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Life Insurance and Divorce: Protecting Your Family's Future

Sometimes in life things don't work out as we plan. One of the most trying examples of this is when a couple decides they can't make their marriage work and, subsequently, file for divorce. Divorce takes a significant financial and emotional toll on both parties, their children, and other family and friends. In the midst of the immediate financial and legal concerns, couples need to look beyond the present to help ensure that their financial futures are secure and that the future needs of children, such as education expenses, will be provided for in the event of an untimely death. Life insurance may offer a solution.

The future educational expenses of college-bound children are growing. According to The College Board's annual report, *Trends in College Pricing—2006*, the average sum of tuition, fees, room, and board for the 2006–2007 school year was \$12,796 at public colleges and \$30,367 at private colleges. Because educational expenses are only expected to increase, the need to plan for future financial security during divorce becomes even more paramount. Let's look at several different scenarios.

After divorce, if the spouse paying alimony and/or child support were to die, then the custodial parent may be hard-pressed to maintain the children's current lifestyle, let alone be able to afford the potentially significant college fees. On the other hand, if the custodial parent were to die prematurely, the ex-spouse may be at a loss to cover daily childcare expenses. For these reasons, divorcing couples may want to strongly consider making life insurance policies part of the divorce decree.



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Consider Your Pension Payout Options

Thoughts of retirement are often accompanied by images of the enjoyable ways you'll spend your days. One thing you may not even consider, though, is that you may be faced with a very important decision come retirement day. If you participate in a **company pension plan**, you'll have to decide *how* you want to receive your pension proceeds. For this reason, take the time *now* to consider your options, so when the time comes, you can make the choice that's right for you.

Typically, most pension plans give retirees the following choices:

1. Income for the rest of your life (**single life option**)
2. Income for the lives of both you and your spouse (**joint and survivorship option**)
3. A **lump-sum distribution**

A Closer Look

At first glance, you might think your marital status will dictate which option is best for you. But, there's a lot more to it than that. Let's take a closer look at the options. The first two options (single life and joint and survivorship) provide you with a fixed income (usually in monthly installments) in exchange for your pension balance. The third option (lump sum) allows you to take your entire pension balance, and you can manage it yourself.

If you're worried about outliving your assets, regardless of your marital status, you should take one of the two "income" options. It's a simple way to ease your fears about running out of money. If you're single, this choice is easy because you can select only the single life option. If you're married, however, it's a different story altogether because you can choose either income option.

The single life option pays a higher monthly income, but payments cease at *your* death. While the joint and survivorship option pays a lower monthly income, payments continue until the death of both you *and* your spouse. If you have other substantial retirement assets or your spouse has his or her own pension, taking the larger income offered by the single life option may be your best bet. On the other hand, if your pension is all you and your spouse have, the spousal security offered by the joint and survivorship option might make sense.

As you carefully review these two income options, keep in mind that there may be an actual "third" income option. This third option is really a combination of the first option—the single life option—and life insurance. By taking the higher income with the single life option and using some of that income to pay the premiums on a life insurance policy, you may be able to "net" more income than with the joint and survivorship option. All the while, your spouse will be protected by a potentially significant life insurance death benefit. After your death, the death benefit proceeds will be received income tax free by your spouse and can be used to help fund his or her own retirement income.

Items to Consider

The success of this combination strategy—often called "pension maximization"—depends on your age, your health, the type of insurance policy, and the schedule of premium payments. The issuance of a life insurance policy is subject to underwriting approval, and you may not qualify. On the other hand, you do not have to qualify for pension benefits; you can be a smoker or in poor health and receive the same benefits. In addition, the issuance of a policy at

a reasonable premium is not guaranteed. Premiums may be higher than expected, and if the premium takes up too much of your monthly benefit amount, this strategy may not make sense. Also, if you waive the spousal provision associated with your benefits, your spouse may lose medical or other benefits provided in conjunction with a pension. Further, your spouse may not have the ability to manage a lump-sum death benefit to reinvest for retirement income. Finally, guarantees of a life insurance policy are based upon the claims-paying ability of the insurer. There is a risk that the policy may not perform as anticipated and produce less income than required. There is also a risk that your spouse will outlive the death benefit source of income, or that the death benefit may "over fund" your spouse's need. In addition, there is a risk that the policy may not perform as anticipated and/or lapse. You have to be a specific age and health to make the numbers work. It's important to find out whether you can make the difference in pension plan distributions less taxes cover the cost of insurance without affecting your lifestyle. You should analyze your situation carefully with the assistance of a financial professional before proceeding with this strategy.

As previously mentioned, selecting an income option requires that you give up your pension balance in exchange for income. In other words, you can't just select a payout option one day and then decide at a later date that you'd like to receive your remaining pension balance in a lump sum. With this in mind, let's turn our attention to the lump-sum distribution.

Taking Control

If you want full control over your pension assets during retirement, or if you are concerned that your

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Fixed Annuities: Guarantee Retirement

Running out of retirement income is a major concern for many Americans. With fewer companies offering traditional pensions with guaranteed payouts, many people must take responsibility for funding their own retirement. **Annuities** that offer a guaranteed fixed rate of return and tax deferral on earnings, as well as income that can last for life, can be an appealing money management option for present and future retirees with a low risk tolerance and/or a need to *diversify* assets.

