



Financial Foresights

Practical Insights For Your Financial Goals

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Hi Everyone,

It looks like the dog days of summer are coming to an end. Now that vacations are over and kids are back in school, it might be a good idea to carve out some time for a financial review. Call me today to schedule your time.

Dave

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Health Savings Accounts for Early Retirees

When deciding if you can afford to retire early, the cost of health insurance will be a key factor in the financial equation. Unless you're lucky enough to have retiree health benefits through your employer, or are entitled to coverage through your spouse's plan, you may need to obtain individual health coverage and pay the entire premium cost--which can be high--until you become eligible for Medicare at age 65. If you're looking to bridge the gap between the time you retire and the time you enroll in Medicare, one option worth considering is a health savings account (HSA).



HSA basics

An HSA is a tax-favored account that can be opened in conjunction with a high-deductible health plan (HDHP) to pay for current health costs and save for future ones. The HSA/HDHP option may be attractive to healthy retirees under age 65 who want more flexibility and potentially lower health insurance premiums than traditional individual health insurance offers.

HSAs aren't right for everyone. If you're interested in this option, ask your financial or tax professional for more information about the features, benefits, and tax implications of HSAs.

An HDHP begins to pay benefits only after you've satisfied a high annual deductible (at least \$1,100 for individual coverage in 2007), although some preventative care may be covered in full immediately. Because you're shouldering a greater portion of your health-care costs, you'll usually pay a lower premium for an HDHP than for traditional health insurance, and you can contribute your premium savings to your HSA. In 2007, you can contribute up to \$2,850 if you have individual coverage, and if you're 55 or older, you can make

an extra "catch-up contribution" of up to \$800. Your HSA contributions are tax deductible, and accumulate tax deferred (along with any earnings) until withdrawn. You can use your HSA funds to pay qualified health-care expenses that aren't covered by your plan. Before age 65, you can withdraw money and use it for nonqualified expenses, but you'll generally pay a 10% penalty, and you'll owe income taxes on the amount you withdraw.

What happens at age 65?

Once you reach age 65 and enroll in Medicare Part A or B, you're no longer eligible for a high-deductible health plan, and that means you can no longer contribute to your HSA. However, any money remaining in the account is yours to keep.

Reaching age 65 gives you a little more flexibility when it comes to using your HSA funds, since at age 65 the 10% penalty on nonqualified withdrawals no longer applies. But before you use your account funds for something other than health-care expenses, keep in mind that you'll still owe income taxes on money used for nonqualified expenses.

The only way to avoid paying taxes on your HSA funds (at any age) is to use them for qualified health-care expenses. Fortunately, the list of qualified expenses is long, and includes items such as prescription drugs, eyeglasses, and Medicare-related expenses such as premiums, deductibles, and co-payments. If you have health benefits through your former employer, you can use your HSA funds to pay your share of your retiree health insurance premium. And, if you decide to buy a tax-qualified long-term care insurance policy, you can also use your HSA funds to pay the premiums (though dollar limits apply). One thing you're not allowed to use your HSA dollars for is the premium cost of a Medigap policy to supplement your Medicare coverage. For a list of other qualified expenses, see IRS Publication 502, *Medical and Dental Expenses*.

Why was the dynasty trust created?

The dynasty trust came into being in the early twentieth century. During this time, the great industrialists, such as Rockefeller, Carnegie, and Ford, who had amassed enormous fortunes, sought a way to preserve their wealth and keep it in their families.



Income taxation of trust income

Federal and state income taxes may be owed on income generated inside the trust. Depending on how the trust is structured, the grantor, the beneficiaries, or the trust entity may be liable for the taxes.

The Power of a Dynasty Trust

Early in the twentieth century, the United States began taxing wealth transfers under the gift and estate tax system. This system was designed to impose tax on each and every generation (father to son, son to grandson, etc.). The very rich soon began to thwart this system by transferring wealth directly to grandchildren, thus skipping a level of taxation. Congress eventually caught on to this strategy and responded with the generation-skipping transfer tax (GSTT). GSTT is an additional tax that's imposed whenever transfers are made to persons who are more than one generation below the taxpayer (e.g., grandfather to grandson). GSTT is a flat tax imposed at the highest gift and estate tax rate in effect at the time of the transfer (45% in 2007).

Furthermore, most states impose their own transfer taxes. Together, these taxes can take an enormous bite whenever substantial wealth is being handed down, and over time they can erode a family's fortune. This can be troublesome to individuals who would prefer to have their legacies benefit their own family members. It's from these circumstances that the dynasty trust evolved.

