Holding Equities for the Long Term: Time Versus Timing

DECEMBER 30, 2018

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Legendary investor Warren Buffett is famous for his long-term perspective. He has said that he likes to make investments he would be comfortable holding even if the market shut down for 10 years. Investing with an eye to the long term is particularly important with stocks. Historically, equities have typically outperformed bonds, cash, and inflation, though past performance is no guarantee of future results and those returns also have involved higher volatility. It can be challenging to have Buffett-like patience during periods such as 2000-2002, when the stock market fell for 3 years in a row, or 2008, which was the worst year for the Standard & Poor's 500* since the Depression era. Times like those can frazzle the nerves of any investor, even the pros. With stocks, having an investing strategy is only half the battle; the other half is being able to stick to it.

Just what is long term?

Your own definition of "long term" is most important, and will depend in part on your individual financial goals and when you want to achieve them. A 70-year-old retiree may have a shorter "long term" than a 30 year old who's saving for retirement.

Your strategy should take into account that the market will not go in one direction forever–either up or down. However, it's instructive to look at various holding periods for equities over the years. Historically, the shorter your holding period, the greater the

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chance of experiencing a loss. It's true that the S&P 500 showed negative returns for the two 10-year periods ending in 2008 and 2009, which encompassed both the tech crash and the credit crisis. However, the last negative-return 10-year period before then ended in 1939, and each of the trailing 10-year periods since 2010 have also been positive.*

The benefits of patience

Trying to second-guess the market can be challenging at best; even professionals often have trouble. According to "Behavioral Patterns and Pitfalls of U.S. Investors," a 2010 Library of Congress report prepared for the Securities and Exchange Commission, excessive trading often causes investors to underperform the market.

The Power of Time

Note: Though past performance is no guarantee of future results, the odds of achieving a positive return in the stock market have been much higher over a 5or 10-year period than for a single year. Another study, "Stock Market Extremes and Portfolio Performance 1926-2004," initially done by the University of Michigan in 1994 and updated in 2005, showed that a handful of months or days account for most market gains and losses. The return dropped dramatically on a portfolio that was out of the stock market entirely on the 90 best trading days in history. Returns also improved just as dramatically by avoiding the market's 90 worst days; the problem, of course, is being able to forecast which days those will be. Even if you're able to avoid losses by being out of the market, will you know when to get back in?

Keeping yourself on track

It's useful to have strategies in place that can help improve your financial and psychological readiness to take a long-term approach to investing in equities. Even if you're not a buy-and-hold investor, a trading discipline can help you stick to a long-term plan.

Have a game plan against panic

Having predetermined guidelines that anticipate turbulent times can help prevent emotion from dictating your decisions. For example, you might determine in advance that you will take profits when the market rises by a certain percentage, and buy when the market has fallen by a set percentage. Or you might take a core-and-satellite approach, using buy-and-hold principles for most of your portfolio and tactical investing based on a shorter-term outlook for the rest.

Remember that everything's relative

Most of the variance in the returns of different portfolios is based on their respective asset allocations. If you've got a well-diversified portfolio, it might be useful to compare its overall performance to the S&P 500. If you discover you've done better than, say, the stock market as a whole, you might feel better about your long-term prospects.

Current performance may not reflect past results

Don't forget to look at how far you've come since you started investing. When you're focused on day-to-day market movements, it's easy to forget the progress you've already made. Keeping track of where you stand relative to not only last year but to 3, 5, and 10 years ago may help you remember that the current situation is unlikely to last forever.

Consider playing defense

Some investors try to prepare for volatile periods by reexamining their allocation to such defensive sectors as consumer staples or utilities (though like all stocks, those sectors involve their own risks). Dividends also can help cushion the impact of price swings. If you're retired and worried about a market downturn's impact on your income, think before reacting. If you sell stock during a period of falling prices simply because that was your original game plan, you might not get the best price. Moreover, that sale might also reduce your ability to generate income in later years. What might

it cost you in future returns by selling stocks at a low point if you don't need to? Perhaps you could adjust your lifestyle temporarily.

Use cash to help manage your mindset

Having some cash holdings can be the financial equivalent of taking deep breaths to relax. It can enhance your ability to act thoughtfully instead of impulsively. An appropriate asset allocation can help you have enough resources on hand to prevent having to sell stocks at an inopportune time to meet ordinary expenses or, if you've used leverage, a margin call.

A cash cushion coupled with a disciplined investing strategy can change your perspective on market downturns. Knowing that you're positioned to take advantage of a market swoon by picking up bargains may increase your ability to be patient.

