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I found out that you can take a vacation without a cell phone - and survive and relax a little bit more! As I was boarding the plane to Hawaii for a week vacation, I realized I didn't have my cell! I still had my laptop I was connected, but a little less so! I let my fabulous office assistants Annette and Casey know so that they could be in touch if necessary, but then I let it go!

Social Responsible Investing: I attended the SRI BaseCamp Conference in San Francisco. There is now $3.7 trillion invested in companies that are screened for being sustainable, responsible in the workplace, to the environment, etc. IMPACT investing*, it is a goal for many of the investment managers. They want the $3.7 trillion to help change the world, to help the companies that they invest in, make positive changes for the world that we live in. Many of my clients are invested this way.
*The return may be lower than if the advisor made decisons based solely on investment considerations.

March 2013

Flournoy Wealth Management

Your Financial Future

Pursuing Life Goals Together

Making the Most of Your 401(k) Plan

A 401(k) plan represents one of the most powerful retirement savings opportunities available today. If your employer offers a 401(k) plan and you're not participating in it, you should be.

Contribute as much as possible

The more you can save for retirement, the better your chances of enjoying a comfortable retirement. If you can, max out your contribution up to the legal limit ($17,500 in 2013, $23,000 if you're age 50 or older). If you need to free up money to do that, try to cut certain expenses. (Note: some plans limit the amount you can contribute.)

Why invest your retirement dollars in a 401(k) plan instead of somewhere else? One reason is that your pretax contributions lower your taxable income for the year. This means you save money in taxes immediately when you contribute to the plan--a big advantage if you're in a high tax bracket. For example, if you earn $100,000 a year and contribute $17,500 to a 401(k) plan, you'll only pay federal income taxes on $82,500 instead of $100,000.

Another reason is the power of tax-deferred growth. Any investment earnings compound year after year and aren't taxable as long as they remain in the plan. Over the long term, this gives you the opportunity to build an substantial sum in your employer's plan. (Your pretax contributions and any earnings will be taxed when paid to you from the plan.)

Consider Roth contributions

Your 401(k) plan may also allow you to make after-tax Roth contributions. Unlike pre-tax contributions, Roth contributions don't lower your current taxable income so there's no immediate tax savings. But because you've already paid taxes on those contributions, they're free from federal income taxes when paid from the plan. And if your distribution is "qualified" (that is, the distribution is made after you satisfy a five-year holding period, and after you reach age 59½, become disabled, or die) any earnings are also tax free.

If your distribution isn't qualified, any earnings you receive are subject to income tax. A 10% early distribution penalty may also be imposed if you haven't reached age 59½ (unless an exception applies).

Capture the full employer match

Many employers will match all or part of your contributions. If you can't max out your 401(k) contributions, you should at least try to contribute as much as necessary to get the full employer match. Employer matching contributions are basically free money. By capturing the full benefit of your employer's match, you'll be surprised how much faster your balance grows. If you don't take advantage of your employer's generosity, you could be passing up a significant contribution towards your retirement.

Access funds if you must

Another beneficial feature that many 401(k) plans offer is the ability to borrow against your vested balance at a reasonable interest rate. You can use a plan loan to pay off high-interest debts or meet other large expenses, like the purchase of a car. You typically won't be taxed or penalized on amounts you borrow as long as the loan is repaid within five years. Immediate repayment may be required, however, if you leave your employer--if you can't repay the loan, you may be treated as having taken a taxable distribution from the plan.

And remember that when you take a loan from your 401(k) plan, the funds you borrow are generally removed from your plan account until you repay the loan, so you may miss out on the opportunity for additional tax-deferred investment earnings. So loans (and withdrawals if available) should be a last resort.

Evaluate your investment choices

Choose your investments carefully. The right investment mix could be one of your keys to a comfortable retirement. That's because over the long term, varying rates of return can make a big difference in the size of your 401(k) plan account.

