Partners in Financial Planning, LLC

421 S College Ave
Salem, VA 24153
540-444-2930
Fax 540-266-3620
info@partnersinfinancialplanning.com
www.partnersinfinancialplanning.com

Dear Clients and Friends,

Welcome to the June edition of our "Partnering With You" newsletter.

If you owe estimated tax payments for the April and May period, the payment is due by June 15th.

Jim, Pam, Ruth, Nikie, Todd, Cheryl, Sandy, Chris, Stephen and Rich

Partnering With You - June 2016

Life Insurance Options After Retirement

Life insurance can serve many valuable purposes during your life. However, once you've retired, you may no longer feel the need to keep your life insurance, or the cost of maintaining the policy may have become too expensive. In these cases, you might be tempted to abandon the policy or surrender your life insurance coverage. But there are other alternatives to consider as well.

Lapse or surrender

If you have term life insurance, you generally will receive nothing in return if you surrender the policy or let it lapse by not paying premiums. On the other hand, if you own permanent life insurance, the policy may have a cash surrender value (CSV), which you can receive upon surrendering the insurance. If you surrender your cash value life insurance policy, any gain (generally, the excess of your CSV over the cumulative amount of premium paid) resulting from the surrender will be subject to federal (and possibly state) income tax. Also, surrendering your policy prematurely may result in surrender charges, which can reduce your CSV.

Exchange the old policy

Another option is to exchange your existing life insurance policy for either a new life insurance policy or another type of insurance product. The federal tax code allows you to exchange one life insurance policy for another life insurance policy, an endowment policy, an annuity, or a qualified long-term care policy without triggering current tax liability. This is known as an IRC Section 1035 exchange. You must follow IRS rules when making the exchange, particularly the requirement that the exchange must be made directly between the insurance company that issued the old policy and the company issuing the new policy or contract. Also, the rules governing 1035 exchanges are complex, and you may incur surrender charges from your current life insurance policy. In addition, you may be subject to new sales, mortality, expense, and surrender charges for the new policy, which can be very substantial and may last for many years afterward.

Lower the premium

If the premium cost of your current life insurance policy is an issue, you may be able to reduce the death benefit, lowering the premium cost in the process. Or you can try to exchange your current policy for a policy with a lower premium cost. But you may not qualify for a new policy because of your age, health problems, or other reasons.

Stream of income

You may be able to exchange the CSV of a permanent life insurance policy for an immediate annuity, which can provide a stream of income for a predetermined period of time or for the rest of your life. Each annuity payment will be apportioned between taxable gain and nontaxable return of capital. You should be aware that by exchanging the CSV for an annuity, you will be giving up the death benefit, and annuity contracts generally have fees and expenses, limitations, exclusions, and termination provisions. Also, any annuity guarantees are contingent on the claims-paying ability and financial strength of the issuing insurance company.

Long-term care

Another potential option is to exchange your life insurance policy for a tax-qualified long-term care insurance (LTCI) policy, provided that the exchange meets IRC Section 1035 requirements. Any taxable gain in the CSV is deferred in the long-term care policy, and benefits paid from the tax-qualified LTCI policy are received tax free. But you may not be able to find a LTCI policy that accepts lump-sum premium payments, in which case you'd have to make several partial exchanges from the CSV of your existing life insurance policy to the long-term care policy provider to cover the annual premium cost.

A complete statement of coverage, including exclusions, exceptions, and limitations, is found only in the policy. It should be noted that carriers have the discretion to raise their rates and remove their products from the marketplace.

Debt Optimization Strategies

You may be able to improve your financial situation by implementing certain debt payoff strategies that can reduce the time you make payments and the total interest you pay. Before starting any debt payoff strategy (or combination of strategies), be sure you understand the terms of your debts, including any prepayment penalties.

Note: All examples are hypothetical and used for illustrative purposes only. Fixed interest rates and payment terms are shown, but actual interest rates and payment terms may change over time.

As part of improving your financial situation, you might consider reducing your debt load. A number of strategies can be used to pay off debt. However, before starting any debt payoff strategy (or combination of strategies), be sure you understand the terms of your debts, including interest rates, terms of payment, and any prepayment or other penalties.

Understand minimum payments (a starting point)

You are generally required to make minimum payments on your debts, based on factors set by the lender. Failure to make the minimum payments can result in penalties, increased interest rates, and default. If you make only the minimum payments, it may take a long time to pay off the debt, and you may have to pay large amounts of interest over the life of the loan. This is especially true of credit card debt.

Your credit card statement will indicate the amount of your current monthly minimum payment. To find the factors used in calculating the minimum payment amount each month, you need to review terms in your credit card contract. These terms can change over time.

For credit cards, the minimum payment is usually equal to the greater of a minimum percentage multiplied by the card's balance (plus interest on the balance, in some cases) or a base minimum amount (such as $15). For example, assume you have a credit card with a current balance of $2,000, an interest rate of 18%, a minimum percentage of 2% plus interest, and a base minimum amount of $15. The initial minimum payment required would be $70 [greater of ($2,000 x 2%) + ($2,000 x (18% / 12)) or $15]. If you made only the minimum payments (as recalculated each month), it would take you 114 months (almost 10 years) to pay off the debt, and you would pay total interest of $1,314.

