FINANCIAL PLANNING

Developing a Financial Plan: Frequently Asked Questions

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How do I determine my long-term financial goals?

The first step is to decide what you realistically want to achieve financially. Financial goals might include early retirement, travel, a vacation home, securing your family's financial comfort on the death of a bread-winner, planning for the care of elderly relatives or building a family business.

Is there any validity to financial planning "rules of thumb" such as "saving 10 percent of your gross income?"

The following **rules of thumb** may work for some people, but they do not make financial sense for everyone. What is more important is to be able to know whether a particular rule of thumb suits your situation. Here are six of the more common rules along with some considerations that should not be overlooked.

1. Life insurance should equal five times your yearly salary.

This rule of thumb has been used to answer the question: How much life insurance should I have? The ideal amount of life insurance is the amount that will, when invested, generate enough income to allow your survivors to maintain the level of income they are used to. "Five times your salary" will accomplish this objective in some cases, but there is no substitute for making the calculations necessary to find out how much life insurance you need to buy for your particular situation. The amount of life insurance you need depends on how many people there are in your family, whether there are other sources of income besides your salary, how old your children are, and a few other factors.

2. Save 10 percent of your salary per year.

You may need to save much more than ten percent of your gross income to have a comfortable retirement. The amount you need to save for retirement depends on how large your existing nest egg is and how old you are. Those who started saving late in life, for instance in their 40s, need to save at least 15 or 20 percent per year.

3. Contribute as much as you can to retirement plans.

This makes sense for most people, but if you've accumulated a large amount of money in a retirement plan, say close to a million dollars, you may reach the point where the negatives of contributing to your retirement plan savings outweigh the positives.

4. You need 80 percent of your pre-retirement income to retire comfortably.

Although people may need 80 percent of their salaries during the first few years of retirement, later on, they are often able to live comfortably on less. The amount of income you need depends on whether you have paid off your mortgage, whether you will have other sources of retirement income, and other factors.

5. Subtract your age from 100 and invest that percentage in stocks.

This is one of those "cookie cutter" rules that only pans out for certain investors. For others, it results in a portfolio that is much too conservative. The best method of allocating percentages among various types of investments depends on your investment goals and needs and your willingness to risk your capital. In this case, rules of thumb do not serve the investor very well at all.

6. Maintain an emergency fund of six months' worth of expenses.

Depending on your family's situation, three months' worth of expenses might be enough. On the other hand, for some families, even six months' worth might be totally inadequate. The amount you should keep on hand depends on how easy it would be for you to take out a short-term loan and how much money you have in savings and investments among other things.

> Do not rely on any rule of thumb to make financial decisions. Instead consider carefully what your needs and goals are, and then calculate what you'll need to do to fulfill them.

What do women in particular need to keep in mind with regard to financial planning?

With more women remaining single, nearly half of all marriages ending in divorce, and the odds of becoming a widow by the age of 55 hovering around 75 percent, nearly 9 out of 10 women will be solely responsible for their financial well-being at some point in their lives. But many are ill-prepared to do so.

Here are several areas where women fall behind when it comes to planning for their financial future:

- Women save considerably less for retirement, on average 60 percent less than men according to a 2010 study conducted by LIMRA of close to 2,500 employees. This is significant because women typically live longer than their male counterparts and need more retirement savings.
- In that same LIMRA study, 29 percent of men and only 14 percent of women consider themselves knowledgeable about financial services and products. Fifty-four percent of women felt at least somewhat knowledgeable about financial products and services, but nearly three-quarters of men felt the same way.
- And, in 2011 a Harris Interactive survey commissioned by RocketLawyer.com found that of the more than 1,000 people surveyed, 5 percent of the women do not have a will, 26 percent of them citing cost as the primary reason they don't have one.

What special problems do unmarried couples have to be concerned with in financial and estate planning?

In 2016, 18 million adults were cohabiting, according to a new Pew Research Center analysis of the Current Population Survey. This represents an increase of 29 percent since 2007. Because unmarried couples don't enjoy the same legal rights and protection as married couples do, financial planning considerations for issues such as retirement planning, estate planning, and taxes can be quite different. For example:

- Unmarried partners do not automatically inherit each other's property. When an unmarried partner dies intestate (without a will) the estate is divided according to laws of the state, with property and assets typically going to parents or siblings and rarely or never to the beloved partner. In other words, married couples who do not have a will have state intestacy laws to back them up, but unmarried couples need to have a will in place in order to make sure that their wishes are met.
- Couples who aren't married also do not have the right to speak for each other in the event of a medical crisis. If your life partner loses consciousness or becomes

incapacitated, someone has to make a decision whether to go ahead with a medical procedure. That person should be you, but unless you have a health care directive such as a living will in place, you have no legal right to make decisions for your partner.

- Tax and estate issues are also more complicated. In most cases, it makes more sense not to own property such as a car or electronics equipment together or to have a joint loan. Whereas marital assets can be divided equally by a judge, there is no legal recourse for unmarried couples in the event of a breakup. Another example is home ownership. If one partner is listed as the sole owner of a home that the couple lives in together and he or she dies, the surviving partner might be left homeless. This can be resolved by properly titling assets, in this case making sure the home is in joint tenancy with rights of survivorship.

Investment Options: Frequently Asked Questions

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- Can I measure my return as the increase in the value of my portfolio over a given period?

What are the steps in the investment process?

The investment process is comprised of several steps that enable you to select a portfolio appropriate to your risk tolerance and desired return. The primary steps in this process are:

- Determine your desired return and risk tolerance
- Develop an asset allocation plan
- Select diversified investments within each asset class
- Monitor your investments

Q: How are risk and return related?

A: Risk and return are positively correlated. The higher the risk of an investment, the higher a return it must offer in order to compensate for the risk. Risks come in many forms such as the volatility of the market, inflation risk, interest rate risk, and business risk. You must determine the degree of risk that you are willing to tolerate. Your investment professional can assist you in this process.

Select the level of risk that permits you to sleep at night. If you have a long investment horizon, then focus on your desired return. Year to year fluctuations should not be a concern. Over the long term, stocks have generated annual returns of about 10 to 11 percent and have had the highest level of risk while long-term government bonds have had long-term returns of 5 to 6 percent and have had the lowest level of risk. The more risk you can tolerate or the higher your desired rate of return, the higher the portion of your portfolio invested in stocks should be.

Q: What is an asset allocation plan?

A: Asset allocation is the distribution of investments among asset classes. Asset classes include different types of stocks, bonds, and mutual funds. It is a significant factor in determining your investment return relative to risk. Proper asset allocation maximizes returns and minimizes risk. This is because different classes of assets react differently to economic upswings or downswings. Allocation differs from diversification in that it balances a portfolio among different classes of assets, for example, growth stocks, long bonds, and large-company stocks, while diversification focuses on variety within an asset class. Generally, allocation among six or seven asset classes is recommended.

Q: What is diversification?

A: Diversification is the selection of multiple investments within a portfolio. For example, investing in a portfolio of 30 stocks rather than in just a few. By maintaining a diversified, varied portfolio, you are minimizing risk. You're less likely to make that "big killing," but when individual investments take a nose-dive, you won't take a big hit.

Q: How can I best monitor my investments?

A: Examine carefully and promptly any written confirmations of trades that you receive from your broker, as well as all periodic account statements. Make sure that each trade was completed in accordance with your instructions. Check to see how much commission you were charged, to make sure it is in line with what you were led to believe you would pay. If commission rates have increased or will increase in the immediate future, or if charges such as custodial fees are to be imposed, then you should be informed in advance.

If securities are held for you in street name (where the customer's securities and assets are held under the name of the brokerage firm instead of the name of the individual who purchased the security or asset), you may request that dividends or interest payments be forwarded to you or put into an interest-bearing account, if available, as soon as they are received, rather than at the end of the month or after some other lengthy period of time.

Set up a file where you can store information relating to your investment activities, such as confirmation slips and monthly statements sent by your broker. Keep notes of any specific instructions given to your account executive or brokerage firm. Good records regarding your investments are important for tax purposes, and also in the event of a dispute about a specific transaction.

Periodically, ask yourself the following questions about your investment:

- Is this investment performing as I was told it would?
- How much money will I get if I sell it today?
- How much am I paying in commissions or fees?
- Have my investment goals changed? If so, is the investment still suitable?
- Have I decided what contingencies need to happen for me to sell the investment (i.e., a certain percentage decrease in value)?

What types of risks are involved in investing?

Nobody invests to lose money. However, investments always entail some degree of risk. Be aware that:

1. The higher the expected rate of return, the greater the risk. Depending on market developments, you could lose some or all of your initial investment or a greater amount.
2. Some investments cannot easily be sold or converted to cash. Check to see if there is any penalty or charge if you must sell an investment quickly or before its maturity date.
3. Investments in securities issued by a company with little or no operating history or published information may involve greater risk.
4. Securities investments, including mutual funds, are not federally insured against a loss in market value.
5. Securities you own may be subject to tender offers, mergers, reorganizations, or third party actions that can affect the value of your ownership interest. Pay careful attention to public announcements and information sent to you about such transactions. They involve complex investment decisions. Be sure you fully understand the terms of any offer to exchange or sell your shares before you act. In

some cases, such as partial or two-tier tender offers, failure to act can have detrimental effects on your investment.

6. The past success of a particular investment is no guarantee of future performance.

What steps can I take to avoid unnecessary risks?

1. Never give in to high pressure. A high-pressure sales pitch can mean trouble. Be suspicious of anyone who tells you, "Invest quickly or you will miss out on a once in a lifetime opportunity."

2. Never send money to purchase an investment based simply on a telephone sales pitch.

3. Never make a check out to a sales representative.

4. Never send checks to an address different from the business address of the brokerage firm or a designated address listed in the prospectus.

> If your broker asks you to do any of these things, contact the branch manager or compliance officer of the brokerage firm.

5. Never allow your transaction confirmations and account statements to be delivered or mailed to your sales representative as a substitute for receiving them yourself. These documents are your official record of the date, time, amount, and price of each security purchased or sold. Verify that the information in these statements is correct.

What questions should I ask before making any investment?

Have this list of questions with you the next time you talk to your broker. Write down the answers you get and the action you decide to take. Your notes may come in handy later if there is a dispute or a problem. A good broker will be happy to answer your questions and will be impressed with your seriousness and professionalism.

- Is this investment registered with the SEC and a state securities agency?
- Does the investment match my investment goals?
- How will the investment make money for me (dividends, interest, capital gains)?
- What set of circumstances have to occur for the value of the investment to go up? To go down? (e.g., must interest rates rise?)
- What fees do I have to pay to buy, maintain, and sell the investment? After fees, how much does the value have to increase by before I make a profit?
- How easy is it for me to unload this investment in a hurry, should I need the money?
- What are the specific risks associated with this investment, for example what is the risk that rising interest rates will devalue your investment or the risk that an economic recession could decrease its value?
- Is the company experienced at what it is doing? How long has it been in business? What is their track record? Who are their competitors?
- Can I get more information: a prospectus, the latest SEC filings, or the latest annual report?

What questions should I ask before making a mutual fund investment?

Here is a list of potential questions to ask before making a mutual fund investment:

- How has the fund performed over the long run? Where can I get an independent evaluation of it?
- What specific risks are associated with it?
- What type of securities does the fund hold?
- How often does the portfolio change?
- Does this fund invest in derivatives, or in any other type of investment that could cause rapid changes in the NAV (Net Asset Value)?
- How does the fund's performance compare to other funds of its type, or to an index of similar investments?
- How much of a fee will I have to pay to buy shares? To maintain shares?
- How often will I get statements? Can you explain what the statement tells me about the investment?

What investment hazards should I look out for?

There are no magic formulas for successful investing. It takes a disciplined, reasoned approach, a commitment to follow some basic, solid rules that have proved effective over time, and to stay in it for the long haul.

Here are some specific tips.

Don't Let Greed Cloud Your Better Judgment. A disciplined approach, taking into account your investment objectives, will pay dividends in more ways than one. Investors who are constantly chasing the jackpot usually lose in the long run.

