each year. A small mistake can greatly change your estate plan.

For example, a bypass or credit shelter trust allows your estate to take advantage of the lifetime estate and gift tax exemption. The trust can pay income to your spouse for the rest of his or her life, then pay the remaining property to your children.

But the tax exemption could be lost if the trust gives your spouse the power to change the beneficiary. Some trusts make that simple mistake and cost the estate additional taxes.

Know your children. Naming the oldest adult child as executor of an estate is very common and often works fine.

It is a big problem, however, when the children have a history of animosity or there is some rivalry. It is not unusual for children who were able to behave civilly while their parents were alive to go to war after a parent's death.

The results are an irreconcilable family and money wasted on attorneys' fees. If you have any doubts about your children's ability to get along after you are gone, name someone outside the family as executor.

Limit specific bequests. A specific bequest gives certain property to a certain person. Specific bequests are appropriate for valuable or unique items.

But putting a lot of specific bequests in your will causes problems. You have to update your will every time you lose, sell, or give away one of the items.

How are you sure that the children are getting equal shares?

What happens if an item can't be located after your death?

What happens to items that somehow didn't get named in your will?

What happens when the market changes the total value of your estate? The specific bequests could leave your family with less than you intended.

It is better to limit specific bequests to valuable items and those you know have meaning to certain individuals. Then have all the other items disposed in the "residuary clause."

This is the clause that says "all the remainder or residue or my estate goes to..." Normally this clause divides the property among the surviving spouse or the children.

Don't divide your heirs. The residuary estate often is divided equally among the children or other loved ones. The trick is choosing a method for dividing the property that works best for your heirs.

Choose the wrong method, and you'll divide the loved ones along with your property. I give specific suggestions for dealing with this issue later in the book.

Keep up with the times. Your estate planner needs to know of any changes in your family and your wealth.
You need to meet with your estate planner when a child or grandchild is born, when there is a marriage or divorce, and when someone dies. Changes might need to be made if you move to another state.

Also check with your estate planner when the amount of your wealth changes or when you sell a significant asset.

Establish your domicile. A state that has death taxes will tax the estate of anyone who was “domiciled” there at the time of death. Domicile is a technical legal term.

In most states it means the place in which you intended to live indefinitely. The state of residence is where you actually lived.

That creates problems for those who split the year between two or more states and also for people who largely moved to a new state but did not sever all their ties with the original state of domicile.

In some cases, two (or more) states each will claim the deceased was domiciled within its borders, and each will assess full taxes on the estate.

Don't leave your heirs in this position. Decide which state you want to be your domicile and find out how to legally establish that domicile.

Then document those steps. States generally look at voter registration, vehicle registration, and driver's license addresses. They also will look at where you spend over half the year and a host of over factors. (There’s a checklist on the members’ section of the Retirement Watch web site.)

Unfortunately, a few states essentially require you to sever all ties. Some will claim you were domiciled there if you retain a property such as your old residence, even if you rent it to others or rarely visit.

If you split time between two or more states and at least one has a death tax, be sure to establish a domicile and document it.

When you take the time to craft the perfect will, the administration of your estate will go smoothly and won't affect how loved ones remember you. But a mistake or poor planning could result in bad blood among your survivors and bad memories of you.

What A Will Can And Cannot Do

A will is one of the simplest yet most powerful documents you can write. A will can decide what happens to valuable property, even billions of dollars’ worth.

It can decide who becomes the guardian of minor children, who controls a business or other entity, and how much of your wealth goes to the government. The will definitely is a requirement of every estate plan.

But a will cannot do everything that is essential to a good estate plan. And there are some things you just aren't allowed to do in a will. Let's take a look at some of these limits and what you can do about them.

A will has no effect over property whose ownership is controlled by law. For example, if you own property jointly with someone, the co-owner normally becomes full owner upon your death.

The details vary by state and the form of ownership (joint owners with right of survivorship, tenants by the entirety, etc.) But in general, when property is jointly owned you cannot use the will to give your share to someone else.

Likewise, life insurance benefits go to the beneficiaries named in the policy, and that cannot be changed in your will. The same applies to annuities and qualified retirement plans, including IRAs.

You name beneficiaries in the plan documents or similar documents, and that's who inherits the account. It doesn't matter what you say about the property in your will.

If you set up a living trust, the trust documents control who receives the property and income owned by the trust. You cannot change that in your will.