For other types of loans, the minimum payment is generally the same as the regular monthly payment.

Make additional payments

Making payments in addition to your regular or minimum payments can reduce the time it takes to pay off your debt and the total interest paid. The additional payments could be made periodically, such as monthly, quarterly, or annually.

For example, if you made monthly payments of $100 on the credit card debt in the previous example (the initial minimum payment was $70), it would take you only 24 months to pay off the debt, and you would pay total interest of just $396.

As another example, let's assume you have a current mortgage balance of $100,000. The interest rate is 5%, the monthly payment is $791, and you have a remaining term of 15 years. If you make regular payments, you will pay total interest of $42,343. However, if you pay an additional $200 each month, it will take you only 11 years to pay off the debt, and you will pay total interest of just $30,022.

Another strategy is to pay one-half of your regular monthly mortgage payment every two weeks. By the end of the year, you will have made 26 payments of one-half the monthly amount, or essentially 13 monthly payments. In other words, you will have made an extra monthly payment for the year. As a result, you will reduce the time payments must be made and the total interest paid.

Pay off highest interest rate debts first

One way to potentially optimize payment of your debt is to first make the minimum payments required for each debt, and then allocate any remaining dollars to the debts with the highest interest rates.

For example, let's assume you have two debts, you owe $10,000 on each, and each has a monthly payment of $200. The interest rate for one debt is 8%; the interest rate for the other is 18%. If you make regular payments, it will take 94 months until both debts are paid off, and you will pay total interest of $10,827. However, if you make monthly payments of $600, with the extra $200 paying off the debt with an 18% interest rate first, it will take only 41 months to pay off the debts, and you will pay total interest of just $4,457.

Use a debt consolidation loan

If you have multiple debts with high interest rates, it may be possible to pay off those debts with a debt consolidation loan. Typically, this will be a home equity loan with a much lower interest rate than the rates on the debts being consolidated. Furthermore, if you itemize deductions, interest paid on home equity debt of up to $100,000 is generally deductible for income tax purposes, thus reducing the effective interest rate on the debt consolidation loan even further. However, a home equity loan potentially puts your home at risk because it serves as collateral, and the lender could foreclose if you fail to repay. There also may be closing costs and other charges associated with the loan.

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Common Financial Wisdom: Theory vs. Practice

It might not always be possible to follow some common financial wisdom.

Note: All investing involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.

In the financial world, there are a lot of rules about what you *should* be doing. In theory, they sound reasonable. But in practice, it may not be easy, or even possible, to follow them. Let's look at some common financial maxims and why it can be hard to implement them.

Build an emergency fund worth three to six months of living expenses

Wisdom: Set aside at least three to six months worth of living expenses in an emergency savings account so your overall financial health doesn't take a hit when an unexpected need arises.

Problem: While you're trying to save, other needs--both emergencies and non-emergencies--come up that may prevent you from adding to your emergency fund and even cause you to dip into it, resulting in an even greater shortfall. Getting back on track might require many months or years of dedicated contributions, leading you to decrease or possibly stop your contributions to other important goals such as college, retirement, or a down payment on a house.

One solution: Don't put your overall financial life completely on hold trying to hit the high end of the three to six months target. By all means create an emergency fund, but if after a year or two of diligent saving you've amassed only two or three months of reserves, consider that a good base and contribute to your long-term financial health instead, adding small amounts to your emergency fund when possible. Of course, it depends on your own situation. For example, if you're a business owner in a volatile industry, you may need as much as a year's worth of savings to carry you through uncertain times.

Start saving for retirement in your 20s

Wisdom: Start saving for retirement when you're young because time is one of the best advantages when it comes to amassing a nest egg. This is the result of compounding, which is when your retirement contributions earn investment returns, and then those returns produce earnings themselves. Over time, the process can snowball.

Problem: How many 20-somethings have the financial wherewithal to save earnestly for retirement? Student debt is at record levels, and young adults typically need to budget for rent, food, transportation, monthly utilities, and cell phone bills, all while trying to contribute to an emergency fund and a down payment fund.

One solution: Track your monthly income and expenses on a regular basis to see where your money is going. Establish a budget and try to live within your means, or better yet *below* your means. Then focus on putting money aside in your workplace retirement plan. Start by contributing a small percentage of your pay, say 3%, to get into the retirement savings habit. Once you've adjusted to a lower take-home amount in your paycheck (you may not even notice the difference!), consider upping your contribution little by little, such as once a year or whenever you get a raise.

Start saving for college as soon as your child is born

Wisdom: Benjamin Franklin famously said there is nothing certain in life except death and taxes. To this, parents might add college costs that increase every year without fail, no matter what the overall economy is doing. As a result, new parents are often advised to start saving for college right away.

Problem: New parents often face many other financial burdens that come with having a baby; for example, increased medical expenses, baby-related costs, day-care costs, and a reduction in household income as a result of one parent possibly cutting back on work or leaving the workforce altogether.