The "SEPP" Exception to the IRA Premature Distribution Tax

In these challenging economic time, you may be considering taking a withdrawal from your traditional IRA. While you're allowed to withdraw funds from your IRAs at any time, for any reason, the question is, should you?

Technically, there are three IRS-approved methods for calculating SEPPs--the RMD (required minimum distribution) method, the fixed amortization method, and the fixed annuitization method. The rules for calculating your SEPPs can be found in IRS Notice 89-25 and Revenue Ruling 2002-62.

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Why you should think twice

Taxable distributions you receive from your IRA before age 59½ are generally referred to as premature distributions, or early withdrawals. To discourage early withdrawals, they're subject to a 10% federal penalty tax (and possibly a state penalty tax) *in addition to* any federal and state income taxes. This 10% penalty tax is commonly referred to as the premature distribution tax.

However, not all distributions before age 59½ are subject to the federal penalty tax. For example, the penalty tax doesn't apply if you have a qualifying disability, or if you use the money to pay certain medical, college, or first-time homebuyer expenses.

The SEPP exception to the penalty tax

But one of the most important (and often overlooked) exceptions, from a retirement income perspective, involves taking a series of "substantially equal periodic payments" (SEPPs) from your IRA. This exception from the federal penalty tax is important because it's available to anyone, regardless of age, and the funds can be used for any purpose.

SEPPs are amounts that are calculated to exhaust the funds in your IRA over your lifetime (or life expectancy) or the joint lives (or joint life expectancy) of you and your beneficiary. To avoid the 10% penalty, you must calculate your lifetime payments using one of three IRS-approved distribution methods, and take at least one distribution annually.

Calculating your payment

If you have more than one IRA, you can take SEPPs from just one of your IRAs or you can aggregate two or more of your IRAs and calculate the SEPPs from the total balance. It's up to you. But you can't use only a portion of an IRA to calculate your SEPPs.

You can also use tax-free trustee-to-trustee transfers (or rollovers) to ensure that the IRA(s) that will be the source of your periodic payments contain the exact amount necessary to generate the payment amount you want based on the IRS formulas. This makes the SEPP exception a very important and flexible retirement income planning tool.

Modifying your payments

Even though your payments must be calculated as though they'll be paid over your lifetime (or over you and your beneficiary's lifetimes), you don't actually have to take distributions for that long. You can change, or stop, your SEPPs after payments from your IRA have been made for at least five years, or after you reach age 59½, whichever is later.

But be careful--if you "modify" the payments before the required waiting period ends, the IRS will apply the 10% penalty tax (plus interest) to all taxable payments you received before age 59½ (unless the modification was due to your death or disability).

For example, assume Mary began taking SEPPs from her traditional IRA account three years ago, when she was 43 years old (using one of the three IRS-approved methods). Mary does not take a distribution this year. Because Mary's payment stream has been modified before she turned 59½, the 10% penalty (plus interest) will now apply retroactively to the taxable portion of all her previous distributions.

The five-year period begins on the date of your first withdrawal, so you can't make any changes before the fifth anniversary of that withdrawal. This is true even if you turn age 59½ in the meantime.

For example, assume John began taking SEPPs from his traditional IRA (using an IRS-approved method) on December 1, 2009, and that he also took payments on December 1 of 2010, 2011, and 2012. John turned 59½ on December 2, 2012. Even though John is over age 59½, he must take one more payment by December 1, 2013. Otherwise, he'll be subject to the 10% penalty on the taxable portion of the distributions he took before he turned age 59½.

Caution: *To ensure that your distributions will qualify for the SEPP exception to the premature distribution tax, be sure to get professional advice. The calculation of SEPPs can be complicated, and the tax penalties involved in the event of an error can be significant.*

Also, if your state imposes a penalty tax on early withdrawals, be sure to determine whether any similar exemption from the state tax is available to you.

