Robert A. Hoey CFP®

Planning Your Financial Future

Summer 2008

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Hi Everyone,

I hope you are enjoying your summer. We are getting closer to my favorite time of year, football time. As most of you know I coach high school football and both of my sons will be in the program again this year. We are hoping for a good year, and a chance to compete in the playoffs.

I will be out of the office most days by 2:15 PM, but I am available for reviews after 5:30 PM and some Saturdays if needed. As always my assistants Debbie and Michelle are available 8:30 to 5:00 PM.

Have a great day,

Rob

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COMMONWEALTH *financial network*

The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(k) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing

A 401(k) plan will usually let you borrow as much as 50% of your vested account balance, up to $50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence.

You pay the interest to yourself, but ...

When you make payments of principal and interest on the loan, the plan deposits those payments back into your individual plan account. This means that you're not only receiving back your loan principal, you're also paying the loan interest to yourself instead of to a financial institution. But the benefits of paying interest to yourself are somewhat illusory.

Here's why. To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (Note: Special tax rules apply to Roth 401(k) contributions.)

The opportunity cost

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because you miss out on the opportunity for more tax-deferred investment earnings.

Other considerations

There are other factors to think about before borrowing from your 401(k) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you terminate employment, your plan may require that your loan become immediately payable. If so, and you don't have the funds to pay it off, the outstanding balance will be treated as a taxable distribution to you, and if you're not yet 59½, a 10% early distribution penalty may also apply to your taxable balance.

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt, or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates with each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(k) plan

The Pros and Cons of Self-Insuring Long-Term Care

The cost of long-term care can be expensive. In 2007, the national average for the cost of care in a nursing home exceeded $66,000 per year. In addition, about 70% of people over age 65 require some long-term care services, with the likelihood of needing such care increasing with age.

Source: National Clearinghouse for Long-Term Care Information, 2007

Thinking about the potential impact of long-term care often involves considering whether to buy long-term care (LTC) insurance or to self-insure. Sometimes your options are limited. For example, poor health or old age may make the cost of LTC insurance too expensive for you, or you may be denied coverage altogether. Medicaid may not be an alternative either if your income and assets exceed minimum qualification limits. In this case, self-insuring may be your only option. But if you are able to choose between LTC insurance and self-insuring, here are some issues to consider.

Why might you self-insure?

There are many reasons why people choose to self-insure rather than buy LTC insurance, presuming these options are available. Often, people will choose to self-insure because they think they have enough income and assets to pay for whatever long-term care they'll need, or they decide not to plan for long-term care because they think they'll never need it during their lives. However, there are both advantages and disadvantages to self-insuring.

Advantages of self-insuring

You have greater flexibility in how you use your financial resources. Even if you choose to allocate income or savings to potential long-term care costs by self-insuring, those assets will still be available to use for other purposes such as retirement, business ventures, or education funding.

Long-term care insurance premiums may become too expensive. Often, people buy LTC insurance during their working years, but find that their income decreases in retirement or policy premiums increase, making LTC insurance hard to pay for. If you own LTC insurance, or you're thinking about buying it, try to estimate what your income will be in retirement and whether you'll be able to afford the premiums, especially if they increase. If you think the premiums might be too costly, as an alternative, consider setting up an LTC savings account into which you can contribute as much as you can afford. This account may not provide the funds that an LTC policy could, but it can help pay for LTC expenses if they occur, and you won't be financially strapped with premium payments you can't afford.

You have more control over your care. Many policies provide only limited benefits--often with additional restrictions and conditions--that may end up covering only a small percentage, or even none, of your long-term care costs. For example, a policy may provide limited benefits for in-home care, even though most people would prefer to receive care at home. If you do need long-term care, using your own assets may give you more control over the type of care you get, where you receive the care, and who provides the care to you, without the restrictions or limits of some LTC insurance policies.

Disadvantages of self-insuring

If you never need long-term care, then, in hindsight, self-insuring is almost always the right choice. But what if you do need long-term care? How long will you need that care and how much will it cost? These uncertainties lead to some of the disadvantages of self-insuring.

