September 2022

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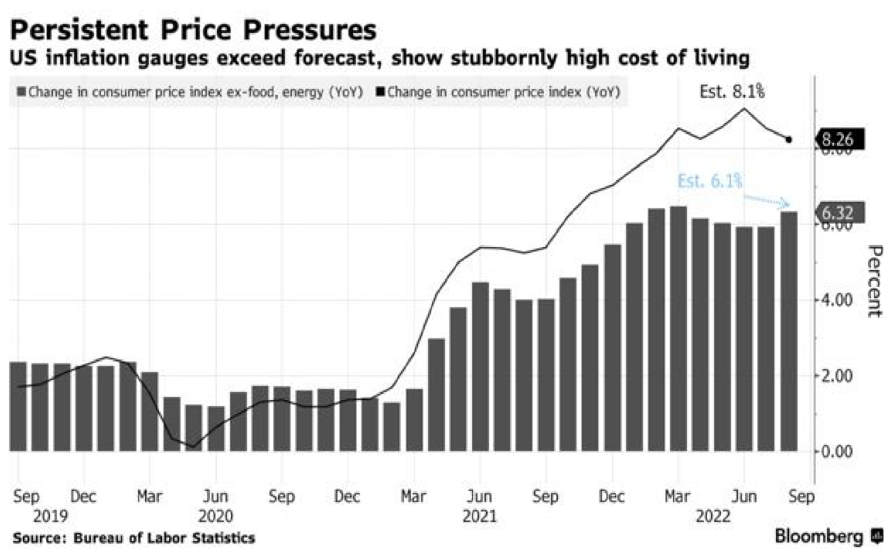
All Things Financial Planning

Jason Foster, Director of Financial Planning, JD

Dear Clients,

Inflation remained uncomfortably high in August, **coming in at 8.3%** as compared to August 2021. This was despite a decline in gas costs, as prices continued to soar across a broad array of other goods and services. For example, the food component of CPI rose by 11.4% year over year in August, up from a 10.9% read in July. The overall inflation rate increased to a 40-year high of 9.1% in June, and then subsequently dropped to 8.5% in July. Although the slight drop to 8.3% in August may mean we are now in a downward trend, this doesn't mean the Federal Reserve will not continue to aggressively raise rates to make sure they have control over inflation, as the overall rate remains much too high.

The Fed raised interest rates by .75% in September, July, and June in an attempt to aggressively curve the upward inflationary trajectory. Chair Powell sent a clear message to market participants that the Fed will raise rates as high and for as long as necessary to bring inflation down. Although rate increases will eventually reduce inflation, the increases will affect growth, and soften the labor market. Much will be determined in the coming months as Fed Chair Jerome Powell attempts to engineer a soft landing for the economy and avoid a significant economic contraction.



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Although not as far sweeping as the now defunct Build Back Better Bill, Democrats in Congress and the Biden Administration received a legislative victory with the passing of the **Inflation Reduction Act**. Most economists agree that the law will do little to actually reduce inflation, but this legislation has some key agenda fulfilling components that both Congress and the President can (and likely will) claim as a success on the campaign trail this fall.

Corporations with at least $1 billion in income will have a minimum tax rate of 15%. Corporations would have to pay the larger of the minimum tax or the regular tax. **There will be no tax changes in rates or brackets for individuals and households**, however. There are also a number of climate change measures, including tax credits for households to offset energy costs, investments in clean energy projects and tax credits aimed at reducing carbon emissions. Installing solar power at your home through the installation of solar panels can result in a tax credit of up to 30% of the cost (up from 26%) from 2022 to 2032. The law also extends the current $7500 electric vehicle tax credit for 10 years as well.

On the healthcare front, the Inflation Reduction Act gives Medicare the power to negotiate certain prescription drug prices. The net effect is that Medicare beneficiaries should pay less. Starting in 2025, Medicare recipients will also benefit from a **$2000 cap** instituted on annual **out-of-pocket prescription drug costs**. Additionally, the subsidy designed to lower medical insurance premiums under the Affordable Care Act has been extended through 2025.

