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Did The Devil Make You Do It? 8 Retirement Miscues

We're all human, and we all make mistakes. Yet some errors are worse than others, and it's important to try to avoid the kinds of miscues that could derail your retirement.

What sort of mistakes? Of course, these will vary from person to person, but here are eight common foul-ups that often bedevil soon- to-be retirees:

Mistake #1—You have no financial plan for retirement.

Although your plan doesn't have to be carved in stone—and in fact it needs to be flexible—it at least should provide some basic guidelines for your future. A bare-bones plan will look at your potential sources of retirement income and approximate what you can expect to spend—and rough estimates are better than no estimates at all. Figuring out what it may take to live comfortably during retirement is the first step toward getting there.

Mistake #2—You have too much debt.

Perhaps nothing can be more damaging to successful retirement than crushing debt. Avoiding high-interest-rate credit card charges can help you head off the problem. If you spend within your means and borrow judiciously you'll be able to save more for retirement and won't be burdened by the need to pay off compounding debt.

Mistake #3—You sacrifice retirement planning for education planning.

Saving money for your children's college education is obviously a lofty and worthwhile goal, and starting early can help ease your financial burden when tuition bills come due. But you may not want to make education saving your primary financial priority. Often, parents are able to help pay college bills while still putting away money for retirement, and your kids can help by taking low-interest loans to cover part of their costs.

Mistake #4—You don't keep an emergency fund.

Even if you've been diligent about saving for retirement, remember to expect the unexpected. You might lose your job or face another financial or medical emergency, and having a cash cushion to fall back on can help you avoid dipping into retirement funds—an option that could have short- and long-term tax and financial consequences. The usual rule of thumb is to try to set aside at least six months worth of salary in a rainy day fund.

Mistake #5—You don't have a long-term investment strategy.

You're likely to fare better if you establish a long-range investment plan for retirement rather than trying to boost your portfolio by chasing hot stocks. Time-tested principles such as asset allocation and diversification can help you make steady progress toward your goals, whereas playing investment

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Giving Stock To Your Kids An Easy, Tax-Efficient Way

An easy, tax-smart way to transfer assets to your heirs is to give stock to them directly rather than selling the shares and giving them the cash. Because you no longer hold the stock, it's removed from your taxable estate and generally won't count as an asset for you for other financial purposes.

For 2014, you can use the annual gift tax exclusion to give away assets valued at up to $14,000 ($28,000 for joint gifts by a married couple) to a recipient without paying gift tax. (And you can make such gifts to as many people as you choose.) Give more than that to anyone in a particular year and you may be able to shelter the excess by using the unified estate and gift tax exclusion ($5.34 million for 2014).

For your child, income tax rules differ slightly depending on whether the stock would have produced a tax loss or a taxable gain if you had sold it.

• If the stock would have produced a tax loss—and if the child then sells it at a taxable gain—the child's "basis" for figuring the size of that gain is the same as your basis (essentially what you paid for the stock). If it's later sold at a loss, the child's basis is the stock's fair market value (FMV) when it's transferred.

• If the stock would have produced a taxable gain (that is, the FMV is higher than your basis), your child uses your basis to calculate any future gain or loss.

On the other hand, depending on your situation, sometimes it may be better to sell the stock, claim a tax loss, and then give the proceeds to your child.

Unused Estate Tax Election

"DSUEA" sounds like a top-secret agency inside the government. But that's not even close. It's actually the acronym for "deceased spouse unused exclusion amount," a key component of the portability provision in the federal estate tax law.

It's important to understand how the DSUEA is calculated and how portability can save a family hundreds of thousands—or possibly even millions—of estate tax dollars.

