Financial Fitness

Duncklee & Nott Monthly Newsletter

Duncklee & Nott
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Hi friends and clients!
Spring has finally come after a long winter! If you haven't filed your taxes yet, please make sure you file by April 15th, or at the very least file an extension. April 15th also marks the last possible day to get 2014 contributions into your IRA and/or Roth IRA.
With tax season and cold weather soon behind us, we can look forward to a more optimistic time of year! Enjoy your Easter and the articles this month!

Jim, Ken, Megan, Sharon, & Susie

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INVESTMENT & RETIREMENT PLANNING

Retirement Withdrawal Rates

During your working years, you've probably set aside funds in retirement accounts such as IRAs, 401(k)s, and other workplace savings plans, as well as in taxable accounts. Your challenge during retirement is to convert those savings into an ongoing income stream that will provide adequate income throughout your retirement years.

Your retirement lifestyle will depend not only on your assets and investment choices, but also on how quickly you draw down your retirement portfolio. The annual percentage that you take out of your portfolio, whether from returns or the principal itself, is known as your withdrawal rate. Figuring out an appropriate initial withdrawal rate is a key issue in retirement planning and presents many challenges.

Why is your withdrawal rate important?

Take out too much too soon, and you might run out of money in your later years. Take out too little, and you might not enjoy your retirement years as much as you could. Your withdrawal rate is especially important in the early years of your retirement, as it will have a lasting impact on how long your savings will last.

Conventional wisdom

So, what withdrawal rate should you expect from your retirement savings? One widely used rule of thumb states that your portfolio should last for your lifetime if you initially withdraw 4% of your balance (based on an asset mix of 50% stocks and 50% intermediate-term Treasury notes), and then continue drawing the same dollar amount each year, adjusted for inflation. However, this rule of thumb has been under increasing scrutiny.

Some experts contend that a higher withdrawal rate (closer to 5%) may be possible in the early, active retirement years if later withdrawals grow more slowly than inflation. Others contend that portfolios can last longer by adding asset classes and freezing the withdrawal amount during years of poor performance. By doing so, they argue, "safe" initial withdrawal rates above 5% might be possible. (Sources: William P. Bengen, "Determining Withdrawal Rates Using Historical Data," *Journal of Financial Planning,* October 1994; Jonathan Guyton, "Decision Rules and Portfolio Management for Retirees: Is the 'Safe' Initial Withdrawal Rate Too Safe?" *Journal of Financial Planning,* October 2004)

Still other experts suggest that our current environment of lower government bond yields may warrant a lower withdrawal rate, around 3%. (Source: Blanchett, Finke, and Pfau, "Low Bond Yields and Safe Portfolio Withdrawal Rates," *Journal of Wealth Management,* Fall 2013)

Don't forget that these hypotheses were based on historical data about various types of investments, and past results don't guarantee future performance.

Inflation is a major consideration

An initial withdrawal rate of, say, 4% may seem relatively low, particularly if you have a large portfolio. However, if your initial withdrawal rate is too high, it can increase the chance that your portfolio will be exhausted too quickly, because you'll need to withdraw a greater amount of money each year from your portfolio just to keep up with inflation and preserve the same purchasing power over time.

In addition, inflation may have a greater impact on retirees. That's because costs for some services, such as health care and food, have risen more dramatically than the Consumer Price Index (the basic inflation measure) for several years. As these costs may represent a disproportionate share of their budgets, retirees may experience higher inflation costs than younger people, and therefore might need to keep initial withdrawal rates relatively modest.

Your withdrawal rate

There is no standard rule of thumb. Every individual has unique retirement goals and means, and your withdrawal rate needs to be tailored to your particular circumstances. The higher your withdrawal rate, the more you'll have to consider whether it is sustainable over the long term.

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

Perhaps you have plenty of money to lend, and you're not earning much on it right now, so when your child asks for a loan, you think, "Why not?" But even if it seems to be the right thing to do, look closely at potential consequences before saying yes.

When Your Child Asks for a Loan, Should You Say Yes?

You raised them, helped get them through school, and now your children are on their own. Or are they? Even adult children sometimes need financial help. But if your child asks you for a loan, don't pull out your checkbook until you've examined the financial and emotional costs. Start the process by considering a few key questions.

Why does your child need the money?

Lenders ask applicants to clearly state the purpose for the loan, and you should, too. Like any lender, you need to decide whether the loan purpose is reasonable. If your child is a chronic borrower, frequently overspends, or wants to use the money you're lending to pay past-due bills, watch out. You might be enabling poor financial decision making. On the other hand, if your child is usually responsible and needs the money for a purpose you support, you may feel better about agreeing to the loan.

Will your financial assistance help your child in the long run?