How does a dynasty trust work?

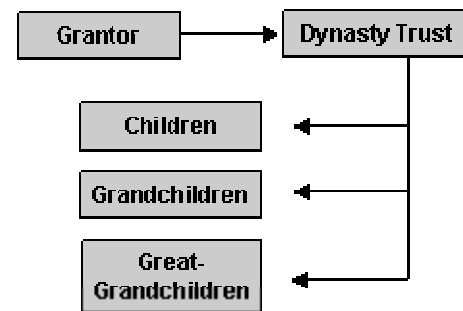
The law allows generation-skipping transfers to go untaxed up to a certain amount by providing a lifetime exemption (currently \$2 million per taxpayer, or \$4 million per married couple). Typically, a dynasty trust is funded with amounts that take full advantage of the GSTT tax exemption. The trust then provides for future generations for as long as it exists. Although the trust assets effectively move from generation to generation, there are no corresponding transfer tax consequences.

To enjoy this tax benefit, access to trust property by the beneficiaries must be limited. You can decide how narrow or broad a beneficiary's access will be within those limits. For example, if you wish to give a beneficiary as much control as possible, you can name the beneficiary as trustee, and give the beneficiary the right to all income and the right to consume principal limited by "ascertainable standards" (i.e., health, education, maintenance and support). The beneficiary can be given even more control by granting a special (or limited) testamentary power of appointment (i.e., the power to name successive beneficiaries).

On the other hand, if you want to restrict

access to the trust as much as possible, you can name an independent trustee who has sole discretion over distributions coupled with a spendthrift provision. The trustee will have full authority to distribute or not distribute income or principal to the beneficiary as the trustee deems appropriate. The spendthrift provision will prevent the beneficiary from voluntarily or involuntarily transferring his or her interest to another before actually receiving a distribution. The greater the restrictions, the less likely creditors or other claimants will be able to reach trust property.

How a dynasty trust works



- ❶ Assets transferred to trust. Taxpayer exemptions may shield transfer from transfer tax.
- ❷
 - Trust provides for beneficiaries according to trust document until trust terminates
 - Trust may be liable for income tax on taxable income
 - Although assets may effectively pass from generation to generation, no transfer taxes apply

How long can a dynasty trust last?

A dynasty trust can last as long as state law allows. In states that still have a "rule against perpetuities," the life of a trust is limited to 21 years after the death of the last beneficiary to die (which conceivably could be 100 or more years). Trusts in the states that have abolished their rules against perpetuities can, in theory, last forever.

The bottom line

A dynasty trust can meet the objectives of high-net-worth individuals concerned about intergenerational planning.

A dynasty trust is not a do-it-yourself project. See an experienced estate planning attorney for more information.

Putting Working Capital to Work

Every business owner knows it's important to keep some cash available to pay bills. But assuring adequate cash flow doesn't mean your assets can't do more for you. For example, if you have an infusion of cash that you don't expect to spend immediately, you don't have to let it sit idle. It may make sense to explore alternatives for putting at least some of that money to work. Managing your working capital wisely can help improve your business's overall performance.

Determine your time frame

Before you think about increasing returns on any excess cash, you need to make sure you've adequately forecasted upcoming needs. What looks like excess now could be needed if your cash flow projection is faulty or an emergency arises.

Is your cash flow relatively steady? Does it change dramatically from season to season? Vary from month to month, or year to year? All of these factors will influence whether and how you should put working capital to work.

For money that's likely to be used at any moment, your major objective is to preserve both capital and liquidity. For money that isn't needed immediately—for example, money you plan to use eventually to grow the business or pay off existing debts—you may have additional flexibility to try to increase the return on that money until it's needed.

For money you'll use soon ...

A *money market savings account*, especially one linked to your checking account, is a relatively straightforward option, and one you may already be using. You may be able to combine your checking and savings balances to meet any minimum balance requirements and avoid monthly fees. A savings account's yield will depend in part on how actively a bank is courting deposits, so it can pay to comparison-shop. Also, check on how many transactions are allowed each month.

If you're a sole proprietor or run a nonprofit organization, you may be able to find an *interest-bearing checking account*. Otherwise, a *sweep account* combines a checking account with an investment account that pays interest. With a sweep account, you set a target balance for the checking account. Once transactions have been posted each day, the account automatically sweeps any cash above that target amount into the income-producing

account—often a money market account or mutual fund, though you may also be able to choose from a range of investments. Investments are automatically liquidated as necessary and the proceeds moved into the checking account to cover outstanding payments and maintain the target balance, which in some cases may be as low as zero.

