The Wealth Architect

Helping you build your financial future.

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Dear Friends,

Welcome to the May 2015 issue of The Wealth Architect. During the month of May, we paid tribute to Mothers on Sunday, the 10th; celebrated Armed Forces Day on Saturday, the 16th; and we'll welcome the "unofficial" start of summer with Memorial Day on Monday, the 25th.

In the words of Joseph Campbell, "A hero is someone who has given his or her life to something bigger than oneself." Let us never forget the sacrifices commemorated on Memorial Day.

Sincerely,
The Professionals at Armao LLP

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How Does Divorce Affect Social Security Retirement Benefits?

One of the challenges of planning for retirement is that an unexpected event, like divorce, can dramatically change your retirement income needs. If you were counting on your spouse's Social Security benefits to provide some of your retirement income, what happens now that you're divorced?

What are the rules?

Even if you're divorced, you may still collect benefits on your ex-spouse's Social Security earnings record if:

- Your marriage lasted 10 years or longer
- You are age 62 or older
- Your ex-spouse is entitled to receive Social Security retirement or disability benefits, and
- The benefit you're entitled to receive based on your own earnings record is less than the benefit you would receive based on your ex-spouse's earnings record

If you've been divorced for at least two years, and the other requirements have been met, you can receive benefits on your ex-spouse's record even if he or she has not yet applied for benefits.

How much can you receive?

If you begin receiving benefits at your full retirement age (66 to 67, depending on your year of birth), your spousal benefit is equal to 50% of your ex-spouse's full retirement benefit (or disability benefit). For example, if your ex-spouse's benefit at full retirement age is $1,500, then your spousal benefit is $750. However, there are several factors that may affect how much you ultimately receive.

Are you eligible for benefits based on your own earnings record? If so, then the Social Security Administration (SSA) will pay that amount first. But if you can receive a higher benefit based on your ex-spouse's record, then you'll receive a combination of benefits that equals the higher amount.

Will you begin receiving benefits before or after your full retirement age? You can receive benefits as early as age 62, but your monthly benefit will be reduced (reduction applies whether the benefit is based on your own earnings record or on your ex-spouse's). If you decide to receive benefits later than your full retirement age, your benefit will increase by 8% for each year you wait past your full retirement age, up until age 70 (increase applies only if benefit is based on your own earnings record).

Will you work after you begin receiving benefits? If you're under full retirement age, your earnings may reduce your Social Security benefit if they are more than the annual earnings limit that applies.

Are you eligible for a pension based on work not covered by Social Security? If so, your Social Security benefit may be reduced.

Planning tip: *If you decide not to collect retirement benefits until full retirement age, you may be able to maximize your Social Security income by claiming your spousal benefit first. By opting to receive your spousal benefit at full retirement age, you can delay claiming benefits based on your own earnings record (up until age 70) in order to earn delayed retirement credits. This can boost your benefit by as much as 32%. Because deciding when to begin receiving Social Security benefits is a complicated decision and may have tax consequences, consult a professional.*

What happens if one of you remarries?

Benefits for a divorced spouse are calculated independently from those of a current spouse, so your benefit won't be affected if your spouse remarries. However, if you remarry, then you generally can't collect benefits on your ex-spouse's record unless your current marriage ends. Any spousal benefits you receive will instead be based on your current spouse's earnings record.

What if your ex-spouse dies?

If your marriage lasted 10 years or more, you may be eligible for a survivor benefit based on your ex-spouse's earnings record.

For more information on how divorce may affect your Social Security benefits, contact the SSA at (800) 772-1213 or visit [socialsecurity.gov.](socialsecurity.gov)

Avoiding Probate: Is It Worth It?

Why avoid probate?

- ***It can be slow; getting needed assets into the hands of your heirs may be delayed***
- ***It can be costly, especially if an estate is large or complex, or ancillary probate is needed***
- ***It is public; documents that you wish to remain private can be accessed by the public***

How to avoid probate

- ***Own assets jointly with right of survivorship***
- ***Own assets that pass by beneficiary designation, such as life insurance and retirement plans***
- ***Use a trust***
- ***Gift assets during your lifetime***

When you die, your estate goes through a process that manages, settles, and distributes your property according to the terms of your will. This process is governed by state law and is called probate. Probate proceedings fall under the jurisdiction of the probate court (also called the Surrogate's, Orphans', or Chancery court) of the state in which you are domiciled at the time of your death. This court oversees probate of your personal property and any real estate that is located in that state. If you own property located in a state other than the state in which you are domiciled at the time of your death, a separate "ancillary" probate proceeding may need to be initiated in the other state.

Note: *"Domicile" is a legal term meaning the state where you intend to make your permanent home. It does not refer to a summer home or a temporary residence.*

Items that are subject to probate are known as probate assets. Probate assets generally consist of any property you own individually at the time of your death that passes to your beneficiaries according to the terms of your will. Examples of nonprobate assets include property that is owned jointly with right of survivorship (e.g., a jointly held bank account) and property that is owned as tenants-by-the-entirety (i.e., real property owned jointly by a husband and wife). Other examples are property that passes to designated beneficiaries by operation of law, such as proceeds of life insurance and retirement benefits, and property held in trust. Property that does not pass by will, right of survivorship, beneficiary designation, or trust will also be subject to probate.

