Investor Insights & Outlook

November 2011 | Vol. No. 1 | Investment Updates

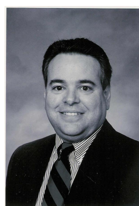
A Quick Guide to Home Equity Loans

If you as a consumer need an additional line of credit, a home equity loan, also known as a second mortgage where your home serves as collateral, is one of several options that you can choose from. There are two major advantages of home equity loans. First, the interest rate on home equity loans is usually lower than credit cards and other consumer loans. Second, you can usually deduct the interest on home equity loans, unlike other loans. There are two types of home equity loans—fixed-rate loans and lines of credit.

A fixed-rate loan provides a single, lump-sum payment to the borrower, and is repaid over a fixed period of time at a pre-determined interest rate. This is useful if you know how much you would need and when you would be able to pay off the loan.

A home equity line of credit (HELOC) is a variable rate loan that works like a credit card. Borrowers are pre-approved for a specific spending limit and can withdraw money when needed via a credit card or special checks. Similar to a fixed-rate loan, the outstanding loan amount must be repaid in full at the end of the term. However, unlike a fixed-rate loan, HELOC interest rates float up or down, generally adjusted based on the current prime rate. A HELOC is a convenient way to cover short-term, recurring costs, such as quarterly tuition for a four-year college degree.

Although home equity loans do provide attractive rates of financing, we caution consumers to think twice about the reasons why one would need an additional line of credit. If you are thinking about using a home equity loan for day-to-day expenses, one should examine whether you are overspending and possibly sinking deeper into debt. If you end up taking out more money than your house is worth, the interest paid on the loan above the value of the home is not tax deductible.



JOHN MEZZASALMA
CPA, CFP®
JDMEZZ@AOL.COM
732-842-1120
mezzadvisors.com

Advisor Biography

John has been in the tax and financial services industry since 1976 and is a member of The Institute of Certified Financial Planners, The NJ CPA Society and his local chapter of The Lions Club International, where he currently serves as their treasurer.

He has been a Certified Public Accountant (CPA) since 1978 and a Certified Financial Planner (CFP®) since 1990.

John specializes in developing financial strategies for physicians, business owners and high net worth individuals. He is also an expert on Income Tax savings strategies for physicians.

John has received numerous awards such as: Finalist in the Individual Investor of the Year Challenge, The National Quality Award; The Oppenheimer President's Council.

Community Service: He currently serves as treasurer of his church and the local chapter of the Lions club where he earned the "Lion of the Year" award for his service.

Personal: He has 3 children. Two of them are CPAs. He also has 5 grandchildren – all girls!

Another Option for Early-Retirement Withdrawals

The recent recession has hit older workers disproportionately. Older workers generally spend a longer time looking for jobs once they've lost them. The sad result is that individuals are tapping retirement accounts to stay in their homes and fund other living expenses, as well as to pay for major life changes such as relocation or further education.

IRA-withdrawal rules are particularly complicated, so this article will focus on one aspect of them in-depth: withdrawals based on the so-called 72(t) exception. Although it's almost never ideal to raid your retirement accounts prematurely, this type of withdrawal may be useful for people who need additional cash to carry them through a specific period in their lives--before they're eligible for a pension or Social Security, for example.

In a nutshell, the 72(t) exception allows individuals who are younger than age 59 1/2 to avoid the 10% early-withdrawal penalty for premature IRA distributions. (It does not help you circumvent any taxes owed on the IRA, however; just the 10% penalty.) To take advantage of 72(t), individuals must receive their IRA assets in what the IRS calls "substantially equal period payments" for a period of at least five years. The payments must continue until the age of 59 1/2 or until five years have elapsed, whichever is longer.

The net effect of that rule is that everyone using this exception will need to take withdrawals for at least five years, and younger folks will have to take distributions over many years. A 50-year-old woman, for example, would have to spread her distributions over 9 1/2 years, until she's 59 1/2. Meanwhile, a 57-year-old man who initiates 72(t) distributions would need to take the distributions for five years until he turns 62, well after he'd already hit the 59 1/2-year mark. If you've begun taking 72(t) distributions but later determine you want to stop, you'll owe the IRS the 10% penalties for early IRA distributions, plus interest. For that reason, it's crucial to be sure that substantially equal periodic payments will work for you.

You don't have to liquidate all of your IRA assets to take advantage of 72(t); if you have separate IRA accounts, you can withdraw from some and leave others alone. It's also possible to reposition your assets in advance of a 72(t) distribution--that is, leave some money in an IRA to compound and grow while repositioning other assets in short-term securities for 72(t) distributions. Furthermore, though the majority of people using this distribution method are doing so with traditional IRA assets, it's also possible to apply this distribution method to Roth assets. (This won't often be desirable, however.)

In general, 72(t) withdrawals will tend to make the most sense for people who need income during a certain period of time. And at the risk of stating the obvious, they'll also be best for folks who have an alternate source of retirement funding besides the amount that they're paying themselves through 72(t).

On the flip side, using this withdrawal method can be complicated and paperwork intensive. It won't make sense for those who need a lump sum to start a business or buy a vacation home because the whole point of 72(t) is that you're receiving payments during a period of at least five years. Nor will 72(t) usually make sense for Roth IRA holders, who have a lot more flexibility in taking withdrawals than do traditional IRA holders. Finally, those who leave their former employers at age 55 or after and have assets in their old 401(k)s can take penalty-free withdrawals directly from their accounts; rolling the assets into an IRA in order to facilitate 72(t) distributions wouldn't be necessary.