Know what you own and why you own it

When the market goes off the tracks, knowing why you made a specific investment can help you evaluate whether those reasons still hold. If you don't understand why a security is in your portfolio, find out. A stock may still be a good long-term opportunity even when its price has dropped.

Tell yourself that tomorrow is another day

The market is nothing if not cyclical. Even if you wish you had sold at what turned out to be a market peak, or regret having sat out a buying opportunity, you may get another chance. If you're considering changes, a volatile market is probably the worst time to turn your portfolio inside out. Solid asset allocation is still the basis of good investment planning.

Be willing to learn from your mistakes

Anyone can look good during bull markets; smart investors are produced by the inevitable rough patches. Even the best aren't right all the time. If an earlier choice now seems rash, sometimes the best strategy is to take a tax loss, learn from the experience, and apply the lesson to future decisions.

***Data source:** Calculations by Broadridge based on total returns on the S&P 500 Index over rolling 1-, 5-, and 10-year periods between 1926 and 2014.*

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Financial Planning–Helping You See the Big Picture

JUNE 10, 2019

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Financial Planning–Helping You See the Big Picture

Do you picture yourself owning a new home, starting a business, or retiring comfortably? These are a few of the financial goals that may be important to you, and each comes with a price tag attached.

That's where financial planning comes in. Financial planning is a process that can help you reach your goals by evaluating your whole financial picture, then outlining strategies that are tailored to your individual needs and available resources.

Why is financial planning important?

A comprehensive financial plan serves as a framework for organizing the pieces of your financial picture. With a financial plan in place, you'll be better able to focus on your goals and understand what it will take to reach them.

One of the main benefits of having a financial plan is that it can help you balance competing financial priorities. A financial plan will clearly show you how your financial goals are related–for example, how saving for your children's college education might impact your ability to save for retirement. Then you can use the information you've gleaned to decide how to prioritize your goals, implement specific strategies, and choose suitable products or services. Best of all, you'll have the peace of mind that comes from knowing that your financial life is on track.

The financial planning process

Creating and implementing a comprehensive financial plan generally involves working with financial professionals to:

- Develop a clear picture of your current financial situation by reviewing your income, assets, and liabilities, and evaluating your insurance coverage, your investment portfolio, your tax exposure, and your estate plan
- Establish and prioritize financial goals and time frames for achieving these goals
- Implement strategies that address your current financial weaknesses and build on your financial strengths
- Choose specific products and services that are tailored to meet your financial objectives
- Monitor your plan, making adjustments as your goals, time frames, or circumstances change

Some members of the team

The financial planning process can involve a number of professionals.

Financial planners typically play a central role in the process, focusing on your overall financial plan, and often coordinating the activities of other professionals who have expertise in specific areas.

Accountants or *tax attorneys* provide advice on federal and state tax issues.

Estate planning attorneys help you plan your estate and give advice on transferring and managing your assets before and after your death.

Insurance professionals evaluate insurance needs and recommend appropriate products and strategies.

Investment advisors provide advice about investment options and asset allocation, and can help you plan a strategy to manage your investment portfolio.

The most important member of the team, however, is you. Your needs and objectives drive the team, and once you've carefully considered any

recommendations, all decisions lie in your hands.

Why can't I do it myself?

You can, if you have enough time and knowledge, but developing a comprehensive financial plan may require expertise in several areas. A financial professional can give you objective information and help you weigh your alternatives, saving you time and ensuring that all angles of your financial picture are covered.

Staying on track

The financial planning process doesn't end once your initial plan has been created. Your plan should generally be reviewed at least once a year to make sure that it's up-to-date. It's also possible that you'll need to modify your plan due to changes in your personal circumstances or the economy. Here are some of the events that might trigger a review of your financial plan:

- Your goals or time horizons change
- You experience a life-changing event such as marriage, the birth of a child, health problems, or a job loss
- You have a specific or immediate financial planning need (e.g., drafting a will, managing a distribution from a retirement account, paying long-term care expenses)
- Your income or expenses substantially increase or decrease
- Your portfolio hasn't performed as expected
- You're affected by changes to the economy or tax laws

Common questions about financial planning

What if I'm too busy?

Don't wait until you're in the midst of a financial crisis before beginning the planning process. The sooner you start, the more options you may have.

Is the financial planning process complicated?

Each financial plan is tailored to the needs of the individual, so how complicated the process will be depends on your individual circumstances. But no matter what type of help you need, a financial professional will work hard to make the process as easy as possible, and will gladly answer all of your questions.

