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The retirement you want with the confidence you need...

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Hello Everyone,

Happy Easter!

I hope this newsletter finds everyone doing well. Besides the allergies, it's nice that Spring is here and we get a little more daylight.

Thank you for being so welcoming of Allison as my Client Services Associate. If you haven't met her, I hope get to do so soon.

As always, please let us know if you have anything you want to discuss or if anything has changed that you feel might affect your current financial plan.

Thank you for your friendship, trust, and business.

God Bless,
John

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Changes to Social Security Claiming Strategies

The Bipartisan Budget Act of 2015 included a section titled "Closure of Unintended Loopholes" that ends two Social Security claiming strategies that have become increasingly popular over the last several years. These two strategies, known as "file and suspend" and "restricted application" for a spousal benefit, have often been used to optimize Social Security income for married couples.

If you have not yet filed for Social Security, it's important to understand how these new rules could affect your retirement strategy. Depending on your age, you may still be able to take advantage of the expiring claiming options. The changes should not affect current Social Security beneficiaries and do not apply to survivor benefits.

File and suspend

Under the previous rules, an individual who had reached full retirement age could file for retired worker benefits--typically to enable a spouse to file for spousal benefits--and then suspend his or her benefit. By doing so, the individual would earn delayed retirement credits (up to 8% annually) and claim a higher worker benefit at a later date, up to age 70. Meanwhile, his or her spouse could be receiving spousal benefits. For some married couples, especially those with dual incomes, this strategy increased their total combined lifetime benefits.

Under the new rules, which are effective as of April 30, 2016, a worker who reaches full retirement age can still file and suspend, but no one can collect benefits on the worker's earnings record during the suspension period. This strategy effectively ends the file-and-suspend strategy for couples and families.

The new rules also mean that a worker cannot later request a retroactive lump-sum payment for the entire period during which benefits were suspended. (This previously available claiming option was helpful to someone who faced a change of circumstances, such as a serious illness.)

Tip: *If you are age 66 or older before the new rules take effect, you may still be able to take advantage of the combined file-and-suspend and spousal/dependent filing strategy.*

Restricted application

Under the previous rules, a married person who had reached full retirement age could file a "restricted application" for spousal benefits after the other spouse had filed for Social Security worker benefits. This allowed the individual to collect spousal benefits while earning delayed retirement credits on his or her own work record. In combination with the file-and-suspend option, this enabled both spouses to earn delayed retirement credits while one spouse received a spousal benefit, a type of "double dipping" that was not intended by the original legislation.

Under the new rules, an individual eligible for both a spousal benefit and a worker benefit will be "deemed" to be filing for whichever benefit is higher and will not be able to change from one to the other later.

Tip: *If you reached age 62 before the end of December 2015, you are grandfathered under the old rules. If your spouse has filed for Social Security worker benefits, you can still file a restricted application for spouse-only benefits at full retirement age and claim your own worker benefit at a later date.*

Basic Social Security claiming options remain unchanged. You can file for a permanently reduced benefit starting at age 62, receive your full benefit at full retirement age, or postpone filing for benefits and earn delayed retirement credits, up to age 70.

Although some claiming options are going away, plenty of planning opportunities remain, and you may benefit from taking the time to make an informed decision about when to file for Social Security.

Earn Too Much for a Roth IRA? Try the Back Door!

If you have taxable compensation, you can contribute up to $5,500 to an IRA in 2016, or $6,500 if you'll be 50 or older by the end of the year. You can't contribute to a traditional IRA for the year you turn 70½, or thereafter.

To be eligible for tax-free qualified distributions from a Roth IRA, you must satisfy a five-year holding period and, in addition, one of the following must apply: you have reached age 59½ by the time of the withdrawal, the withdrawal is made because of disability, or the withdrawal is made to pay first-time homebuyer expenses ($10,000 lifetime limit from all IRAs).

It's not clear how long the back door is going to remain open. There have been suggestions that this is a loophole that should be legislatively closed.

Background

Roth IRAs, created in 1997 as part of the Taxpayer Relief Act, represented an entirely new savings opportunity--the ability to make after-tax contributions that could, if certain conditions were met, grow entirely free of federal income taxes. These new savings vehicles were essentially the inverse of traditional IRAs, where you could make deductible contributions but distributions would be fully taxable. The law also allowed taxpayers to "convert" traditional IRAs to Roth IRAs by paying income taxes on the amount converted in the year of conversion.

Unfortunately, the law contained two provisions that limited the ability of high-income taxpayers to participate in the Roth revolution. First, the annual contributions an individual could make to a Roth IRA were reduced or eliminated if his or her income exceeded certain levels. Second, individuals with incomes of $100,000 or more, or whose tax filing status was married filing separately, were prohibited from converting a traditional IRA to a Roth IRA.