Don't Rely on Tips. The "hot tip" is the bane of investors. There may be short-term gain in some cases, but in this regard, it's generally wise to follow the maxim, "What goes up must come down."

Be Resolute. Develop a comprehensive, reasoned plan with your adviser, and stick to it, despite the temptation to "take a flyer." When you have developed your plan, and in the absence of other factors, follow it.

Consider All Your Needs and Get a Plan That Fits. For financial planning to be truly effective, all your needs must be considered: money management, tax planning, retirement planning, estate planning, insurance, etc.

Evaluate Investments Periodically. An investment program is not static and unchanging. Your financial situation and objectives may change, as does the economic situation. Review your plan with your adviser and, if necessary, update it to reflect your current and long-term needs.

Monitor your investments. Stay informed. Don't rely on others to "take care of" your portfolio. Keep up with your reading, whether in newsletters, magazines, or the internet.

Read Broker-Account Forms With Care. Many investors pay scant attention to the forms involved in opening and maintaining a brokerage account. As pointed out earlier, many investors are not aware that much of the paperwork is intended, at least in part, to protect the broker and the form against any complaints they might bring.

What should I invest my IRA in?

Like any other investment, you should match the portfolio with your desired return, risk tolerance and investment time horizon. The higher your desired return and risk tolerance and the longer your time horizon, the greater the portion of your portfolio should be in equity investments such as common stocks. Since IRAs are generally long-term investments, equity investments are generally appropriate for a portion of the account.

For those with a lower risk tolerance, short-term fixed income investment would be appropriate. Many people have their IRAs invested in CDs. This is appropriate only for those with a very short time horizon or very low-risk tolerance. IRA money, like any other investment, should be invested in something that will provide a decent return.

Municipal bonds should never be used within an IRA. In doing so, you sacrifice return and may convert otherwise tax-free income to taxable income when you withdraw the funds.

What are derivatives and options?

A derivative is an investment instrument whose value is based on underlying assets such as stocks, bonds, commodities, currencies, interest rates and market indexes. Options are one of the most common types of derivatives and are a useful tool for enhancing a portfolio's income and in many cases, reducing risk. Other types of derivatives include futures contracts, forward contracts, and swaps, but these are more appropriate for sophisticated investors.

Stock options are contracts that give the purchaser the right to buy or sell at a specific price and within a certain period of time, for instance, 100 shares of corporate stock (known as the underlying security). These options are traded on a number of stock exchanges and on the Chicago Board Options Exchange.

When investors buy an option contract, they pay a premium, typically the price of the option as well as a commission on the trade. If they buy a "call" option, they are speculating that the price of the underlying security will rise before the option period expires. If they buy a "put" option, they are speculating that the price will fall.

> While options trading can be very useful as part of an overall investment strategy, it can also be very complicated and sometimes extremely risky. If you plan to trade in options, make sure that you understand basic options strategy and that your registered representative is qualified in this area.

How can I avoid the most frequent money-losing mistakes?

Here are the top mistakes that cause investors to lose money unnecessarily.

- Using a cookie-cutter approach
- Taking unnecessary risks
- Allowing fees and commissions to eat up profits
- Not starting early enough
- Ignoring the costs of taxes
- Letting emotion govern your investing

Q: Should I use a standard asset allocation formula such as those seen in many popular finance magazines?

A: Most investors are satisfied with a one-size-fits-all investment plan. However, your individual needs as an investor must govern any plans you make. For instance, how much of your investment can you risk losing? What is your investment timetable? (i.e., are you retired or a young professional?) The allocation of your portfolio's assets among various types of investments should match your particular needs.

Q: Can I make a decent return without taking unnecessary risks?

A: You do not have to risk your capital to make a decent return on your money. While all investments have some degree or risk, many investments that offer a return that beats inflation without unduly jeopardizing your hard-earned money. For instance, Treasuries are one of the safest possible investments and offer a decent return with very little risk.

Q: What is the downside of high fees and commissions?

A: Many investors allow brokers' commissions, fees, and other costs to cut into their returns. Be aware of the fees you are paying and make sure they are appropriate for the services you are receiving. The more you pay in fees the lower your net return will be.

Q: When should I start investing?

A: Today. Many investors are not cognizant of the power of interest compounding. By starting out early enough with your investment plan, you can invest less, and in the long run, still come out ahead of where you would be if you start later in life.

Q: What is the impact of taxes on my investment returns?

A: Net profits on your share of your mutual funds' stock sales are taxable to you as capital gains. Unless you are in a tax-deferred retirement account, the taxes will eat into your profits. The solution? Invest in funds where shares are bought and sold less frequently and have a low turnover rate (10 percent or less per year).

Q: Should I let my emotions affect my investments?

A: Never give in to pressure from a broker to invest in a "hot" security or to sell a fund and get into another one. The key to a successful portfolio lies in planning, discipline, and reason. Emotion and impulse have no role to play. Try to stay in a security or fund for the long haul. On the other hand, when it's time to unload a loser, then let go of it. Finally, do not fall prey to the myth of "market timing." This is the belief that by getting into or out of a security at exactly the right moment, we can retire rich. Market timing does not work.

Instead, use investment strategies that do work: a balanced allocation of your portfolio's assets among securities that suit your individual needs, the use of dollar-cost averaging and dividend-reinvestment programs, and a well-disciplined, long-haul approach to saving and investment.

What is the difference between my cumulative return and annualized return?

Suppose Mr. N. Vestor invests $100 in an investment that earns 10 percent this year and 10 percent the next year. What is his cumulative return? The answer is 21 percent.

Here's why. N. Vestor's 10 percent gain makes his $100 grow to $110. Next year, he earns another 10 percent, leaving him with $121. His investment has earned a cumulative 21 percent return over two years. His annualized return, however, is 10 percent.

The fact that the cumulative return of 21 percent is greater than twice the 10 percent annual return is due to the effect of compounding, which means that your yearly earnings are added to your original investment before the current year's earnings are applied.

What is the rule of 72?

The rule of 72 is a way of finding out long it will take for your investment to double. Divide an investment's annual return into 72, and you will have the number of years necessary to double your investment.

> An investment's annual return is 10 percent. Ten percent divided into 72 is 7.2, so your investment will double in 7.2 year.

What is "Total Return" and why is it important?

If you reinvest all of your gains, including dividends and interest, you will be getting the most from compounding. The percentage you achieve is termed "total return." It includes appreciation, interest and dividends. It is particularly important in examining the past and current performance of mutual funds.

Mutual funds must, by law, distribute almost all of their capital gain and dividend income each year. Many investors reinvest these distributions, using them to buy more fund shares. Because the fund's share price is reduced after a fund makes a distribution, the long-term price trend of a fund's shares may not accurately reflect the fund's performance. However, the fund's total return, which takes into account reinvested dividends, is often a more accurate reflector of the fund's performance.

How does "yield" differ from "total return?"

Yield is the amount of dividends or interest paid annually by an investment. The yield is usually expressed as a percentage of the investment's current price. It does not consider appreciation.

Because certificates of deposit and money-market funds maintain the same value, their total return does not differ much from their yield. But because stocks and bonds fluctuate in price, there can be a large difference between yield and total return.

Can I measure my return as the increase in the value of my portfolio over a given period?

Investors often take the following shortcut, which often yields misleading results. Instead of looking at total return, they simply compare their year-end portfolio value with the value at the beginning of the year, and attribute the entire growth to investment gains.

The reason this shortcut may be misleading is that any additional investments or withdrawals made during the year are not taken into account.

Annuities: Frequently Asked Questions

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- Is it a good idea to buy annuities for my IRA or qualified plan?
- How will my annuity payouts be taxed?
- What tax must my beneficiaries or heirs pay if my annuity continues after my death?
- How should I shop for an annuity?
- What are the added or hidden costs in buying an annuity?
- Is it better to take an annuity or a lump-sum distribution?
- What is a joint and survivor annuity?
- Can I change from a joint and survivor annuity if it doesn't meet my needs?

What are variable annuities?

Variable annuity contracts are sold by insurance companies. Purchasers pay a premium of, for example, $10,000 for a single payment variable annuity or $50 a month for a periodic payment variable annuity. The insurance company deposits these premiums in an account that is invested in a portfolio of securities. The value of the portfolio goes up or down as the prices of its securities rise or fall.

After a specified period of time, which often coincides with the year the purchaser turns age 65, the assets are converted into annuity payments. Although the insurance company guarantees a minimum payment, these payments are variable, since they depend on the periodic performance of the underlying securities.

Almost all variable annuity contracts carry sales charges, administrative charges, and asset charges. The amounts differ from one contract to another and from one insurance company to another.

Fixed annuity contracts are not considered securities and are not regulated by the SEC (Securities and Exchange Commission).

How do annuities work?

An annuity, in essence, is insurance against "living too long." In contrast, traditional life insurance guards against "dying too soon." Briefly, here is how annuities function: An investor hands over funds to an insurance company. The insurer invests the funds. At the end of the annuity's term, the insurer pays the investor his or her investment plus the earnings. The amount paid at maturity may be a lump sum or an annuity, which is a set of periodic payments that are guaranteed as to amount and payment period.

Earnings that occur during the term of the annuity are tax-deferred and an investor is not taxed until the amounts are paid out. Because of the tax deferral, your funds have the chance to grow more quickly than they would in a taxable investment.

Should I invest in annuities?

There are two reasons to use an annuity as an investment vehicle:

1. You want to save money for a long-range goal, and/or
2. You want a guaranteed stream of income for a certain period of time.

Annuities lend themselves well to funding retirement, and, in certain cases, education costs.

One negative aspect of an annuity is that you cannot get to your money during the growth period without incurring taxes and penalties. The tax code imposes a 10 percent premature withdrawal penalty on money taken out of a tax-deferred annuity before age 59-1/2, and insurers impose penalties on withdrawals made before the term of the annuity is up. The insurers' penalties are termed "surrender charges," and they usually apply for the first seven years of the annuity contract.

These penalties lead to a de facto restriction on the use of annuities as an investment. It really only makes sense to put your money in an annuity if you can leave it there for at least ten years, and only when the withdrawals are scheduled to occur after age 59-1/2. This is why annuities work well mostly for retirement needs, or for education funding in cases where the depositor will be at least 59-1/2 when withdrawals begin.

Annuities can also be effective in funding education costs where the annuity is held in the child's name under the provisions of the Uniform Gifts to Minors Act. The child would then pay tax on the earnings when the time came for withdrawals. A major drawback to this planning technique is that the child is free to use the money for any purpose, not just education costs.

If an investment adviser recommends a tax-deferred variable annuity, should you invest it? Or would a regular taxable investment be better?

Generally, you should be aware that tax-deferred annuities very often yield less than regular investments. They have higher expenses than regular investments, and these expenses eat into your returns. On the plus side, the annuity provides a death benefit. You should also be aware that there may be a commission on the product an investment adviser may be entitled to a commission on the product he or she is recommending.

Should a retiree purchase an immediate annuity?

At first glance, the immediate annuity would seem to make sense for retirees with lump-sum distributions from retirement plans. After all, an initial lump-sum premium can be converted into a series of monthly, quarterly or yearly payments, representing a portion of principal plus interest, and guaranteed to last for life. The portion of the periodic payout that is a return of principal is excluded from taxable income.

However, there are risks. For one thing, when you lock yourself into a lifetime of level payments, you aren't guarding against inflation. You are also gambling that you will live long enough to get your money back. Thus, if you buy a $150,000 annuity and die after collecting only $60,000, the insurer often gets to keep the rest. Unlike other investments, the balance doesn't go to your heirs. Furthermore, since the interest rate is fixed by the insurer when you buy it, you are locking into today's low rates.

You can hedge your bets by opting for what's called a "certain period," which, in the event of your death, guarantees payment for some years to your beneficiaries. There are also "joint-and-survivor" options, which pay your spouse for the remainder of his or her life after you die, or a "refund" feature, in which a portion of the remaining principal is resumed to your beneficiaries.