Looking Backward and Forward on Entitlement Programs

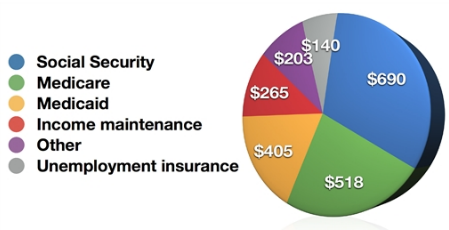
An unsustainable path

The bipartisan Bowles/Simpson Deficit Reduction Commission stated that "our nation is on an unsustainable fiscal path" in regard to entitlement spending.

Last year's presidential election, along with the more recent fiscal cliff and debt ceiling negotiations, have put the spotlight on our nation's tax policy, deficit, and entitlement programs. For some, entitlement programs are necessary--a social compact for America in an era of longer life spans, the decline of employer-provided pensions and health insurance in retirement, and a widening gap between the haves and the have-nots. For others, the current level of entitlement spending is jeopardizing our country's fiscal health and creating an "entitlement lifestyle." No matter where you stand in the debate, do you know the basic facts on our country's largest entitlement programs?

Where the money goes

All entitlement spending isn't created equal. The "Big Three" of Social Security, Medicare, and Medicaid account for more than two-thirds of all federal entitlement spending. Social Security and Medicare are primarily age-based programs, whereas Medicaid is based on income level. According to the U.S. Bureau of Economic Analysis, in 2010, the federal government spent a total of $2.2 trillion on entitlement programs, with the Big Three accounting for $1.6 trillion of this total. The largest expenditure was for Social Security ($690 billion), followed by Medicare ($518 billion) and Medicaid ($405 billion).



A history of growth

Alexis de Tocqueville, the famous French political thinker who traveled to the United States in the early 1830s and wrote about the uniqueness of our young nation's individual self-reliance in his famous book, *Democracy in America,* would likely be surprised to observe the growth in spending on entitlement programs that has occurred in the United States over the past 50 years. According to the Bureau of Economic Analysis, in 1960, U.S. government transfers to individuals totaled about $24 billion in current dollars. By 2010, that figure was $2.2 trillion, almost 100 times as much.

Current status

Let's look at our two main entitlement programs--Social Security and Medicare.

Social Security. Created in 1935, Social Security is a "pay-as-you-go" system, meaning that payments to current retirees come primarily from payments into the system by current wage earners in the form of a 12.4% Social Security payroll tax (6.2% each from employee and employer). These payroll taxes are put into two Social Security Trust Funds, which also earn interest. According to projections by the Social Security Administration, the trust funds will continue to show net growth until 2022, after which, without increases in the payroll tax or cuts in benefits, fund assets are projected to decrease each year until they are fully depleted in 2033. At that time, it's estimated that payroll taxes would only be able to cover approximately 75% of program obligations.

Medicare. Created in 1965, Medicare is a national health insurance program available to all Americans age 65 and older, regardless of income or medical history. It consists of Part A (hospital care) and Part B (outpatient care)--which together make up "traditional" Medicare; Part C (Medicare Advantage, which is private insurance partly paid by the government); and Part D (outpatient prescription drugs through private plans only). Medicare Part A is primarily funded by a 2.9% Medicare payroll tax (1.45% each from employee and employer), which in 2013 is increased by 0.9% for employees with incomes above $200,000 (single filers) or $250,000 (married filing jointly). In addition, starting in 2013, a new 3.8% Medicare contribution tax on the net investment income of high-earning taxpayers will take effect.

Looking ahead, Medicare and Medicaid are expected to face the most serious financial challenges, due primarily to increasing enrollment. The Congressional Budget Office, in its report *Budget and Economic Outlook: Fiscal Years 2012 to 2022,* predicts that federal spending on Medicare will exceed $1 trillion by 2022, while federal spending on Medicaid will reach $605 billion (state spending for Medicaid is also expected to increase). According to the CBO, reining in the costs of Medicare and Medicaid over the coming years will be the central long-term challenge in setting federal fiscal policy.