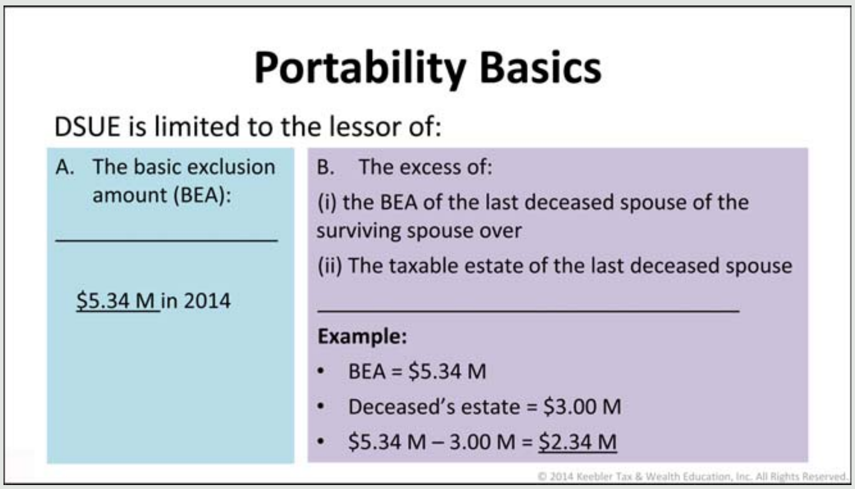
Consider the basic federal estate tax framework. For starters, there's an unlimited marital deduction between spouses. Any amount that's transferred from one spouse to another, whether through a bequest or a lifetime gift, is automatically exempt from estate and gift taxes. In addition, each person's estate can benefit from an exemption for transfers to heirs other than a spouse.

Under the latest tax law changes, the estate tax exemption is permanently fixed at an inflation-adjusted amount based on $5 million. The "basic exclusion amount" (BEA) for 2014 is $5.34 million and increases to $5.43 million in 2015. That allows a married couple to transfer up to $10.77 million to other heirs in 2015, and that amount will be even higher in future years.

The basic premise behind portability is quite simple. When one spouse dies, any unused BEA amount is available to the estate of his or her surviving spouse. Normally a surviving spouse will be able to add the deceased spouse's unused exclusion amount to his or her maximum exempt amount.

Hypothetical example: Susan and Jim, husband and wife, own $3 million individually and $4 million jointly with rights of survivorship. (For simplicity, we will avoid any gains or losses in the value of the assets.) That adds up to a combined estate of $10 million. Their wills specify that their individually owned assets will go to their children when each parent dies.

Now suppose that Susan died in 2014 when the BEA was $5.34 million. Under the tax law formula (see chart), the DSUEA is limited to the lesser of (a) the BEA and (b) the excess of (i) the BEA of the last deceased spouse over (ii) the taxable estate of the last deceased spouse. In the example involving Susan and Jim, the DSUEA is $2.34 million. Therefore, when Jim dies, his estate will be able to utilize the $2.34 million DSUEA—plus the BEA available to Jim in the year of his death.



How much tax will that save? With a 40% top estate tax rate, the savings on the $2.24 million DSUEA is $936,000 ($2.34 million x 40%)!

To take advantage of the portability provision your heirs must make an election on an estate tax return. Coordinate this estate tax break with other aspects of your overall estate plan. ●

Keeping A 529 Plan Rolling Along

If you were thinking ahead, you may have set up a tax-advantaged Section 529 plan for your first child at an early age. Once your kid is ready for college, you'll reap the rewards of your foresight.

But what happens when your son or daughter graduates? If there's still money in the plan, your tax savings don't have to stop there. If you have other children, you could designate one of them to be next in line as the 529 plan beneficiary, and then choose another and another . . . possibly even extending the plan's benefits to your grandchildren!

Section 529 plans, sponsored and operated by individual states, encourage families to set aside funds for future education expenses of the younger generation. As long as certain requirements are met, the money invested in the plan can grow without any erosion by taxes; and distributions that go to pay qualified college expenses—including tuition, fees, books, supplies, equipment, and room and board for full-time students—are completely tax-free.

There are two main types of plans: prepaid tuition plans and college savings plans. A prepaid tuition plan enables you to lock in rates at an in-state public college, whereas a college savings plan gives you more flexibility—the money can be used at a public or private college of your choice—but doesn't offer guarantees.

Keep in mind that it doesn't matter which state's college savings plan you choose, because no matter where it's set up, you can choose where to spend money from the account. But there could be an advantage to using your home state's plan. More than half of the 50 states offer a state tax deduction or credit for Section 529 plan deposits made by residents.

Now suppose your daughter is finishing college and your son is poised to attend next fall. Assuming some

4 Of The Main Reasons To Keep Your Bypass Trust

For decades, the bypass trust was a common staple of family estate plans. But it appeared that this tool might become a relic of days gone by after the American Taxpayer Relief Act of 2012 (ATRA) preserved the "portability" provision of the estate tax law. Because of this provision, a bypass trust no longer was needed to ensure that each spouse in a marriage could maximize his or her estate tax exemption.

