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Life Insurance Options After Retirement Q&As on Roth 401(k)s

Debt Optimization Strategies

How many types of government savings bonds are there, and what's the difference between them?





Financial Update *Ideas and Action Steps for Achievers*

Life Insurance Options After Retirement

Life insurance can serve many valuable purposes during your life. However, once you've retired, you may no longer feel the need to keep your life insurance, or the cost of maintaining the policy may have become too expensive. In these cases, you might be tempted to abandon the policy or surrender your life insurance coverage. But there are other alternatives to consider as well.

Lapse or surrender

If you have term life insurance, you generally will receive nothing in return if you surrender the policy or let it lapse by not paying premiums. On the other hand, if you own permanent life insurance, the policy may have a cash surrender value (CSV), which you can receive upon surrendering the insurance. If you surrender your cash value life insurance policy, any gain (generally, the excess of your CSV over the cumulative amount of premium paid) resulting from the surrender will be subject to federal (and possibly state) income tax. Also, surrendering your policy prematurely may result in surrender charges, which can reduce your CSV.

Exchange the old policy

Another option is to exchange your existing life insurance policy for either a new life insurance policy or another type of insurance product. The federal tax code allows you to exchange one life insurance policy for another life insurance policy, an endowment policy, an annuity, or a qualified long-term care policy without triggering current tax liability. This is known as an IRC Section 1035 exchange. You must follow IRS rules when making the exchange, particularly the requirement that the exchange must be made directly between the insurance company that issued the old policy and the company issuing the new policy or contract. Also, the rules governing 1035 exchanges are complex, and you may incur surrender charges from your current life insurance policy. In addition, you may be subject to new sales, mortality, expense, and surrender charges for the new policy, which can be very substantial and may last for many years afterward.

Lower the premium

If the premium cost of your current life insurance policy is an issue, you may be able to reduce the death benefit, lowering the premium cost in the process. Or you can try to exchange your current policy for a policy with a lower premium cost. But you may not qualify for a new policy because of your age, health problems, or other reasons.

Stream of income

You may be able to exchange the CSV of a permanent life insurance policy for an immediate annuity, which can provide a stream of income for a predetermined period of time or for the rest of your life. Each annuity payment will be apportioned between taxable gain and nontaxable return of capital. You should be aware that by exchanging the CSV for an annuity, you will be giving up the death benefit, and annuity contracts generally have fees and expenses, limitations, exclusions, and termination provisions. Also, any annuity guarantees are contingent on the claims-paying ability and financial strength of the issuing insurance company.

Long-term care

Another potential option is to exchange your life insurance policy for a tax-qualified long-term care insurance (LTCI) policy, provided that the exchange meets IRC Section 1035 requirements. Any taxable gain in the CSV is deferred in the long-term care policy, and benefits paid from the tax-qualified LTCI policy are received tax free. But you may not be able to find a LTCI policy that accepts lump-sum premium payments, in which case you'd have to make several partial exchanges from the CSV of your existing life insurance policy to the long-term care policy provider to cover the annual premium cost.

A complete statement of coverage, including exclusions, exceptions, and limitations, is found only in the policy. It should be noted that carriers have the discretion to raise their rates and remove their products from the marketplace.



Which is the better option, pretax or Roth contributions?

The answer depends upon your personal situation. If you think you'll be in a similar or higher tax bracket when you retire, Roth 401(k) contributions may be more appealing, since you'll effectively lock in today's lower tax rates. However, if you think you'll be in a lower tax bracket when you retire, pretax 401(k) contributions may be more appropriate. Your investment horizon and projected investment results are also important factors.

Q&As on Roth 401(k)s

The Roth 401(k) is 10 years old! With 62% of employers now offering this option, it's more likely than not that you can make Roth contributions to your 401(k) plan.¹ Are you taking advantage of this opportunity?

What is a Roth 401(k) plan?

A Roth 401(k) plan is simply a traditional 401(k) plan that permits contributions to a designated Roth account within the plan. Roth 401(k) contributions are made on an after-tax basis, just like Roth IRA contributions. This means there's no up-front tax benefit, but if certain conditions are met both your contributions and any accumulated investment earnings on those contributions are free of federal income tax when distributed from the plan.

Who can contribute?

Anyone! If you're eligible to participate in a 401(k) plan with a Roth option, you can make Roth 401(k) contributions. Although you cannot contribute to a Roth IRA if you earn more than a specific dollar amount, there are no such income limits for a Roth 401(k).

Are distributions really tax free?

Because your contributions are made on an after-tax basis, they're always free of federal income tax when distributed from the plan. But any investment earnings on your Roth contributions are tax free only if you meet the requirements for a "qualified distribution."

In general, a distribution is qualified if:

- It's made after the end of a five-year holding period, and
- The payment is made after you turn 59½, become disabled, or die

The five-year holding period starts with the year you make your first Roth contribution to your employer's 401(k) plan. For example, if you make your first Roth contribution to the plan in December 2016, then the first year of your five-year holding period is 2016, and your waiting period ends on December 31, 2020. Special rules apply if you transfer your Roth dollars over to a new employer's 401(k) plan.

