



## Princeton Retirement Planning

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This is the time of year when most of us are sitting down with our accountants or tax preparers. This is a great opportunity to review exactly how much you're contributing to your retirement plan (401k, 403b, 457, IRAs, etc). We can help you figure out how to maximize your retirement plan.

Also, did you know that if you're age 50 or older, you can defer *more* than the stated "maximum deferral"?

Please feel free to give us a call to discuss your personal situation.

Best regards,

Kevin

## March 2013 & Retirement Reminders

Making the Most of Your 401(k) Plan

Looking Backward and Forward on Entitlement Programs

Why a GRAT Can Be GREAT

I refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?



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RETIREMENT PLANNING & WEALTH MANAGEMENT, LLC

## Making the Most of Your 401(k) Plan



A 401(k) plan represents one of the most powerful retirement savings opportunities available today. If your employer offers a 401(k) plan and you're not participating in it, you should be.

### Contribute as much as possible

The more you can save for retirement, the better your chances of enjoying a comfortable retirement. If you can, max out your contribution up to the legal limit (\$17,500 in 2013, \$23,000 if you're age 50 or older). If you need to free up money to do that, try to cut certain expenses. (Note: some plans limit the amount you can contribute.)

Why invest your retirement dollars in a 401(k) plan instead of somewhere else? One reason is that your pretax contributions lower your taxable income for the year. This means you save money in taxes immediately when you contribute to the plan--a big advantage if you're in a high tax bracket. For example, if you earn \$100,000 a year and contribute \$17,500 to a 401(k) plan, you'll only pay federal income taxes on \$82,500 instead of \$100,000.

Another reason is the power of tax-deferred growth. Any investment earnings compound year after year and aren't taxable as long as they remain in the plan. Over the long term, this gives you the opportunity to build a substantial sum in your employer's plan. (Your pretax contributions and any earnings will be taxed when paid to you from the plan.)

### Consider Roth contributions

Your 401(k) plan may also allow you to make after-tax Roth contributions. Unlike pre-tax contributions, Roth contributions don't lower your current taxable income so there's no immediate tax savings. But because you've already paid taxes on those contributions, they're free from federal income taxes when paid from the plan. And if your distribution is "qualified" (that is, the distribution is made after you satisfy a five-year holding period, and after you reach age 59½, become disabled, or die)

any earnings are also tax free.

If your distribution isn't qualified, any earnings you receive are subject to income tax. A 10% early distribution penalty may also be imposed if you haven't reached age 59½ (unless an exception applies).

### Capture the full employer match

Many employers will match all or part of your contributions. If you can't max out your 401(k) contributions, you should at least try to contribute as much as necessary to get the full employer match. Employer matching contributions are basically free money. By capturing the full benefit of your employer's match, you'll be surprised how much faster your balance grows. If you don't take advantage of your employer's generosity, you could be passing up a significant contribution towards your retirement.

### Access funds if you must

Another beneficial feature that many 401(k) plans offer is the ability to borrow against your vested balance at a reasonable interest rate. You can use a plan loan to pay off high-interest debts or meet other large expenses, like the purchase of a car. You typically won't be taxed or penalized on amounts you borrow as long as the loan is repaid within five years. Immediate repayment may be required, however, if you leave your employer--if you can't repay the loan, you may be treated as having taken a taxable distribution from the plan.

And remember that when you take a loan from your 401(k) plan, the funds you borrow are generally removed from your plan account until you repay the loan, so you may miss out on the opportunity for additional tax-deferred investment earnings. So loans (and withdrawals if available) should be a last resort.

### Evaluate your investment choices

Choose your investments carefully. The right investment mix could be one of your keys to a comfortable retirement. That's because over the long term, varying rates of return can make a big difference in the size of your 401(k) plan account.



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### An unsustainable path

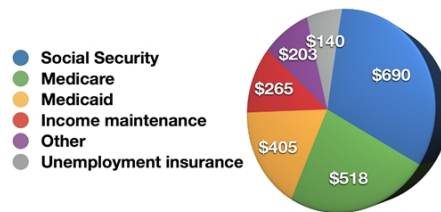
The bipartisan Bowles/Simpson Deficit Reduction Commission stated that "our nation is on an unsustainable fiscal path" in regard to entitlement spending.

## Looking Backward and Forward on Entitlement Programs

Last year's presidential election, along with the more recent fiscal cliff and debt ceiling negotiations, have put the spotlight on our nation's tax policy, deficit, and entitlement programs. For some, entitlement programs are necessary--a social compact for America in an era of longer life spans, the decline of employer-provided pensions and health insurance in retirement, and a widening gap between the haves and the have-nots. For others, the current level of entitlement spending is jeopardizing our country's fiscal health and creating an "entitlement lifestyle." No matter where you stand in the debate, do you know the basic facts on our country's largest entitlement programs?

### Where the money goes

All entitlement spending isn't created equal. The "Big Three" of Social Security, Medicare, and Medicaid account for more than two-thirds of all federal entitlement spending. Social Security and Medicare are primarily age-based programs, whereas Medicaid is based on income level. According to the U.S. Bureau of Economic Analysis, in 2010, the federal government spent a total of \$2.2 trillion on entitlement programs, with the Big Three accounting for \$1.6 trillion of this total. The largest expenditure was for Social Security (\$690 billion), followed by Medicare (\$518 billion) and Medicaid (\$405 billion).