Yet even today, the bypass trust remains a viable estate planning option. Consider the following background on how bypass trusts can help and four reasons why you might keep such a trust as part of your estate plan:

What Is a Bypass Trust?

A bypass trust (also called a "credit shelter trust") is established so that assets you leave to your family will bypass your spouse's estate on their way to your children. That way, the trust can use the full estate tax exemption to which each person is entitled. Without a bypass trust, some or all of the assets from the first spouse to die might go to the other spouse, and though there's usually no tax on an inheritance between spouses, the second spouse to die then would have both spouses' assets and only one individual exemption to shield that money from federal estate taxes.

Typically, each spouse might include a provision in his or her will that sets up a trust for the surviving spouse's benefit, and funds it with the equivalent of the deceased spouse's basic exemption amount (BEA). Then, when the surviving spouse dies, the remaining assets go to the kids. As long as the trust is structured properly, this arrangement may avoid estate tax by utilizing the estate tax exemptions of both spouses.

Under ATRA, the BEA is set at a generous level, subject to annual indexing for inflation, and the exempt amount in 2014—$5.34 million—rises to $5.43 million in 2015.

The law's so-called portability provision, established in 2010 and then permanently extended by ATRA, seems to accomplish much of what you'd create a bypass trust to do. Any part of your exemption that you don't use can be added to your spouse's exemption, letting the two of you avoid estate taxes on a total of nearly $11 million. This works no matter who dies first or how you split your assets.

Yet even though portability may eliminate one reason for establishing a bypass trust, other reasons remain. Here are four of the main considerations:

Four Protections of a Bypass Trust

1. Asset protection. Normally, assets that are owned by a surviving spouse become fair game for creditors. What can make the situation even more frustrating for family members is that assets might be siphoned off to help pay the debts of someone who marries the surviving spouse. However, a bypass trust protects the assets from the clutches of creditors, while keeping them safe from lawsuits.

2. Bloodline protection. This isn't as ominous as it sounds. You're not actually trying to preserve your family's bloodlines—you're just using a bypass trust to safeguard the interests of family members to whom you want to leave part of your estate. Although your, and your spouse's wills could name your children as "successor beneficiaries" (to inherit when both of you have died) your intentions could change, especially if the surviving spouse eventually remarries. Without a trust, there's no guarantee that the children of the initial marriage will receive their fair share of the spoils when the surviving parent dies. With a bypass trust, you can arrange for the assets to pass to your children, regardless of future marriages.

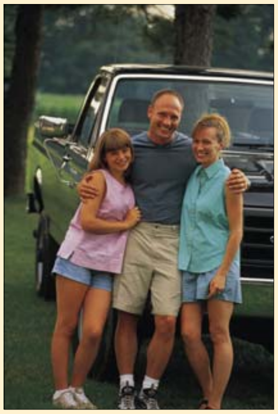
3. Spendthrift protection. Remarriage isn't the only financial concern of a married couple. Assets can be squandered through their children's free-spending ways, or the children might assign their interests in your estate to spouses or others. Including a spendthrift provision in a bypass trust can guard against these potential dangers, while still allowing the assets to be used in a reasonable manner.

4. Power of appointment. A bypass trust can provide greater flexibility by granting a power of appointment to the surviving spouse. This gives the survivor the ability to use the trust assets for his or her health, education, maintenance, or support. Rather than granting a broad "general power" of appointment, it's usually better to provide a "limited power," permitting the beneficiary to allocate only his or her share of the trust among potential recipients.

This list isn't all-inclusive. Other possible reasons for using a bypass trust include maximizing the benefits of the generation-skipping tax (GST) exemption for gifts to grandchildren (the GST exemption is not portable), accounting for state inheritance laws and taxes, creating additional protection for especially large estates that are appreciating in value, and planning for Medicaid eligibility.

With all of this in mind, you may not want to skip over the bypass trust. Consider the entire spectrum of benefits it might provide in your situation. ●

funds are left in the account, you can simply switch the beneficiary designation for the 529 plan to the younger child. Typically, a plan will allow one such change each year. If a younger child will enter college before the older one graduates, you might want to set up a separate account.



Although a plan can continue indefinitely, with your grandchildren eventually becoming beneficiaries, it terminates when the latest beneficiary reaches age 30. Of course, if there's a gap—say, your youngest child turns 30 and you have no grandchildren—you still can set up a new plan for a grandchild in the future.

