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How to Takeover an Aging Parent's Finances

Like many difficult situations with people we love, planning to take over an older relative's finances is best done in happier times, when both sides are healthy and various options can be considered. Unfortunately, events can sometimes intervene – death, illness or natural disasters can make an elder's need for assistance a critical matter.

Once stricken, older relatives may be unable to understand questions or express their wishes in proper detail. If there is no plan, family members grasp at responsibilities – or shirk them – without any idea of what the older relative would really want.

What's critical to understand is that such talks should go far beyond money. They need to be discussions about independence and basic preferences for the way an individual wants to live or die. Demographers believe that with the rising number of single Americans – those divorced or never married – these conversations will become increasingly complicated as they fall to nieces and nephews, younger friends or designated representatives, such as Vigil Trust.

Want to avoid a worst-case scenario? Start the conversation now. Here are some ideas:

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VIGIL Strategies

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The Social Security "Supertax"

Over the years we have seen very little written on the subject of Social Security taxation. But in certain situations, understanding how Social Security benefits are taxed and planning for this tax in consideration of taxable capital gains arising from your investment activities and in connection with planning for distributions from your IRA can result in a significant tax difference in how much tax you owe.

The Social Security Tax Rule

We are talking here about the tax you pay on Social Security you receive; this is NOT to be confused with Social Security *eligibility*. Once you are eligible and receiving Social Security, you may or may not pay tax on those benefits.

To determine the amount of tax you pay on Social Security, take 50% of your Social Security benefits received for the year and add to that your other income. If this total is less than \$32,000 (\$25,000 for single persons), you pay no tax on your Social Security benefits. You will pay tax on 50% of the Social Security benefit above that floor and if your total exceeds \$44,000 (\$34,000 for single persons) you pay tax on 85% of the amount of Social Security benefits to the extent you exceed that limit.

How are IRA Distributions Affected?

IRA distributions are considered as "other income" for the purpose of the Social Security taxation formula discussed above. If you take a distribution out of your IRA, we all understand you will pay tax on that distribution. However, in certain situations taking money out of your IRA can cause the tax on your Social Security to increase (your benefits don't change, but the amount of tax you have to pay increases), meaning that the effective tax rate on your IRA distribution is the tax on that distribution *plus* the extra tax you have to pay on your Social Security benefits because of that distribution. Consider the following:

Single retiree A has Social Security benefits of \$24,000 per year, a little job paying \$4,000 per year and \$6,000 per year of taxable interest and dividends. The Social Security taxation formula above says Retiree A pays no tax on his Social Security (i.e., 1/2 of \$24,000 (\$12,000) plus \$4,000 plus \$6,000 is \$22,000, which is less than the \$25,000 floor for single people).

However, if Retiree A takes \$10,000 out of his IRA this year, not only will he pay tax on the IRA distribution, but he will now pay tax on \$3,500 of his Social Security that was otherwise tax-free to him (\$22,000 other income plus \$10,000 IRA distribution means "income" is \$32,000; \$32,000 minus \$25,000 is \$7,000 of Social Security that is subject to 50% inclusion).

We call this the Social Security "Supertax" – unsuspectingly creating or increasing tax on Social Security benefits because of other taxable income you receive.

What about Capital Gains?

Same situation as above. Yes, capital gains are still subject to a very favorable tax rate on the gain itself during 2008. However, the full amount of the capital gain is added into the income formula for determining the taxation of Social Security benefits. For example:



Let's say that in addition to the above, Retiree A has some investments in mutual funds. While the mutual fund performance has not been good this year, the funds are forced to make a capital gain distribution of \$12,000 because a wave of redemptions from the funds due to poor performance have caused the fund to have to distribute capital gains to shareholders.

Retiree A's income will be \$44,000 (\$32,000 plus \$12,000 of capital gains). \$10,000 of Social Security (\$44,000 minus \$34,000 limit) will have an inclusion of 85% and \$9,000 (\$34,000 minus \$25,000 floor) will have an inclusion of 50%.

