Family Wealth Management
Planning for Generations

Financial Perspectives

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FHA Reverse Mortgages Come Lock, Stock & Barrel

A new perk could potentially boost the size of reverse mortgage loans. An interest rate lock, now available on mortgages approved by the Federal Housing Administration (FHA)—about 90% of the reverse mortgage market—lets borrowers pin down an interest rate when applying for a loan. Until now, you risked a higher-than-expected interest rate on closing day—and, as a result, a reduced loan amount.

If you're 62 or older and have paid off most of your home loan, a home equity conversion mortgage—more commonly known as a reverse mortgage—lets you "reverse" the mortgage process. Instead of making monthly payments on your home, you sell your house to a lender in exchange for a lump sum, monthly payments, or, most commonly, an equity line of credit.

The loan needn't be paid back until you sell your house, vacate it for longer than a year, or die. Then, you or your estate repays the loan's principal and interest. Should your house sell for less than the borrowed amount, the bank eats the loss.

How do interest rates affect how much you borrow? They're one of the factors lenders consider—along with your age, and the value and location of your home—in determining a maximum loan amount. Rates for FHA reverse mortgages are based on the yield of the 10-year U.S. Treasury security, with an average 1% margin. Even a mild rate increase can affect the size of the loan.

Consider a 76-year-old man with a house valued at $500,000. He was approved to tap $315,548 in equity based on a 4.37% interest rate. But if rates rose a quarter percentage point—to 4.62%—before closing and he hadn't locked in the lower rate, he'd qualify for only $305,162, or $10,386 less, according to the National Reverse Mortgage Lenders Association.

The lock, which lenders must provide free of charge, is a no-lose proposition when you close within 60 days of filing your application, explains a report from the Department of Housing and Urban Development (HUD), which provides FHA-approved loans. That's how long your rate is guaranteed. If interest rates drop before closing, you can opt for the new lower rate.

HUD approved the reverse mortgage lock in March 2003, but it wasn't implemented until recently because lenders needed time to adjust the loan process and wanted reassurance that Fannie Mae, the government-sponsored agency that invests in mortgages, would buy locked home equity conversion loans.

Although Congress created reverse mortgages in 1989 to offer cash-strapped seniors access to steady, tax-free income, today the loans are being used to finance retirement luxuries such as second homes, vacations, and even personal aircraft. But are they for everyone? Consider these factors:

Is a reverse loan worth the cost if you borrow only a small amount? For minor borrowing, this may be a very expensive way to go, with origination fees, appraisal costs,

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Time To Start Planning Our Next Client Event

We recently completed our latest Client Advisory Board meeting, in which we shared our plans for the upcoming year. We will be scheduling a quarterly Client Education Event to inform you about topics of current interest—such as creative uses of reverse mortgages and new developments in the area of retirement income planning—as well as some programs that have been created to protect your investment principal during unstable times.

We'd like your opinion on topics that you feel would be relevant to you and other clients; simply drop me an email with your suggestions. You are of course free to invite a guest or two who you feel would benefit from an informative and educational session, not to mention the fun activities like golf lessons, wine tasting, and bungee jumping (just wanted to see if you were paying attention!) that we tie into these events.

Finally, you will be receiving a client survey in the next several weeks that will help us to improve our service and deliverables. We appreciate your taking the time to complete it and return it to us in a timely manner. Those who reply will be eligible for a drawing for dinner at the winner's favorite restaurant! That's how much we appreciate your opinions.

Martin V. Higgins

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Why Use A Beneficiary-Controlled Trust?

Whether you are passing along assets to heirs, expecting an inheritance yourself, or have already received one in trust, a beneficiary-controlled trust could prove useful. As the name suggests, the beneficiary of this trust enjoys significant control over its assets—about the same level of control as if the beneficiary actually owned the property.

But the trust offers a distinct advantage over outright ownership. Assuming it's set up properly, assets are shielded from the claims of creditors, divorcing spouses, and federal estate tax.