A final bonus: There's a special gift tax break for 529 plans. Not only are transfers to 529s considered gifts that qualify for the annual gift tax exclusion ($14,000 in 2014), you can make up to five years worth of contributions in one year. And your spouse can do the same. Together, you could transfer up to $140,000 into a child's or grandchild's 529 entirely exempt from gift tax. ●

Social Security: Taxes In And Out

It seems like the IRS has you coming and going on Social Security. While you are working for a living, you must pay taxes into the system to provide benefits for current retirees. Then, when you finally retire, you're entitled to receive retirement benefits but they might be subject to tax as well.

Don't confuse the two taxes. The Social Security tax you pay as an employee is a payroll tax that applies to wages, commissions, and other compensation as part of the FICA tax. An employee's combined FICA rate for Social Security and Medicare in 2014 is 7.65% on the first $117,000 of compensation and 1.45% (Medicare only) above that. But the tax that may apply to Social Security benefits you get in retirement is a federal income tax that is reported along with other items on Form 1040. It's more complicated than the payroll tax.

Here's how it works: You're liable for tax on Social Security benefits if your provisional income (PI) exceeds certain thresholds in the tax law. For this purpose, PI is the total of (1) your adjusted gross income (AGI), (2) your tax-exempt interest income (for example, from municipal bonds), and (3) one-half of the Social Security benefits you received. For example, if the combined AGI of you and your spouse is $100,000 and you collect $5,000 in municipal bond income and $20,000 in Social Security benefits, your PI is $125,000 ($100,000 + $5,000 + $20,000).

There are actually two thresholds for computing the tax on Social Security benefits.

Threshold 1: For a PI between $32,000 and $44,000 ($25,000 and $34,000 for single filers), you're taxed on the lesser of one-half of your benefits or 50% of the amount by which PI exceeds $32,000 ($25,000 for single filers).

Threshold 2. For a PI greater than $44,000 ($34,000 for single filers), you're taxed on 85% of the amount by which PI exceeds $44,000 ($34,000 for single filers) plus the lesser of the amount determined under the first tier or $6,000 ($4,500 for single filers). Silver lining: You'll never owe tax on more than 85% of your total benefits.

These two thresholds aren't indexed annually for inflation. If your PI exceeds a relatively low level of $32,000 ($25,000 for single filers), you'll owe the tax year in and year out. And you'll get hit with the higher tax rate every year that your PI exceeds just $44,000 ($34,000 for single filers).

What can you do about it? You might lower your PI by harvesting capital losses to offset capital gains or deferring taxable income to the following year. But remember that the income from tax-free municipal bonds counts against you in the calculation of PI. Consider all the relevant factors, including the potential tax implications for Social Security benefits, in your investment decisions. ●

8 Retirement Miscues

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hunches is likely to produce more losers than winners. And taking a smart, deliberate approach is as important for investing the assets in tax-sheltered retirement plans, such as 401(k)s and IRAs, as it is for taxable accounts.

Mistake #6—You underestimate health-care costs.

As people live longer and longer—and as growth in health-care costs continues to outpace overall inflation—you'll need to allocate a healthy portion of your savings to personal care. Often, health insurance plans and Medicare will cover much less than you've counted on and you'll need to use your savings to make up the difference. What's more, an extended stay in a nursing home could destroy your retirement nest egg. Consider buying long-term-care insurance to help ward off future disasters.

Mistake #7—You don't factor in taxes.

People often disregard the impact that federal and state taxes can have on their retirement savings. For instance, if you've been accumulating funds in a 401(k) plan and traditional IRAs, when you withdraw money from those accounts to pay your retirement expenses those distributions normally will be taxed at ordinary income rates. In addition, whether you want to or not, you'll have to start taking money from those accounts after you turn age 70½. Your long-term plan for retirement needs to take these taxes into account.

Mistake #8—You count too heavily on Social Security benefits.

After you've paid into the Social Security system during your working career, it's only fair that you reap the benefits. But those monthly payments usually aren't enough to live on comfortably, not by a long shot. It's important to view Social Security as only a supplement to other sources of retirement income—from your investments, company retirement plans, and IRAs.

Making any of these mistakes could cause trouble when it's time to retire. But if you know what to look out for you may be able to avoid problems—and the best time to start fixing things is now. ●

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