So by virtue of having taken a \$10,000 IRA distribution and having received a \$12,000 capital gain distribution from his mutual funds, Retiree A will pay tax on the IRA distribution, tax on the capital gains **PLUS tax on \$13,000 of previously tax-free Social Security benefits!**

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Planning Points

So what do you do about this? In some cases there is nothing you can do – if your sources of retirement income (pensions, interest income, etc.) take you over the 85% taxing threshold already, you will always pay tax on 85% of your Social Security benefit and there is nothing you can do about it. But if you are paying tax on less than 85% of your benefit, and particularly if you are paying tax on none of your benefit, consider the following:

Watch your IRA distributions. If you are between ages 59 ½ and 70 ½, you *may* but *need not* take money out of your IRA without penalty. You possibly should consider taking some money out now if you can do so without triggering Social Security tax to avoid paying Social Security tax later when you are required to take IRA distributions after age 70 ½. And if taking money out of your IRA will trigger Social Security tax and you have other resources to tap for the money you need, consider tapping the other resources.

Closely monitor your capital gains situation. One side benefit of markets like we have had the past several months is that most portfolios have positions that have imbedded losses for tax purposes. If you have gains from mutual funds or otherwise, consider using sound strategies to harvest some losses to offset those gains to avoid extra tax on your Social Security benefits.

This is just another example of a situation where knowing what you are doing and paying attention to the details of your finances can save you thousands of dollars in taxes – avoid doing things that will cause you to pay tax on otherwise tax-free income! But if you need help, seek it out. The money you can save by avoiding mistakes is well worth the cost you pay to get the help you need. ✓



Tom Batterman
President
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Decide what’s important to talk about first: Maybe this conversation isn’t just about where the will or health care power of attorney is. Maybe this conversation is about you noticing that a parent or loved one is moving slower, is more forgetful, is clearly looking like their health has taken a turn for the worse – and maybe that’s why you want to know where the will is. Jumping into money issues first is usually a mistake. Deal with immediate health and lifestyle issues first.

Explain why you want to talk about finances: In some families, having a successful financial discussion means several attempts and some frustration. Don’t let yourself become angry or frustrated – just keep starting the conversation until it catches on. It might make sense to say something like, “You’ve always been so independent, Mom. I just want you to give us the right instructions so we do exactly what you want.”

Prepare your questions in advance: When a parent or relative is unconscious or unresponsive, the younger relative is immediately in the drivers’ seat. That’s why it’s critical to make a list of questions for the elderly relative to answer in detail. The basics: Where important papers are, how household expenses are paid, who doctors and specialists are, what medicines are being taken and whether there’s a will, an advanced directive and a funeral plan (and money or insurance proceeds to pay for it). There may be dozens more questions beyond these based on your family’s personal circumstances. But in creating this list, ask yourself: “What do I need to know if this person suddenly becomes sick or dies?”

Offer to get some qualified advice: If you don’t fully understand your relative’s financial affairs, it might make sense for you both to talk to a financial adviser. A

qualified adviser can offer specific suggestions on critical legal documents that should be in place and ways to make sure accounts to pay medical and household bills are accessible to the older person and the designated friend or relative who will hold power of attorney.

Plan a caregiving strategy together: You should discuss the relative’s preferences and trigger points for various stages of health care. An individual always wants to stay in his or her home, but you should have an honest discussion about how much you can do at home as a caregiver and whether various services (home health aide, geriatric care manager, assisted living) should be introduced at various stages. Talking through what a parent will be able to live with at various health stages – and putting that information in writing – will save plenty of doubt and bitterness later.

Discuss what should happen with the home: If an elderly relative becomes sick and irreversibly incapacitated, the equity in his or her home may come under consideration as a resource to pay uncovered medical or household maintenance. Since the home is both a major asset and an emotional focal point, it’s best to get good advice and spell out specifically what the elderly relative wants done with his property and under what conditions.

Make sure everyone knows the plan: Once you settle on a strategy, make sure all family and friends understand the plan and their assignments. ✓

Time to Ditch That Annuity?