The IRS will be bolstered under the new law as well, with **$80 billion over 10 years being allocated to the IRS** for enforcement. Businesses and high net worth individuals can expect audit rates to rise in the future, and whether one is audited may depend on how aggressive they have been regarding certain tax savings strategies and techniques. The IRS still only has 3 years to audit a return, unless they identify a substantial error, then the audit period could be extended.

"Here's our new retirement plan — At age 65, we'll get divorced then marry other people who planned better."

Divorce and Beneficiary Designations. One question recently brought to me when we were assisting a client with the administration of an estate is what happens when a former spouse is left as a beneficiary on a retirement account or life insurance policy, assuming this beneficiary designation was unintentional.

The answer depends on where the deceased party resided prior to death and the state law applicable. Under **Colorado law section 15-11-804**, a divorce decree automatically revokes the designation of the ex-spouse as a beneficiary on any retirement account or life insurance policy, and as a fiduciary in any will or trust. Unless these beneficiary designations are updated after the divorce decree showing clear intent to name the former spouse as beneficiary, or there is a specific court order or contract related to the division of the marital estate that mandates the ex-spouse be the beneficiary, the former spouse is ignored as primary beneficiary and the assets will flow instead to the named contingent beneficiaries.

The law also converts the title to real estate that ex-spouses own together as joint tenants with the right of survivorship to either real property owned solely by one of the spouses, dictated by the divorce decree, or to tenants in common property. Thus, if a new deed is not executed prior to the death of one of the spouses, the surviving ex-spouse would not receive the deceased ex-spouse's interest in the property, but instead, deceased ex-spouse's interest in the property is preserved and would bypass surviving ex-spouse to the rightful heirs.

Although Colorado has created a bit of a statutory safety net for heirs of divorcees, the hope is that once a divorce is finalized, both the estate and financial plans are thoroughly reviewed and updated so we can proactively make the necessary changes to beneficiary designations and named fiduciaries within the estate plan. The obvious goal here is to avoid legal entanglements that complicate the administration of the estate and increase the costs. We can assist with this process.

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Holistiplan and Tax Planning. Part of our financial planning process involves advising clients on the best tax mitigation strategies. Although we do not file tax returns and encourage you to seek specific tax advice from your CPA, we do assist with year over year tax planning. To further this service, we utilize both eMoney and tax planning software called Holistiplan.

The Holistiplan software enables us to analyze income tax matters on a more granular level to help identify strategies and look for opportunities in a specific year. The software uses technology to read your tax return from the previous year and creates a customized tax report complete with relevant observations in just seconds. Holistiplan has been particularly helpful in identifying key income break points for tax planning opportunities like Roth conversions, charitable gifting techniques, and tax efficient withdrawals. Although used for modeling and illustration purposes, and actual projections should be verified through the use of an accountant, this software is an extremely helpful financial planning tool as we review potential tax savings opportunities for you. As we venture deeper into the latter half of this year, let us know if you have an interest in CFM reviewing tax planning measures for the 2022 tax year.