What if my spouse and I disagree?

A financial professional is trained to listen to your concerns, identify any underlying issues, and help you find common ground.

Can I still control my own finances?

Financial planning professionals make recommendations, not decisions. You retain control over your finances. Recommendations will be based on your needs, values, goals, and time frames. You decide which recommendations to follow, then work with a financial professional to implement them.

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High-Income Individuals Face New Medicare-Related Taxes

MAY 31, 2019

The health-care reform legislation enacted in 2010 included new Medicare-related taxes that first took effect in 2013. These new taxes target high-income individuals and families. Here are the basics:

Additional Medicare payroll tax

If you receive a paycheck, you probably have some familiarity with the Federal Insurance Contributions Act (FICA) employment tax; at the very least, you've probably seen the tax deducted on your paystub. The old age, survivors, and disability insurance ("OASDI") portion of this FICA tax is equal to 6.2 percent of covered wages (up to $132,900 in 2019, $128,400 in 2018). The hospital insurance or HI portion of the tax (commonly referred to as the Medicare payroll tax) is generally equal to 1.45 percent of covered wages, and is not subject to a wage cap. FICA tax is assessed on both employers and employees (that is, an employer is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax, and each employee is subject to the 6.2 percent OASDI tax and the 1.45 percent HI tax on wages as well), with employers responsible for collecting and remitting the employees' portions of the tax.

Self-employed individuals are responsible for paying an amount equivalent to the combined employer and employee rates on net self-employment income (12.4 percent OASDI tax on net self-employment income up to the taxable wage base, and 2.9 percent HI tax on all net self-employment income), but are able to take a deduction for the employer portion of the self-employment taxes paid.

Beginning in 2013, the hospital insurance (HI) tax on high-wage individuals increased by 0.9 percent (to 2.35 percent). Who is subject to the additional tax? If you're married and file a joint federal income tax return, the additional HI tax applies to the extent that the combined wages of you and your spouse exceed $250,000. If you're married but file a separate return, the additional tax applies to if your wages exceed $125,000. For everyone else, the threshold is $200,000 of wages. So, a single individual with wages of $230,000 will owe HI tax at a rate of 1.45 percent on the first $200,000 of wages, and HI tax at a rate of 2.35 percent on the remaining $30,000 of wages for the year.

Employers are responsible for collecting and remitting the additional tax on wages that exceed $200,000. (Employers do not factor in the wages of a married employee's spouse.) You are responsible for the additional tax if the amount withheld from your wages is insufficient (if too much is withheld, you're entitled to a credit on your federal income tax return). The employer portion of the HI tax remains unchanged (at 1.45 percent).

If you're self-employed, the additional 0.9 percent tax applies to self-employment income that exceeds the dollar amounts above (reduced, though, by any wages subject to FICA tax). If you're self-employed, you won't be able to deduct any portion of the additional tax.

Medicare contribution tax on unearned income

A 3.8 percent Medicare contribution tax also first became effective in 2013. Referred to as the "unearned income Medicare contribution tax," or the "net investment income tax" it is imposed on the unearned income of high-income individuals (the new tax is also imposed on estates and trusts, although slightly different rules apply). The tax is equal to 3.8 percent of the lesser of your net investment income (generally, net income from interest, dividends, annuities, royalties and rents, and capital gains, as well as income from a business that is considered a passive activity or a business that trades financial instruments or commodities), or your modified adjusted gross income (basically, your adjusted gross income increased by any foreign earned income exclusion) that exceeds $200,000 ($250,000 if married filing a joint federal income tax return, $125,000 if married filing a separate return).

So, effectively, you're only subject to the additional 3.8 percent tax if your adjusted gross income exceeds the dollar thresholds listed above. It's worth noting that interest on tax-exempt bonds, veterans' benefits, and excluded gain from the sale of a principal residence that are excluded from gross income are not considered net investment income for purposes of the additional tax. Qualified retirement plan and IRA distributions are also not considered investment income.

Both taxes can apply

You can be subject to both taxes, but not on the same income. In other words, if your wages exceed the dollar threshold that applies to your filing status, you're subject to the new additional Medicare payroll tax. If you also have unearned income, that unearned income may (assuming your modified adjusted gross income exceeds the relevant threshold) be subject to the new Medicare tax on unearned income.