It's natural to want to help your child, but you also want to avoid jeopardizing your child's independence. If you step in to help, will your child lean on you the next time, too? And no matter how well-intentioned you are, the flip side of protecting your child from financial struggles is that your child may never get to experience the satisfaction that comes with successfully navigating financial challenges.

Can you really afford it?

Perhaps you can afford to lend money right now, but look ahead a bit. What will happen if you find yourself in unexpected financial circumstances before the loan is repaid? If you're loaning a significant sum and you're close to retirement, will you have the opportunity to make up the amount? If you decide to loan your child money, be sure it's an amount that you could afford to lose, and don't take money from your retirement account.

What if something goes wrong?

One potential downside to loaning your child money is the family tension it may cause. When a financial institution loans money to someone, it's all business, and the repayment terms are clear-cut. When you loan money to a relative, it's personal, and if expectations aren't met, both your finances and your relationship with your child may be at risk.

For example, how will you feel if your child treats the debt casually? Even the most responsible child may occasionally forget to make a payment. Will you scrutinize your child's financial decisions and feel obligated to give advice? Will you be okay with forgiving the loan if your child is unable to pay it back? And how will other family members react? For example, what if your spouse disagrees with your decision? Will other children feel as though you're playing favorites?

If you decide to say yes

Think like a lender

Take your responsibility, and the borrower's, seriously. Putting loan terms in writing sounds too businesslike to some parents, but doing so can help set expectations. You can draft a loan contract that spells out the loan amount, the interest rate, and a repayment schedule. To avoid playing the role of parent-turned-debt collector, consider asking your child to set up automatic monthly transfers from his or her financial account to yours.

Pay attention to some rules

Having loan documentation may also be necessary to meet IRS requirements. If you're lending your child a significant amount, prepare a promissory note that details the loan amount, repayment schedule, collateral, and loan terms, and includes an interest rate that is at least equal to the applicable federal rate set by the IRS. Doing so may help ensure that the IRS doesn't deem the loan a gift and potentially subject you to gift and estate tax consequences. You or your child may need to meet certain requirements, too, if the loan proceeds will be used for a home down payment or a mortgage. The rules and consequences can be complex, so ask a legal or tax professional for information on your individual circumstances.

If you decide to say no

Consider offering other types of help

Your support matters to your child, even if it doesn't come in the form of a loan. For example, you might consider making a smaller, no-strings-attached gift to your child that doesn't have to be repaid, or offer to pay a bill or two for a short period of time.

Don't feel guilty

If you have serious reservations about making the loan, don't. Remember, your financial stability is just as important as your child's, and a healthy relationship is something that money can't buy.

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Evaluating College Acceptances

Comparing costs

To compare colleges based on costs in an apples-to-apples way, determine your out-of-pocket cost, or net price, at each college. Your out-of-pocket cost is the total cost minus any grant or scholarship aid the college is offering. Once you know your out-of-pocket cost at each college, determine how much, if anything, you or your child will need to borrow. Then calculate what the monthly loan repayment amount would be for borrowing amounts at different colleges.

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For the majority of high school seniors, spring is crunch time. Most college acceptances arrive in March or April, and a deposit must be received by the college the student plans to attend by May 1. The period of time between acceptances and deposit can be intense as students and their parents weigh a number of factors. Here are two questions to ask as your family evaluates college acceptances.

How well does the college meet your child's needs?

Presumably, all the colleges your child applied to would do a good job of meeting your child's needs; otherwise he or she wouldn't have applied there in the first place. But now that your child has a definite list of options, it's time to look at things a little more closely.

Most colleges host an accepted students day geared exclusively to incoming students. Even if your child has already visited the college, visiting again might be helpful. Your child will meet other accepted students, hear in more detail about the offerings related to academics, extracurricular activities, and student life, and possibly notice things on campus that he or she might have missed the first time around. Some colleges even offer overnight stays in the dorms that can give your child an extra taste of life at that college. Your child might also have the opportunity to explore the surrounding area and see what it would be like to travel back and forth from home. Does the college still have the same appeal that it did when your child applied? If not, why?

If your child can't visit, there are other ways to do additional research. Your child might e-mail a particular department, professor, or student ambassador with specific questions. Your child could also browse online forums for student reviews of specific colleges. While no college is immune from the occasional "sour grapes" reviewer, there might be a ring of truth to a particular issue if more than one student brings it up across multiple forums. At the very least, a cluster of negative reviews might prod your child to investigate further.

Finally, don't overlook academic flexibility. Many college students end up changing their majors down the road. If your child decided to change majors, would he or she be able to find another one relatively easily? Or is the school very focused in one area--for example, business, creative, or technology--where that would be difficult?

What is the cost to you and your child?