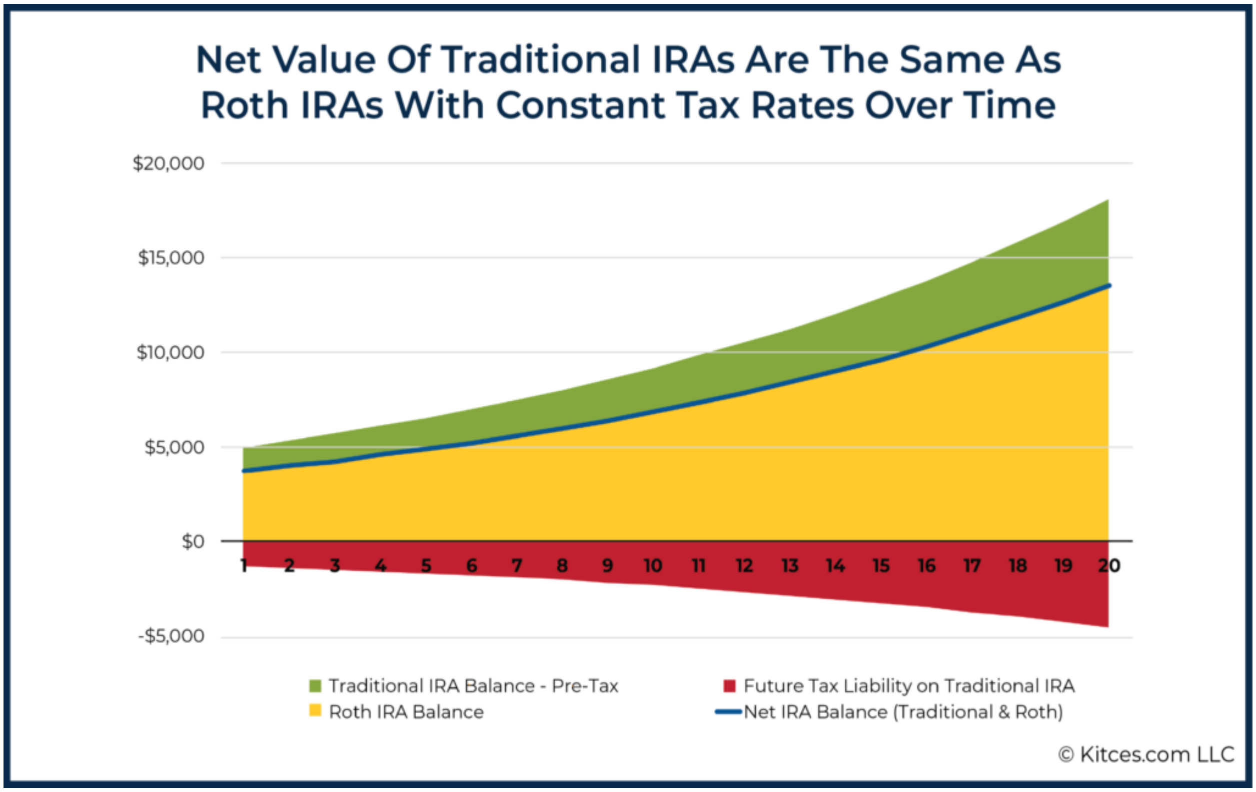
"One more time — explain to me why enjoying life after I retire is more important than enjoying life now."

Discounted Roth Conversions During the Bear Market Decline
by Jason Foster, Director of Financial Planning, JD

We have written extensively about Roth IRAs and the benefit these accounts have over other types of accounts, most notably the tax-free growth they enjoy. We have also written about factors to consider when converting traditional IRA or 401k money to Roth money, and how it's never a "one size fits all" approach. While individuals at any income level can complete Roth conversions, it does not necessarily mean that doing so will be a tax-efficient decision.

From a simplified tax planning perspective, **whether traditional or Roth accounts are better long term depends on that individual's tax rate today as compared to their expected future tax rate**. As the foregoing chart shows, if an individual's tax rate is the same in the year they are making the conversion and in the year they withdraw from the account, there is ultimately no difference in having the money in a pre-tax versus a Roth account.

Putting aside these variables and unknowns, **bear markets** can present a unique opportunity



It follows then that it will be more advantageous to make traditional contributions when a person's marginal tax rate is higher today than it will be when the funds are withdrawn in the future, and Roth contributions (or conversions) when the future marginal tax rate is expected to be higher than it is today.