Some plans offer quasi-inflation adjusted payments. One company offers a guaranteed increase in payments of 10 percent at three-year intervals for the first 15 years. Payments are then subject to an annual cost-of-living adjustment, with a 3 percent maximum. However, for these enhancements to apply, you will have to settle for much lower monthly payments than the simple version.

A few companies have introduced immediate annuities that offer potentially higher returns in return for some market risk. These "variable, immediate annuities" convert an initial premium into a lifetime income; however, they tie the monthly payments to the returns on a basket of mutual funds.

If you want a comfortable retirement income, your best bet is a balanced portfolio of mutual funds. If you want to guarantee that you will not outlive your money, you can plan your withdrawals over a longer time horizon.

How do life annuities differ from life insurance?

While traditional life insurance guards against "dying too soon," an annuity, in essence, can be used as insurance against "living too long." With an annuity, you will receive in return a series of periodic payments that are guaranteed as to amount and payment period. Thus, if you choose to take the annuity payments over your lifetime (there are many other options), you will have a guaranteed source of "income" until your death.

If you "die too soon" (that is, you don't outlive your life expectancy), you will get back from the insurer far less than you paid in. On the other hand, if you "live too long" and outlive your life expectancy you may get back far more than the cost of your annuity--along with the resultant earnings. By comparison, if you put your funds into a traditional investment, you may run out of funds before your death.

What's the down side to buying an annuity?

You cannot get to your money during the growth period without incurring taxes and penalties. The tax code imposes a 10 percent premature-withdrawal penalty on money taken out of a tax-deferred annuity before age 59-1/2 and insurers impose penalties on withdrawals made before the term of the annuity is up. The insurers' penalties are termed "surrender charges," and they usually apply for the first seven years of the annuity contract.

What types of annuities are available?

You can purchase a **single-premium annuity**, in which the investment is made all at once (perhaps using a lump sum from a retirement plan payout).

With the **flexible-premium annuity**, the annuity is funded with a series of payments. The first payment can be quite small.

The **immediate annuity** starts payments right after the annuity is funded. It is usually funded with a single premium, and is usually purchased by retirees with funds they have accumulated for retirement.

With a **deferred annuity**, payouts begin many years after the annuity contract is issued. Deferred annuities are used as long-term investment vehicles by retirees and non-retirees alike. They are used in tax-deferred retirement plans and as individual tax-sheltered annuity investments, and may be funded with a single or flexible premium.

With a **fixed annuity** contract, the insurance company puts your funds into conservative, fixed income investments such as bonds. Your principal is guaranteed, and the insurance company gives you an interest rate that is guaranteed for a certain minimum period--from a month to a year, or more. A fixed annuity contract is similar to a CD or a money market fund, depending on length of the period during which interest is guaranteed, and is considered a low risk investment vehicle.

This guaranteed interest rate is adjusted upwards or downwards at the end of the guarantee period.

All fixed annuities also guarantee you a certain minimum rate of interest of 3 to 5 percent for the entirety of the contract.

The fixed annuity is a good annuity choice for investors with a low risk tolerance and a short-term investing time horizon. The growth that will occur will be relatively low. In times of falling interest rates, fixed annuity investors benefit, while in times of rising interest rates they do not.

The **variable annuity**, which is considered to carry with it higher risks than the fixed annuity (about the same risk level as a mutual fund investment) gives you the ability to choose how to allocate your money among several different managed funds. There are usually three types of funds: stocks, bonds, and cash-equivalents. Unlike the fixed annuity, there are no guarantees of principal or interest. However, the variable annuity does benefit from tax deferral on the earnings.

You can switch your allocations from time to time for a small fee or sometimes for free.

The variable annuity is a good annuity choice for investors with a moderate to high risk tolerance and a long-term investing time horizon.

> Today, insurers make available annuities that combine both fixed and variable features.

What are my options for collecting my annuity?

When it's time to begin taking withdrawals from your deferred annuity, you have several choices. Most people choose a monthly annuity-type payment, although a lump sum withdrawal is also possible. The size of your monthly payment depends on several factors including:

1. The size of the amount in your annuity contract
2. Whether there are minimum required payments
3. The annuitant's life expectancy
4. Whether payments continue after the annuitant's death

Summaries of the most common forms of payment (settlement options) are listed below. Keep in mind that once you have chosen a payment option, you cannot change your mind.

Fixed Amount gives you a fixed monthly amount (chosen by you) that continues until your annuity is used up. The risk of using this option is that you may live longer than your money lasts. If you die before your annuity is exhausted, your beneficiary gets the rest.

Fixed Period pays you a fixed amount over the time period you choose. For example, you might choose to have the annuity paid out over ten years. If you are seeking retirement income before some other benefits start, this may be a good option. If you die before the period is up, your beneficiary gets the remaining amount.

Lifetime or Straight Life payments continue until you die. There are no payments to survivors. The life annuity gives you the highest monthly benefit of the options listed here.

The risk is that you will die early, thus leaving the insurance company with some of your funds.

Life with Period Certain gives you payments as long as you live (as does the life annuity) but with a minimum period during which you or your beneficiary will receive payments, even if you die earlier than expected. The longer the guarantee period is, the lower the monthly benefit will be.

Installment-Refund pays you as long as you live and guarantees that, should you die early, whatever is left of your original investment will be paid to a beneficiary.

Joint and Survivor. In one joint and survivor option, monthly payments are made during the annuitants' joint lives, with the same or a lesser amount paid to whoever is the survivor. In the option typically used for retired employees, monthly payments are made to the retired employee, with the same or a lesser amount to the employee's surviving spouse or other beneficiary. In this case, the spouse's (or other co-annuitant's) death before the employee won't affect what the survivor employee collects. The amount of the monthly payments depends on the annuitants' ages and whether the survivor's payment is to be 100 percent of the joint amount or some lesser percentage.

What's the tax on payouts from a qualified plan or IRA annuity?

A tax-qualified annuity is one used to fund a qualified retirement plan, such as an IRA, Keogh plan, 401(k) plan, SEP (Simplified Employee Pension), or some other retirement plan.

1. Any nondeductible or after-tax amount you put into the plan is not subject to income tax when withdrawn
2. The earnings on your investment are not taxed until withdrawal.

If you withdraw money before the age of 59 1/2, you may have to pay a 10 percent penalty on the amount withdrawn in addition to the regular income tax. One of the exceptions to the 10 percent penalty is for taking the annuity out in equal periodic payments over the rest of your life.

Once you reach age 72, you will have to start taking withdrawals in certain minimum amounts specified by the tax law (with exceptions for Roth IRAs and for employees still working after age 72).

Is it a good idea to buy annuities for my IRA or qualified plan?

Though this is sometimes done, no tax advantage is gained by putting annuities in such a plan since qualified plans and IRAs as well as annuities are tax-deferred. It might be better, depending on your situation, to put other investments such as mutual funds in IRAs and qualified retirement plans, and hold annuities in your individual account.

How will my annuity payouts be taxed?

Payouts are taxed differently for qualified and non-qualified plans. These differences are summarized below.

Qualified and Non-Qualified Annuities

A tax-qualified annuity is one used to fund a qualified retirement plan, such as an IRA, Keogh plan, 401(k) plan, SEP (Simplified Employee Pension), or some other retirement plan. The tax-qualified annuity, when used as a retirement savings vehicle, is entitled to all of the tax benefits-and penalties--that Congress saw fit to attach to such plans.

The tax benefits are:

1. The amount you put into the plan is not subject to income tax, and/or
2. The earnings on your investment are not taxed until withdrawal.

A non-qualified annuity, on the other hand, is purchased with after-tax dollars. You still get the benefit of tax deferral on the earnings.

Tax Rules for Qualified Annuities

When you withdraw money from a qualified plan annuity that was funded with pre-tax dollars, you must pay income tax on the entire amount withdrawn.

Once you reach age 72, you will have to start taking withdrawals, in certain minimum amounts specified by the tax law.

Tax Rules for Non-Qualified Annuities

With a non-qualified plan annuity that was funded with after-tax dollars, you pay tax only on the part of the withdrawal that represents earnings on your original investment.

If you make a withdrawal before the age of 59-1/2, you will pay the 10 percent penalty only on the portion of the withdrawal that represents earnings.

With a non-qualified annuity, you are not subject to the minimum distribution rules that apply to qualified plans after you reach age 72.

What tax must my beneficiaries or heirs pay if my annuity continues after my death?

Taxes may apply to your beneficiary (the person you designate to take further payments) or your heirs (your estate or those who take through the estate if you didn't designate a beneficiary).

Income tax. Annuity payments collected by your beneficiaries or heirs are subject to tax on the same principles that would apply to payments collected by you.

Exception: There's no 10 percent penalty on withdrawal under age 59-1/2 regardless of the recipient's age, or your age at death.

Estate tax. The present value at your death of the remaining annuity payments is an asset of your estate and subject to estate tax with other estate assets. Annuities passing to your surviving spouse or to charity would escape this tax.

How should I shop for an annuity?

Check Out The Insurer. Make sure that the insurance company offering it is financially sound. Annuity investments are not federally guaranteed, so the soundness of the insurance company is the only assurance you can rely on. Several services rate insurance companies.

Compare Contracts. For immediate annuities: Compare the settlement options. For each $1,000 invested, how much of a monthly payout will you get? Consider the interest rate and any penalties and charges.

Deferred annuities. Compare the rate, the length of guarantee period, and a five-year history of rates paid on the contract, not just the interest rates.

Variable annuities. Check out the past performance of the funds involved.

If a particular fund has a great track record, ascertain whether the same management is still in place. Although past performance is no guarantee, consistent management will grant you better odds.

What are the added or hidden costs in buying an annuity?

There are costs associated with annuities. Here are the most important items you should be aware of:

Sales Commission. Ask for details on any commissions you will be paying. What percentage is the commission? Is the commission deducted as a front-end load? If so, your investment is directly reduced by the amount of the commission. A no-load annuity contract, or at least a low-load contract, is the best choice.

Surrender Penalties. Find out the surrender charges (that is, the amounts charged for early withdrawals). The typical charge is 7 percent for first-year withdrawals, 6 percent for the second year, and so on, with no charges after the seventh year.

> Be sure the surrender charge "clock" starts running with the date your contract begins, not with each new investment.

Other Fees and Costs. Ask about all other fees. With variable annuities, the fees must be disclosed in the prospectus. Fees lower your return, so it is important to know about them. Fees might include:

- Mortality fees of 1 to 1.35 percent of your account (protection for the insurer in case you live a long time)
- Maintenance fees of $20 to $30 per year
- Investment advisory fees of 0.3 percent to 1 percent of the assets in the annuity's portfolios

Other Considerations. Some annuity contracts offer "bail-out" provisions that allow you to cash in the annuity if interest rates fall below a stated amount without paying surrender charges.

There may also be a "persistency" bonus which rewards annuitants who keep their annuities for a certain minimum length of time.

Is it better to take an annuity or a lump-sum distribution?

As in so many areas of retirement planning, that depends upon your particular needs and circumstances.

- An annuity preserves the tax shelter for funds not yet paid out as annuity income, continuing to grow tax-free to fund future payouts.
- A lump sum withdrawal may be preferable for those in questionable health.
- Consider an annuity with a "refund feature" that guarantees a fixed sum to your heirs should you die earlier than expected.

What is a joint and survivor annuity?

A joint and survivor annuity pays a certain annuity during your life and half that amount (it could be more) to your surviving spouse for life.

In almost all cases, the annual amount you will get under a joint and survivor annuity will be less than you would get under an annuity on your life alone.

Can I change from a joint and survivor annuity if it doesn't meet my needs?

Joint and survivor annuities are almost always required in pension plans, and sometimes in other plans. But you and your spouse can still agree to some other form.

Chief reasons for such agreement are so that your child or other family member can share in the income, or to take a lump sum distribution, or to take a larger annual amount over the participant's life alone.

Bonds: Frequently Asked Questions

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What is a bond?

A bond is a certificate promising to repay, no later than a specified date, a sum of money that an investor or bondholder has loaned to a company. In return for the use of the money, the company (or municipality or other government entity) also agrees to pay bondholders a certain amount of interest (referred to as a coupon) each year, and is typically a percentage of the amount loaned.