In 2005, however, Congress passed the Tax Increase Prevention and Reconciliation Act (TIPRA), which repealed the second barrier, allowing anyone to convert a traditional IRA to a Roth IRA--starting in 2010--regardless of income level or marital status. But TIPRA did not repeal the provision that limited the ability to make annual Roth contributions based on income. The current limits are set forth in the chart below:

Phaseout ranges for determining ability to fund a Roth IRA in 2016*	
Single/head of household	$117,000-$132,000
Married filing jointly	$184,000-$194,000
Married filing separately	$0-$10,000
***Applies to modified adjusted gross income (MAGI)**	

Through the back door...

Repeal of the provisions limiting conversions created an obvious opportunity for high-income taxpayers who wanted to make annual Roth contributions but couldn't because of the income limits. Those taxpayers (who would also run afoul of similar income limits that prohibited them from making deductible contributions to traditional IRAs) could simply make nondeductible contributions to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA--a "back door" Roth IRA.

The IRS is always at the front door...

For taxpayers who have no other traditional IRAs, establishment of the back-door Roth IRA is essentially tax free. Income tax is payable on the earnings, if any, that the traditional IRA generates until the Roth conversion is complete. However, assuming the contribution and conversion are done in tandem, the tax impact should be nominal. (The 10% penalty tax for distributions prior to age 59½ generally doesn't apply to taxable conversions.)

But if a taxpayer owns other traditional IRAs at the time of conversion, the tax calculation is a bit more complicated because of the so-called "IRA aggregation rule." When calculating the tax impact of a distribution (including a conversion) from any traditional IRA, all traditional and SEP/SIMPLE IRAs a taxpayer owns (other than inherited IRAs) must be aggregated and treated as a single IRA.

For example, assume Jillian creates a back-door Roth IRA in 2016 by making a $5,500 contribution to a traditional IRA and then converting that IRA to a Roth IRA. She also has another traditional IRA that contains deductible contributions and earnings worth $20,000. Her total traditional IRA balance prior to the conversion is therefore $25,500 ($20,000 taxable and $5,500 nontaxable).

She has a distribution (conversion) of $5,500: 78.4% of that distribution ($20,000/$25,500) is considered taxable ($4,313.73), and 21.6% of that distribution ($5,500/$25,500) is considered nontaxable ($1,186.27).

Note: These tax calculations can be complicated. Fortunately, the IRS has provided a worksheet (Form 8606) for calculating the taxable portion of a conversion.

There's also a side door...

Let's assume Jillian in the example above isn't thrilled about having to pay any income tax on the Roth conversion. Is there anything she can do about it?

One strategy to reduce or eliminate the conversion tax is to transfer the taxable amount in the traditional IRAs ($20,000 in our example) to an employer qualified plan like a 401(k) prior to establishing the back-door Roth IRA, leaving the traditional IRAs holding only after-tax dollars. Many 401(k) plans accept incoming rollovers. Check with your plan administrator.

Think Twice Before Counting on a COLA

Will you receive a Social Security COLA in 2016?

The Social Security Administration has announced that, because of low annual inflation, Social Security recipients will not receive a cost-of-living adjustment (COLA) in their benefit checks in 2016. (Source: Social Security Administration press release, October 15, 2015)

****Source: 2015 Annual Report of the Boards of Trustees of the Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds, p.32***

The rising costs of food, gas, electricity, and health care can strain anyone's budget. The situation is even worse if your living expenses increase while your income stays the same, because your purchasing power will steadily decline over time. That's why cost-of-living adjustments, or COLAs, are especially valuable to retirees and others living on fixed incomes.

A COLA is an increase in regular income you receive (such as a Social Security or pension benefit) that is meant to offset rising prices. It's important protection because price inflation has occurred in most years during the last 40 years. However, a COLA may not be payable in years when inflation slows or declines.

How COLAs work

It's easy to think of a COLA as a "raise," but a COLA is meant to help you maintain your standard of living, not improve it. For example, let's say you receive a $2,000 monthly retirement benefit, and the overall cost of the things you need to purchase increases by 3% during the year. The next year, you receive a 3% COLA, or an extra $60 a month, to help you manage rising prices.

That 3% COLA doesn't sound like much, but without a COLA, inflation can seriously erode your retirement income. Assuming a 3% inflation rate, in just 10 years, the purchasing power of your monthly $2,000 benefit would drop to $1,520; in 25 years, the purchasing power of your benefit would be only $963, less than half of what you started with.

Who receives COLAs?

Social Security is the major source (and in some cases the only source) of inflation-protected retirement income for many Americans. COLAs are also commonly paid to retirees who are covered by state or federal pensions. However, most private pensions do not offer COLAs.

Less commonly, employers may offer COLAs as part of compensation packages. For an additional cost, you might also be able to purchase riders for certain insurance policies (such as disability income and long-term care policies) to ensure that the benefits you receive keep pace with inflation (subject to contractual terms, conditions, and limitations).

When there is no Social Security COLA

Social Security COLAs are officially announced each October and reflect the annual increase in the average Consumer Price Index for Urban Wage Earners and Clerical Workers (CPI-W). The average CPI-W for the third calendar quarter of the last year a COLA was payable is compared to the average CPI-W for the third calendar quarter of the current year. Any percentage increase that results is the COLA for that year and will be payable to beneficiaries beginning in January of the following year. However, beneficiaries will not receive a COLA if there is no increase in the average annual CPI-W.

