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INVESTMENT HOUSE, LLC

Financial Solutions Under One Roof

Financial Myths, Mistakes, and Misunderstandings

Throughout our financial lives, we may be influenced by myths, mistakes, and misunderstandings (MMMs). Here are just a few.

In the beginning . . .

"I don't invest because I don't know much about it." It's time to learn, because a basic understanding of investing concepts can help you make more informed financial decisions.

"Wow, they'll give me that much credit! I must be able to handle it." Just because the credit-card company or bank extends a large amount of credit to you, it doesn't mean you should use all of it. The more you borrow, the larger the monthly payments, and before you know it, you've bitten off more than you can chew. Figure out how much you'll owe based on the amount you borrow and determine if it will fit within your budget. Generally speaking, if you can't afford the payment, don't incur the debt.

"I'm young. I'll worry about retirement when I'm older." Planning for retirement involves saving enough by a desired age to enable you to support yourself without having to work. If you wait to begin saving for retirement, you'll have to sock more away or put off retirement to a later date. So the earlier you begin saving, the better.

Go figure

Sometimes we think we know something and rely on it as being correct, when in fact it couldn't be further from the truth.

"I know my finances like the back of my hand. I don't need to write them down." You'd be surprised how often we think we know how much we can afford until our bills start to exceed our income. If you write down your expenses and income (e.g., create a spending plan or budget), you'll know how much you can spend.

"I'll dip into my retirement account and make it up later." First, if you borrow from your 401(k), you'll likely pay fees and interest. If you take money from a traditional IRA, you'll pay income tax on the amount you take and possibly a 10% penalty. Remember, these accounts are intended for retirement. Taking money out now increases the risk you might run out of money during retirement.

"My child will pay back the money I loaned to him or her." Good luck. That "loan" is probably going to turn into a gift, which isn't necessarily a bad thing if it really helps your child, but be sure you can afford the loan/gift before making it.

And later on . . .

As we get older, we may fall prey to some MMMs that can be the source of needless angst, such as:

"I won't need as much income in retirement." Maybe, but it might be a mistake to count on it. In fact, in the early years of retirement, you may find that you spend just as much money, or maybe more, than when you were working, especially if you are still paying a mortgage. And don't forget to factor in increasing health-care costs.

And speaking of health care, **"the new health-care law cuts my basic Medicare benefits and services."** Just the opposite is true. The Affordable Care Act (ACA) mandates that no guaranteed Medicare benefits are cut. In fact, the ACA expands Medicare benefits to include a free annual wellness assessment.

And finally, **"If I die without a will, the state will get my assets and property."** This isn't necessarily true. Each state has intestacy laws, which determine who gets what when someone dies without a will. But those laws generally deal with assets in your name at your death that don't have a designated beneficiary or joint owner. In any case, if you want to have some say in who will inherit your assets after your death, you need to prepare an estate plan, which probably includes a will.

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Retiring and Relocating? Don't Neglect State Taxes!

For an accurate comparison among the states, you'll need to consider your total tax burden. A tax professional can assist you in this task.

If you're retired, or about to retire, you may be thinking about relocating to a state that has low tax rates or provides special tax benefits to retirees. Here's a survey that may jump-start your search for a tax-friendly state in which to spend your golden years.

State income taxes in general

State income taxes typically account for a large percentage of the total taxes you pay. So you may consider yourself lucky if you live in one of the seven no-income-tax states: Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. (New Hampshire and Tennessee impose income tax only on interest and dividends.)

But if you're considering a state that does impose an income tax, as a retiree you'll want to know how that state treats Social Security and retirement income.

State income taxes and Social Security

Social Security income is completely exempt from tax in 28 of the states with an income tax (as well as the District of Columbia): Alabama, Arizona, Arkansas, California, Delaware, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Mississippi, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, South Carolina, Virginia, and Wisconsin.

Some states (for example, Connecticut, Kansas, Missouri, and Montana) don't tax Social Security benefits if income is less than a specified dollar amount (Nebraska joins this list in 2015). And at least three states (Colorado, Utah, and West Virginia) provide a general income exclusion or credit for seniors that takes Social Security into account. Most of the remaining states tax Social Security benefits to the same extent they're taxed under federal law.

State income taxes and retirement income

Of the states with an income tax, most provide at least some relief for retirement income, but this can range from a credit of less than $500 (Ohio and Utah) to an exclusion for all or most retirement income (Hawaii, Illinois, and Mississippi). Only a handful of states, including California, Nebraska, North Carolina, North Dakota, Rhode Island, and Vermont, currently tax all retirement income and don't provide any general income exclusion for seniors.