Today’s market can open the door if you are looking to get rid of the variable annuities purchased several years ago. Falling investment values along with declining surrender charges may provide you with a way out.

They were all the rage in the late 1990s. Many investors believed that stock market returns could only go up, even though the market had crested highs never seen before. The lure of deferred taxation on investment gains, the ability to access an ever-increasing pool of money managers, and the ability to trade subaccounts frequently made non-qualified deferred variable annuities hard to resist. In fact, they became so popular that investors began purchasing annuities to fund their IRA accounts—even though the tax deferral feature of an annuity is redundant in a retirement account.

In 2003, a tax law change made the tax deferral feature of annuities less valuable by reducing the maximum tax rate on capital gains and qualified dividends to 15%. Deferred annuities lost much of their luster when investors realized that deferring a 15% tax on investment income may not offset the fact that all gains withdrawn from an annuity will be taxed as ordinary income at the taxpayer’s rate in the year of withdrawal.

Trapped losses
Y2K came and went with a 1,000-point drop in the Dow. The 9/11 disaster dropped the Dow more than 3,000 points from the beginning of the new century. Then a good old-fashioned bear market bit off another 1,000 points of the Dow by October of 2002. By that time, those late-’90s annuities, along with most other investment accounts, were bleeding with losses.

Moreover, those annuity losses were trapped by hefty surrender charges that would add insult to injury for anyone surrendering a contract in those first few years. Many policies have surrender charges that start at 10% or 12% of the cash value (or even higher) and don’t run out for 10 to 15 years or more. Some contracts even impose the surrender charges on the original investment—not the current cash value. Other contracts impose a full cycle of surrender charges on each deposit, rather than starting the clock when the annuity is first purchased.

To make matters worse, the surrender charges imposed by annuity providers do not figure into the calculation of gain or loss upon surrender. An annuity purchased for \$100,000, with a cash value three years later of \$80,000 and a surrender charge of \$6,400 would yield \$73,600 upon surrender, for a real money loss of \$26,400. However, only \$20,000 is considered a realized loss, because the surrender charge itself cannot be deducted as part of the loss.

Fast-forward to today’s market
In the last bear market, in 2003, it was the surrender charges that discouraged annuity owners from surrendering these contracts in favor of other nondeferred accounts. In 2008 those surrender charges should be down to the 1% or 2% level. Depending on the investment performance, there could be some gains over original cost in these contracts, but they are likely to be much lower now that the Dow is trading near 2000 levels. Many contracts will be underwater or approaching a loss position and you should seek advice of what to do with them.

There are many options available to you and you should seek the help of a professional that can help you make sense of the entire contract. Many of these contracts have layers of expenses that can easily reach 3% or more annually. Unfortunately, you have no choice but to

read the entire prospectus for the annuity policy to unravel the layers of fees that exist. You will have to determine if surrendering the annuity makes sense.

A word of caution
One popular strategy to get out of an underperforming non-qualified deferred annuity is to exchange it for another annuity, taking advantage of tax code section 1035. The original policy and the replacement policy must have the same owner, annuitant, and beneficiary. The tax basis of the replacement policy will generally be the same as the cost basis of the original one.

An exchange rarely makes sense if the surrender period has not expired, since the surrender charges are rarely waived except under certain promotional offerings by the original annuity issuer. Be careful of these, since often the waiver of surrender charges is to entice policyholders to exchange to a new annuity with longer or higher surrender charges than those remaining on the original annuity. Even if the old annuity is truly heinous—and some are—it still may make more sense to run out the surrender charges on the old one.

An exchange from an annuity that is no longer subject to surrender charges to a new annuity that will impose a new surrender charge schedule should be considered very carefully. A policy owner nearing retirement age with low gains in his or her policy would be better off holding the contract until reaching age 59½, then surrendering the policy and taking the small tax hit for the gains. Always consult a professional tax advisor to confirm your possible options.

Unfortunately, swapping annuities that are no longer subject to surrender charges for brand-new ones with all the bells and whistles is a misused sales tactic. Be sure you get help to objectively evaluate all your options with existing annuities. ✓