You can't establish a beneficiary-controlled trust for yourself. However, as an heir, you could ask to receive your inheritance in that form. Or, if you are the beneficiary of a trust scheduled to terminate by paying you its assets—thus ending their protection—the laws in your state may let you reinvent the terminating trust as a beneficiary-controlled trust.

Many parents and grandparents, meanwhile, especially those who have experienced a messy divorce first-hand, choose to leave property in trust to financially responsible heirs, rather than bequeath it outright. The trust's creator, known as the grantor, can even use his or her generation-skipping transfer-tax exemption (currently $2 million) to set up the trust as a dynasty trust so later generations may enjoy the benefits.

Control springs from tapping the beneficiary to serve as trustee, although top attorneys believe it's necessary for there to be a co-trustee who is responsible for decisions about distributing trust assets. Even so, that role could be filled by a friend, and the trust can be drafted as a discretionary trust permitting the friend to make distributions for any reason. In any event, the beneficiary can be given the power to replace the co-trustee.

Enjoy significant control over assets as beneficiary—about the same level as if you actually owned the property.

The trust document can also be drafted to allow the beneficiary to:

- manage the trust assets
- appoint an investment advisor
- choose who will inherit the trust at the beneficiary's death, and whether the successor will enjoy the same level of control.

But the trust should prevent the beneficiary from leaving it to an estate, creditors, or the creditors of an estate. Such provisons would make trust assets subject to estate tax at the beneficiary's death.

Control doesn't have to be absolute. For instance, one parent wanted to discourage capricious behavior, so the trust he created for his adult child permitted the son to replace the co-trustee only once every five years. Or investment control could be restricted to specific assets, such as a private business in which the beneficiary is involved, with professional management mandated for the trust's securities portfolio. Delaying control is possible, too. A bank can serve as trustee until the beneficiary reaches a certain age, finishes school, or meets another goal set by the grantor.

When setting up a beneficiary-controlled trust, be sure to discuss the details and benefits with the potential heirs, particularly so they'll understand the purpose of any restrictions on control you decide to include. That way, they'll be more likely to appreciate this trust for what it is—an aid to their wealth, not a hindrance. ●

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For Children With Special Education Needs, IRS Ruling

For parents of children needing special education, a recent IRS ruling could make schooling more affordable. A private letter ruling issued in March 2005 suggests that private school costs may be deductible as a medical expense when the goal is to help a student overcome physical or mental disabilities and move on to a mainstream school.

Private letter rulings come in response to requests from taxpayers seeking guidance about the tax consequences of a specific action. Though not considered precedents, such rulings nevertheless provide useful clues about the tax agency's current thinking. In this case, the parents of two children with learning disabilities asked whether tuition at the children's school qualified as a deductible medical expense. Both kids had been diagnosed as having medical conditions, including dyslexia, that "handicap their ability to learn," according to the ruling. Specifically, the parents wanted to know whether the children's school constituted a "special school" whose tuition could therefore be deducted.

But that's the wrong question, according to the IRS letter. It doesn't matter what kind of school it is, but rather "exactly what the school provides an individual." The ruling goes on to explain that "a school can have a normal education program for most students, and a special education program for those who need it. Thus a school can be 'special' for one student but not for another."

The ruling lists numerous characteristics of special education. A physician must diagnose "a medical condition requiring special education to correct the condition," and though a doctor need not provide the care, the school "must have professional staff competent to design and supervise a curriculum providing medical care." Such care might include teaching Braille to someone who is visually impaired or

Missing A Rollover Deadline May Be OK

Though "the dog ate it" never worked with your sixth-grade teacher, it might work for rolling over your retirement account if you miss Uncle Sam's 60-day deadline.

If you leave your job or retire and want to take your 401(k) or pension funds with you, moving the money into an IRA can be a great way to preserve the benefits of tax-deferred investing. But be careful *how* you transfer the funds. The easiest, safest way is for your former employer to mail a check for the full balance of your account directly to your IRA trustee or custodian. All you have to do is let your plan administrator know where to send the money.

But if you need immediate cash, you can have the check made out to you. As long as you follow one crucial IRS stipulation, your rollover should go smoothly. You must deposit the entire value of your pension or 401(k) account into your IRA within 60 days.