Make sure you understand how your particular type of retirement income is treated. Some states exempt public pensions, but tax private pensions; or exempt public pensions earned in that state, but not public pensions earned in another state. Some states exempt employer retirement benefits, but not IRA income. Others exempt a specific dollar amount of retirement income, but only if you've reached a certain age or have income within certain limits. In some states, military pensions are partially or fully exempt, while in others they're fully taxable. Some states exempt defined benefit pension payments, but tax 401(k) distributions. A good source for information is your state's Department of Revenue website.

Can the state I'm moving *from* tax my benefits?

What happens if you spent your working life in a state like California that fully taxes retirement income, but you relocate after you retire to Florida, a state that has no income tax? Can California tax your pension benefit? While the answer used to be unclear, federal law now clearly prohibits states from taxing certain retirement income unless you're a resident of, or domiciled in, that state.

Whether you're considered a resident of, or domiciled in, a state is determined by the laws of that particular state. In general, your residence is the place you actually live. Your domicile is your permanent legal residence--even if you don't currently live there, you have an intent to return and remain there. So in our example, if you're no longer a resident of, or domiciled in, California, that state cannot tax your pension benefit under federal law.

The law applies to all qualified plans (for example, 401(k), profit-sharing, and defined benefit plans), IRAs, 403(b) plans, 457(b) plans, and governmental plans.

The law provides only limited protection for other (nonqualified) deferred compensation plan benefits. So-called "top-hat" plan benefits that are paid over an employee's lifetime, or over a period of at least 10 years, are covered by the law. But stock options, stock appreciation rights (SARs), and restricted stock are not; states are free to tax these benefits even after you relocate.

Other considerations

Remember that states impose many other kinds of taxes (for example, sales, real estate, and gift and estate taxes). Some states offer special tax breaks to seniors, like property tax reductions or additional exemptions, standard deductions, or credits based on age. For an accurate comparison among the states, you'll need to consider your total tax burden. A tax professional can assist you in this task.

Leaving Assets to Your Heirs: Income Tax Considerations

An inheritance is generally worth only what your heirs get to keep after taxes are paid. Here we have focused primarily on federal income taxes. Depending on your circumstances, you may wish to also consider federal estate tax and state income, estate, and inheritance taxes.

Note: It is generally recommended that you designate IRA and other retirement plan beneficiaries, their shares, and any backup beneficiaries on the plan beneficiary form. This will help assure that retirement plan benefits pass as you wish at your death and that a beneficiary will be able to stretch distributions over his or her remaining life expectancy.

An inheritance is generally worth only what your heirs get to keep after taxes are paid. So when it comes to leaving a legacy, not all property is created equal--at least as far as federal income tax is concerned. When evaluating whom to leave property to and how much to leave to each person, you might want to consider how property will be taxed and the tax rates of your heirs.

Favorable tax treatment for heirs

Roth IRAs

Assets in a Roth IRA will accumulate income tax free and qualified distributions from a Roth IRA to your heirs after your death will be received income tax free. An heir will generally be required to take distributions from the Roth IRA over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is your beneficiary, your spouse can treat the Roth IRA as his or her own and delay distributions until after his or her death. So your heirs will be able to continue to grow the assets in the Roth IRA income tax free until after the assets are distributed; any growth occurring after funds are distributed may be taxed in the future.

Note: *The Supreme Court has ruled that inherited IRAs are not retirement funds and do not qualify for a federal exemption under bankruptcy. Some states may provide some protection for inherited IRAs under bankruptcy. You may be able to provide some bankruptcy protection to an inherited IRA by placing the IRA in a trust for your heirs. If this is a concern of yours, you may wish to consult a legal professional.*

Appreciated capital assets

When you leave property to your heirs, they generally receive an initial income tax basis in the property equal to the property's fair market value (FMV) on the date of your death. This is often referred to as a "stepped-up basis," because basis is typically stepped up to FMV. However, basis can also be "stepped down" to FMV.

If your heirs sell the property with a stepped-up (or a stepped-down) basis immediately after your death for FMV, there should be no capital gain (or loss) to recognize since the sales price will equal the income tax basis. If they sell the property later for more than FMV, any appreciation after your death will generally be taxed at favorable long-term capital gain tax rates. If the appreciated assets are stocks, qualified dividends received by your heirs will also be taxed at favorable long-term capital gain tax rates.