If your distribution isn't qualified (for example, you make a hardship withdrawal from your Roth account before age 59½), the portion of your distribution that represents investment earnings will be taxable and subject to a 10% early distribution penalty, unless an exception applies. (State tax rules may be different.)

How much can I contribute?

There's an overall cap on your combined pretax and Roth 401(k) contributions. In 2016, you can contribute up to \$18,000 (\$24,000 if you are

age 50 or older) to a 401(k) plan. You can split your contribution between Roth and pretax contributions any way you wish. For example, you can make \$10,000 of Roth contributions and \$8,000 of pretax contributions. It's totally up to you.

Can I still contribute to a Roth IRA?

Yes. Your participation in a Roth 401(k) plan has no impact on your ability to contribute to a Roth IRA. You can contribute to both if you wish (assuming you meet the Roth IRA income limits).

What about employer contributions?

While employers don't have to contribute to 401(k) plans, many will match all or part of your contributions. Your employer can match your Roth contributions, your pretax contributions, or both. But your employer's contributions are always made on a pretax basis, even if they match your Roth contributions. In other words, your employer's contributions, and any investment earnings on those contributions, will be taxed when you receive a distribution of those dollars from the plan.

Can I convert my existing traditional 401(k) balance to my Roth account?

Yes! If your plan permits, you can convert any portion of your 401(k) plan account (your pretax contributions, vested employer contributions, and investment earnings) to your Roth account. The amount you convert is subject to federal income tax in the year of the conversion (except for any after-tax contributions you've made), but qualified distributions from your Roth account will be entirely income tax free. The 10% early-distribution penalty generally doesn't apply to amounts you convert.²

What else do I need to know?

Like pretax 401(k) contributions, your Roth contributions can be distributed only after you terminate employment, reach age 59½, incur a hardship, become disabled, or die. Also, unlike Roth IRAs, you must generally begin taking distributions from a Roth 401(k) plan after you reach age 70½ (or, in some cases, after you retire). But this isn't as significant as it might seem, because you can generally roll over your Roth 401(k) money to a Roth IRA if you don't need or want the lifetime distributions.

¹ Plan Sponsor Council of America, *58th Annual Survey of Profit Sharing and 401(k) Plans* (2015) (Reflecting 2014 Plan Experience)

² The 10% penalty tax may be reclaimed by the IRS if you take a nonqualified distribution from your Roth account within five years of the conversion.





You may be able to improve your financial situation by implementing certain debt payoff strategies that can reduce the time you make payments and the total interest you pay. Before starting any debt payoff strategy (or combination of strategies), be sure you understand the terms of your debts, including any prepayment penalties.

Note: All examples are hypothetical and used for illustrative purposes only. Fixed interest rates and payment terms are shown, but actual interest rates and payment terms may change over time.



As part of improving your financial situation, you might consider reducing your debt load. A number of strategies can be used to pay off debt. However, before starting any debt payoff strategy (or combination of strategies), be sure you understand the terms of your debts, including interest rates, terms of payment, and any prepayment or other penalties.

Understand minimum payments (a starting point)

You are generally required to make minimum payments on your debts, based on factors set by the lender. Failure to make the minimum payments can result in penalties, increased interest rates, and default. If you make only the minimum payments, it may take a long time to pay off the debt, and you may have to pay large amounts of interest over the life of the loan. This is especially true of credit card debt.

Your credit card statement will indicate the amount of your current monthly minimum payment. To find the factors used in calculating the minimum payment amount each month, you need to review terms in your credit card contract. These terms can change over time.

For credit cards, the minimum payment is usually equal to the greater of a minimum percentage multiplied by the card's balance (plus interest on the balance, in some cases) or a base minimum amount (such as \$15). For example, assume you have a credit card with a current balance of \$2,000, an interest rate of 18%, a minimum percentage of 2% plus interest, and a base minimum amount of \$15. The initial minimum payment required would be \$70 [greater of (\$2,000 x 2%) + (\$2,000 x (18% / 12)) or \$15]. If you made only the minimum payments (as recalculated each month), it would take you 114 months (almost 10 years) to pay off the debt, and you would pay total interest of \$1,314.

For other types of loans, the minimum payment is generally the same as the regular monthly payment.

Make additional payments

Making payments in addition to your regular or minimum payments can reduce the time it takes to pay off your debt and the total interest paid. The additional payments could be made periodically, such as monthly, quarterly, or annually.

For example, if you made monthly payments of \$100 on the credit card debt in the previous example (the initial minimum payment was \$70), it would take you only 24 months to pay off the debt, and you would pay total interest of just \$396.

As another example, let's assume you have a current mortgage balance of \$100,000. The interest rate is 5%, the monthly payment is \$791, and you have a remaining term of 15 years. If you make regular payments, you will pay total interest of \$42,343. However, if you pay an additional \$200 each month, it will take you only 11 years to pay off the debt, and you will pay total interest of just \$30,022.