Bondholders are not owners of the company. They do not share in dividend payments or vote on company matters and the return on their investment does not usually depend on how successful the company is. Bondholders are entitled to receive the amount of interest originally agreed upon, as well as a return of the principal amount of the bond, provided they hold the bond for the time period specified. For example, if you buy a bond with a face value of $1000 and a coupon of 8 percent with a 10-year maturity rate, you'll receive $80 in interest every year, and at the end of the 10 years, you'll get your $1,000 back.

What are the various types of bonds?

Bonds are categorized by the entities that issue them such as corporate, US Treasury, GSE (Government Sponsored Enterprises) debt securities, and municipal bonds. Corporate bonds generally are issued in denominations of $1,000 or sometimes, $5,000. Treasury bonds are issued denominations of $1,000 while municipal bonds are issued in denominations of $5,000. These numbers refer to the face value of the bond and is the amount that the company agrees to repay to the bondholder when the bond matures.

The prices at which these bonds trade may differ from their face values because the price or value of a bond is closely related to the movement of interest rates in the economy. As interest rates change, so too will the value of the bond. If you need to sell the bond before it matures, it may be worth more (or less) than the price you originally paid for it.

Some bonds are callable or redeemable, which means that the issuer can elect to buy them back from holders at the face amount before the date of maturity, often referred to as the call date. The price of a callable bond is always lower than the price of a regular bond and the yield is typically higher.

How are bonds classified?

Bonds are classified in three ways: by the issuing organization, by their maturity, and by their quality.

Issuing Organization

The U.S. government sells bonds through the Treasury to finance the national debt and through various federal agencies for special purposes. State and local municipalities sell bonds to finance schools, hospitals, highways, bridges, airports, and the like, and corporations sell bonds to finance long-term capital project such as new plants or equipment.

Maturity

Maturity means the length of time until the principal is repaid.

- Short-term bonds mature in less than two years, but in some cases may also refer to bonds that mature in less than one year
- Long-term bonds mature in more than ten years
- Intermediate-term bonds, as the name implies, mature between short and long term debt

Treasury bills have maturity dates of one year or less, Treasury notes mature between one and ten years, and Treasury bonds have maturates of ten years or longer.

> As a general rule, the longer the bond's maturity, the greater the interest-rate risk.

What is meant by the term "bond quality?"

Bond quality refers to the creditworthiness of the issuing organization; in other words, the likelihood that it will be able to repay its debt. Independent rating services, such as Moody's Investors Service, Inc. or Standard & Poor's, publish directories that rate bond quality. A lower rating means the service associates a greater credit risk with that particular bond issue. Rating agencies use a combination of letters A through D to estimate the risk for prospective investors. For example, AAA (or Aaa) is the highest quality bond while C or D rated bonds are in default of payment.

The ratings are not meant to measure the attractiveness of the bond as an investment, but rather the risk. That is, how likely the principal will be paid if held to maturity.

Only the U.S. Treasury's debt is considered free of credit risk.

What is a "bond call provision?"

Investors considering long-term bonds should be alert to the possibility of a "call" or redemption feature in bonds, which can frustrate expectations of a high yield over the life of the bonds. Such a call feature gives the issuing corporation the right to call in or redeem its bonds after a specified number of years have elapsed. Growing numbers of corporations are reserving such early redemption features in their bonds in hopes of refinancing later at the lower interest rates. The call feature has three effects:

- After the call date there's no guarantee that high yields will continue
- It may limit the appreciation of the bonds
- It creates the risk that, where the purchase price is higher than the redemption price, part of the investment will be lost

There are a number of different call provisions, some of which are complex and hard to understand, but brokers are required to disclose call features in writing. Check the indenture, which is the contract between the bond issuer and bondholder, and seek out bonds that either have no call feature or have call protection or choose bonds that have the latest possible redemption date.

What is a bond rating?

The table below provides a summary of the ratings:

Moody's Rating:	Indicates:	Standard & Poor's Rating:
Aaa	Highest Quality	AAA
Aa	High Quality	AA
A	Good Quality	A
Baa	Medium Quality	BBB
Ba	Speculative Elements	BB
B	Speculative	B
Caa	More Speculative	CCC
Ca	Highly Speculative	CC
—	In Default	D
N	Not Rated	N

For more detailed definitions of each rating, consult the publications of the rating services.

What factors affect bond prices?

Think of bond prices and interest rates as opposite ends of a see-saw. When rates fall, prices rise. When rates rise, prices fall. Why does it work this way?

> You buy a bond worth $10,000, which pays 9 percent interest until maturity in 30 years. Suppose you need to sell that bond after only 10 years, at which time,

the interest rates on new loans is 11 percent. Why should investors buy your bond paying only 9 percent when they can get 11 percent elsewhere?

To sell it, you'll need to drop the price of the bond below the price you paid for it. Then, when the bond matures, your buyer will get more than he or she paid for it, making up for the lower-than-market interest payments received meanwhile.

On the other hand, if you needed to sell the bond when the prevailing interest rates on new loans was at 7 percent, you could charge a premium price for your bond that pays a more favorable 9 percent rate. Your buyer will receive less than he or she paid for it when the bond matures, making up for the higher-than-marketplace interest payments received in the interim.

Bond prices are also influenced by maturity. The extent of the change in bond price is also influenced by the maturity of the bond. The longer the maturity is, the greater the change in price for a given change in interest rates. For example, a rise in interest rates will bring about a larger drop in price for a 20-year bond than for an otherwise equivalent 10-year bond.

Bond mutual fund share values generally reflect bond prices. Fund managers decide which bonds to buy and sell, and when, in accordance with the fund's investment objective. And, of course, shares in a bond mutual fund can be redeemed or liquidated at any time.

Bond fund managers try to lengthen or shorten the fund's average maturity (within the fund's overall investment objectives) to anticipate changing interest rates.

Changes in bond mutual fund prices due to changing interest rates do not reflect on the creditworthiness of the bond issuers. If, however, their creditworthiness changes, bond mutual fund prices may also change. This type of price volatility is known as credit risk.

This is one good reason to invest in bond funds. Because a fund consists of a pool of bonds from an array of organizations, the effect of one default on the share price of the entire fund is not nearly as great as it would be for an investor who held only that single bond.

Should I buy individual bonds directly or through a mutual fund?

The biggest difference between an individual bond and a bond mutual fund is that with individual bonds you can "lock in" the rate, but with a bond mutual fund because the bond fund contains many different bonds, neither the dividend payments you receive nor the maturity date is fixed. So you can't lock in the principal or your payment rate.

Let's examine the implications of this difference.

A bond mutual fund is issued by an investment company of which the sole business is managing a portfolio of individual bonds. Investors purchase ownership shares in the fund, with each share representing ownership in all the bonds in the fund's portfolio. Thus, a pool of shareholders owns a pool of bonds. Professional money managers use shareholders' investments to buy and sell bonds for the portfolio in accordance with the fund's investment objective.

Due to pooled resources and the professional money management, bond fund shareholders can invest in far more bonds than the average individual investor could. For example, you would need to pay $25,000 for a single Government National Mortgage Association (GNMA or Ginnie Mae) bond, but you can invest in most GNMA bond mutual funds for only $1,000.

Liquidity is another important difference between an individual bond and a bond fund. By law, the bond fund must buy back your shares at any time. You may receive more or less than your purchase price, depending on how the value of the fund's underlying portfolio has changed.

In contrast, for an individual bond, if you invested in it directly, you would need to find your own buyer if you wanted to sell the bond before it matured.

Bond fund portfolios can contain many different types of bonds of different maturates and varying quality. Risks also vary depending on the type of fund. All bond funds are subject to interest rate risk and most are subject to credit risk. There may be other types of risk as well. Each fund's investment objective, the types of bonds it invests in, related risks, fees, and other information can be found in the fund's prospectus.

What types of bond funds are there?

The table below shows eight common types of bond funds and some of their key characteristics.

Type of Bond Fund	**Goals**	**Invest Primarily In**	**Principal Risks**
Corporate Bond	Income, Capital Preservation	Corporate Debt	Interest Rate, Some Credit
Global Bond	Capital Appreciation	U.S. and non-U.S. Corporate and Government Debt	Currency, Policy, Interest Rate, Some Credit
Ginnie Mae (GNMA)	Income	Mortgage Securities backed by the Government National Mortgage Association	Prepayment, Interest Rate

High-Yield	Income, Capital Appreciation Corporate Bond	Lower Quality Corporate Debt	Credit, Interest Rate
Income (Bond)	Federal Tax-exempt Income, Capital Preservation	State and Local Government Debt	Interest Rate, Some Credit
Long-Term Municipal Bond	Federal Tax-exempt Income, Capital Preservation	State and Local Government Debt	Interest Rate, Some Credit
State Long-term Municipal Bond	Federal and State Tax-exempt Income, Capital Preservation	State and Local Government Debt of Only One State	Interest Rate, Some Credit
U.S. Government Income	Capital Preservation, Income	U.S. Treasury and Other Government Securities	Interest Rate

What are municipal bonds?

Bonds issued by states, cities, or certain agencies of local governments (such as school districts) are called municipal bonds. An important feature of these bonds is that the interest a bondholder receives is not subject to federal income tax. In addition, the interest is also exempt from state and local tax if the bondholder lives in the jurisdiction of the issuing authority. Because of the tax advantages, however, the interest rate paid on municipal bonds is generally lower than that paid on corporate bonds.

Rating agencies evaluate bonds issued by state and local governments and their agencies and take into consideration such factors as the tax base, population statistics, total debt outstanding, and the area's general economic climate.

There are different types of municipal bonds. Some are general obligation bonds secured by the full faith and credit of a state or local government and backed by its taxing power. Others are revenue bonds that are issued to finance specified public works (such as bridges or tunnels) and are directly backed by the income from the specific project.

Prices of most municipal bonds are not usually quoted in daily newspapers.

> If you are interested in a particular bond issue, consult bond dealers for their current prices. Your public library may also have copies of a municipal bond guide or a "Blue List."

What do I need to know about U.S. Government bonds?

Like state and local governments, the U.S. Government also issues debt securities to raise funds. Because these are backed by the federal government itself, they are considered to be very low risk.

Government debt securities include Treasury bills with maturates of up to one year, Treasury notes with that mature between one and ten years, and Treasury bonds with maturates between ten and thirty years.

Other U.S. Government agencies issue bonds, notes, debentures, and participation certificates as well.

While government securities do not have to be registered with the SEC, transactions involving them are subject to the anti-fraud provisions of the securities laws and SEC rules.

Can I buy treasury bonds without a broker?

Treasury bills, notes, and bonds can be purchased directly from the Federal Reserve. Call the Federal Reserve branch nearest you and ask them to mail you information on purchasing through the Treasury Direct program.

Mutual Funds: Frequently Asked Questions

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How are mutual fund distributions taxed?

You must generally report as income any mutual fund distribution, whether or not it is reinvested. The tax law generally treats mutual fund shareholders as if they directly owned a proportionate share of the fund's portfolio of securities. The fund itself is not taxed on its income if certain tests are met and substantially all of its income is distributed to its shareholders. Thus, all dividends and interest from securities in the portfolio, as well as any capital gains from the sales of securities, are taxed to the shareholders.
There are two types of taxable distributions: ordinary dividends and capital gain distributions.

Ordinary dividends are the most common type of distribution from a corporation and are paid out of the earnings and profits of the corporation. For mutual funds, this is the interest and dividends earned by securities held in the fund's portfolio that represent the net earnings of the fund. Ordinary dividends are periodically paid out to shareholders and are taxable as ordinary income unless they are qualified dividends. Qualified dividends are ordinary dividends that meet the requirements to be taxed as net capital gains and are included with your capital gain distributions as long-term capital gain, regardless of how long you have owned your fund shares.