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Tax Benefits of Home Ownership

MAY 31, 2019

In tax lingo, your principal residence is the place where you legally reside. It's typically the place where you spend most of your time, but several other factors are also relevant in determining your principal residence. Many of the tax benefits associated with home ownership apply mainly to your principal residence — different rules apply to second homes and investment properties. Here's what you need to know to make owning a home really pay off at tax time.

Deducting mortgage interest

One of the most important tax benefits that comes with owning a home is the fact that you may be able to deduct any mortgage interest that you pay. If you itemize deductions on Schedule A of your federal income tax return, you can generally deduct the interest that you pay on debt resulting from a loan used to buy, build, or improve your home, provided that the loan is secured by your home. In tax terms, this is referred to as "home acquisition debt." You're able to deduct home acquisition debt on a second home as well as your main home (note, however, that when it comes to second homes, special rules apply if you rent the home out for part of the year).

For mortgage debt incurred prior to December 16, 2017, up to $1 million of home acquisition debt ($500,000 if you're married and file separately) qualifies for the interest deduction. If your mortgage loan exceeds $1 million, some of the interest that you pay on the loan may not be deductible.

For mortgage debt incurred after December 15, 2017, up to $750,000 of home acquisition debt ($375,000 if you're married and file separately) qualifies for the interest deduction. If your mortgage loan exceeds $750,000, some of the interest that you pay on the loan may not be deductible.

A deduction is no longer allowed for interest on home equity indebtedness. Home equity used to substantially improve your home is not treated as home equity indebtedness and can still qualify for the interest deduction.

For more information, see IRS Publication 936.

Mortgage insurance

You can generally treat amounts you paid during 2017 for qualified mortgage insurance as home mortgage interest, provided that the insurance was associated with home acquisition debt, and was being paid on an insurance contract issued after 2006. Qualified mortgage insurance is mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, the Rural Housing Service, and qualified private mortgage insurance (PMI) providers. The deduction is phased out, though, if your adjusted gross income was more than $100,000 ($50,000 if married filing separately).

Starting in 2018, amounts paid for qualified mortgage insurance are generally not deductible.

Deducting real estate property taxes

If you itemize deductions on Schedule A, you can also generally deduct real estate taxes that you've paid on your property in the year that they're paid to the taxing authority. However, for 2018 to 2025, individuals are able to claim an itemized deduction of up to only $10,000 ($5,000 for married filing separately) for state and local property taxes and state and local income taxes (or sales taxes in lieu of income taxes). Previously, there were no dollar limits.

If you pay your real estate taxes through an escrow account, you can only deduct the real estate taxes actually paid by your lender from the escrow account during the year. Only the legal property owner can deduct real estate taxes. You cannot deduct homeowner association assessments, since they are not imposed by a state or local government.

AMT considerations

If you're subject to the alternative minimum tax (AMT) in a given year, your ability to deduct real estate taxes may be limited. That's because, under the AMT calculation, no deduction is allowed for state and local taxes, including real estate tax.

Deducting points and closing costs

Buying a home is confusing enough without wondering how to handle the settlement charges at tax time. When you take out a loan to buy a home, or when you refinance an existing loan on your home, you'll probably be charged closing costs. These may include points, as well as attorney's fees, recording fees, title search fees, appraisal fees, and loan or document preparation and processing fees. You'll need to know whether you can deduct these fees (in part or in full) on

your federal income tax return, or whether they're simply added to the cost basis of your home.

Before we get to that, let's define one term. Points are certain charges paid when you obtain a home mortgage. They are sometimes called loan origination fees. One point typically equals one percent of the loan amount borrowed. When you buy your main home, you may be able to deduct points in full in the year that you pay them if you itemize deductions and meet certain requirements. You may even be able to deduct points that the seller pays for you. More information about these requirements is available in IRS Publication 936.

Refinanced loans are treated differently. Generally, points that you pay on a refinanced loan are not deductible in full in the year that you pay them. Instead, they're deducted ratably over the life of the loan. In other words, you can deduct a certain portion of the points each year. If the loan is used to make improvements to your principal residence, however, you may be able to deduct the points in full in the year paid.

What about other settlement fees and closing costs? Generally, you cannot deduct these costs on your tax return. Instead, you must adjust your tax basis (the cost, plus or minus certain factors) in your home. For example, you'd increase your basis to reflect certain closing costs, including:

1. Abstract fees
2. Charges for installing utility services
3. Legal fees
4. Recording fees
5. Surveys
6. Transfer or stamp taxes
7. Owner's title insurance

For more information, see IRS Publication 530.