You could further augment this approach if you knew what the actual higher tax rate will be in the future. One could then **"fill up" the lower tax brackets** today with converted money, but only until it reaches the point that their tax rate is as high as it's anticipated to become in the future. This allows you to convert and "lock in" at lower tax rates. The problem, of course, is without the proverbial crystal ball, you really have no way of knowing exactly when you plan to withdraw the money and your applicable future tax rate at that time. Throw in the fact that these tax rates and brackets will likely be adjusted by Congress, and it becomes a planning exercise involving lots of assumptions

when it comes to Roth conversions. While a declining market can be stressful to navigate, especially if you are nearing or just recently entered into retirement, it can create tax planning opportunities such as tax loss harvesting to offset capital gains and ordinary income, or when it comes to Roth conversions, **converting traditional IRA or 401k investments at a temporarily depressed value**. As the value of the account drops, the dollar amount to be converted to a Roth account will represent a larger percentage of the pre-tax account, resulting in a larger portion of the future growth of the account being shifted into a Roth without moving into a higher tax bracket as a larger portion of the account is converted.

Example: Steve and Victoria have a taxable income of $200K putting them in the 24% income tax bracket. Victoria has a $1M traditional IRA and wants to convert $120K of the account value this year, which they could without leaving the 24% tax bracket.

If she had completed the conversion at the beginning of the year, the $120K Roth conversion would have turned 12% of her account into a Roth IRA. However, at the mid-year point, Victoria's IRA suffers a 20% decline, bringing the account balance to $800,000. Which means that a $120K conversion would now allow Victoria to shift 15% of the IRA into a Roth IRA, while still keeping them in the 24% bracket.

As a result, for the exact same tax cost on the $120K Roth conversion, when the market eventually recovers 25%, instead of having $1M (initial balance) - $120K (converted amount) = $880K in a traditional IRA, and $120K in a Roth IRA, Victoria will instead hold $800K (initial balance) - $120K (converted amount) + $170K (gain from 25% market recovery) = $850K in a traditional IRA and $120K + $30K (gain from the 25% market recover) = $150K in a Roth IRA.

Utilizing cash to pay taxes versus taking funds that could have otherwise been converted to pay those taxes allows for a larger balance of the tax-free Roth account to enjoy a market rebound. At worst using a taxable account by selling taxable investments to generate the cash needed for the taxes is still a better result than paying the taxes from converted money, because the taxable account grows in a less tax-efficient manner (especially if the sale can target higher-cost-basis assets that don't themselves generate an additional capital gain, and/or if there are any tax losses that can be harvested to offset any embedded gains that are triggered on the sale of taxable investments.) But if there is cash on hand to pay these taxes, this would be the preferred approach. While you might have rather done something other than pay taxes with the cash, you are effectively paying for the future tax-free growth of the Roth account, which should be considered a very productive use of the cash, versus receiving a nominal 1-2% return on the money, or possibly utilizing the cash to buy some type of depreciating asset.[1]

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Although the current bear market can be emotionally difficult to navigate, such a market can create some savvy tax planning strategies that can result in future tax savings for pro-active planners. Assuming the right set of factors, a Roth conversion can be one such opportunity, effectively allowing one to convert a greater percentage of taxable retirement money to a tax-free vehicle once the market recovers, all while staying within the same tax bracket. If you would like us to do a Roth conversion analysis for you to see if it might be an effective tax planning strategy, let your advisor or the planning team here know and we'll get to work on it.

[1] Information and example associated with this article found in the recent article entitled, "When Roth Conversions Go 'On Sale': Discounted Roth Conversions During a Bear Market Decline," published on June 22, 2022, by Adam Van Deusen and Michael Kitces.

Pros and Cons of Owning a Vacation Home in Retirement
by Jason Foster, Director of Financial Planning, JD

Accenting your retirement plans with a vacation home is a common consideration for many clients who are looking forward to the next phase of their lives. Whether that vacation home is purchased prior to retirement or afterward is an exercise in financial planning, and we often model out these scenarios for clients so they can see exactly how the projections will play out in our planning software. While we crunch the numbers, we will also have a conversation detailing some pros and cons to consider when thinking about owning a second home. Although not meant to be comprehensive, this article details a number of these considerations.