Like the return on any other investment, mutual fund dividend payments decline or rise from year to year, depending on the income earned by the fund in accordance with its investment policy. You should receive a Form 1099-DIV, Dividends and Distributions, from each payer for distributions of $10.00 or more; however, even if you do not receive a Form 1099-DIV or Schedule K-1 (dividends received through a partnership, an estate, a trust, or a subchapter S corporation), you must still report all taxable dividends.

Ordinary dividends are taxed at ordinary tax rates for whatever tax bracket you fall under. Qualified dividends are taxed at a 15 percent rate.

Capital gain distributions are the net gains, if any, from the sale of securities in the fund's portfolio. When gains from the fund's sales of securities exceed losses, they are distributed to shareholders. As with ordinary dividends, capital gain distributions vary in amount from year to year and are reported on Form 1099-DIV, Dividends and Distributions. Capital gain distributions are always reported as long-term capital gains for tax purposes.

Are reinvested dividends from a mutual fund taxable?

Most mutual funds offer you the option of having dividend and capital gain distributions automatically reinvested in the fund a--good way to buy new shares and expand your holdings. Most shareholders take advantage of this service, but you should be aware that you do not avoid paying tax by doing this. Reinvested ordinary dividends are taxed as ordinary income, just as if you had received them in cash and reinvested capital gain distributions are taxed as long-term capital gain.

> If you reinvest, add the amount reinvested to the "cost basis" of your account. "Cost basis" is the amount you paid for your shares. The cost basis of your new shares purchased through automatic reinvesting is easily seen from your fund account statements. This information is important later on when you sell shares.

Make sure that you don't pay any unnecessary capital gain taxes on the sale of mutual fund shares because you forgot about reinvested amounts. When you reinvest dividends and capital gain distributions to buy more shares, you should add the cost of those shares (that is, the amount invested) to the cost basis of the shares in that account because you have already paid tax on those shares.

> You bought 500 shares in Fund PQR in 1990 for $10,000. Over the years you reinvested dividends and capital gain distributions in the amount of $10,000, for which you received 100 additional shares. This year, you sold all 600 of those shares for $40,000.
>
> If you forget to include the price paid for your 100 shares purchased through reinvestment (even though the fund sent you a statement recording the shares you received in each transaction), you will unwittingly report on this year's tax return a capital gain of $30,000 ($40,000 - $ 10,000) on your redemption of 600 shares, rather than the correct capital gain of $20,000 ($40,000 [$10,000 + $10,000]).

Failure to include reinvested dividends and capital gain distributions in your cost basis is a costly mistake.

Am I subject to tax if I switch from one fund to another in the same mutual fund family?

The "exchange privilege," or the ability to exchange shares of one fund for shares of another, is a popular feature of many mutual fund "families." Families are fund organizations offering a variety of funds.

For tax purposes, exchanges are treated as if you had sold your shares in one fund and used the cash to purchase shares in another fund. This means you must report any capital gain from the exchange on your return. The same tax rules used for calculating gains and losses when you redeem shares apply when you exchange them.

> Gains on these redemptions and exchanges are taxable whether the fund invests in taxable or tax-exempt securities.

Am I subject to tax on return-of-capital distributions?

Sometimes mutual funds make distributions to shareholders that are not attributable to the fund's earnings. These are called **nontaxable distributions**, also known as returns of capital. Note that nontaxable distributions are not the same as the tax-exempt dividends. Because a return of capital is a return of part of your investment, it is not taxable. Your mutual fund will show any return of capital on Form 1099-DIV in the box for nontaxable distributions.

If you receive a return of capital distribution, your basis in the shares is reduced by the amount of the return.

> Two years ago you purchased 100 shares of Fund ABC at $10 a share. Last year, you received a $1-per-share return of capital distribution, which reduced your basis in those shares by $1, to give you an adjusted basis of $9 per share. This year, you sell your 100 shares for $15 a share. Assuming no other transactions during this period, you would have a capital gain this year of $6 a share ($15 - $9) for a total reported capital gain of $600.

Non-taxable distributions cannot reduce your basis below zero. If you receive returns of capital that, taken together, exceed your original basis, you must report the excess as a long-term capital gain.

Should I invest in tax-exempt funds to cut my income taxes?

If you're in the higher tax brackets and are seeing your investment profits taxed away, you might want to consider tax-exempt mutual funds as an alternative.

The distributions of municipal bond funds that are attributable to interest from state and municipal bonds are exempt from federal income tax, although they may be subject to state tax.

The same is true of distributions from tax-exempt money market funds. These funds also invest in municipal bonds, but only in those that are short-term or close to maturity, the aim being to reduce the fluctuation in NAV that occurs in long-term funds.

Many taxpayers can ease their tax bite by investing in municipal bond funds. The catch with municipal bond funds is that they offer lower yields than comparable taxable bonds. For example, if a U.S. Treasury bond yields 4.8 percent, then a quality municipal bonds of the same maturity might yield 4 percent. The tax advantage makes it worthwhile to invest in the lower-yielding tax-exempt fund, and the tax advantage to a particular investor hinges on that investor's tax bracket.

To figure out how much you'd have to earn on a taxable investment to equal the yield on a tax-exempt investment, use this formula:

The tax-exempt yield divided by (1 minus your tax bracket) = equivalent yield of a taxable investment.

> You are in the 24 percent bracket, and the yield of a tax-exempt investment is 4 percent. Applying the formula, we get 0.04 divided by (1.00 minus 0.24) =

0.0526. Therefore, 5.26 percent is the yield you would have to receive from a taxable investment to match the tax-exempt yield of 4 percent.

For some taxpayers, portions of income earned by tax-exempt funds may be subject to the federal alternative minimum tax.

Although income from tax-exempt funds is federally tax-exempt, you must still report on your tax return the amount of tax-exempt income you received during the year. This is an information-reporting requirement only and does not convert tax-exempt earnings into taxable income.

Your tax-exempt mutual fund will send you a statement summarizing its distributions for the past year and explaining how to handle tax-exempt dividends on a state-by-state basis.

Capital gain distributions paid by municipal bond funds (unlike distributions of interest) are not free from federal tax. Most states also tax these capital gain distributions.

How do states generally tax mutual fund distributions?

Generally, states treat mutual fund distributions as taxable income, just as the federal government does. However, states may not provide favored tax rates for dividends or long-term capital gains. Further, if your mutual fund invests in U.S. government obligations, states generally exempt dividends attributable to federal obligation interest from state taxation.

Mutual funds that invest in state obligations are another special situation. Most states do not tax income from their own obligations, whether held directly or through mutual funds. On the other hand, the majority of states do tax income from the obligations of other states. Thus, in most states, you will not pay state tax to the extent you receive, through the fund, income from obligations issued by your state or its municipalities.

What are the tax benefits and drawbacks of investing in a foreign mutual fund?

Dividends from funds investing in foreign stocks may qualify for the 15/5/0 percent rate on dividends. If your fund invests in foreign stocks or bonds, part of the income it distributes may have been subject to foreign tax withholding. If so, you may be entitled to a tax deduction or credit for your prorata share of taxes paid. Your fund will provide you with the necessary information.

A tax credit provides a dollar-for-dollar offset against your tax bill while a deduction reduces the amount of income on which you must pay tax, so it is generally advantageous to claim the foreign tax credit. If you decide to take the credit, you may need to attach a special form to your Form 1040, depending on the amount of credit involved.

Stocks: Frequently Asked Questions

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How are Stocks Traded?

Generally, stocks are traded in blocks or multiples of 100 shares, which are called round lots. An amount of stock consisting of fewer than 100 shares is said to be an odd lot.

On an exchange, an order that involves both a round lot and an odd lot-say 175 shares will be treated as two different trades and may be executed at different prices.

In the financial world, a trade is jargon for buy and sell. Your broker will charge you a different commission on each trade, and will confirm each of them separately.

These distinctions do not generally apply to trades executed in the OTC (Over-the-Counter) market. OTC stocks are not traded on a formal exchange such as New York Stock Exchange (NYSE) or the American Stock Exchange (AMEX).

What are the Differences between Stock Exchange Trades and Over-the-Counter Trades?

To be traded on an exchange such as the NYSE or AMEX, the issuing company must meet the exchange's listing standards; these may include requirements on the company's assets, number of shares publicly held, and number of stockholders. Organized markets for other instruments, including standardized options, impose similar restrictions.

The National Association of Securities Dealers' Automated Quotation System (NASDAQ), operated by the Financial Industry Regulatory Authority (FINRA), is considered a stock exchange. Like the exchanges, NASDAQ has certain listing standards which must be met for securities to be traded in that market.

Many securities are not traded on an exchange because the issuing companies are too small to meet exchange requirements. Instead, they are traded Over-the-Counter or OTC by broker-dealers negotiating directly with each other via computer and phone.

Investors who buy or sell securities on an exchange or over the counter usually will do so with the aid of a broker-dealer firm. The registered representative is the link between the investor and the traders and dealers who actually buy and sell securities on the floor of the exchange or elsewhere.

Market prices for stocks traded over the counter and for those traded on exchanges are established in somewhat different ways. The exchanges centralize trading in each security at one location the floor of the exchange. There, auction principles of trading establish the market price of a security according to the current buying and selling interests. If such interests do not balance, designated floor members known as specialists are expected to step in to buy or sell for their own account, to a reasonable degree, as necessary to maintain an orderly market.

Are My Mutual Fund Investments Protected by Insurance?

There are no guarantees for investors. No matter how you buy a fund through a brokerage firm, a bank, an insurance agency, a financial planning firm, or directly through the mail, bond funds, unlike bank deposits, are not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Nor are they guaranteed by the bank or other financial institution through which you make your investment. Mutual funds involve investment risk, including the possible loss of principal. Conversely, investment risk always includes the potential for greater reward.

Even though mutual funds are not insured, there are some protections. Mutual funds are highly regulated by both the federal government primarily through the Securities and Exchange Commission and each of the state governments.

For example, all funds must meet certain operating standards, observe strict anti-fraud rules, and disclose specific information to potential investors. After you invest, funds must provide you with reports at least twice a year that describe how the fund fared during the period covered.

How are Securities Held?

Today, debt securities are held in electronic book-entry form, but in the past were issued as paper certificates. Ownership is transferred via computer rather than via actual transfer of paper certificates, reducing the possibility of loss, theft, or mutilation of the certificates.

There are still, however, many securities that are in certificate form. For example, you may have inherited stock certificates in paper form from a grandparent or other older relatives. Certificates representing your ownership of stocks or bonds are valuable documents and should be kept in a safe place. If a certificate is lost or destroyed, it may prove time-consuming and costly to obtain a replacement. Furthermore, some securities certificates may not be replaceable at all.

What are the Differences between Preferred Stock and Common Stock?

Stocks may be designated as common stock, which is the most widely known form, or as preferred stock. Preferred shareholders have more of a stake in the company's assets and earnings and when dividends are issued, they are paid before shareholders of common stock. in addition, when you hold preferred stock you receive dividend payouts at a regular interval and generally have a stated dividend while common stock dividends are based on company performance. Shareholders with common stock may or may not receive a dividend and are last in line to be paid when a company goes belly up and is liquidated or reorganized in bankruptcy.

What are Restricted Securities?

Some stocks are designated as "restricted" or "unregistered" because they were originally issued in a private sale or other transaction where they were not registered with the SEC. Restricted or unregistered securities may not be freely resold unless a registration statement is filed with the SEC or unless an exemption under the law permits resale.

How Can Foreign Stocks Be Bought?

Foreign corporations that sell securities in the United States must register those securities with the SEC. They are generally subject to the same rules and regulations that apply to securities of U.S. companies, although the nature of information foreign companies makes available to investors may be somewhat different.

U.S. investors who are interested in foreign securities may also purchase American Depositary Receipts (ADRs). These are negotiable receipts, registered in the name of a U.S. citizen, which represent a specific number of shares of a foreign corporation. Denominations are in U.S. dollars and the security is held by a U.S. financial institution overseas. Listed on either the NYSE, AMEX or NASDAQ, ADRs are an excellent way to buy shares in a foreign company, but keep in mind that there are still risks associated with doing so.

What are Dividend Reinvestment Plans (DRIPs)?