Tax treatment of home improvements and repairs

Home improvements and repairs are generally nondeductible. Improvements, though, can increase the tax basis of your home (which in turn can lower your tax bite when you sell your home). Improvements add value to your home, prolong its life, or adapt it to a new use. For example, the installation of a deck, a built-in swimming pool, or a second bathroom would be considered an improvement. In contrast, a repair simply keeps your home in good operating condition. Regular repairs and maintenance (e.g., repainting your house and fixing your gutters) are not considered improvements and are not included in the tax basis of your home. However, if repairs are performed as part of an extensive remodeling of your home, the entire job may be considered an improvement.

Exclusion of capital gain when your house is sold

If you sell your principal residence at a loss, you generally can't deduct the loss on your tax return. If you sell your principal residence at a gain you may be able to exclude some or all of the gain from federal income tax.

Generally speaking, capital gain (or loss) on the sale of your principal residence equals the sale price of your home less your adjusted basis in the property. Your adjusted basis is the cost of the property (i.e., what you paid for it initially), plus amounts paid for capital improvements, less any depreciation and casualty losses claimed for tax purposes.

If you meet all requirements, you can exclude from federal income tax up to $250,000 ($500,000 if you're married and file a joint return) of any capital gain that results from the sale of your principal residence. Anything over those limits is generally subject to tax. In general this exclusion can be used only once every two years. To qualify for the exclusion, you must have owned and used the home as your principal residence for a total of two out of the five years before the sale.

For example, you and your spouse bought your home in 1981 for $200,000. You've lived in it ever since and file joint federal income tax returns. You sold the house yesterday for $350,000. Your entire $150,000 gain ($350,000 – $200,000) is excludable. That means that you don't have to report your home sale on your federal income tax return.

What if you fail to meet the two-out-of-five-year rule? Or what if you used the capital gain exclusion within the past two years with respect to a different principal residence? You may still be able to exclude part of your gain if your home sale

was due to a change in place of employment, health reasons, or certain other unforeseen circumstances. In such a case, exclusion of the gain may be prorated.

Additionally, special rules may apply in the following cases:

1. If your principal residence contained a home office or was otherwise used partially for business purposes
2. If you sell vacant land adjacent to your principal residence
3. If your principal residence is owned by a trust
4. If you rented part of your principal residence to tenants, or used it as a vacation or second home
5. If you owned your principal residence jointly with an unmarried individual.

Note: Members of the uniformed services, foreign services, and intelligence community, as well as certain Peace Corps volunteers and employees may elect to suspend the running of the two-out-of-five-year requirement during any period of qualified official extended duty up to a maximum of ten years.

Consult a tax professional for details.

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Health-Care Reform: Tax Changes for Individuals

MAY 31, 2019

The health-care reform legislation signed into law in 2010 contained a number of tax changes. Some of these changes took effect immediately; others have only recently become effective. Here are some of the changes worth noting:

Changes that went into effect prior to 2013

If you frequent tanning salons, you're probably well aware that the health-care reform legislation brought with it a 10 percent tax assessed on amounts paid for indoor tanning services.

The legislation also extended the tax benefits associated with employer health plans (i.e., the ability to exclude the value of the benefits from income) to any children who have not reached age 27 by the end of the year.

In addition, the legislation made changes to flexible spending arrangements (FSAs), health reimbursement arrangements (HRAs), health savings accounts (HSAs), and Archer MSAs: over-the-counter medications (except for insulin and medications that are prescribed by a physician) are no longer considered qualified medical expenses for purposes of reimbursement and tax-free distributions. And, the additional tax that applies to HSA and Archer MSA distributions not made for qualifying expenses increased to 20 percent.

Changes that went into effect in 2013

Do you typically itemize your deductions on Schedule A? Starting in 2013, unreimbursed medical expenses were deductible on Schedule A only to the extent that they exceeded 10 percent of adjusted gross income (AGI), instead of the 7.5 percent threshold that applied in prior years. Until 2016, however, if you or your spouse turned age 65 before the end of the taxable year, the 7.5 percent AGI threshold continued to apply. Beginning in 2017, the 10 percent AGI threshold was to apply to individuals who had reached age 65 as well. However, for 2017 and 2018, the threshold has now been reduced to 7.5 percent for everyone; it increases to 10 percent in 2019.

Also starting in 2013, high-income individuals were subject to two new Medicare-related taxes. Those with wages over $200,000 (married couples filing jointly with wages over $250,000) are subject to an additional 0.9 percent hospital insurance (Medicare) payroll tax. A 3.8 percent Medicare contribution tax is also imposed on the unearned income of individuals with modified adjusted gross income (MAGI) over $200,000, or married couples filing jointly with MAGI over $250,000.