Additional real estate that diversifies your investments. Besides the intangible enjoyment factor attached to owning a second home in that ideal location you have always longed for, a vacation home can **diversify** the assets on your balance sheet, and can be a **potential hedge against stock market volatility**. While it can also go down in value, at least temporarily, as we have started to see recently, and as we saw for the prolonged real estate market downturn from 2007 through 2010, it is an investment that can appreciate as well.

Having another asset on the balance sheet also allows for flexibility when it comes to financing other investments or future purchases through **home equity loans or lines of credit**. Interest rates on a loan securing your second home can be lower than rates associated with using other types of debt. Accessing your equity in such a way can provide tax free cash flow for any emergency needs, medical expenses, long term care, etc. This might be preferable to selling other investments or taking additional distributions from retirement accounts from a tax planning perspective, but will depend on the applicable interest rate, other solutions available, and a number of planning factors specific to you.

Paying cash or financing. Whether the home is financed or you pay cash should depend on your financial plan and which option better assists in you achieving your long-term planning objectives. Draining liquidity on the balance sheet to purchase the property would result in the avoidance of servicing new debt in the plan, but could be detrimental to the long-term success of your plan. This could be especially true if you would have to pay taxes on the sale of any low basis liquid assets that have appreciated nicely over the years to purchase an illiquid asset such as a vacation home.

If you are considering financing the purchase, it might make sense to be patient for mortgage rates to drop, as **15- and 30-year mortgage rates have increased considerably in 2022**, and they typically run higher for second home purchases. The percentage associated with the down payment may also be higher – expect to pay at least 10%, and possibly up to 25% down. The amount you put down may also affect the mortgage rate itself. Another consideration – if you are in retirement already and planning on financing the property, you may have more difficulty securing a mortgage than when you were working and had regular income to support this new monthly mortgage obligation, as the potential lender analyzes your cash flow for qualification purposes.

Factoring in increased expenditures. Another factor to think about in purchasing a vacation home is the effect the property will have on your overall cost of living. Although many clients will not have to adjust their lifestyle to afford the second home, once we have an understanding of the ongoing costs associated with the future purchase (utilities, insurance, property taxes, association dues, cleaning costs, furnishings, renovation work, etc.), our planning team can provide potential **solutions to cover the increased expenses in the long term budget**, if necessary. We could recommend working longer before official retirement so investments have an opportunity to grow and appreciate on the balance sheet to offset any net negative cash flow that will result from additional ongoing expenditures associated with a second home. We can also model out an alternative scenario that shows a plan to sell the primary residence at a certain point during retirement, using the equity to pay off the vacation home mortgage with the remaining proceeds adding liquidity back on the balance sheet, if this is a desirable solution. Ideally, we would want to identify flexibility and optionality within the financial plan to manage this change in cash flow.

Legacy property for future generations. If you envision the second home as a legacy property for your heirs, it is worth having the conversation with them about how ownership will be structured. **A trust could be created** after you have passed that can own the property for your heirs. A trustee would manage the property according to the specific terms of the trust agreement. Such an arrangement can help resolve conflict and provide pre-arranged solutions when conflicts arise. The trustee can take care of the expenses and upkeep associated with the property. The trust can dissolve after a certain period of time, or can last through the lifetimes of multiple generations.