Parents of college-bound kids have likely seen the steady stream of news stories about skyrocketing student loan debt and the debilitating effects of taking on too much debt. For many parents, a thorough review of the affordability of each college is mandatory.

A college acceptance packet should include a detailed breakdown of any financial aid the college is offering, whether it's loans, grants, scholarships (need-based or merit-based), or a work-study job. Make sure to read the fine print carefully and understand *exactly* what the college is offering. For example, a college might say, "Congratulations! You've been awarded $25,000..." which you might think is a scholarship but which actually includes $5,500 in loans. As you review the award, keep in mind that if a college says it is meeting "100% of your demonstrated need," the college is the one who defines your need, not you.

The goal is to compare your out-of-pocket cost at each college. To do this, look at the total cost of attendance for each school (this figure includes tuition and fees, room and board, plus a discretionary sum for books, personal expenses, and transportation). Next, list any grants or scholarships the college is offering--this is "free" money. If the grant or scholarship is merit-based, find out whether it's guaranteed for all four years and the requirements that must be met to qualify each year (for example, a 3.5 minimum GPA, participation in certain activities). If the grant or scholarship is need-based, find out whether you can expect a similar amount each year as long as your income and assets stay roughly the same (and you have the same number of children in college), and ask whether it increases each year to match any annual increases in tuition or room and board.

The difference between a college's total cost of attendance and any grant or scholarship aid is your out-of-pocket cost or "net price." Compare your net price across all colleges. Next, with your net price in hand, determine how much, if anything, you or your child will need to borrow. Multiply this figure by four to get an idea of what your total borrowing costs might be over four years. Then use a loan repayment calculator to show your child what the monthly loan repayment would be over a standard 10-year term at a fixed interest rate. Armed with this information, you'll be in a better position to make a sound financial decision for your family.

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I owe a large amount of money to the IRS. Can I pay what I owe in installments?

Unfortunately, not everyone gets a refund during tax season. If you are in the unenviable position of owing a large amount of money to the IRS, you may be able to pay what you owe through an installment agreement with the IRS.

With an installment agreement, the amount of your payment will be based on how much you owe in unpaid taxes and your ability to pay that amount within the agreement's time frame. Although you are generally allowed up to 72 months to pay, your plan may be for a shorter length of time.

To request an installment agreement, fill out Form 9465, Installment Agreement Request, and attach it to your tax return, or mail it by itself directly to your designated Internal Revenue Service Center. If your balance due is not more than $50,000, you can apply for an installment agreement online at IRS.gov.

The IRS will generally let you know within 30 days after receiving your request whether it is approved or denied (if you apply online, you'll get immediate notification of approval). If the request is approved, the IRS will send you a notice detailing the terms of your agreement. You will also be required to pay a fee of $120 ($52 if you make your payments by direct debit). You can make your payments by check, money order, credit card, payroll deduction, or direct debit from your bank account.

Keep in mind that even if your request for an installment agreement is granted, you will still be charged interest and may be charged a late-payment penalty on any tax not paid by its due date. This interest and any applicable penalties will be charged until the balance you owe to the IRS is paid in full.

It is important to realize that the fees and interest charged by the IRS for an installment agreement can add up. As a result, before you enter into an installment agreement, the IRS suggests that you consider other alternatives, such as getting a bank loan or using available credit on a credit card.

Will I have to pay a penalty tax if I don't have qualifying health insurance?

It depends. One of the main objectives of the health-care reform law, the Patient Protection and Affordable Care Act (ACA), is to encourage uninsured individuals to obtain health-care coverage. As a result of the ACA, everyone must have qualifying health insurance coverage, qualify for an exemption, or pay a penalty tax. This requirement is generally referred to as the individual insurance or individual shared responsibility mandate.

Health insurance plans that meet the requirements of the ACA generally include employer-sponsored health plans, government health plans, and health insurance purchased through state-based or federal health insurance exchange marketplaces.

Individuals who are exempt from the individual insurance mandate include:

- Those who qualify for religious exemptions
- Certain noncitizens
- Incarcerated individuals
- Members of federally recognized American Indian tribes
- Those who qualify for a hardship exemption

Individuals may also qualify for an exemption if:

- They are uninsured for less than three months
- The lowest-priced insurance coverage available to them would cost more than 8% of their income
- They are not required to file an income tax return because their income is below a specified threshold

For tax year 2014, the penalty tax equals the greater of 1% of the amount of your household income that exceeds a specific amount (generally, the standard deduction plus personal exemption amounts you're entitled to for the year) or $95 per uninsured adult (half that for uninsured family members under age 18), with a maximum household penalty of $285. In 2015, the percentage rate increases to 2%, the dollar amount per uninsured adult increases to $325, and the maximum household penalty increases to $975.