Health FSAs that are part of a cafeteria plan are capped at a $2,650 (in 2018, $2,600 in 2017) reimbursement limit.

Changes effective in 2014

This is the year of the carrot and the stick. A premium assistance tax credit is available to help eligible individuals purchase health-care insurance through the Exchange Marketplace. Who qualifies? Individuals with household income between 100 percent and 400 percent of the federal poverty level will qualify, with the exact amount of the credit based on income level (for a family of four, that means income from $24,300 to $97,200 in 2017, $24,250 to $97,000 in 2016). Generally, individuals who are offered coverage through an employer health plan don't qualify for the credit unless the employer health plan doesn't cover an adequate share of benefits (60 percent), or it's considered "unaffordable" (the employee portion of the premium is 9.5 percent or more of the employee's household income).

And then there's the stick. Beginning in 2014, if you're a U.S. citizen or legal resident, you'll generally be required to have adequate health-care coverage. If you don't, you'll face a penalty tax unless you qualify for an exemption. For 2014, the tax was equal to the greater of 1 percent of the amount of your household income that exceeds a specific amount (generally, the standard deduction plus personal exemption amounts you're entitled to for the year) or $95 per uninsured adult (half that for uninsured family members under age 18), with a maximum household penalty of $285. In 2015, the percentage rate increased to 2 percent, the dollar amount per uninsured adult increased to $325, and the maximum household penalty increased to $975. In 2016 and 2017, the percentage rate is 2.5 percent, the dollar amount per uninsured adult is $695, and the maximum household penalty is $2,085. This health insurance individual mandate has been eliminated for months beginning after December 31, 2018.

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Gift and Estate Taxes

MAY 31, 2019

Gift and Estate Taxes

If you give away money or property during your life, those transfers may be subject to federal gift and estate tax and perhaps state gift tax. The money and property you own when you die (i.e., your estate) may also be subject to federal gift and estate tax and some form of state death tax. These property transfers may also be subject to generation-skipping transfer taxes. You should understand all of these taxes, especially since the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (the 2001 Tax Act), the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act), the American Taxpayer Relief Act of 2012 (the 2012 Tax Act), and the Tax Cuts and Jobs Act. The recent Tax Acts contain several changes that make estate planning much easier.

Federal gift and estate tax — background

Under pre-2001 Tax Act law, no federal gift and estate tax was imposed on the first $675,000 of combined transfers (those made during life and those made at death). The tax rate tables were unified into one — that is, the same rates applied to gifts made and property owned by persons who died in 2001. Like income tax rates, gift and estate tax rates were graduated. Under this unified system, the recipient of a lifetime gift received a carryover basis in the property received, while the recipient of a bequest, or gift made at death, got a step-up in basis (usually fair market value on the date of death of the person who made the bequest or gift).

The 2001 Tax Act, the 2010 Tax Act, the 2012 Tax Act, and the Tax Cuts and Jobs Act substantially changed this tax regime.

Federal gift and estate tax — current

The 2001 Tax Act increased the applicable exclusion amount for gift tax purposes to $1 million through 2010. The applicable exclusion amount for estate tax purposes gradually increased over the years until it reached $3.5 million in 2009. The 2010 Tax Act repealed the estate tax for 2010 (and taxpayers received a

carryover income tax basis in the property transferred at death), or taxpayers could elect to pay the estate tax (and get the step-up in basis). The 2010 Tax Act also re-unified the gift and estate tax and increased the applicable exclusion amount to $5,120,000 in 2012. The top gift and estate tax rate was 35 percent in 2012. The 2012 Tax Act increased the applicable exclusion amount to $5,490,000 (in 2017) and the top gift and estate tax rate to 40 percent (in 2013 and later years). The Tax Cuts and Jobs Act, signed into law in December 2017, doubled the gift and estate tax exclusion amount and the GST tax exemption (see below) to $11,180,000 in 2018. The amount is $11.400,000 in 2019. After 2025, they are scheduled to revert to their pre-2018 levels and cut by about one-half.