The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. Please consult with a tax and/or financial professional before making any investment decisions.

Government Health-Care Spending: Medicare

It is a well-known fact that the United States spends much more than other developed countries on health care, both in absolute dollars and as a percentage of GDP. Two enormous, complicated programs, Medicare and Medicaid, account for the majority of government health-care spending in the U.S. Both programs have been growing rapidly, which is expected to continue in the coming years.

Medicare and Medicaid were both created in the mid-1960's as part of Lyndon Johnson's Great Society agenda. As of 1970, 62% of total health-care spending was still private, with out-of-pocket spending the single most significant source. During the subsequent forty years, however, Medicare and Medicaid each expanded by more than 11% annually due to benefit expansions and demographic change, pushing public-sector spending up to nearly 50% of total health-care expenditures. During the same time, private-sector spending also grew at a robust 8.7% annually, as employer-sponsored insurance became the predominant conduit of health-care spending.

Looking forward, the Centers for Medicare & Medicaid Services (CMS) project 6.5% annual health-care spending growth over the next decade. Public sector growth is again expected to outpace private spending growth, with a 6.9% growth rate compared to 6% for the private sector. Combined, Medicare and Medicaid are expected to account for 39% of U.S. health-care spending in 2019, up from 37% in 2010 and 17% in 1970.

Medicare is a federal government program that provides health insurance to people over age 65, and people with certain disabilities. In 2009, more than 43 million people received health insurance benefits through Medicare at a total cost of approximately $510 billion. Medicare benefits are divided into three parts: Part A Hospital Insurance, Part B Medical Insurance, and Part D Prescription Drug Insurance. Part C created a private version of Medicare, now called Medicare Advantage. More details about these benefits can be found in the attached table.

Original Medicare's relatively high cost-sharing provisions and lack of a limit on out-of-pocket spending can leave beneficiaries exposed to potentially devastating expenses in the case of a serious adverse health event. For this reason, most Medicare beneficiaries also carry supplemental insurance. Employer-sponsored retiree health plans, though becoming less common, still cover approximately 30% of the Medicare population. 20% of Medicare beneficiaries purchase individual supplemental policies, also called Medigap policies. Medicaid helps pay Medicare's premiums and cost-sharing for another 20% of the Medicare population. Only about 10% of Medicare beneficiaries are estimated to be completely without supplemental coverage.

Medicare Benefits Breakdown

Benefit	Approx. % of Spending	What Does It Cover?	What Does It Cost Beneficiaries?
Part A	39	Inpatient hospital care, skilled nursing facilities, and in some cases hospice or home care.	Generally no monthly premium as long as the beneficiary paid sufficient payroll taxes while working. Deductible and co-insurance for hospital stays exceeding 60 days.
Part B	26	Physician services, outpatient care, and in some cases physical or occupational therapy and home health care.	Monthly premium, deductible, and 20% co-insurance after the deductible is met.
Part C	23	Same benefits as Part A, Part B, and often Part D. Medicare Advantage plans are offered by private insurance companies as an alternative to original government-run Medicare.	Monthly premium, deductibles, co-pays, and co-insurance.
Part D	11	Prescription drugs.	Part D benefits are only offered through private insurance companies, which charge a premium in addition to deductibles, co-pays, and co-insurance.

Source: Kaiser Family Foundation and Medicare.gov

Simple Steps for Late Savers

The sooner you start putting aside money for retirement, the more you might have once that highly anticipated day arrives. Saving for college tuition, purchasing a new home, unforeseen medical expenses, or life's other necessities, surprises, or even enjoyments can cause investors to postpone saving. Starting the retirement planning process late in one's life can be daunting, but it is by no means impossible.

Crunch the Numbers: The first step to getting back on track is to put together a budget—this will force you to focus on your financial situation and can serve as a roadmap to success. Once you have outlined all of your expenses, simply subtract the total from your net income. The result will give you a clear indication of how much you can potentially save, and also help you identify areas in which you may be spending too much.

Cut Any Unnecessary Expenses: There are essential expenses that cannot be eliminated: food, electricity, etc. However, most people can identify some areas, like entertainment, that are not vital to one's existence and can be cut back on. The more areas that you can trim will lead to more money that can be earmarked for retirement.

Take Advantage of Catch-up Contributions: Catch-up contribution limits allow investors age 50 and above to increase their contribution. For example, they can make an extra contribution of $5,500 to their 401(k) in 2011, equating to a maximum contribution of $22,000. IRA catch-ups are $1,000 in 2011, leading to a maximum contribution of $6,000.

©2011 Morningstar, Inc. All Rights Reserved. The information contained herein (1) is intended solely for informational purposes; (2) is proprietary to Morningstar and/or the content providers; (3) is not warranted to be accurate, complete, or timely; and (4) does not constitute investment advice of any kind. Neither Morningstar nor the content providers are responsible for any damages or losses arising from any use of this information. Past performance is no guarantee of future results. "Morningstar" and the Morningstar logo are registered trademarks of Morningstar, Inc. Morningstar Market Commentary originally published by Robert Johnson, CFA, Director of Economic Analysis with Morningstar and has been modified for Morningstar Newsletter Builder.

JOHN MEZZASALMA
CPA, CFP®

106 APPLE ST
STE 107
TINTON FALLS, New Jersey 07724

JDMEZZ@AOL.COM
mezzadvisors.com

Tel:732-842-1120
Fax:732-676-7639