A sweep account also may be linked to a line of credit, enabling you to set a zero target balance for one or more checking accounts and borrow to cover checks. Deposits are then automatically used to pay down the line of credit and minimize interest charges.

If you have a longer time horizon ...

If you're confident you won't need the money for at least several months—for example, if you're raising capital for a future expansion or equipment purchase—you could explore buying a *certificate of deposit (CD)* with a term that matches your time frame. You get a guaranteed interest rate, FDIC insurance up to \$100,000, and return of your principal when you need it. Or put some money into a short-term CD and the rest into a longer-term investment with a higher yield. If an emergency requires use of the money, you might forfeit interest on only part of the assets.

You also could explore *short-term Treasury bills*, which can be bought in \$1,000 multiples and whose terms range from a few days to six months. T-bills are bought at a discount to their face value; when they mature, you receive the difference between the purchase price and the face value as interest. *Treasury notes* are available in 2-, 5-, and 10-year denominations. CDs and T-bills can be rolled over if they mature before you need the cash.

A *short-term bond fund* might offer a higher yield; however, it will not be FDIC-insured. Also, share prices of the fund may go down as a result of interest rate increases, and you could lose principal. Companies in a high tax bracket or with frequent large cash balances might consider *tax-exempt bonds* or even a custom-tailored money management solution.

If you're a sole proprietor, you have more freedom to invest the money as you might in a personal account—for example, by having an investment account with a specific goal, such as retirement or purchasing office space.

A financial professional can help you review the many possibilities for putting cash to work.



No interest in business checking

Since the Depression, banks have not been allowed to offer interest directly on a small business's checking account unless you are a sole proprietor, nonprofit organization, or governmental entity. The original intent was to provide stability to the banking system and to prevent interest rates from becoming exorbitant because of competition among banks for business deposits. Sweep accounts and savings accounts linked to checking accounts have functioned as substitutes.



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Ask the Experts



Two-career couples--who should retire first?

You and your spouse are both employed and nearing retirement age. Even if you've accumulated enough assets to allow you both to

retire at the same time, however, you might not want to do so. The transition into retirement can often be difficult, and doubly so if you're both struggling through that phase simultaneously. So, who should retire first?

If one spouse is earning significantly more than the other, then it usually makes sense for that spouse to continue to work in order to maximize current income, ease the financial transition into retirement, and perhaps even increase your retirement nest egg.

But what if your incomes are relatively equal? Here are some other factors to consider:

- **Pensions:** If only one of you is covered by an employer pension plan, it may make sense for that person to continue to work if he or she hasn't yet maximized that pension benefit. Similarly, consider how

continuing to work would impact your Social Security benefits.

- **Insurance:** Are either of you eligible for retiree health insurance? If so, are you required to work to a certain age to get that important coverage?
- **Plans:** Does one of you have specific plans for your retirement years? Perhaps you'd like to concentrate on a hobby, or spend time volunteering, or even learn a new skill? If so, consider whether that person should retire first in order to pursue those goals.
- **Job satisfaction:** Does one of you find working more self-fulfilling than the other? Would one of you feel more lost without your current routine?

One thing is clear--you'll need to discuss this with your spouse, preferably well ahead of time.

Are online retirement planning calculators useful?

The answer is an unqualified "maybe." Online retirement calculators are designed to help you determine whether or not you've saved enough for retirement, and if not, how much you'll need to save each year in order to eliminate the shortfall.

But the output of a retirement calculator is only as good as the data that goes in, and it's here that the various online calculators differ greatly. Some ask you only a few simple questions, and base their results on a large number of assumptions. These are easy to use, but the results can be suspect. Other, more sophisticated, calculators require more effort on your part, but may (or may not) come up with more meaningful results.

In many cases, online calculators fall short because you can't override their built-in assumptions, even though they clearly don't apply to you. Some specific items to consider:

- Can you insert your own life expectancy? If a calculator is using standard life

expectancy tables, it could significantly understate the amount of retirement assets you'll need.

- Can you input your own expected rates of return? Does the calculator take inflation into account? At what rate?
- Can you specify your anticipated expenses during retirement?
- Are amounts you've already saved taken into account?
- Can you input your expected income during retirement (for example, from a part-time job, Social Security, a retirement plan, or an annuity contract)?

All retirement calculators, sophisticated or not, have one good trait in common--they get you thinking about your retirement. But in most cases, the results should be considered a ballpark estimate, and a starting point for a more detailed discussion with a seasoned financial professional.