### A history of growth

Alexis de Tocqueville, the famous French political thinker who traveled to the United States in the early 1830s and wrote about the uniqueness of our young nation's individual self-reliance in his famous book, *Democracy in America*, would likely be surprised to observe the growth in spending on entitlement programs that has occurred in the United States over the past 50 years. According to the Bureau of Economic Analysis, in 1960, U.S. government transfers to individuals totaled about \$24 billion in current dollars. By 2010, that figure was \$2.2 trillion, almost 100 times as much.

### Current status

Let's look at our two main entitlement

programs--Social Security and Medicare.

**Social Security.** Created in 1935, Social Security is a "pay-as-you-go" system, meaning that payments to current retirees come primarily from payments into the system by current wage earners in the form of a 12.4% Social Security payroll tax (6.2% each from employee and employer). These payroll taxes are put into two Social Security Trust Funds, which also earn interest. According to projections by the Social Security Administration, the trust funds will continue to show net growth until 2022, after which, without increases in the payroll tax or cuts in benefits, fund assets are projected to decrease each year until they are fully depleted in 2033. At that time, it's estimated that payroll taxes would only be able to cover approximately 75% of program obligations.

**Medicare.** Created in 1965, Medicare is a national health insurance program available to all Americans age 65 and older, regardless of income or medical history. It consists of Part A (hospital care) and Part B (outpatient care)--which together make up "traditional" Medicare; Part C (Medicare Advantage, which is private insurance partly paid by the government); and Part D (outpatient prescription drugs through private plans only). Medicare Part A is primarily funded by a 2.9% Medicare payroll tax (1.45% each from employee and employer), which in 2013 is increased by 0.9% for employees with incomes above \$200,000 (single filers) or \$250,000 (married filing jointly). In addition, starting in 2013, a new 3.8% Medicare contribution tax on the net investment income of high-earning taxpayers will take effect.

Looking ahead, Medicare and Medicaid are expected to face the most serious financial challenges, due primarily to increasing enrollment. The Congressional Budget Office, in its report *Budget and Economic Outlook: Fiscal Years 2012 to 2022*, predicts that federal spending on Medicare will exceed \$1 trillion by 2022, while federal spending on Medicaid will reach \$605 billion (state spending for Medicaid is also expected to increase). According to the CBO, reining in the costs of Medicare and Medicaid over the coming years will be the central long-term challenge in setting federal fiscal policy.

### Reform

There has been little national consensus by policymakers on how to deal with rising entitlement costs. At some point, though, reform is inevitable. That's why it's a good idea to make sure your financial plan offers enough flexibility to accommodate an uncertain future.



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## Why a GRAT Can Be GREAT



**A GRAT that is structured so that the annuity payments to you are high enough to result in a gift valued at zero is known as a "zeroed out" GRAT. With this type of GRAT, since there is no gift, no gift tax is due and no applicable exclusion amount is used.**

If you have property that's rapidly appreciating or generating high earnings, and you're ready to pass it down to your children or other heirs but want to continue receiving income from the property for a period of years, a GRAT, which stands for grantor retained annuity trust, may be a great strategy for you. The goal of a GRAT is to transfer property with minimal gift tax consequences.

A GRAT is an irrevocable trust into which you make a onetime transfer of property, and from which you receive a fixed amount each year for a specified number of years (the annuity period). At the end of the annuity period, the property remaining in the trust (the remainder interest) is distributed to the beneficiaries you've named in the trust document.

### Potential tax benefits of a GRAT

A transfer of property to an irrevocable trust is a taxable gift. The value of the gift on which gift tax is imposed is generally its fair market value. However, because you retain an interest in a GRAT, the value of the transfer is discounted; gift tax is imposed only on the remainder interest (and any gift tax due may be sheltered by your applicable exclusion amount).

This taxable value is calculated using an interest rate provided by the IRS (known as the discount rate or Section 7520 rate), which is based on current interest rates and changes monthly. This interest rate assumes the GRAT property will earn a certain rate of return during the annuity period. Any actual return that exceeds the assumed return passes to the remainder beneficiaries free from gift and estate tax. Investment performance, therefore, is central to this strategy.

**Tip:** The current low Section 7520 rates are very beneficial for GRATs.

### ... and the catch

The catch to this strategy is that you must outlive the annuity period. If you die before the annuity period expires, the value of the property in the trust on the date of your death will be included in your estate for estate tax purposes. This, however, merely puts you in the same position you would have been in had you not used the GRAT (except for the costs to create and maintain the trust).

**Tip:** In order to reduce the risk that the grantor will not outlive the annuity period, annuity periods as short as two years are often used. Sometimes a series of these short-term GRATs are used.

**Note:** It may be advisable for the remainder beneficiaries to buy life insurance on your life

(the life of the grantor) so that funds will be available to pay the estate taxes in case the GRAT property is included in your estate due to your early death.