Dividend reinvestment plans, often referred to as DRIPs or DRPs, are associated with company-sponsored plans, but may also be purchased through a broker, and offer opportunities to make small, regular cash investments in participating companies without paying prohibitive transaction fees. Further, all or a part of your dividends can be reinvested and used to purchase more shares, although some plans offer the option to receiving dividends by check.

> Treat your decision to enroll in a DRIP just as seriously as you would a decision to invest in a company. Before investing, subject the company to your usual research and analysis.

Many U.S. companies have direct stock purchase programs that allow investors to buy a company's shares directly from the company instead of using a broker. To enroll in the

DRIP, contact the transfer agent or the company's shareholder relations department, and ask for an enrollment form. Then return the form, usually along with your first optional cash investment, to the company.

Once you are enrolled, you can invest more money directly through the company's transfer agent. Many companies offer an automatic investment service, that is, they will automatically withdraw a pre-set amount from your bank account to make optional cash investments. There may be a fee for this service.

Direct stock purchase plans cost an investor less, since there is no broker commission to pay, and often no fee. Some programs have automatic investment options, which will debit a set amount each month from an investor's bank account.

Dividend reinvestment isn't mandatory. Investors can receive dividend payments, and they can be automatically deposited in a bank account. Some companies that offer direct-purchase programs do not pay dividends.

As with anything else, there are positives and negatives. The main drawback associated with DRIPs is that calculation of capital-gains taxes becomes complex when dividends have been reinvested over the years, and lots have been bought at varying prices. This can be remedied by carefully keeping track of the cost basis of shares when dividends are reinvested. Further, investors who invest through an IRA need not deal with the problem of calculating capital gains taxes at all. In addition, the dividends are taxable income even though you reinvest them.

Saving for College: Frequently Asked Questions

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- What types of grants are available for college?
- What types of loans are available for college?
- How can I increase the amount of financial aid my child is entitled to?
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When should I start saving for my child's education?

This depends on how much you think your children's education will cost. The best way is to start saving before they are born. The sooner you begin the less money you will have to put away each year.

> Suppose you have one child, age six months, and you estimate that you'll need $120,000 to finance their college education 18 years from now. If you start putting away money immediately, you'll need to save $3,500 per year for 18 years (assuming an after-tax return of 7 percent). On the other hand, if you put off saving until the child is six years old, you'll have to save almost double that amount every year for twelve years.

Another advantage of starting early is that you'll have more flexibility when it comes to the type of investment you'll use. You'll be able to put at least part of your money in equities, which, although riskier in the short-run, are better able to outpace inflation than other investments in the long-run.

How much will my child's college education cost?

How much will your child's education cost? It depends on whether your child attends a private or state school. According to the College Board, for the 2020-21 school year the total expenses - tuition, fees, board, personal expenses, and books and supplies - for the average four-year private college are about $54,880 per year and about $26,820 per year for the average four-year in-state public college. However, these amounts are averages: the tuition, fees, and board for some private colleges can exceed $75,000 per year whereas the costs for a state school can often be kept under $10,000 per year. It should also be noted that in 2020-21 the average amount of grant aid for a full-time undergraduate student was about $7,330 and $21,660 for four-year public and private schools, respectively. More than 70 percent of full-time students receive grant aid to help pay for college.

How should I invest my child's college fund?

As with any investment, you should choose those that will provide you with a good return and that meet your level of risk tolerance. The ones you choose should depend on when you start your savings plan-the mix of investments if you start when your child is a toddler should be different, from those used if you start when your child is age 12.

The following are often recommended as investments for education funds:

- **Series EE bonds:** These are extremely safe investments. They should be held in the parents' names. If the adjusted gross income of you and your spouse at the time of redemption is at or under the amount set by the tax law, the interest on bonds bought after January 1, 1990, is tax-free as long as it is used for tuition or other qualified education costs. If your adjusted gross income is above the threshold amount, the tax break is phased out.
  You can exclude from your gross income interest on qualified U.S. savings bonds if you have qualified higher education expenses during the year in which you redeem

the bonds. For tax year 2022, the exclusion begins phasing out at $85,800 ($83,200 in 2021) modified adjusted gross income ($76,000 indexed for inflation) and is eliminated for adjusted gross incomes of more than $100,800 ($98,200 in 2021). For married taxpayers filing jointly, the tax exclusion begins phasing out at $128,650 ($124,800 in 2021) and is eliminated for adjusted gross incomes of more than $158,650 ($154,800 in 2021). The exclusion is unavailable to married filing separately.

- **U.S. Government bonds:** These are also investments that offer a relatively higher return than CDs or Series EE bonds. If you use zero-coupon bonds, you can time the receipt of the proceeds to fall in the year when you need the money. A drawback of such bonds is that a sale before their maturity date could result in a loss on the investment. Further, the accrued interest is taxable even though you don't receive it until maturity.
- **Certificates of deposit:** These are safe, but usually provide a lower return than the rate of inflation. The interest is taxable. These should generally only be used by the most risk-averse investors and for relatively short investment horizons.
- **Municipal bonds:** Assuming the bonds are highly rated, the tax-free interest on them can provide an acceptable return if you're in the higher income tax brackets. Zero-coupon municipals can be timed to fall due when you need the funds and are useful if you begin saving later in the child's life.
- Be sure to convert the tax-free return quoted by sellers of such bonds into an equivalent taxable return. Otherwise, the quoted return may be misleading. The formula for converting tax-free returns into taxable returns is as follows:
  Divide the tax-free return by 1.00 minus your top tax rate to determine the taxable return equivalent. For example, if the return on municipal bonds is 1 percent and you are in the 32 percent tax bracket, the equivalent taxable return is 2.6 percent (1 percent divided by 68 percent).**Stocks:** An appropriate mutual fund or portfolio containing stocks can provide you with a higher yield than bonds at an acceptable risk level. Stock mutual funds can provide superior returns over the long term. Income and balanced funds can meet the investment needs of those who begin saving when the child is older.

What is the American Opportunity Tax Credit?

The American Opportunity Tax Credit (AOTC) was made permanent by the Protecting Americans from Tax Hikes Act of 2015 (PATH). The maximum credit, available only for the first four years of post-secondary education, is $2,500. You can claim the credit for each eligible student you have for which the credit requirements are met.

Income limits. To claim the American Opportunity Tax Credit, your modified adjusted gross income (MAGI) must not exceed $90,000 ($180,000 for joint filers). To claim the Lifetime Learning Credit, MAGI must not exceed $69,000 ($138,000 for joint filers). "Modified AGI" generally means your adjusted gross income. The "modifications" only come into play if you have income earned abroad.

Amount of credit. For most taxpayers, 40 percent of the AOTC is a refundable credit, which means that you can receive up to $1,000 even if you owe no taxes.

Which costs are eligible? Qualifying tuition and related expenses refer to tuition and fees, and course materials required for enrollment or attendance at an eligible education institution. They now include books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance.

"Related" expenses do not include room and board, student activities, athletics (other than courses that are part of a degree program), insurance, equipment, transportation, or any personal, living, or family expenses. Student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance. For expenses paid with borrowed funds, count the expenses when they are paid, not when borrowings are repaid.

> The tax law says that you can't claim both a credit and a deduction for the same higher education costs. It also says that if you pay education costs with a tax-free scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts.

What is the "kiddie tax?"

In the past, parents would invest in the child's name in order to shift income to the lower-bracket child. However, the addition of the "kiddie tax" mostly put an end to that strategy.

In 2022, the amount that can be used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax" is $1,150 ($1,100 in 2021). The same $1,150 amount is used to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax." For example, one of the requirements for the parental election is that a child's gross income for 2022 must be more than $1,150 but less than $11,500.

For 2022, the net unearned income for a child under the age of 19 (or a full-time student under the age of 24) that is not subject to "kiddie tax" is $2,300 ($2,200 in 2021).

> These rules apply to unearned income. If a child has earned income, this amount is always taxed at the child's rate.

What is a Coverdell (Section 530) Education Savings Account and who is eligible for one?

In 2022, you can contribute up to $2,000 each year to a Coverdell education savings account (Section 530 program) for a child under 18. These contributions are not deductible, but they grow tax-free until withdrawn. Contributions for any year can be made through the [unextended] due date for the return for that year. The maximum contribution amount for each child is phased out for modified AGI between $190,000 and $220,000 (joint filers) and $95,000 and $110,000 (single filers). These amounts are not indexed to inflation.

> For the $2,000 contribution limit, there is no adjustment for inflation and therefore, the limit is expected to remain at $2,000.

Only cash can be contributed to a Section 530 account and you cannot contribute to the account after the child reaches their 18th birthday.

Anyone can establish and contribute to a Section 530 account, including the child, and you may establish 530s for as many children as you wish. The child need not be a dependent. In fact, he or she need not be related to you, but the amount contributed during the year to each account cannot exceed $2,000. The maximum contribution amount for each child is phased out for modified AGI between $190,000 and $220,000 (joint filers) and $95,000 and $110,000 (single filers). These amounts are not indexed to inflation.

If you have insufficient savings for your child's education when he is close to entering college, what should you do?

Many families find themselves in the same boat. Fortunately, there are ways to generate additional funds both now and when your child is about to enter school:

- You can start saving as much as possible during the remaining years. However, unless your income level is high enough to support an extremely stringent savings plan, you will probably fall short of the amount you need.
- You can take on a part-time job. However, this will raise your income for purposes of determining whether you are eligible for certain types of student aid. In addition, your child may be able to take on part-time or summer jobs.
- You can tap your assets by taking out a home equity loan or a personal loan, selling assets or borrowing from a 401(k) plan.
- You (or your child) can apply for various types of student aid and education loans.

What types of grants are available for college?

Grants. The best type of financial aid because they do not have to be paid back -- are amounts awarded by governments, schools, and other organizations. Some grants are need-based and others are not.

- The Federal Pell Grant Program offers federal aid based on need.
- Don't assume that middle class families are ineligible for needs-based aid or loans. The assessment of whether a family qualifies as "in need" depends on the cost of the college and the size of the family.
  State education departments may make grants available. Inquiries should be made of the state agency.
- Employers may provide subsidies.
- Private organizations may provide scholarships. Inquiries should be made at schools.
- Most schools provide aid and scholarships, both needs-based and non-needs-based.
- Military scholarships are available to those who enlist in the Reserves, National Guard, or Reserve Officers Training Corps. Inquiries should be made at the branch of service.

Try negotiating with your preferred college for additional financial aid, especially if it offers less than a comparable college.

What types of grants are available for college?

There are various student loan programs available. Some are need-based, and others are not. Here is a summary of loans:

- Stafford loans (formerly guaranteed student loans) are federally guaranteed and subsidized low-interest loans made by local lenders and the federal government. They are needs-based for subsidized loans; however an unsubsidized version is also available.
- Perkins loans are provided by the federal government and administered by schools. They are needs-based. Inquiries should be made at school aid offices.
- Parent loans for undergraduate students (PLUS) and supplemental loans for students are federally guaranteed loans by local lenders to parents, not students. Inquiries should be made at college aid offices.
- Schools themselves may provide student loans. Inquiries should be made at the school.

How can I increase the amount of financial aid my child is entitled to?