The only time a will overrides a trust is when the trust document gives you a "power of appointment." Normally you can exercise that power in a will to direct who inherits the trust property.

But a trust with a power of appointment generally is included in your estate for tax purposes.

Here's something that few people realize, because they spend a lot of space addressing this issue in their wills.

In many states, your will cannot control what is done with your body, how your funeral is arranged, or anything of that nature.

In fact, in those states you have no legal control over these matters. You can leave directions and letters covering them to your executor and relatives, but they are under no legal obligation to follow your wishes.

It also is difficult to provide for the care of a disabled person or minor in a will. It is better to set up a trust through your will or during your lifetime. The trustee has to follow the directions in the trust agreement.

It doesn't matter whether the real estate was the principal residence, a vacation home, or undeveloped land. Siblings can find reasons to fight over it.

You can, of course, disinherit someone through your will. The only exception in most states is your spouse.

A spouse generally is entitled to a minimum share of the other spouse's estate, usually between one-third and two-thirds of the estate, unless there is a valid prenuptial or postnuptial agreement in which the spouse waives all or part of this right.

But you don't have to leave your spouse more than the minimum required by the state, and you don't have to provide for anyone else unless you made a binding promise to him or her.

If you are disinheriting someone who ordinarily would be considered a loved one or a natural object of your affection, then you should state that in the will. It is best not to simply ignore the person and say nothing.

If you do that, the disinherited person, usually a child, could effectively argue that you or your lawyer simply made a mistake and accidentally left out his or her name.

You don't have to state a reason for disinheriting, but most lawyers believe it is wise to state a brief reason. That might prevent a lawsuit claiming that you were unduly influenced by someone or weren't mentally competent.

One reason that usually is easy to defend is that you believe you amply gave to them during your lifetime or that the person has acquired adequate resources on his or her own.

A disinherited person still can challenge a will. That's why some wills leave at least something to everyone, then include a clause stating that anyone who challenges the will and loses gets nothing, known as an in terrorem clause.

That is a deterrent from tying the estate up in the courts and siphoning the bulk of it in lawyer's fees. But it doesn't always stop lawsuits. The disgruntled heir can sue other people instead of challenging the will directly. For example, a charity that solicited your donation might be sued for interfering with a child's expected inheritance.

The trick with the combination of the token inheritance and in terrorem clause is to determine an amount to leave the person that will be large enough to discourage him or her from risking losing it if a lawsuit fails.

What about strings or conditions on gifts?

You can put any string or condition on a gift if it is not against public policy as determined by the courts. Today, that generally means most racial restrictions are eliminated as are actions that violate the law or encourage the violation of the law.

For example, you probably cannot leave a scholarship fund for "whites only." It is an open question whether you can make an inheritance contingent on the beneficiary not marrying outside a race or religion.

You can place almost any other condition in the will or a trust. You can even make gifts contingent on the beneficiary's being married, staying married, or being employed.

One fellow was denied membership in a club during his lifetime. He provided that his daughter could inherit as long as she did not marry a member of that club.

In another case, Canadian courts upheld a will in which the deceased left his estate to the woman who had the most children in the 10 years following his death. Several women had nine children each and split the estate.

One will leave the entire estate to the only child on the condition that he be a registered Republican, a member of the Moose lodge, never change his surname, be employed in either the family business or certain specified occupations, have his wife sign a postnuptial agreement, and attend a Christian church with his family at least twice a month.

None of those objectives appears to be against public policy, so the will probably is legal. The will was not challenged.

Of course, there's the question of who is going to enforce such restrictions.

Suppose the son in this last instance met all these qualifications, received the inheritance, and the estate was settled and closed.

Five years later, he becomes a Democrat, quits the Moose lodge, and stops going to church.

Is the executor now going to hire a lawyer and ask a court to get the money back? Probably not. If not, who will complain?

The state attorney general or a similar official probably has standing to sue to ensure the state's laws are respected, but it is questionable whether he or she would find out about the events and choose to spend resources on a lawsuit.

Wills are very flexible and powerful. But they do have limits.

You need to determine your goals, then meet with an estate planner to decide how best to achieve your goals. Part of the solution will be a will, but other actions and tools also will be needed.

Handling The #1 Toughest Estate Problem

The most difficult part of an estate plan can be the family home or a second home.