Reform

There has been little national consensus by policymakers on how to deal with rising entitlement costs. At some point, though, reform is inevitable. That's why it's a good idea to make sure your financial plan offers enough flexibility to accommodate an uncertain future.

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What is pet insurance?

For many, a pet is a full-fledged member of the family. And just as health-care costs for human family members have risen over the years, so has the cost of veterinary care. It's probably not surprising, then, that pet insurance has gone in a fairly short period of time from relative obscurity to something that more and more people are considering.

With pet insurance, you pay premiums to a pet insurance provider; in return, the provider agrees to pay for some of your pet's medical costs, according to the specific terms and limits detailed in the policy agreement. How much you pay in premiums and the coverage you receive vary widely by provider, and depend on factors that include breed and age.

If you are considering pet insurance, it's important to request quotes from several providers (a list of 12 pet insurance providers, along with some helpful information, is available at www.avma.org, the website of the American Veterinary Medical Association). After obtaining quotes from multiple providers, look carefully at the coverage details offered by each company.

With pet insurance, costs associated with "wellness" care (e.g., regular office visits and vaccinations) generally aren't covered. Pre-existing conditions are also generally excluded. Some providers also exclude certain hereditary or common conditions--for example, many pet insurance providers exclude coverage for hip dysplasia, a disease often associated with larger dog breeds.

In addition to comparing coverages, make sure that you understand your out-of-pocket responsibilities. You may be responsible for a co-payment. You're probably also responsible for a specified deductible amount before a policy will make any payment. And once you've satisfied any deductible, a policy is likely to pay only a certain percentage of covered costs. So, for example, you might have a policy that pays 80% of covered costs after you satisfy the policy deductible. Some providers also cap benefits on a per-illness, annual, or lifetime basis.

One final note--with your health insurance, your provider probably bills your insurance directly. That's generally not the case with pet insurance. Typically, you pay all costs up front, and then you submit claims to the pet insurance provider for reimbursement.

Is pet insurance worth the cost?

The last thing you want is to have to forgo lifesaving treatment for your pet sometime down the road because you simply don't have the money to pay for it. But that's a situation many pet owners eventually face. Pet insurance can provide some peace of mind, but is it worth the cost? That's a tough question to answer.

Let's say that you have a two-year-old Labrador retriever. You get quotes from all the major pet insurance providers, and after carefully comparing coverages and details, you decide on a policy that will pay 80% of covered costs after you satisfy an annual $250 deductible. Your cost for the policy is $40 each month. In most years, you don't have any reimbursable claims--just routine visits or claims that don't exceed the deductible. After six years, your lovable Lab swallows a sock, things go horribly wrong, and he needs surgery at a cost of $4,000. Good thing you purchased the insurance, right?

Remember, you have a $250 deductible, so you will have to cover that yourself. And, the insurance policy will only reimburse you for 80% of the remaining $3,750, or $3,000. Consider this: If, instead of purchasing the pet insurance policy, you set aside $40 each month into an account earning 3%, you would have a little over $3,000--the same amount you would receive from the insurance policy--saved by the time the operation was needed. Of course, this example assumes that you have the discipline to set money aside each month. And, of course, if the great sock catastrophe happened in year two instead of year six, the insurance might seem like a wise purchase.

The bottom line is that pet insurance companies are in business to make a profit, and that is how they set their rates. By purchasing a pet insurance policy, you're shifting some of the potential financial risk from you to the insurance provider, and you are paying for that as part of your premiums. That doesn't mean purchasing pet insurance is a bad decision; you just have to consider the numbers carefully. At the same time, you have to factor in that it's not all about the numbers--you may believe now that there's a limit to what you will spend to treat a pet, but if and when that time comes, emotions often have a tendency to trump logic.