Here are some strategies that may increase the amount of aid for which your family is eligible:

- **Try to avoid putting assets in your child's name.** As a general rule, education funds should be kept in the parents' names, since investments in a child's name can impact negatively on aid eligibility. For example, the rules for determining financial aid decrease the amount of aid for which a child is eligible by 35 percent of assets the child owns and by 50 percent of the child's income.
- If your child owns $1,000 worth of stock, the amount of aid for which he or she is eligible for is reduced by $350. On the other hand, the amount of aid is reduced by (effectively) only 5.6 percent of your assets and from 22 to 47 percent of your income.
  Reduce your income. Income for financial aid purposes is generally determined based upon your previous year's income tax situation. Therefore, in the years immediately prior to and during college, try to reduce your taxable income. Some ways to do this include:
  1. Defer capital gains.
  2. Sell losing investments.
  3. Reduce the income from your business. If you are the owner of your own business, you may be able to reduce your taxable income by taking a lower salary, deferring bonuses, etc.
  4. Avoid distributions from retirement plans or IRAs in these years.
  5. Pay your federal and state taxes during the year in the form of estimated payments rather than waiting until April 15 of the following year.
  6. Since a portion of discretionary assets is included in the family's expected contribution from income, reduce discretionary assets by paying off credit cards and other consumer loans.
  7. Take advantage of vehicles which defer income, such as 401(k) plans, other retirement plans or annuities.
- **Detail any financial hardships.** If you have any financial hardships, let the deciding authorities know (via the statement of financial need) exactly what they are if they are not clear from the application. The financial aid officer may be able to assist you in explaining hardships.
- **Have your child become independent.** In this case, your income is not considered in determining how much aid your child will be eligible for. Students are considered independent if they:
  1. Are at least 24 years old by the end of the year for which they are applying for aid
  2. Are veterans

3. Have dependents other than their spouse
4. Are wards of the court or both parents are deceased
5. Are graduate or professional students
6. Are married and are not claimed as dependents on their parents' returns

How can I save taxes on college savings?

If you decide to invest in your child's name, here are some tax strategies to consider:

- You can shift just enough assets to create $2,300 in 2022 ($2,200 in 2021) taxable income to an under age 19, child.
- You can buy U.S. Savings Bonds (in the child's name) scheduled to mature after your child reaches age 18.
- You can invest in equities that pay small dividends but have a lot of potential for appreciation. The dividend income earned when your child is under the age of 19 will be minimal with tax relief, and the growth in the stocks will occur over the long term.
- If you own a family business, you can employ your child in the business. Earned income is not subject to the "kiddie tax," and is deductible by the business if the child is performing a legitimate function. Additionally, if your business is a sole proprietorship and your child is younger than 19 years old, then he or she will not pay social security taxes on the income.

Retirement Assets: Frequently Asked Questions

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- How can I continue the tax shelter for retirement plan assets after age 72?
- Suppose there are still retirement assets in my account at my death. Can the shelter continue for those who receive those assets?
- Can moving to another state when I retire save me taxes on my retirement plan?
- What is a reverse mortgage?

Will my heirs owe income taxes when they inherit my retirement assets?

Yes, generally under the same rules that would apply to your withdrawals of the same amounts had you lived--unless it's a Roth IRA. A Roth IRA is exempt from federal income tax as long as the account was opened five years before any withdrawals were taken.

Also, your spouse can rollover your account to his or her IRA. No early withdrawal penalty applies, regardless of your beneficiary's age, but a spouse who rolled over to an IRA may owe an early withdrawal penalty on IRA withdrawals taken before age 59 ½.

Will my heirs owe estate taxes on inherited retirement assets?

Only a small percentage of estates (based on the value of one's assets at death, and including large lifetime gifts) are subject to the estate tax and there is no estate tax on assets passing to a surviving spouse or charity. However, if the estate is subject to federal estate tax, (except in 2010, when there was no estate tax) you can deduct the portion of the federal estate tax that is attributed to the IRA. You also won't have to pay tax on the portion of withdrawals that are attributed to any nondeductible contributions made to the IRA.

Is estate tax deferred if my heir will get an annuity?

No. The estate is taxed on the annuity's present value.

How can I minimize or eliminate tax on inherited retirement assets?

You can minimize or eliminate tax on inherited retirement assets by using the following methods:

1. Leave them to your spouse. This saves money owed to estate tax and helps postpone withdrawals subject to income tax--provided your spouse takes no withdrawals before age 59 ½.
2. Leave them to charity. Although there's no financial benefit to the family, again, this saves income and estate taxes.
3. Leave them to family for life, with the remainder to charity in the form of a charitable remainder trust. This reduces estate tax with some benefits to family.
4. Provide life insurance to pay estate tax on retirement assets. The benefit of this option is that it provides estate liquidity, avoiding taxable distributions to pay estate tax.

How should I take distributions from my retirement plan?

If your assets are in a tax-favored retirement fund such as a company or Keogh pension or profit-sharing plan (including thrift and savings plans), 401(k), IRA or stock bonus plan when it comes time to take distributions you have several options:

- Take everything in a lump sum
- Keep the money in the account, with regular distributions or withdrawals on an as-needed basis
- Purchase an annuity with all or part of the funds
- Take a partial withdrawal (leaving the balance for withdrawal later)
- Take a rollover distribution
- A combination of any of the above

Your retirement assets may be distributed in kind as employer stock, or an annuity or insurance contract. Sometimes certain withdrawal options may be associated with certain retirement plans, for instance, annuities are more common with pension plans. Other types of plan favor the other options, but for the most part most of these options are available for most plans. And more than likely, you'll want to preserve the tax shelter as long as possible by withdrawing no more than you need at any given time.

Timing your withdrawal can be a factor, too. Withdrawals before age 59 ½ risk a tax penalty. At the other end, withdrawals are generally required to start at age 72 or face a tax penalty. The only exceptions are Roth IRAs and non-owner-employees still working beyond that age.

When is it best to take a lump-sum distribution from my retirement plan?

Your personal needs should decide. You may need a lump sum to buy a retirement home or retirement business. If your employer requires that you take a lump sum distribution, it may be wise to roll it over into an IRA.

What should I do about my retirement plan assets in my ex-employer's plan if I change jobs?

There are several things you might do depending upon your needs:

1. If you don't need the assets to live on, try to continue the tax shelter and leave the money where it is.
2. Transfer or roll over the assets into your new employer's plan--if that plan allows it (this can be tricky, though).
3. If you've decided to start your own business, set up a Keogh and move the funds there.
4. Roll them over into your IRA.

Can creditors get at my retirement assets?

In general, employer plans such as your 401(k), IRAs and pension plan funds are protected from general creditors unless you've used these assets as securities against a loan or you are entering into bankruptcy. If this is the case, there's a chance they could be seized, but if the money is in a registered IRA, pension plan, or 401(k), it's more than likely they will be protected in case of bankruptcy (subject to state and federal law of course).

How will my state tax affect my retirement withdrawals?

Each state is different, but in general, consider the following:

1. While withdrawals are generally taxable in states with income tax, some offer relief for retirement income, up to a specified dollar amount.
2. If your state doesn't allow deductions for Keogh or IRA investments allowed under federal law, these investments and sometimes more may come back tax-free.
3. State tax penalties for early withdrawal (before 59 ½) or inadequate withdrawal (after age 72) are unlikely.

I understand that I'm required to take money out of my retirement plan after I reach age 72. Why is that?

Retirement plans offer the biggest tax shelter in the federal system since funds grow tax-free while in the plan. But the shelter is primarily intended for retirement. So when you reach 72 (or shortly thereafter), you must start to withdraw from the plan.

How can I continue the tax shelter for retirement plan assets after age 72?

The shelter can continue for a large part of those assets, for a long time, assuming you don't need them to live on. You can spread withdrawals over a period based on, but longer than, your life expectancy, for example, over a period of at least 27.4 years if you're 72 now. You are free, however, to withdraw at a faster rate or even all of it if you wish. The shelter continues for whatever is not withdrawn.

Suppose there are still retirement assets in my account at my death. Can the shelter continue for those who receive those assets?

Generally, yes. Persons you have named as your plan beneficiaries can withdraw over their life expectancies (or more rapidly if they wish). The withdrawal period is generally shorter where no individual beneficiary is named (for example, where your estate is the beneficiary), but your spouse can sometimes spread withdrawals over a longer period.

Can moving to another state when I retire save me state taxes on my retirement plan?

Money from retirement plans, including 401(k)s, IRAs, company pensions and other plans, is taxed according to your residence when you receive it.

If you move from a state with a high income tax, such as New York, to one with little or no income tax (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming have none), you will indeed save money on state income tax.

However, establishing residence in a new state may take as long as one year; if you retain property in both states, you may owe taxes to both.

What is a reverse mortgage?

A reverse mortgage is a type of home equity loan that allows you to convert some of the equity in your home into cash while you retain home ownership. Reverse mortgages work much like traditional mortgages, only in reverse. Rather than making a payment to your lender each month, the lender pays you. Most reverse mortgages do not require any repayment of principal, interest, or servicing fees for as long as you live in your home.

Retired people may want to consider the reverse mortgage as a way to generate cash flow. A reverse mortgage allows homeowners age 62 and over to remain in their homes while using their built-up equity for any purpose: to make repairs, keep up with property taxes or simply pay their bills.

Reverse mortgages are rising-debt loans, which means that the interest is added to the principal loan balance each month (because it is not paid on a current basis). Therefore, the total amount of interest you owe increases significantly with time as the interest compounds. Reverse mortgages also use up some or all of the equity in your home.

All three types of loan plans, whether FHA-insured, lender-insured, or uninsured charge origination fees and closing costs. Insured plans also charge insurance premiums, and some impose mortgage servicing charges.

Finally, homeowners should realize that if they're forced to move soon after taking the mortgage (because of illness, for example), they'll almost certainly end up with a great deal less equity to live on than if they had simply sold the house outright. That is particularly true for loans that are terminated in five years or less.

Retirement Plan Distributions: Frequently Asked Questions

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How should I take distributions from my retirement plan?

If your assets are in a tax-favored retirement fund such as a company or Keogh pension or profit-sharing plan (including thrift and savings plans), 401(k), IRA or stock bonus plan, when it comes time to take distributions you have several options:

- Take everything in a lump sum
- Keep the money in the account, with regular distributions or withdrawals on an as-needed basis

- Purchase an annuity with all or part of the funds
- Take a partial withdrawal (leaving the balance for withdrawal later)
- Take a rollover distribution
- A combination of any of the above

Your retirement assets may be distributed in kind-as employer stock, or an annuity or insurance contract. Sometimes certain withdrawal options may be associated with certain retirement plans, for instance, annuities are more common with pension plans. Other types of plan favor the other options, but for the most part most of these options are available for most plans. And more than likely, you'll want to preserve the tax shelter as long as possible by withdrawing no more than you need at any given time.

Timing your withdrawal can be a factor, too. Withdrawals before age 59 ½ risk a tax penalty. At the other end, withdrawals are generally required to start at age 72 or face a tax penalty. The only exceptions are Roth IRAs and non-owner-employees still working beyond that age.

When is it best to take a lump-sum distribution from my retirement plan?

Your personal needs should decide. You may need a lump sum to buy a retirement home or retirement business. If your employer requires that you take a lump sum distribution, it may be wise to roll it over into an IRA.

What should I do about my retirement plan assets in my ex-employer's plan if I change jobs?

There are several things you might do depending upon your needs:

1. If you don't need the assets to live on, try to continue the tax shelter and leave the money where it is.
2. Transfer or roll over the assets into your new employer's plan--if that plan allows it (this can be tricky, though).
3. If you've decided to start your own business, set up a Keogh and move the funds there.
4. Roll them over into your IRA.

Can creditors get at my retirement assets?

In general, employer plans such as your 401(k), IRAs and pension plan funds are protected from general creditors unless you've used these assets as securities against a loan or you are entering into bankruptcy. If this is the case, there's a chance they could be seized, but if the money is in a registered IRA, pension plan, or 401(k), it's more than likely they will be protected in case of bankruptcy (subject to state and federal law of course).

How will my state tax affect my retirement withdrawals?

Each state is different, but in general, consider the following:

1. While withdrawals are generally taxable in states with income tax, some offer relief for retirement income, up to a specified dollar amount.
2. If your state doesn't allow deductions for Keogh or IRA investments allowed under federal law, these investments and sometimes more may come back tax-free.
3. State tax penalties for early withdrawal (before 59 ½) or inadequate withdrawal (after age 72) are unlikely.

Can moving to another state when I retire save me state taxes on my retirement plan?

Money from retirement plans, including 401(k)s, IRAs, company pensions and other plans, is taxed according to your residence when you receive it.

If you move from a state with a high income tax, such as New York, to one with little or no income tax (Texas, Nevada and Florida have none), you will indeed save money on state income tax.