Often the property is a large part of the estate's value. It also cannot be divided among the heirs. They either sell the property or share it. But the emotions surrounding a family property probably are the biggest reason that it can be a problem.

Estate planning strategies need to be combined with an understanding of the emotions involved. Estates large and small have been dissipated by legal fights over family homes.

Don't think owning a modest house means this issue doesn't apply to you. It often is lifelong rivalries and disagreements, some of which have been under the surface because of the parents' presence, that trigger the behavior of siblings. Fights have been known to take place over trailers. It doesn't matter whether the real estate was the principal residence, a vacation home, or undeveloped land. Siblings can find reasons to fight over it.

Fortunately, there is much you can do to avoid these fights. Here are some strategies to consider:

- **Sell the home while you are alive or provide in your will that it will be sold and the cash distributed**. You take a risk that it might be sold in a temporarily bad market. It also means the property won't become the equivalent of a family heirloom, which is a disappointment to some people. But it also avoids problems between siblings.

- **Name someone outside the family as executor of the estate**. This might avoid some battles, and it keeps one sibling from having an advantage. Appoint a child as executor only if you are confident that he or she can be fair and impartial and do what’s best for the estate.

- If the children will keep and share the property, especially a vacation home or retreat, **set the rules governing use and expense-sharing**.

- **Decide how the property will be valued**. This is important whether the children will continue to own the home or plan to sell it and split the proceeds. It is essential if one child is to be the primary owner. You probably want to ensure a relatively even split of the estate between your offspring. If there’s some question of how the property was valued or whether it was sold for a fair price, there could be disputes among the heirs.

- **Put the property in a trust with an independent trustee**. You can do this either now or in your will. You might be able to structure this with tax advantages, such as a qualified personal residence trust, which we discuss later in this book. But a trust can be valuable in itself to resolve disputes. In the trust agreement you set the rules governing the use, sharing, and sale of the property. Under the trust your children are the beneficial owners of the property, but the trustee controls things. The trustee also can decide to sell the property if that seems the best move.

- **Prepare for buyouts**. When the estate plan is set up so that the heirs share the property, the financial status or interests of your children might change.

Some might not be able to afford the upkeep or might want to use their share of the value for other things. Provide that those who want to keep the property have first right of refusal to buy the shares of the other siblings. It is possible that those who want to keep the property cannot afford to buy out their siblings. That would create some disagreement among them. But at least you should give them the legal right to keep the property if they can afford it and set a way to value it.

Some people buy life insurance so that those who don't want to own a share of the property (and its expenses) can be bought out by the estate and receive the fair value of their shares of the property.

There are two additional strategies that generate tax benefits while avoiding some of the disputes that arise from inherited homesteads. One option is the sale or gift of the property to your children followed by a leaseback. Another common strategy is the personal residence trust.

These strategies can be very effective ways to reduce your estate and gift taxes while settling how a family home is handled in the future. Be sure to consult an experienced estate planning attorney if any interest you.

Celebrity Estate Planning Tips (Prince, Tom Petty, Aretha Franklin, Stan Lee, Casey Kasem, and more)

You probably have heard of the fortunes that have been lost because little or no estate planning was done. In fact, there are books and web sites detailing how famous fortunes were lost or diminished because of poor or no estate planning.

For example, Elvis Presley's fortune went from over $10 million at his death to a little over $3 million after estate taxes and other costs were paid; Marilyn Monroe's estate went from a little over $800,000 to less than $425,000 after subtracting taxes and other costs.

Truth is, celebrities and the very wealthy frequently make headlines with estate planning problems that provide important lessons for the rest of us.

Their lifestyles might be different, but the rich and famous deal with as many estate planning issues as the rest of us.

Here are some celebrities whose estates made headlines and what you can learn from them.

Prince. The singer/songwriter left an estate estimated to be worth $300 million and is considered one of the top-earning deceased celebrities. The already-valuable estate continues to increase with the new earnings.

Unfortunately, Prince neglected the most basic step. He didn’t have a will. With no will, Prince had no say in deciding who would inherit his estate and the future income from his songs, recordings and other assets.

State law, in his case Minnesota’s, decides who receives the assets and income, as well as the percentage of each. Of course, once it was known there was no will, many people claimed to be related to Prince.

Everyone with a claim took a DNA test. The DNA tests determined Prince had one full sister and five half-siblings who qualified as relatives under Minnesota law. The estate would be divided among them in the proportions set under the law.