One solution: Open a savings account and set up automatic monthly contributions in a small, manageable amount--for example, $25 or $50 per month--and add to it when you can. When grandparents and extended family ask what they can give your child for birthdays and holidays, you'll have a suggestion.

Subtract your age from 100 to determine your stock percentage

Wisdom: Subtract your age from 100 to determine the percentage of your portfolio that should be in stocks. For example, a 45-year-old would have 55% of his or her portfolio in stocks, with the remainder in bonds and cash.

Problem: A one-size-fits-all rule may not be appropriate for everyone. On the one hand, today's longer life expectancies make a case for holding even more stocks in your portfolio for their growth potential, and subtracting your age from, say, 120. On the other hand, considering the risks associated with stocks, some investors may not feel comfortable subtracting their age even from 80 to determine the percentage of stocks.

One solution: Focus on your own tolerance for risk while also being mindful of inflation. Consider looking at the historical performance of different asset classes. Can you sleep at night with the investments you've chosen? Your own peace of mind trumps any financial rule.

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Salem, VA 24153
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Partners in Financial Planning, LLC is a fee-only financial planning and investment management firm located in Salem, Virginia. Our mission is to provide comprehensive, caring financial guidance that allows our clients to spend less time worrying about their finances and more time enjoying their lives.

The information provided herein is intended for general educational and informational purposes. Please consult with your financial advisor for tailored advice related to your specific situation.

Can I make charitable contributions from my IRA in 2016?

Yes, if you qualify. The law authorizing qualified charitable distributions, or QCDs, has recently been made permanent by the Protecting Americans from Tax Hikes (PATH) Act of 2015.

You simply instruct your IRA trustee to make a distribution directly from your IRA (other than a SEP or SIMPLE) to a qualified charity. You must be 70½ or older, and the distribution must be one that would otherwise be taxable to you. You can exclude up to $100,000 of QCDs from your gross income in 2016. And if you file a joint return, your spouse (if 70½ or older) can exclude an additional $100,000 of QCDs. But you can't also deduct these QCDs as a charitable contribution on your federal income tax return--that would be double dipping.

QCDs count toward satisfying any required minimum distributions (RMDs) that you would otherwise have to take from your IRA in 2016, just as if you had received an actual distribution from the plan. However, distributions (including RMDs) that you actually receive from your IRA and subsequently transfer to a charity cannot qualify as QCDs.

For example, assume that your RMD for 2016 is $25,000. In June 2016, you make a $15,000 QCD to Qualified Charity A. You exclude the $15,000 QCD from your 2016 gross income. Your $15,000 QCD satisfies $15,000 of your $25,000 RMD. You'll need to withdraw another $10,000 (or make an additional QCD) by December 31, 2016, to avoid a penalty.

You could instead take a distribution from your IRA and then donate the proceeds to a charity yourself, but this would be a bit more cumbersome and possibly more expensive. You'd include the distribution in gross income and then take a corresponding income tax deduction for the charitable contribution. But the additional tax from the distribution may be more than the charitable deduction due to IRS limits. QCDs avoid all this by providing an exclusion from income for the amount paid directly from your IRA to the charity--you don't report the IRA distribution in your gross income, and you don't take a deduction for the QCD. The exclusion from gross income for QCDs also provides a tax-effective way for taxpayers who don't itemize deductions to make charitable contributions.

Can I name a charity as beneficiary of my IRA?

Yes, you can name a charity as beneficiary of your IRA, but be sure to understand the advantages and disadvantages.

Generally, a spouse, child, or other individual you designate as beneficiary of a traditional IRA must pay federal income tax on any distribution received from the IRA after your death. By contrast, if you name a charity as beneficiary, the charity will not have to pay any income tax on distributions from the IRA after your death (provided that the charity qualifies as a tax-exempt charitable organization under federal law), a significant tax advantage.

After your death, distributions of your assets to a charity generally qualify for an estate tax charitable deduction. In other words, if a charity is your sole IRA beneficiary, the full value of your IRA will be deducted from your taxable estate for purposes of determining the federal estate tax (if any) that may be due. This can also be a significant advantage if you expect the value of your taxable estate to be at or above the federal estate tax exclusion amount ($5,450,000 for 2016).

Of course, there are also nontax implications. If you name a charity as sole beneficiary of your IRA, your family members and other loved ones will obviously not receive any benefit from those IRA assets when you die . If you would like to leave some of your assets to your loved ones and some assets to charity, consider leaving your taxable retirement funds to charity and other assets to your loved ones. This may offer the most tax-efficient solution, because the charity will not have to pay any tax on the retirement funds.

If retirement funds are a major portion of your assets, another option to consider is a charitable remainder trust (CRT). A CRT can be structured to receive the funds free of income tax at your death, and then pay a (taxable) lifetime income to individuals of your choice. When those individuals die, the remaining trust assets pass to the charity. Finally, another option is to name the charity and one or more individuals as co-beneficiaries. (Note: There are fees and expenses associated with the creation of trusts.)

The legal and tax issues discussed here can be quite complex. Be sure to consult an estate planning attorney for further guidance.

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