Long-term care expenses can deplete your assets and income, leaving little or nothing for your spouse or dependents. Paying for some of your care with LTC insurance may allow you to conserve more of your savings and income for your spouse or dependents.

You may need to depend on family members to provide your care. Some people gamble that they'll never incur long-term care expenses. If they're wrong, their options may be very limited. If they can't qualify for Medicaid, their assets and income may be enough to pay for some of the care, but not all of it. Consequently, they often rely on family to provide some if not most of their long-term care. Long-term care insurance may cover some of the costs of skilled or custodial services and nursing home care, relieving your family of some of these caregiving responsibilities.

Self-insuring could increase your taxes. Depending on the type of assets you have, paying for long-term care from your savings could increase your income taxes. Withdrawals from certain retirement plans such as IRAs or 401(k)s are usually subject to ordinary income taxes, so taking sizable withdrawals from them to pay for long-term care expenses might increase your income taxes significantly. On the other hand, if your LTC insurance is tax qualified (as most policies are), then benefits paid from the policy for care are generally not subject to income taxes.

The Three C's of Credit

When you're looking for credit, it's worth understanding what potential creditors are looking for when they're looking at you. Traditionally, they're looking for the three C's: capacity, character, and collateral.

Capacity

Potential creditors want to know if you have the wherewithal to repay a debt. To this end, they'll inquire (usually on an application form) about your income information: How much is it? Does it come from wages, commissions, or some other source? Does it come on a regular or seasonal basis?

On the flip side, they'll also want to know about your expenses, especially any debt obligations. In addition, they'll want to know how many dependents you have and whether you're required to pay any child support and/or alimony.

Of particular interest to potential creditors is your debt-to-income ratio. This ratio compares your monthly recurring debt obligations to your monthly gross income. Your recurring obligations include your mortgage or rent, credit card payments, loan payments--including the one you're applying for--and alimony/child support you pay. Your income includes bonuses, commissions, and any other income you receive, such as Social Security, pensions, and alimony/child support.

Note: *The debt-to-income ratio is also known as the back-end ratio. A second ratio, called the front-end ratio, compares your rent or total mortgage payment to your gross income, and is used primarily to determine whether you qualify for certain mortgage loans.*

Your debt-to-income ratio goes a long way toward determining whether you are granted credit, how much, and at what interest rates. While many other factors affect your capacity to repay a loan, lenders generally consider debt-to-income ratios of 35% or less to be ideal, 36% to 42% to be manageable, 44% to 49% to be risky, and 50% or above to be unacceptable.

Character

Okay, your sweetheart thinks you're the best thing since sliced bread, and your bosom buddy knows you're one in a million. But that's not the sort of character endorsement creditors are looking for. What creditors want to know is, given that you *can* repay a debt (capacity), *will* you?

When it comes to your credit character, lenders often look for another C: consistency. Have you bounced around from address to address, or job to job? Doing so makes creditors nervous. Longevity in employment and residency indicate stability, and that's what creditors like to see.

Lenders also firmly believe that your past actions are a good predictor of your future behavior. So, they're looking to see if you've used credit before, and what your repayment track record has been like. To do this, they rely primarily on your credit report and your credit score.

Collateral

Maybe you've proven your capacity to repay a loan and your excellent character, but the lender may want something of value to secure the debt, particularly if the loan is for a large amount and/or a long term. If you default on the loan, the lender would be legally entitled to take possession of that item as a form of compensation. Tangible property used in this fashion is called collateral.

Typical examples of consumer loans that involve collateral arrangements are mortgages and home equity loans (failure to repay the loan can result in foreclosure) and vehicle loans (failure to repay the loan can result in repossession). While seizing property in the event of a loan default may not repay the entire balance due, it would at least mitigate the creditor's loss.