That likely will create other problems in the future, because these relatives have to work together to manage the assets and income. Prince didn’t put a structure in place to manage the assets, which we’ll discuss shortly.

Also, there still are other potential heirs. There’s a man Prince’s father referred to as his brother and treated as a brother, though the two had no genetic or legal relationship. That man’s descendants claim they qualify as relatives.

The probate court judge ruled against them, but they’re appealing. The estate could be tied up in the courts for a while. That’s all because Prince didn’t prepare even a basic will.

Aretha Franklin. Almost as bad as not having a will is having multiple, contradictory and poorly prepared wills. Initially, lawyers and family members said the “Queen of Soul” didn’t have a will.
After a few months, three wills were found. One will was found tucked in a spiral notebook that was under some furniture cushions. Two others were found in a locked cabinet; it took a while to locate the key to the lock.

Also, all the wills were handwritten. Only 26 states consider handwritten wills to be valid. One of them is Franklin’s home state of Michigan.

Naturally, the wills are being challenged by some family members who could inherit more if Franklin is ruled to have died without a will and state law determines how the estate is distributed.

Franklin’s estate is in for a long court process to determine if the handwriting was Franklin’s, if she was of sound mind when they were written, and if the latest one revokes or merely amends the earlier wills.

If the court accepts a will, it must interpret the handwriting, which apparently includes cross outs. Preparing a will yourself, especially a handwritten one, eventually can cost a lot more money than it saves.

Franklin’s estate is going to spend more money sorting out the issues than it would have cost her to work with an estate planner.

In addition, it’s likely to be years before the issues are decided.

Tom Petty. Some estate plans smooth over or work around family conflicts. Others make them worse.

Petty was somewhat unique among celebrities in that the singer/songwriter had a full estate plan in place and it had been updated shortly before his death.

Unfortunately, the plan tried to skirt around the potential tension between his widow and two children from a previous marriage.

Most of Petty’s assets were in a living trust with his widow as sole trustee. That appears to give her full discretion and decision-making authority.

But the trust also said the widow and daughters “shall be entitled to participate equally in the management” of the property. Petty’s widow took the position that means the three should share equally in the income and cash flow.

The daughters believe it means that all major decisions are decided by a vote of the three. That, of course, means the daughters could outvote the widow all the time.

The three don’t agree on how to manage the estate assets, so they are mired in litigation and no actions can be taken to create new sources of income.

In blended families and others in which conflicts are likely, details need to be spelled out. Petty could have required that professionals be hired to manage the assets or spelled out how his family was to “participate equally” so no one could offer a different interpretation.

Petty also could have emulated Frank Sinatra and others. Sinatra gave each heir separate assets in his or her own name, so the group didn’t have to agree on how to manage the assets.

Stan Lee, Casey Kasem, Peter Max, Brook Astor and others. Elder financial exploitation and abuse might be the pre-eminent estate planning problem today. Being wealthy doesn’t protect you, unless you made solid plans for the possibility you might become frail or have diminished capacity.

That’s what happened to each of these famous people. In most cases, one or two people isolate the person and gain control of the income and assets.

The best protection against this is to have a team of people ready to act on your behalf instead of waiting until it’s too late and you become reliant on one person.

You can move assets to a living trust and have several co-trustees take over management of the assets when that’s appropriate. You also can have a power of attorney naming agents to handle your assets that aren’t in the trust.

An advance medical directive that names people who will make your medical decisions also is key.

Carefully select the people who will take these roles. You want people who are qualified to make the decisions and who will put your interests first. It’s often a good idea to have at least one professional, such as an attorney or accountant, involved.

Frank Sinatra. Some celebrity estates provide positive lessons of what to do. Sinatra knew there was potential for conflict between his children from his first marriage and his widow (his fourth wife).

To deal with the conflict, Sinatra’s will first provided significant details of how assets were to be distributed. The will also included a no-contest, or in terrorem, clause. The clause provides that if anyone challenges the will, that person is disinherited.

Sinatra's was a detailed clause, citing 13 specific legal actions that would cause an heir to be disinherited. No one challenged the distribution of the estate.

Elizabeth Taylor. You don't hear much about Taylor's wealth or estate. There's a good reason for that.

Taylor was a sharp businessperson who was married multiple times and had a complicated family situation. She knew there were potential conflicts over her estate and liked her privacy.