An alternative approach could involve using a Limited Liability Company to govern the ownership of a legacy property, providing percentage member interests to heirs. The **LLC Operating Agreement** can govern and manage the property in the same way a trust agreement can, but can allow member owners to vote according to their percentage interest on major decisions related to the property. The LLC is also easy to set up during your lifetime, and can give you all or a majority of the voting member interests so you can control and manage the property until you pass. The entity can provide a layer of asset protection for any liability associated with the property, as long as the LLC owns it. This arrangement can protect the other assets on your balance sheet, as it isolates the liability only to the LLC and shields the members from personal liability. And if you wish for this property to be part of your legacy and estate planning, an LLC provides further flexibility to allow for the gifting of percentage ownership interests (sometimes at a discounted valuation) to heirs during your lifetime, while still allowing you to control and manage the property.

Renting your second home. As we review your financial plan, if your objective involves renting the property, we can provide an analysis of how the additional cash flow might affect the success of the plan. There will be much to consider if you decide to rent your second home. If you **rent the property fewer than 15 days during the tax year, the rental income does not need to be included on your tax return**. If you are renting it because you are hoping for a regular source of income, there will be times when it is likely vacant – and there still will be a potential mortgage, property taxes and utilities to pay. This might create unexpected cash flow issues if your financial plan relies upon this extra income to work. You also may want to use your vacation home during the period of time when renting the home is most desirable, which further impacts a financial plan that is dependent upon the extra cash flow to be successful.

There are **extra costs** and considerations associated with rental properties as well. This might include expenses related to finding tenants, managing the tenants, creating contracts, fixing and replacing things, increased costs of utilities and insurance, cleaning services, evicting tenants when necessary, dealing with possible liability, etc. A thorough understanding of the applicable tax rules when using the property for personal use and when using it as a rental for accounting purposes will be important. **Check with your CPA or tax preparer** and they should be able to assist you with the understanding of these rules. The creation of an LLC to own the property, and having adequate insurance on the property that contemplates using the property as a rental, are a must. You may decide a **property management company** is necessary to minimize some of the headaches of managing a rental property. The property management company will take a percentage of the rents for stepping into your shoes and managing the property. This percentage will vary depending on the market and location of the property, but it could be in the range of 8% to 20%. This certainly eats into any net profit, but it takes the burden of managing the property off your plate and these costs are tax deductible, along with the other aforementioned expenditures.

Complex tax rules apply. The IRS treats second homes, including vacation homes and investment properties, as capital assets. If the property grows considerably in value and you decide to sell, you would have to pay taxes on the capital gain above the adjusted basis. On the other hand, if the property loses value, you can use the losses on the property to offset other capital gains on your tax return. To qualify to exclude all or a portion of the capital gain when you sell, you must pass both ownership and use tests for your property. Essentially, the property must be treated as the equivalent of your primary residence.

Real estate depreciation is an important tax planning tool for rental property owners. Depreciating a property allows one to deduct the purchase price and improvement costs from your tax returns over the life of the property. Most residential rental property is depreciated at **approximately 3.64% per year over a 27.5 year "recovery" period**. Once the property is sold and assuming it is sold for more than its depreciated value, you'll owe tax on that gain through the depreciation recapture tax.

If you decide not to rent the property, you can now **deduct any mortgage interest paid up to $750K of principal mortgage debt** on the second home. You can **deduct up to $10K of state, local and property taxes** on your federal tax return as well, so if you are able to itemize deductions, there might be an opportunity to maximize this deduction with the inclusion of the property taxes paid on your second home. If you purchase a second home, let your CPA know as soon as possible so they can assist you with taking advantage of all available tax breaks and deductions.

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Owning a vacation home in retirement is a worthwhile pursuit, and one that comes with lasting memories and the potential to create a legacy to leave to heirs and future generations. But like most significant financial planning decisions, it requires a thorough review of the pros and cons associated with the ownership of a second property. As mentioned at the outset of this article, we often help clients model out the purchasing options and future ongoing expenditures in our planning software, so clients can feel comfortable with the financial decision to own a second home. During this process, we have detailed conversations involving the topics and considerations discussed within this article. Let us know if you are thinking about such a purchase. We would be happy to assist you with the planning.