The "can'ts" of credit

There are some things a potential creditor can't do when considering you for credit. A creditor can't use your age, gender, marital status, race, color, religion, or national origin to:

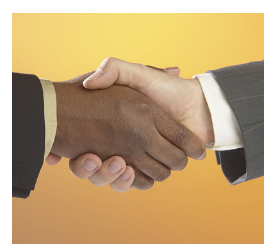
- Discourage you from applying for credit
- Refuse to grant you credit if you otherwise qualify for it
- Make you a loan on terms different from those granted another person with similar income, expenses, credit history, and collateral
- Close an existing account

Furthermore, a creditor can't refuse to consider any public income you may receive, such as Social Security, veterans benefits, or welfare benefits.

Other C's that matter

Capital: *Assets that could cover a debt (such as investments, bank savings accounts, personal property, or real estate) if your income became unavailable. In some cases, lenders will want you to use your capital as collateral.*

Conditions: *These are often factors beyond your control, such as the general health of the economy, a growth spurt or a downturn in the industry that employs you, and even (for mortgages) changes in the neighborhood around your property.*



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Ask the Experts

Can I enroll in Medicare at age 65, even if I'm not yet eligible for full Social Security benefits?

Yes. Although full retirement age for Social Security is increasing, 65 remains the age at which most Americans become eligible for Medicare. You don't have to be retired to enroll in Medicare, so you should still consider signing up for Medicare Part A (hospital insurance) and Medicare Part B (medical insurance) at age 65, even if you plan on working longer. Make sure to contact the Social Security Administration approximately 3 months before your 65th birthday to discuss your options, because enrollment rules are relatively complicated, and there may be consequences if you wait until later to sign up.

For example, when you become eligible for Medicare Part A at age 65, you have a certain period, called your initial enrollment period, in which to sign up for Medicare Part B. Most people won't pay a premium for Part A, but you'll always pay a premium for Part B. Your initial enrollment period is a seven-month period that begins three months before your 65th birthday, includes the month you turn age 65, and ends three months after your 65th birthday. If you don't sign up for Part B during your initial enrollment period, you can't sign up until the next general enrollment period that runs from January 1 through March 31 of each year, and you'll generally pay a higher premium for Part B coverage. Your monthly premium will increase by 10% for each 12-month period you were eligible for, but did not enroll in, Medicare Part B, unless you were covered by group health insurance through your employer or your spouse's employer. In that case, you may qualify for a special enrollment period, and you may not have to pay a premium penalty.

For more information about enrollment requirements and other factors you should consider when deciding when to sign up for Medicare, contact the Social Security Administration at (800) 772-1213 or visit the Medicare website at www.medicare.gov.

What are Medicare Advantage plans?

Most people who are covered by Medicare are enrolled in original Medicare. Original Medicare includes Part A, which helps cover inpatient hospital care, skilled nursing care, hospice care, and some home health care, and Part B, which covers medically necessary services, including doctor's visits, outpatient care, and some preventative services.

As an alternative to original Medicare, you may opt to enroll in a Medicare Advantage (MA) plan when you first become eligible for Medicare (and have already enrolled in Parts A and B), or during certain enrollment periods. MA plans are also called Part C plans, and although they are part of the Medicare program, they are managed by private companies. MA plans provide all the benefits and cover all of the services that original Medicare provides. However, they may also offer benefits and services that are not covered under original Medicare (but which may be covered under an optional supplemental policy), including prescription drug coverage, vision care, dental services, and hearing aids, although coverages vary.

But while original Medicare allows you to visit any health-care provider or facility that accepts Medicare, most MA plans are managed care plans--either HMOs or PPOs--that have provider networks. This means that you'll usually need to see a health-care provider who belongs to the plan or receive health-care services through a facility included in the network. This may limit your choice of health-care providers. Other MA plan types may be available, including private fee-for-service plans, but these are less common.

You can generally join an MA plan if you live in the service area covered by the plan, and you have Medicare Parts A and B. But before choosing an MA plan, make sure it suits your needs. Review the benefits provided and coverage limits, and the provider network (if any). You should also make sure you understand what out-of-pocket costs may apply. These may include premiums, deductibles, and copayments that are different than those in original Medicare or a supplemental policy.