Sound simple? It may not be. Beyond restoring any of the nest egg you've spent, you'll also have to come up with additional funds to replace the 20% your employer is required to withhold for tax purposes. After the deadline, missing money is taxed as though you had withdrawn it. You'll owe income tax and, if you're under age 59½, you'll also be liable for a 10% early withdrawal penalty. The clock starts ticking on the day your ex-employer puts the check in the mail and your envelope must be postmarked by day 60.

What if you miss the 60-day deadline? You could be taxed as though you had emptied your retirement account—which, technically, is exactly what you've done. Or at least that's how things worked until Revenue Procedure 2003-16 opened the floodgates for exemptions. Procedure 2003-16 is an evolving "guidebook"to cases in which the IRS waived a missed deadline and gave taxpayers another 60 days to get their money into an IRA.

The IRS started getting more flexible after The Economic Growth and Tax Relief Reconciliation Act of 2001 introduced the idea that waivers be granted in situations beyond an investor's "reasonable control." Before the tax law changes, pardons for a missed IRA rollover deadline were made in only two circumstances: if a financial institution made an error, or if you were eligible for a 120-day rollover period because you or a qualified family member needed the money to help buy or renovate a home. (If you're under 59½, you could use up to $10,000 toward a home without replacing it for your rollover.)

Now, if your financial advisor makes a mistake during the rollover process, or a medical condition, death in the family, or even inclement weather is to blame for your tardiness, you can appeal to the IRS. Provided you can prove your "true intent" to roll over in a timely fashion, you may very well be granted another 60 days to complete the transfer.

Consider, for example, these private letter rulings that gave a taxpayer the benefit of the doubt:

- John Smith experienced short-term memory loss after the death of a friend and mailed his papers several weeks late. He was later hospitalized for depression.
- When a snowstorm hit the Northeast, Mary James got to the mailbox one day late.
- Michael Markin couldn't reach his advisor, who was on vacation, to finalize the paperwork. His rollover papers weren't ready until three days after the deadline.
- Susan Johnson's advisor accidentally put the money in a regular brokerage account.

In each of these cases, the individuals had the purest of motives; they just didn't make it to the finish line on time. Under other circumstances, though, the IRS may not be as kind. For example, in another ruling, Barney Clark was grieving over the loss of his wife and missed the deadline. During the 60 days, he had used funds to pay medical bills and make car repairs. Despite his proven intention to replace the money on time, the IRS would not pardon him, because he had "enjoyed" personal use of the funds.

While you shouldn't bank on an excuse note from the IRS, if you have missed the rollover deadline, talk to us about whether it's worth pursuing the matter further. Applying for a private letter ruling costs $95. Better yet, let us know if you switch jobs. We can guide you on how to handle the paperwork and will do our best to ensure there are no mistakes. ●

May Reduce School Costs

"giving remedial language training to correct a condition caused by a birth defect."

Because these two children attend a school at which they receive care fitting the IRS definition, the cost of tuition is indeed deductible as a medical expense, according to the private letter ruling.

For other parents of children with special needs, the ruling spells out the circumstances under which they might be able to deduct school costs. Keep in mind, though, that medical expenses are deductible only if you itemize deductions, and then only to the extent that they exceed 7.5% of your adjusted gross income.

Still, considering the high cost of attending a private school where students receive individualized attention, it shouldn't be difficult to cross that deductibility threshold. Consider the Forman School, in Litchfield, Connecticut, which specializes in helping students with "learning differences." Boarders at Forman paid $43,000 for the 2004-2005 academic year. For a family with an adjusted gross income of $150,000, such expenses could result in a medical deduction of $31,750 ($43,000 – ($150,000 x 0.075)). That "discount" could bring the cost of very special education within reach. ●

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Maximum Savings? Try A Solo DB Plan

For years, entrepreneurs have discovered that a defined-benefit (DB) retirement plan lets them save much more on a tax-deductible basis than they can put into any other retirement vehicle. And now, thanks to relaxed tax rules and pre-packaged deals offered by several financial institutions, plans for one-person businesses—the solo DB—have enjoyed a sudden surge in popularity.