### The risk

The key to this strategy is investment performance. If the trust property does not outperform the discount rate, there will be no excess return, and no tax savings will be achieved.

### ... and other drawbacks

Gifts of present interests qualify for the annual gift tax exclusion. But, because the gift to the remainder beneficiaries is a future interest, not a present interest, transfers to a GRAT do not qualify for the annual exclusion.

Additionally, a GRAT is generally not appropriate for making gifts to grandchildren or other skip persons (persons who are more than one generation below you). That is because there are rules that prevent you from allocating your generation-skipping transfer (GST) tax exemption until the annuity period expires. Because you cannot effectively leverage your GST tax exemption, a GRAT should not be used for generation-skipping transfer tax planning.

Finally, property transferred by reason of your death will receive a step-up (or step-down) in income tax cost basis (i.e., the property's value will generally be increased to its fair market value on the date of your death); property that is transferred during your lifetime by gift does not receive a step-up in basis. Losing the step-up in basis may mean significant capital gains taxes for the remainder beneficiaries.

### Other considerations

Some property that may be appropriate for a GRAT includes:

- High-yield or high-growth investment portfolio
- Commercial rental property
- Closely held stock
- Family limited partnership (FLP) interests
- Any property with appreciation potential, such as real property, precious metals, and artwork

A GRAT is usually considered a grantor-type trust for income tax purposes. All income, gains, deductions, and losses flow through to you on your personal income tax return. The GRAT document must be precisely drafted for the property to receive GRAT tax treatment. You should consult an experienced estate planning attorney if you are considering this strategy.



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## I refinanced my mortgage loan last year. Can I deduct any of the costs associated with refinancing the loan?

Now more than ever, homeowners are taking advantage of historically low interest rates and refinancing their mortgage loans. Did you pay points to your lender when you refinanced your loan? If so, you may be able to deduct them.

Points are costs that a lender charges when you take out a mortgage loan or refinance an existing mortgage loan on your home. One point equals 1% of the loan amount borrowed (e.g., 2 points on a \$300,000 loan equals \$6,000).

In order for points to be deductible, they must have been charged by your lender as up-front interest in return for a lower interest rate on your loan. If the points were charged for services provided by the lender in preparing or processing the loan, then the points are not deductible.

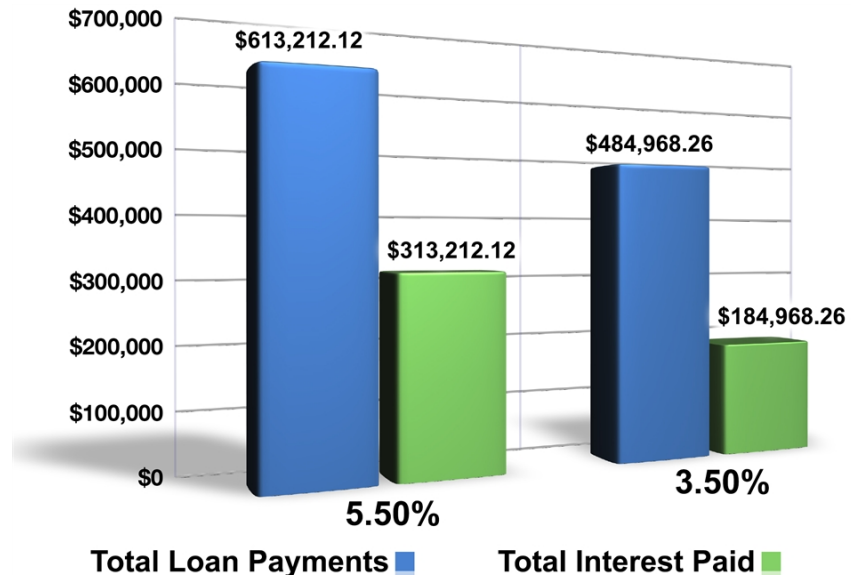
When deducting points, keep in mind that unlike points paid on a loan used to purchase a home, points paid on a refinanced loan usually cannot be deducted in the year that you paid them. Instead, the points may need to be amortized over the life of the loan.

For example, assume that you refinanced to a \$300,000/30-year mortgage loan and paid \$6,000 in points. You would be able to deduct 1/30 of those points each year over the 30-year loan period, or \$200 per year.

The one exception to the amortization rule is if part of your refinanced loan is used to make improvements to your primary residence. In that case, you may be able to deduct the portion of the points that is allocable to the home improvements in the year that the points are paid. In addition, if you choose to refinance again or sell your home in the future, you can generally claim the entire unamortized deduction that remains. For more information on the deductibility of points, you can refer to [IRS Publication 936](#).

As for other costs you may have incurred from refinancing, such as recording, title search, appraisal, and attorney's fees, they are not deductible. Furthermore, unlike costs associated with a home purchase, costs associated with a refinance cannot be added into the cost basis (value) of your home for income tax purposes.

The Potential Benefits of Refinancing Your Mortgage



Assuming a \$300,000/30-year fixed-rate mortgage

This is a hypothetical example and does not reflect all of the costs that may be associated with refinancing. Actual results may vary.