Note: *If your heirs receive property from you that has depreciated in value, they will receive a basis stepped down to FMV and will not be able to claim any loss with respect to the depreciation before your death. You may want to consider selling depreciated property while you are alive so that you can claim the loss.*

Not as favorable tax treatment for heirs

Tax-deferred retirement accounts

Assets in a tax-deferred retirement account (including a traditional IRA or 401(k) plan) will accumulate income tax deferred within the account. However, distributions from the account will be subject to income tax at ordinary income tax rates when distributed to your heirs (if there were nondeductible contributions made to the account, the nondeductible contributions can be received income tax free). An heir will generally be required to take distributions from the tax-deferred retirement account over his or her remaining life expectancy. (Of course, your beneficiaries can always withdraw more than the required minimum amounts.) If your spouse is the beneficiary of the account, the rules may be more favorable. So your heirs will be able to defer taxation of the retirement account until distribution, but distributions will generally be fully subject to income tax at ordinary income tax rates.

Note: *Your heirs do not receive a stepped-up (or stepped-down) basis in your retirement accounts at your death.*

Even though distributions are taxable, your heirs will nevertheless generally appreciate receiving tax-deferred retirement accounts from you. After all, they do get to keep the amounts remaining after taxes are paid.

Toxic or underwater assets

Your heirs might not appreciate receiving property that is subject to a mortgage, lien, or other liability that exceeds the value of the property. In fact, an heir receiving such property may want to consider disclaiming the property.

Always nice to receive

Life insurance and cash

Life insurance proceeds received by your heirs will generally be received income tax free. Your heirs can generally invest life insurance proceeds and cash they receive in any way that they wish. When doing so, yours heirs can factor in how the property will be taxed to them in the future.

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What factors could negatively impact my credit report?

Having a good credit report is important when it comes to personal finance, because most lenders use credit reports to evaluate the creditworthiness of a potential borrower. Borrowers with good credit are presumed to be more creditworthy and may find it easier to obtain a loan, often at a lower interest rate.

A number of factors could negatively impact your credit report, including:

- *A history of late payments.* Your credit report provides information to lenders regarding your payment history over the previous 12 to 24 months. For the most part, a lender may assume that you can be trusted to make timely monthly debt payments in the future if you have done so in the past. Consequently, if you have a history of late payments and/or unpaid debts, a lender may consider you to be a high credit risk and turn you down for a loan.
- *Too many credit inquiries.* Each time you apply for credit, the lender will request a copy of your credit history. The lender's request then appears as an inquiry on your credit report. Too many inquiries in a short amount of time could be viewed negatively by a potential lender, since it may indicate that the borrower has a history of being turned down for loans or has access to too much credit.
- *Not enough good credit.* You may have good credit, but not enough of it. As a result, you may need to build up more of your credit history before a lender deems you worthy to take on any additional debt.
- *Uncorrected errors on your report.* Uncorrected errors on a credit report could make it difficult for a lender to accurately evaluate creditworthiness, and could result in a loan denial. If you have errors on your credit report, it's important to take steps to correct your report, even if it doesn't contain derogatory information.

Finally, if you are ever turned down for a loan, there is a way to find out the reason behind it. Under federal law, you are entitled to a free copy of your credit report as long as you request it within 60 days of receiving notice of a company's adverse action against you. For more information, visit the Federal Trade Commission's website.

I'm looking to buy a home. What are some common mortgage mistakes to avoid?

Navigating the complex world of mortgages can be difficult. As a result, it's easy to make mistakes when applying for a mortgage loan.

Here are some common mortgage mistakes you should try to avoid:

- *Taking on a mortgage that is too big for you to handle.* The mortgage you are qualified or preapproved for isn't necessarily how much you can afford. Be sure to examine your budget and lifestyle to make sure that your mortgage payment--including any extras, such as mortgage insurance--is within your means.
- *Neglecting to read the fine print.* Before you sign any paperwork, make sure that you fully understand the terms of your mortgage loan and the costs associated with it. For example, are you are applying for an adjustable-rate mortgage? If so, it's important to be aware of how and when the interest rate for the loan will adjust.
- *Overlooking your credit.* A positive credit history may not only make it easier to obtain a mortgage loan, but potentially could also result in a lender offering you a lower interest rate. Be sure to review your credit report and check it for inaccuracies. You may have to take the necessary steps to improve your credit history, such as paying your monthly bills on time and limiting credit inquiries on your credit report (which are made every time you apply for new credit).
- *Putting down too little.* While it is possible to obtain a mortgage with a minimal down payment, a larger down payment may help you get more attractive mortgage terms. In addition to requiring private mortgage insurance, lenders generally offer lower loan limits and higher interest rates to borrowers who have a down payment of less than 20% of a home's purchase price.
- *Forgetting to shop around.* Be sure to shop around among various lenders and compare the types of loans offered, along with the costs and rates associated with those loans. Consider each lender's customer service reputation as well.

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