No COLA for Social Security beneficiaries also means no increase in two Social Security limits: the contribution and benefit base (also called the Social Security wage base) and the retirement earnings test exempt amounts.

The contribution and benefit base is the cap on the annual amount of wages and self-employment income subject to Social Security payroll taxes. The retirement earnings test applies only to people under full retirement age (FRA) who receive Social Security benefits and also have earnings from work. If your earnings from work exceed a specific annual limit--the retirement earnings test exempt amount--part of your Social Security benefit will be withheld. (There are actually two different earnings test exempt amounts. One limit applies before the calendar year you reach FRA, and a higher limit applies in the year you reach FRA, up until the month you reach FRA.)

Medicare beneficiaries are also affected. A "hold harmless" provision in the Social Security Act protects most Social Security beneficiaries from increases in their Medicare Part B premium when there is no Social Security COLA. However, about 30% of Medicare beneficiaries are not protected by this provision, including those subject to income-adjusted Part B premiums, those who are enrolled in Medicare but not receiving Social Security benefits, and those who are newly entitled to Medicare.* If you fall into one of these groups, you may pay a substantially higher Medicare Part B premium when no COLA is payable.

Putting COLAs in perspective

As important as COLAs are, they are still vulnerable to cutbacks. For example, pension plans that are underfunded may view reducing COLAs as a relatively simple way to cut costs, and some plans have attempted to eliminate COLAs altogether.

Consider taking additional measures to account for the effect of long-term inflation. For example, use realistic inflation and investment return assumptions when planning for retirement, maintain a diversified portfolio that reflects your time horizon and tolerance for risk, and consider investments that have historically held their own against inflation.

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Should I loan my child money for a down payment on a house?

For a lot of young people today, it's difficult to purchase a home without at least some financial assistance. As a result, many young adults turn to their parents or other family members for help with a down payment.

If you plan on lending your child money for a down payment on a house, you should try to assume the role of a commercial lender. Setting the terms of the loan in writing will demonstrate to your child that you take both your responsibility as lender and your child's responsibility as borrower seriously.

While having an actual loan contract may seem too businesslike to some parents, doing so can help set expectations between you and your child. The loan contract should spell out the exact loan amount, the interest rate and a repayment schedule. To avoid the uncomfortable situation of having to remind your child that a payment is due, consider asking him or her to set up automatic monthly transfers from his or her bank account to yours.

This type of loan documentation is also important for IRS purposes because there may be potential income and gift tax issues with these types of loans. For example, interest paid by your child will be considered taxable income, and if adequate interest is not charged for the loan, special imputed interest rules may apply.

If you don't feel comfortable lending your child money, you may want to consider making a smaller, no-strings-attached gift that doesn't have to be repaid. Currently, you can gift up to $14,000 annually per person under the gift tax exclusion. However, if you do gift money for a down payment, your child's lender may still require him or her to put up some of his or her own money, depending on the type of mortgage chosen.

Keep in mind that lending money to family members can be a tricky proposition. Before entering into this type of financial arrangement, you should take the time to carefully weigh both the financial and emotional costs.

How long will I have to pay for private mortgage insurance?

It depends. There are generally two ways that private mortgage insurance (PMI) can be removed from your mortgage loan. The first is if you request PMI cancellation directly from your lender. The second is through termination by your lender.

You can request PMI cancellation directly from your lender once you have reached the date when the principal balance of your mortgage is scheduled to fall to 80% of the original value of your home. You can find this date on the PMI disclosure form that was given to you when you first obtained your mortgage. The cancellation request can be made earlier if you have made additional mortgage payments that have reduced your principal balance to 80% at an earlier date. Your lender may also require you to meet certain other criteria in order to cancel your PMI, such as certification that there are no subordinate liens on the home and evidence that the property has not declined below the original value.

If you don't request PMI cancellation directly from your lender, your PMI could still be removed from your loan if it is terminated by your lender. Your lender is required to terminate PMI on the date when the principal balance on your loan is scheduled to reach 78% of the original value of your home or once you reach the midpoint of your loan's amortization schedule (e.g., year 15 of a 30-year loan), whichever occurs first.

Unfortunately, some mortgage companies don't always follow the rules pertaining to PMI termination and continue to collect PMI premiums from borrowers beyond the termination date. As a result, many borrowers find themselves paying unnecessarily for PMI. (Source: Private Mortgage Insurance Cancellation and Termination, Consumer Financial Protection Bureau Compliance Bulletin, August 2015) If you think you have reached, or are about to reach, the point in your loan where PMI cancellation or termination is a possibility, you should contact your mortgage lender for more information.

Keep in mind that the above rules regarding PMI apply to borrowers who are current on their loans and apply only to conventional mortgage loans closed on or after July 29, 1999.

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