When you purchase a **fixed annuity**, you receive a guarantee that your money will earn interest at a specified rate, and your return (the money paid back to you) will occur on a set schedule in fixed amounts. There are two payment options: **single premium** (one lump-sum payment) or **multiple premiums** (payments made in installments). Payouts to you can begin immediately or at a future time—they are usually scheduled for retirement—and can last for your lifetime or another scheduled length of time.

Retirees often favor **immediate annuities**, which can begin to provide income at regular intervals as soon as a single, lump-sum premium has been paid. **Deferred annuities**, often favored by those *saving* for retirement, accrue premium payments

(your contributions) over time (the accumulation period) with the payout scheduled for a future date. Earnings on premiums are tax deferred.

Tax Treatment

Because annuities help people save for retirement, they receive favorable tax treatment. Tax deferral allows your potential earnings to enjoy **compound interest** without immediate taxation, which can significantly impact the value of your savings. Unlike some qualified retirement plans, annuities are not subject to income or contribution limits. Annuity payments that are not part of a qualified retirement plan are paid with after-tax dollars. Your principal contribution will not be taxed again, but interest *earnings* are taxable. When used to fund a qualified plan, annuities offer no additional tax advantages.

The Internal Revenue Service (IRS) determines the amount not taxable using an annuity **exclusion ratio**, which accounts for your principal contributions and life expectancy, as well as the annuity's expected return for the life of the contract. The total amount you may exclude from income tax is limited to the total amount of premium you put into the annuity.

The tax benefits of fixed annuities do come with a restriction: Withdrawals taken prior to age 59½ may be subject to a 10% federal tax penalty, in addition to surrender charges, income taxes, and, in some cases, withdrawal charges. Furthermore, if you withdraw funds during the accumulation period, the issuing company may levy withdrawal charges. If you cash in the full value of the annuity, you may incur surrender charges.

Fixed annuities can be an important part of your overall savings and income

strategy, helping to meet diverse financial goals and objectives. If you are currently saving for retirement, a fixed annuity can help supplement your existing long-term vehicles, such as a **401(k) plan** or an **Individual Retirement Account (IRA)**. If you are a retiree, a fixed annuity can provide you with a regular income stream during your golden years. Remember that in order to plan for the future, you must consider it *before* it occurs. ■

Note: Fixed annuities are neither insured nor guaranteed by the FDIC. Guarantees are based on the claims-paying ability of the issuing company.



consider your pension payout options

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pension income may not keep pace with the cost of living, then a lump-sum distribution could be the thing for you. You can take a lump-sum distribution in one of two ways. You can either roll it over into your own **Individual Retirement Account (IRA)** or receive the pension proceeds net of income taxes. Unless you plan on us-

ing your pension assets for something other than retirement, don't even think about receiving your lump sum net of income taxes. The IRA rollover makes the most sense because you'll continue to receive the benefits of tax-deferred accumulation and only be taxed when you take withdrawals from the IRA.

As you can see, before you relax into a comfortable retirement, you must make a difficult decision about your pension proceeds. This will require you to carefully consider several options and determine which one best meets your financial needs and goals. ■

life insurance and divorce: protecting your family's future

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A custodial parent may want to look into purchasing a life insurance policy on his or her ex, but if this turns out to be an impossibility, transferring ownership and beneficiary arrangements on an existing policy may be another option. If policy premiums fall outside of the budget, the custodial parent may request alimony or child support increases to cover the costs. If the non-custodial parent remains the policy owner, the divorce decree can include arrangements to ensure the custodial parent is named as the irrevocable beneficiary and receives ongoing proof that the payments continue to be made and the policy remains in effect.

A parent without custody may wish to keep the policies he or she

already has to protect the financial interests of other family members, such as children from a new marriage. In this case, the non-custodial parent should consider purchasing a new policy with the ex as the beneficiary. If this is done before or during the divorce proceedings, gift tax will not be owed.

For existing policies, individuals should remember that the insurance company must be notified of any beneficiary changes: Using a will for this purpose will not be valid. In addition, should the insured remarry and the policy name the "husband" or "wife" of the insured as the beneficiary, the new spouse may receive the proceeds. If the insured does not remarry and this same policy language is in force, then the proceeds

may be paid to the secondary beneficiary. If the insured's estate is named as the new beneficiary, insurance proceeds will likely be held up in the probate process. If minor children are named as the new beneficiaries, additional problems may arise, as insurance companies generally will not pay minors directly. For this reason, it may be a good idea to create a trust for minor children and name the trust as the beneficiary of the policy proceeds.

Laws vary from state to state, so consulting with an insurance professional is very important. Divorce is rarely easy, but with a well-planned strategy, the short- and long-term financial needs of children can be ensured should life take an unexpected turn. ■

Higher Education Tuition Deduction Extended

The Tax Relief and Health Care Act, signed into law on December 20, 2006, extended some popular tax breaks on the verge of expiration, including the higher education tuition deduction. Through 2007, an above-the-line deduction worth \$4,000 is available to individuals paying qualified higher education expenses. To qualify,



single filers must have adjusted gross incomes (AGIs) of \$65,000 or less, while joint filers must have AGIs of \$130,000 or less. A \$2,000 deduction is available to single filers with AGIs under \$80,000 and to joint filers with AGIs under \$160,000. If you claim either the Hope Credit or the Lifetime Learning Credit, you may not take this deduction. ■

The information provided is not written or intended as tax or legal advice and may not be relied on for purposes of avoiding any Federal tax penalties. Individuals are encouraged to seek advice from their own tax or legal counsel. Individuals involved in the estate planning process should work with an estate planning team, including their own personal legal or tax counsel.