However, many transfers can still be made tax free, including:

1. Gifts to your U.S. citizen spouse; you may give up to $155,000 in 2019 ($152,000 in 2018) tax free to your noncitizen spouse
2. Gifts to qualified charities
3. Gifts totaling up to $15,000 (in 2018 and 2019) to any one person or entity during the tax year, or $30,000 (in 2018 and 2019) if the gift is made by both you and your spouse (and you are both U.S. citizens)
4. Amounts paid on behalf of any individual as tuition to an educational organization or to any person who provides medical care for an individual

Federal generation-skipping transfer tax

The federal generation-skipping transfer (GST) tax imposes tax on transfers of property you make, either during life or at death, to someone who is two or more generations below you, such as a grandchild. The GST tax is imposed in addition to, not instead of, federal gift and estate tax. You need to be aware of the GST tax if you make cumulative generation-skipping transfers in excess of the GST tax exemption ($11,400,000 in 2019, $11,180,000 in 2018). A flat tax equal to the highest estate tax bracket in effect in the year you make the transfer (40 percent in 2018 and 2019) is imposed on every transfer you make after your exemption has been exhausted.

State transfer taxes

Currently, a few states impose a gift tax, and a few states impose a generation-skipping transfer tax. Some states also impose a death tax, which could be in the form of estate tax, inheritance tax, or credit estate tax (also known as a sponge or pickup tax). Contact an attorney or your state's department of revenue or taxation to find out more information

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Understanding Defined Benefit Plans

MAY 24, 2019

You may be counting on funds from a defined benefit plan to help you achieve a comfortable retirement. Often referred to as traditional pension plans, defined benefit plans promise to pay you a specified amount at retirement.

To help you understand the role a defined benefit plan might play in your retirement savings strategy, here's a look at some basic plan attributes. But since every employer's plan is a little different, you'll need to read the summary plan description, or SPD, provided by your company to find out the details of your o

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To help you understand the role a defined benefit plan might play in your retirement savings strategy, here's a look at some basic plan attributes. But since every employer's plan is a little different, you'll need to read the summary plan description, or SPD, provided by your company to find out the details of your own plan.

What are defined benefit plans?

Defined benefit plans are qualified employer-sponsored retirement plans. Like other qualified plans, they offer tax incentives both to employers and to participating employees. For example, your employer can generally deduct contributions made to the plan. And you generally won't owe tax on those contributions until you begin receiving distributions from the plan (usually during retirement). However, these tax incentives come with strings attached–all qualified plans, including defined benefit plans, must comply with a complex set of rules under the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code.

How do defined benefit plans work?

A defined benefit plan guarantees you a certain benefit when you retire. How much you receive generally depends on factors such as your salary, age, and years of service with the company.

Each year, pension actuaries calculate the future benefits that are projected to be paid from the plan, and ultimately determine what amount, if any, needs to be contributed to the plan to fund that projected benefit payout. Employers are normally the only contributors to the plan. But defined benefit plans can require that employees contribute to the plan, although it's uncommon.

You may have to work for a specific number of years before you have a permanent right to any retirement benefit under a plan. This is generally referred to as "vesting." If you leave your job before you fully vest in an employer's defined benefit plan, you won't get full retirement benefits from the plan.

How are retirement benefits calculated?

Retirement benefits under a defined benefit plan are based on a formula. This formula can provide for a set dollar amount for each year you work for the employer, or it can provide for a specified percentage of earnings. Many plans calculate an employee's retirement benefit by averaging the employee's earnings during the last few years of employment (or, alternatively, averaging an employee's earnings for his or her entire career), taking a specified percentage of the average, and then multiplying it by the employee's number of years of service.

Note: Many defined benefit pension plan formulas also reduce pension benefits by a percentage of the amount of Social Security benefits you can expect to receive.

How will retirement benefits be paid?

Many defined benefit plans allow you to choose how you want your benefits to be paid. Payment options commonly offered include:

- A single life annuity: You receive a fixed monthly benefit until you die; after you die, no further payments are made to your survivors.
- A qualified joint and survivor annuity: You receive a fixed monthly benefit until you die; after you die, your surviving spouse will continue to receive benefits (in an amount equal to at least 50 percent of your benefit) until his or her death.
- A lump-sum payment: You receive the entire value of your plan in a lump sum; no further payments will be made to you or your survivors.

Choosing the right payment option is important, because the option you choose can affect the amount of benefit you ultimately receive. You'll want to consider all of your options carefully, and compare the benefit payment amounts under each option. Because so much may hinge on this decision, you may want to discuss your options with a financial advisor.

What are some advantages offered by defined benefit plans?

- Defined benefit plans can be a major source of retirement income. They're generally designed to replace a certain percentage (e.g., 70 percent) of your preretirement income when combined with Social Security.
- Benefits do not hinge on the performance of underlying investments, so you know ahead of time how much you can expect to receive at retirement.
- Most benefits are insured up to a certain annual maximum by the federal government through the Pension Benefit Guaranty Corporation (PBGC).