Another strategy is to pay one-half of your regular monthly mortgage payment every two weeks. By the end of the year, you will have made 26 payments of one-half the monthly amount, or essentially 13 monthly payments. In other words, you will have made an extra monthly payment for the year. As a result, you will reduce the time payments must be made and the total interest paid.

Pay off highest interest rate debts first

One way to potentially optimize payment of your debt is to first make the minimum payments required for each debt, and then allocate any remaining dollars to the debts with the highest interest rates.

For example, let's assume you have two debts, you owe \$10,000 on each, and each has a monthly payment of \$200. The interest rate for one debt is 8%; the interest rate for the other is 18%. If you make regular payments, it will take 94 months until both debts are paid off, and you will pay total interest of \$10,827. However, if you make monthly payments of \$600, with the extra \$200 paying off the debt with an 18% interest rate first, it will take only 41 months to pay off the debts, and you will pay total interest of just \$4,457.

Use a debt consolidation loan

If you have multiple debts with high interest rates, it may be possible to pay off those debts with a debt consolidation loan. Typically, this will be a home equity loan with a much lower interest rate than the rates on the debts being consolidated. Furthermore, if you itemize deductions, interest paid on home equity debt of up to \$100,000 is generally deductible for income tax purposes, thus reducing the effective interest rate on the debt consolidation loan even further. However, a home equity loan potentially puts your home at risk because it serves as collateral, and the lender could foreclose if you fail to repay. There also may be closing costs and other charges associated with the loan.



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there, and what's the c While the U.S. government has issued 13 types of savings bonds, there are currently only two series available for

purchase through the U.S. Treasury Department: Series EE bonds and Series I bonds. U.S. savings bonds are nonmarketable securities, which means you can't resell them unless you're authorized as an issuing or redeeming agent by the U.S. Treasury Department. Savings bonds are guaranteed by the federal government as to the timely payment of principal and interest.

You can buy Series EE bonds and I bonds in any amount from \$25 up to \$10,000, which is the maximum amount you can purchase for each bond type per calendar year. In other words, you may buy a total of \$10,000 annually in both EE and I bonds, for an annual total of \$20,000 for the two types combined.

Series EE bonds earn a fixed rate of interest as long as you hold them, up to 30 years. You'll know the interest rate the bond will earn when you buy it. The U.S. Treasury announces the rate each May 1 (for new EE bonds issued between May 1 and October 31) and November

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1 (for new EE bonds issued between November 1 and April 30).

Series I bonds are similar to EE bonds, but I bonds offer some protection against inflation by paying interest based on a combination of a fixed rate and a rate tied to the semi-annual inflation rate. The fixed rate component doesn't change, whereas the rate tied to inflation is recalculated and can change every six months. The total interest (fixed and inflation adjusted) compounds semi-annually.

In any case, the interest on EE or I savings bonds isn't paid to you until you cash in the bonds. You can cash in EE bonds or I bonds any time after one year, but if you cash them out before five years, you lose the last three months of interest.

The interest earned on both EE and I bonds is generally exempt from state income tax but subject to federal income tax. Interest income may be excluded from federal income tax when bonds are used to finance higher-education expenses, although restrictions may apply.



I have matured U.S. savings bonds. Are they still earning interest and, if not, can I roll them over to another savings bond?

Once U.S savings bonds have reached maturity, they stop earning interest. Prior to 2004,

you could convert your Series E or EE savings bonds for Series HH bonds. This would have allowed you to continue earning tax-deferred interest. However, after August 31, 2004, the government discontinued the exchange of any form of savings bonds for HH bonds, so that option is no longer available.

Since matured savings bonds no longer earn interest, there is no financial benefit to holding on to them. If you have paper bonds, you can cash them in at most financial institutions, such as banks or credit unions. However, it's a good idea to call a specific institution before going there to be sure it will redeem your bonds. As an alternative, you can mail them to the Treasury Retail Securities Site, PO Box 214, Minneapolis, MN 55480, where they will be redeemed. If you have electronic bonds, log on to <u>treasurydirect.gov</u> and follow the directions there. The proceeds from your redeemed bonds can be deposited directly into your checking or savings account for a relatively

nds have quick turnover.

Another important reason to redeem your matured savings bonds may be because savings bond interest earnings, which can be deferred, are subject to federal income tax when the bond matures or is otherwise redeemed, whichever occurs first. So if you haven't previously reported savings bond interest earnings, you must do so when the bond matures, even if you don't redeem the bonds.

Using the money for higher education may keep you from paying federal income tax on your savings bond interest. The savings bond education tax exclusion permits qualified taxpayers to exclude from their gross income all or part of the interest paid upon the redemption of eligible Series EE and I bonds issued after 1989 when the bond owner pays qualified higher-education expenses at an eligible institution. However, there are very specific requirements that must be met in order to qualify, so consult with your tax professional.