Consider Susan, a fictional 53-year-old real-estate professional with no employees. As the accompanying chart shows, a DB plan would allow her to contribute—and avoid current income tax on—a much larger portion of her earnings than she could funnel into an individual 401(k) plan, another popular option for the self-employed. The tax savings of a DB plan can be particularly striking if you have a day job or spouse who works, because second incomes are often taxed at high marginal rates.

In addition, a solo DB can cut your taxes dramatically even if you're over age 70½ and must take minimum withdrawals from the account.

Your DB contribution is calculated by an actuary, who considers your age, life expectancy, assets in the plan, projected investment return, and a target annual retirement benefit of as much as $170,000 (adjusted for inflation). The goal is to accumulate a nest egg large enough to fund the target retirement benefit for life, explains actuary Jeffrey J. Berends, executive vice president of CCA Small Business Group, an affiliate of Chicago Consulting Actuaries.

What's Your Maximum Contribution?

2005 Business Income *	Solo Defined-Benefit Plan**	Solo 401(k) Plan ***
$50,000	$50,000	$28,000
$150,000	$150,000	$46,000
$250,000	$166,112	$46,000

* Net earnings from self-employment, minus one-half of self-employment tax
** Assumes business owner was born October 1, 1952, will retire in 10 years, and will earn a 5.5% return on plan assets.
*** Includes a $4,000 catch-up contribution for owners age 50 or over.

Source: Chicago Consulting Actuaries

The principal drawback? Contributions are mandatory. Although you may be able to make a reduced contribution, or perhaps none at all, you should only adopt a DB if you anticipate making high-dollar contributions for several years. So this is best for established, profitable businesses with predictable cash flow. Also keep in mind that if you later hire full-time workers over age 20, you'll have to contribute for them, too.

Before signing up for a solo DB, review the provider's investment menu. Plans offered through investment companies, for instance, generally restrict your choices to their funds, which may not match your needs. Also look at fees for plan set-up, account maintenance, and yearly actuarial work and other expenses. Finally, ask whether you'll be presented with a fully prepared, signature-ready IRS Form 5500, which must be filed for the plan each year.

To reduce your 2005 tax bill, the plan must be established by December 31, though you don't have to fund it until your business files its tax return—no later than September 15, 2006, if you receive filing extensions. Of course, the sooner you put tax-deferred money to work, the bigger the potential benefit. ●

FHA Reverse Mortgages

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closing costs, and mortgage-servicing charges accounting for a significant chunk of your loan balance. Moreover, because the house must ultimately be sold to repay the debt, you or your estate will also eventually have to pay home-sale closing costs. Fees vary widely from one provider to the next, so making accurate comparisons can be difficult.

Will you be disqualified for state funding? While proceeds from your loan won't affect your eligibility for Social Security or Medicare, the money could keep you from receiving benefits from programs such as Medicaid or Aid for Dependent Children. You may be able to get around this problem if you select a monthly payment schedule, then spend your check during the month you receive it.

How much equity can you really tap? Lenders won't let you borrow against the full value of your home. You may only be able to tap as little as 60% of your home equity with an FHA-insured loan. But non-FHA reverse mortgages—available from Fannie Mae and Financial Freedom Senior Funding Corp., a lender in Irvine, California—have higher lending limits. No matter which program you choose, however, you'll always lose some of your equity to fees.

If all of this sounds complicated, the good news is you don't have to make a decision in the dark. To get an FHA-approved reverse mortgage loan, you're required to meet with a HUD-approved certified housing counselor, who helps determine whether the loan makes sense, how much you need, and the payment arrangement that works for you. Contact HUD at 800-569-4287 for more information about counseling agencies and FHA-approved lenders. And while Fannie Mae and Financial Freedom don't force applicants to meet with a counselor, they do require applicants to review extensive literature on reverse mortgages.

With today's booming real estate prices, your home may be worth far more than ever before. Unlocking your equity with a reverse mortgage could make sense, particularly now that you can lock in your interest rate. ●

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