How do defined benefit plans differ from defined contribution plans?

Though it's easy to do, don't confuse a defined benefit plan with another type of qualified retirement plan, the defined contribution plan (e.g., 401(k) plan, profit-sharing plan). As the name implies, a defined benefit plan focuses on the ultimate benefits paid out. Your employer promises to pay you a certain amount at retirement and is responsible for making sure that there are enough funds in the plan to eventually pay out this amount, even if plan investments don't perform well.

In contrast, defined contribution plans focus primarily on current contributions made to the plan. Your plan specifies the contribution amount you're entitled to each year (contributions made by either you or your employer), but your employer is not obligated to pay you a specified amount at retirement. Instead, the amount you receive at retirement will depend on the investments you choose and how those investments perform.

Some employers offer hybrid plans. Hybrid plans include defined benefit plans that have many of the characteristics of defined contribution plans. One of the most popular forms of a hybrid plan is the cash balance plan.

What are cash balance plans?

Cash balance plans are defined benefit plans that in many ways resemble defined contribution plans. Like defined benefit plans, they are obligated to pay you a specified amount at retirement, and are insured by the federal government. But they also offer one of the most familiar features of a defined contribution plan: Retirement funds accumulate in an individual account (in this case, a hypothetical account).

This allows you to easily track how much retirement benefit you have accrued. And your benefit is portable. If you leave your employer, you can generally opt to receive a lump-sum distribution of your vested account balance. These funds can be rolled over to an individual retirement account (IRA) or to your new employer's retirement plan.

What you should do now

It's never too early to start planning for retirement. Your pension income, along with Social Security, personal savings, and investment income, can help you realize your dream of living well in retirement.

Start by finding out how much you can expect to receive from your defined benefit plan when you retire. Your employer will send you this information every year. But read the fine print. Estimates often assume that you'll retire at age 65 with a single life annuity. Your monthly benefit could end up to be far less if you retire early or receive a joint and survivor annuity. Finally, remember that most defined benefit plans don't offer cost-of-living adjustments, so benefits that seem generous now may be worth a lot less in the future when inflation takes its toll.

Here are some other things you can do to make the most of your defined benefit plan:

- Read the summary plan description. It provides details about your company's pension plan and includes important information, such as vesting requirements and payment options. Address questions to your plan administrator if there's anything you don't understand.
- Review your account information, making sure you know what benefits you are entitled to. Do this periodically, checking your Social Security number, date of birth, and the compensation used to calculate your benefits, since these are common sources of error.
- Notify your plan administrator of any life changes that may affect your benefits (e.g., marriage, divorce, death of spouse).
- Keep track of the pension information for each company you've worked for. Make sure you have copies of pension plan statements that accurately reflect

the amount of benefits you're entitled to receive.

- Watch out for changes. Employers are allowed to change and even terminate pension plans, but you will receive ample notice. The key is, read all notices you receive.
- Assess the impact of changing jobs on your pension. Consider staying with one employer at least until you're vested. Keep in mind that the longer you stay with one employer, the more you're likely to receive at retirement.

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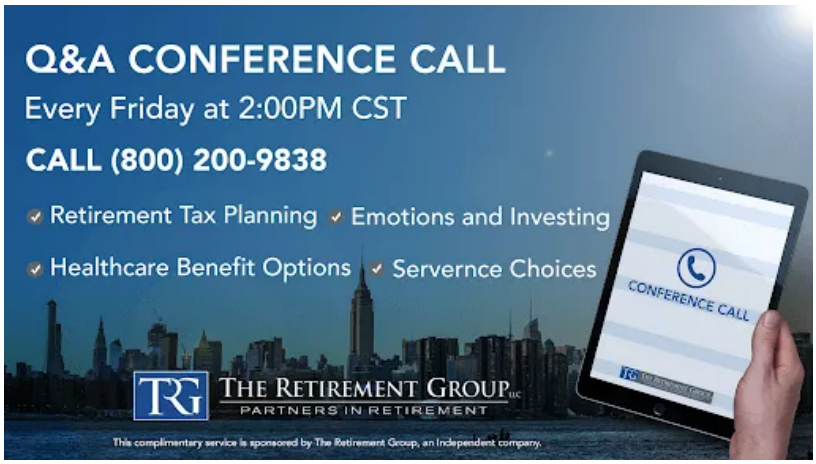

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