However, establishing residence in a new state may take as long as one year; if you retain property in both states, you may owe taxes to both.

IRAs: Frequently Asked Questions

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When should I use a rollover to my IRA?

That depends on your particular needs and circumstances. Here are some reasons you might want to roll over distributions to your IRA:

1. You want to, or have to, take a distribution from your employer's plan and want these funds to continue to grow tax-free in your own IRA.
2. As a self-employed individual, you are terminating your Keogh plan or retiring from business and want to continue the tax shelter for these distributions.
3. You are the beneficiary of a deceased person's retirement plan and want to continue the tax shelter for these distributions in your own IRA.

Is there a downside to an IRA rollover?

Here are some of the disadvantages of an IRA rollover:

1. Rollovers from company or Keogh plans may take away your spouse's right to share in plan assets.
2. IRAs can't claim the limited tax relief allowed on lump-sum distributions.

To avoid tax hassles, rollovers should be done between the trustees of the plans involved. In other words, the check should not be made out to you personally, but to the trustee of the rollover account.

Traditional vs Roth IRAs: Frequently Asked Questions

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What's good about investing in IRAs?

There are two types of IRAs, Traditional IRAs and Roth IRAs, both of which are discussed in this Financial Guide. Traditional IRAs defer taxation of investment income and withdrawals are taxable income--except for withdrawals of previously non-deductible contributions. In most cases, however, contributions are deductible. Roth IRAs are subject to many of the same rules as Traditional IRAs, but there are several differences, the primary one being that contributions are not deductible and are made after-tax. As such, qualified distributions are generally tax-free.

Can anyone have a traditional IRA?

If you have income from wages or self-employment income, you can contribute up to $6,000 in 2022 (same as 2021). As such, IRAs are available even to children who meet these conditions. Persons age 50 and older can contribute an additional $1,000 for a total of $7,000 in 2022 (same as 2021).

Can my stay at home spouse have an IRA?

Yes. Contributions of $6,000 for each spouse are allowed in 2022 (same as 2021) if the couple's wages or self-employment earnings are $12,000 or more. If less, the contribution amount cannot exceed you or your spouse's taxable compensation for the year.

What makes Roth IRAs so special?

Roth IRAs offer the following advantages:

- Withdrawals, if they qualify, are completely exempt from income tax, unlike all other retirement plans.
- You can quickly build up a Roth IRA account by converting traditional IRAs into Roth IRAs, but there is a tax cost.
- Since there is no age requirement for withdrawals from a Roth IRA, more money can be left in an account and passed on to heirs than is allowed under other plans.

Can anyone have a Roth IRA?

Not everyone can have a Roth IRA. The following conditions apply:

- You can't contribute to a Roth IRA for a year with income (AGI) above $144,000 if single or $214,000 on a joint return in 2022 ($140,000 and $208,000, respectively, in 2021).
- You must have earnings from personal services (at least $6,000 or more) to make the (maximum) contribution, although an additional contribution of $1,000 is allowed for persons age 50 and over.

Can I set up a Roth IRA for my spouse?

Yes, subject to the income conditions above. This allows contributions of $6,000 each if the couple's earnings are at least $12,000 in 2022($13,000 if only one of you is age 50 or older or $14,000 if both of you are age 50 or older). Each spouse can make a contribution up to the current limit; however, the total of your combined contributions can't be more than the taxable compensation reported on your joint return.

Can I set up a Roth IRA for my child?

Yes, for a child with personal service earnings, and subject to the other income conditions.

What's the downside to Roth IRAs?

The following is a brief list of negative issues regarding Roth IRAs:

- Roth IRA contributions are not tax-deductible. There's never a deduction for Roth IRA contributions.
- To build a sizable Roth IRA fund, you must convert a traditional IRA (or, after 2007, funds from an employer plan). Conversions are taxable.

> Under the new tax reform law, for taxable years beginning after December 31, 2017, if a contribution to a regular IRA has been converted into a contribution to a Roth IRA, it can no longer be converted back into a contribution to a regular IRA. This provision prevents a taxpayer from using recharacterization to unwind a Roth conversion.

What can I do if I converted to a Roth IRA and my income exceeds $100,000?

The income limit was permanently removed for tax years starting in 2010. Anyone, even those with high incomes, can convert from a traditional IRA to a Roth IRA.

What if my Roth IRA assets fall in value after conversion?

When you convert from a traditional IRA to a Roth IRA you pay taxes on the value of your account as of the conversion date. If your account loses value and the account is worth less money you'll end up paying taxes on the money you no longer have in your account.

> Say you convert $50,000 in a traditional IRA to a Roth IRA and the value drops to $35,000. If you didn't make any nondeductible contributions, the taxable distribution would be $50,000 and that would be the amount you would be paying taxes on. However, now your account is only worth $35,000. By re-characterizing the account you can avoid paying taxes on the money you no longer have ($50,000). You'll be back to a traditional IRA, but of course, the account is now worth only $35,000.

Prior to 2018, the IRS allowed you "re-characterize" the account back to a traditional IRA, essentially putting you right back where you were - at least tax-wise. However, tax reform legislation passed in 2017 repealed this special rule, and re-characterizations are no longer permitted.

How are my heirs taxed on inherited Roth IRA wealth?

Your heirs are taxed as follows:

- No tax paid on withdrawals as long as the funds have been in the Roth IRA for at least five years.
- Starting in 2020 (SECURE Act), an heir inheriting a Roth IRA must withdraw the funds within 10-years after the account owner's death (some exceptions apply). Heirs with Roth IRAs inherited prior to 2020 can spread the withdrawal over his or her life, continuing the tax shelter for amounts not withdrawn.
- Estate tax treatment is the same as for traditional IRAs.

Social Security Benefits: Frequently Asked Questions

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Who is entitled to Social Security disability benefits?

An individual who is determined by the Social Security Administration to be "disabled" receives an Award Letter, which is a notice of decision that explains how much the disability benefit will be and when payments start. It also tells you when you can expect your condition to be reviewed to see if there has been any improvement.

If family members are eligible, they will receive a separate notice and a booklet about things they need to know.

Under the Social Security disability insurance program (Title II of the Act), there are three basic categories of individuals who can qualify for benefits on the basis of disability:

- A disabled insured worker under full retirement age.
- An individual disabled since childhood (before age 22) who is a dependent of a parent entitled to Title II disability or retirement benefits or was a dependent of a deceased insured parent.
- Disabled widow or widower, age 50-60 if the deceased spouse was insured under Social Security.
- Been disabled or expected to be disabled for at least 12 months
- Has filed an application for benefits, and
- Completed a five month waiting period; however, the 5-month waiting period does not apply to individuals filing as children of workers. Under SSI, disability payments may begin as early as the first full month after the individual applied or became eligible for SSI. In addition, if you become disabled a second time within five years after your previous disability benefits stopped, there is no waiting period before benefits start.

Under Title XVI, or SSI, there are two basic categories under which a financially needy person can get payments based on disability:

- An adult age 18 or over who is disabled.
- Child (under age 18) who is disabled.

For all individuals applying for disability benefits under Title II, and for adults applying under Title XVI, the definition of disability is the same. The law defines disability as the inability to engage in any substantial gainful activity (SGA) by reason of any medically determinable physical or mental impairment(s) which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.

Meeting this definition under Social Security is difficult. Insured means that you have accumulated sufficient credits in the Social Security system. Visit the Social Security Administration's Website to apply for an estimate.

When do Social Security disability benefits begin?

If you are getting disability benefits on your own work record, or if you are a widow or widower getting benefits on a spouse's record, there is a five month waiting period and your payments will not begin until the sixth full month of disability. The 5-month waiting period does not apply to individuals filing as children of workers. Under SSI, disability payments may begin as early as the first full month after the individual applied or became eligible for SSI.

If the sixth month has passed, your first payment may include some back benefits. Your check should arrive on the third day of every month. If the third falls on a Saturday, Sunday, or legal holiday, then you will receive your check on the last banking day before that day. The check you receive is the benefit for the previous month.

> The check you receive dated July 3 is for June. Your benefit can either be mailed to you or be deposited directly into your bank account.

Are Social Security disability benefits taxable?

Some people who get Social Security have to pay taxes on their benefits. The rules are the same regardless as to whether Social Security benefits are received due to retirement or disability. If you file a federal tax return as an "individual" and your combined income is more than $25,000, you have to pay taxes. Combined income is defined as your adjusted gross income + Nontaxable interest + 1/2 of your Social Security benefits. If you file a joint return, you may have to pay taxes if you and your spouse have a combined income that is more than $32,000. If you are married and file a separate return, you will probably pay taxes on your benefits. Social Security has no authority to withhold state or local taxes from your benefit. Many states and local authorities do not tax Social Security benefits. However, you should contact your state or local taxing authority for more information.

How long do Social Security disability payments continue?

Your disability benefits generally continue for as long as your impairment has not medically improved and you cannot work. They will not necessarily continue indefinitely, however.

Because of advances in medical science and rehabilitation techniques, an increasing number of people with disabilities recover from serious accidents and illnesses. Also, many individuals, through determination and effort, overcome serious conditions and return to work in spite of them.

What happens to Social Security disability benefits when I reach retirement age?

If you are still getting disability benefits when you reach retirement age, your benefits will be automatically changed to retirement benefits, generally in the same amount. You will then receive a new booklet explaining your rights and responsibilities as a retired person.

If you are a disabled widow or widower, your benefits will be changed to regular widow or widower benefits (at the same rate) at 60, and you will receive a new instruction booklet that explains the rights and responsibilities for people who get survivors benefits.

What happens if Social Security turns down my claim for disability benefits?

If you disagree with SSA's decision, you can appeal it. You have 60 days to file a written appeal (either by mail or in person) with any Social Security office. Generally, there are four levels to the appeals process. They are:

- **Reconsideration.** Your claim is reviewed by someone who did not take part in the first decision.
- **Hearing before an Administrative Law Judge.** You can appear before a judge to present your case.
- **Review by Appeals Council.** If the Appeals Council decides your case should be reviewed, it will either decide your case or return it to the administrative law judge for further review.
- **Federal District Court.** If the Appeals Council decides not to review your case or if you disagree with its decision, you may file a civil lawsuit in a Federal District Court and continue your appeal all the way to the US Supreme Court if necessary.

If you disagree with the decision at one level, you have 60 days to appeal to the next level until you are satisfied with the decision or have completed the last level of appeal.

You have two special appeal rights when a decision is made that you are no longer disabled.

They are as follows:

- **Disability Hearing.** As part of the reconsideration process, this hearing allows you to meet face-to-face with the person who is reconsidering your case to explain why you feel you are still disabled. You can submit new evidence or information and can bring someone who knows about your disability. This special hearing does not replace your right to also have a formal hearing before an administrative law judge (the second appeal step) if your reconsideration is denied.
- **Continuation of Benefits.** While you are appealing your case, you can have your disability benefits and Medicare coverage (if you have it) continue until an administrative law judge makes his or her decision. However, you must request the continuation of your benefits during the first 10 days of the 60 days mentioned earlier. If your appeal is not successful, you may have to repay the benefits.

Will I receive Social Security when I retire?

Retirement benefit calculations are based on your average earnings during a lifetime of work under the Social Security system. For most current and future retirees, The Social Security Administration (SSA) averages your 35 highest years of earnings. Years in which you have low earnings or no earnings may be counted to bring the total years of earnings up to 35.

You can collect early retirement benefits at age 62, but keep in mind that for anyone born from 1943 to 1954, the full retirement age is age 66, and increases gradually until it reaches 67 for those born in years 1960 and later. Then you can collect additional benefits for every year you delay your retirement until age 70. After you begin to collect Social Security benefits, you will continue to receive them for life.

How can I find out what Social Security will pay me when I retire?

You can create a my Social Security account with SSA and view your Social Security Statement online at any time.

Can I count on Social Security being around when I retire?

With retirement on the horizon for scores of baby boomers, it's very likely that Social Security will be in your future; however, the Social Security trust fund will less and less able to pay benefit increases, which increase annually as the taxable wage base rises without some kind of reform.