Taylor created one or more living trusts and transferred most of her assets to them. Even rights to her name and likeness and publicity rights were in trust.

A living trust avoids probate, so there's no public record of the value of the assets, who received them and other matters. The trusts also are harder to challenge than a will. That's why we know so little about Taylor's net worth and how it was distributed. It also is why we don't hear about any acrimony regarding Taylor's estate.

When you create a living trust, be sure to transfer legal title to your assets to the trust. Don't be like the many people who had lawyers draft trust agreements and then failed to follow through and be sure the trusts were legal owners of their assets. The trust is useless if it doesn't have legal title to assets.

Luke Perry. This is another positive case. The actor died unexpectedly of a stroke. Despite being relatively young and apparently healthy, Perry had a solid estate plan in place.

Perry was on life support in the hospital. After five days, his family decided to remove the life support. They were able to do this without a court order, because Perry had an advance medical directive that enabled family members (or others) to make decisions when he wasn't able to do so.

Otherwise, the family would have had to ask for a court order. That would have opened the possibility that one or more family members could challenge the request, as has happened in many families, and required him to be left on life support indefinitely.

Perry also reportedly had a will and living trust in place that divided his assets among his loved ones. Because Perry had a cancer scare a few years earlier, he realized he wasn't too young to prepare an estate plan and put one in place to protect him and his family.

The list goes on and on. In some cases, assets went to someone the deceased probably didn't want to have them, because the estate plan was out of date or improperly prepared.

In other cases, potential heirs engaged in disputes over who should receive the assets. In many cases, a large share of the assets went to lawyers for the different sides who were arguing over what the deceased's intentions were.

These disputes depleted the estates and split the families.

What you don't often hear is how these problems are not exclusive to the rich and famous. The same things happen to the estates of many executives, small business owners, professionals, and other ordinary Americans.

These stories are much more tragic, because after a large fortune is depleted a small fortune often remains. But when a small fortune is depleted, a modest amount or less remains.

Over the years, I have written much about estate planning and estate and gift taxes. In many articles in my monthly newsletter, *Retirement Watch*, I've explored numerous aspects of estate planning and described dozens of ways to safeguard wealth for a spouse, other loved ones, and charity without cutting back on one's own lifestyle.

An article, however, is not enough by itself to help people plan and organize their estates. Estate planning is a large field with many considerations. It also is subject to many changes.
Even when an estate is fairly simple, a number of issues must be addressed before an estate plan is complete and can accomplish the owner's goals.

That is why I periodically compile and expand the estate planning information in one report.

This report discusses the key estate planning issues in one place and helps one efficiently understand the information and plan an estate. Past editions of this report have been very popular.

I like to think that is because the reports are written so that the non-professional can understand them, and they cover a wide range of estate planning issues instead of focusing on one issue or tool. I also try to use practical examples to explain the concepts.

It seems that each edition contains a version of this sentence: Since the last edition was published, estate planning has changed dramatically. And it's always been accurate. It's also accurate this time.

The most significant changes, of course, were in the tax law. The law was changed several times beginning in 2001 with the estate tax actually being repealed for one year. The latest changes were in the 2017 Tax Cuts and Jobs Act. The changes should have caused every will and estate plan to be rewritten.

Estate planning also was affected by many other changes other than the federal estate and gift tax. These less-publicized changes affect trusts, personal property, powers of attorney, IRAs, medical care, family relationships, and many other areas.

Significant changes in the stock market, interest rates, and the economy also affect estate plans and estate planning strategies. The growing number of digital assets (social media pages, email accounts, and more) changed the composition of estates and forced changes in the law and planning.

All these changes should cause people to reconsider their estate plans or to initiate them if they didn't already have plans.

Estate planning always has been important, but it has grown in importance. The baby boomers are at or reaching that stage of life when retirement and estate planning are primary concerns.

In addition, the parents of many baby boomers still are alive and have estates to manage and plan.

These groups of Americans are the wealthiest generations in history. They own a large percentage of this country's assets, and how those assets are managed will influence the performance of the economy in coming years and also is likely to affect government policies.

At a minimum, this book should enable you to intelligently discuss your estate with a planner and save time and money in the planning process.

For many of you, the report will generate ideas that otherwise wouldn't have made their way into the estate plan and will enrich your heirs by thousands of dollars.

When you and an estate planning professional work together, the odds are low that the IRS, attorneys, and others you didn't intend will be your main beneficiaries or that major portions of your estate will be lost to unnecessary expenses and mismanagement.

A good estate plan will put more after-tax, after-expense wealth in the hands of your heirs and without much delay.

BONUS CHAPTER:

New Rules for 529 College Savings Plans & K-12 Tuition

You might be familiar with 529 college savings plans.

These are sort of like Roth IRAs for college savings. They were created in the 1990s, and all 50 states sponsor one or more 529 savings plans.

In a 529 savings plan, you contribute money to an account and name a beneficiary for the account, usually one of your children or grandchildren.

The money in the account is invested, and the income and gains compound tax free.

Some plans let you choose how the account is invested from among mutual funds selected by the plan sponsor.

In other plans, the sponsor decides how the money is invested, or allows you to choose from several diversified portfolios it manages.

When money is distributed from the account to pay for qualified educational expenses, the distribution of the principal and earnings is tax free.

If a distribution *isn't* used to pay for qualified education expenses, the earnings are taxable — and there likely will also be a 10% federal tax penalty.

There also are estate and gift tax benefits. Contributions to an account qualify for the annual gift tax exclusion.

So, starting back in 2018, you can deposit up to $15,000 per account beneficiary, without worrying about the effect on your lifetime estate and gift tax exclusion.

In addition, you can bundle up to five years of annual gifts in one year, allowing you to make up to $75,000 of tax-free contributions per beneficiary in one year.

You're also able to change the account beneficiary. You can even take the contributions back for any reason without tax consequences, though there might be a penalty of up to 10%.

The Tax Cuts and Jobs Act of 2017 increased the benefits of 529 savings plans.

Previously, the plans could be used to pay only for post-secondary school expenses.

<u>Under the new law, the plans also can be used to pay for up to $10,000 of tuition annually for kindergarten through grade 12</u>.

The $10,000 is per student, not per account. Therefore, a student who is a beneficiary of multiple accounts can have only a total of $10,000 distributed tax free each year to pay for K-12 expenses. Excess distributions are included in gross income.

Only tuition for grades K-12 qualifies for a tax-free distribution.

Expenses other than tuition don't qualify for a tax-free distribution. (The definition of qualified expenses is broader when the money is used for secondary education.) The school can be public, private, or religious.

More than 30 states allow full or partial deductions for contributions to 529 plans; some allow other benefits, such as tax credits, instead of deductions.

Some states allow their residents to take deductions or credits only for contributions to a plan sponsored by the state, while others allow the tax breaks for contributions to any 529 plan.

If you're helping pay for private school tuition of a child or grandchild — and your state allows a tax break for 529 account contributions, consider opening an account with the youngster as a beneficiary.

Contribute to the account an amount at least equal to the maximum state tax benefit. When tuition is due, distribute an amount equal to the tuition.

Read your state law closely. Some states, such as New York, limit the tax breaks only for college-related expenses.

Some are debating whether to change their laws to match the new federal law.

Also, many states are worried the federal law change will increase use of the plans and cost the states' tax revenue.

They're considering reducing or eliminating the state tax benefits. So, if this is attractive to you, take advantage of the benefits while you can.

Biography

Bob Carlson is editor of the monthly newsletter *Retirement Watch*, the monthly video series *Retirement Watch Spotlight*, and a weekly free e-letter, *Retirement Watch Weekly*.

In these, he provides independent, objective research covering all the financial issues of retirement and retirement planning.

He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than $5 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw $42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011.

His latest book is *Where's My Money: Secrets to Getting the Most out of Your Social Security*. He's also written the revised edition of *The New Rules of Retirement* (Wiley, 2016; first edition 2004). He also co-authored *Personal Finance after 50 for Dummies* (with Eric Tyson; Wiley, 2015) and wrote *Invest Like a Fox Not Like a Hedgehog* (Wiley, 2007).

He has written numerous other books and reports, including *The New Rules of Estate* Planning, *Securing Your Lifetime Stream of Income*, Tax *Wise Money Strategies*, *Retirement Tax Guide*, *How to Slash Your Mutual Fund Taxes*, *Bob Carlson's Estate Planning Files*, and *199 Loopholes That Survived Tax Reform*. He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post*, and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed 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 many editions of *Who's Who in America* and *Who's Who in the World*.