Why avoid probate?

Most wills have to be probated. The rules vary from state to state, but in some states, smaller estates are exempt from probate, or they may qualify for an expedited process.

Probate can be slow. Depending on where your executor probates your estate and the size of your probate estate, the probate process can take as little as three months or as long as three years. Three years can be a long time to wait for needed income. It can take even longer if the estate is a complicated one or if any of the heirs are contesting the will.

Probate can be costly. Probate costs usually include court costs (filing fees, etc.), publication costs for legal notices, attorney's fees, executor's fees, bond premiums, and appraisal fees. Court costs and attorney's fees can vary from state to state. Typically, the larger the estate, the greater the probate costs. However, if a smaller estate has complex issues associated with its administration or with distribution of its assets (e.g., if the person who died owned property in several states), probate can be quite costly.

Probate is a public process. Wills and any other documents submitted for probate become part of the public record--something to consider if you or your family members have privacy concerns.

Why choose to go through probate?

For most estates, there's usually little reason to avoid probate. The actual time and costs involved are often modest, and it just doesn't make sense to plan around it. And there are actually a couple of benefits from probate. Because the court supervises the process, you have some assurance that your wishes will be abided by, and if a family squabble should arise, the court can help settle the matter. Further, probate offers some protection against creditors. As part of the probate process, creditors are notified to make their claims against the estate in a timely manner. If they do not, it becomes much more difficult for them to make their claims later on.

In addition, some states require that your will be probated before the beneficiaries under your will can exercise certain rights. Among the rights that may be limited are the right of your surviving spouse to waive his or her share under the will and elect a statutory share instead, use your residence during his or her remaining life, set aside certain property, and receive a family allowance.

How to avoid probate

An estate plan can be designed to limit the assets that pass through probate or to avoid probate altogether. Property may be passed outside of probate by owning property jointly with right of survivorship; by ensuring that beneficiary designation forms are completed for those types of assets that allow them, such as IRAs, retirement plans, and life insurance (to avoid probate you shouldn't name your estate as beneficiary); by putting property in a trust; and by making lifetime gifts.

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The IRS has warned: "IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction." (Source: IRS Instructions to Form 1099-R, 2015)

Note: All investing involves risk, including the potential loss of principal.

Self-Directed IRAs

A self-directed IRA isn't a different type of IRA. Rather, the term refers to any individual retirement account (traditional or Roth) that allows you to direct the investment of your IRA assets into nontraditional investments. For example, in addition to the usual IRA mainstays (stocks, bonds, mutual funds, and CDs), a self-directed IRA might invest in real estate, limited partnership interests, a small business, or anything else the law (and your IRA trustee/custodian) allows. In fact, the only investment you can't have in an IRA is life insurance. Collectibles (artwork, stamps, wine, and antiques) aren't strictly prohibited, but if your IRA purchases these items, you could suffer adverse tax consequences.

Getting started

First, you'll need to find a trustee or custodian that specializes in self-directed IRAs. Make sure you understand the expenses involved--some trustees charge transaction fees and/or asset-based fees, depending on the particular investment. You also need to be aware of the prohibited transaction rules. These rules are designed to make sure that only your IRA, and not you (or your immediate family), benefits from your IRA transactions. If you violate these rules, your account will cease to be treated as an IRA, with potentially devastating tax consequences.

Finally, you need to understand the UBIT (unrelated business income tax) rules. Even though IRA investments usually grow tax deferred (or even potentially tax free in the case of a Roth IRA), if your IRA conducts certain business activities or has debt-financed income, then your IRA could be taxed currently on all or part of the income generated.

What are prohibited transactions?

Generally, a prohibited transaction is any improper use of an IRA by you, your beneficiary, or a "disqualified person" including certain family members. The following are examples of prohibited IRA transactions:

- Selling property to, or buying property from, the IRA
- Borrowing money from it
- Receiving unreasonable compensation for managing it
- Using it as security for a loan
- Buying property for personal use (present or future) with IRA funds

The IRS has warned: "IRAs that include, or consist of, non-marketable securities and/or closely held investments, in which the IRA owner effectively controls the underlying assets of such securities or investments, have a greater potential for resulting in a prohibited transaction." (Source: IRS Instructions to Form 1099-R, 2015)

Consequences of engaging in a prohibited transaction

Generally, if you (or your beneficiary after your death) engage in a prohibited transaction at any time during the year, the account stops being an IRA as of the first day of that year. The account is also treated as distributing all its assets to you at their fair market values on the first day of the year. For a traditional IRA, if the total of those values exceeds your basis in the IRA, you'll have taxable income that's included in your income. If you're not yet age 59½, the 10% premature distribution penalty tax may also apply.

The IRS hasn't yet provided specific guidance describing how these rules apply to Roth IRAs. However, it's likely that if you've satisfied the requirements for a qualified distribution, the distribution will still be tax free. A nonqualified distribution from a Roth IRA will result in taxable income to the extent the distribution exceeds your Roth IRA contributions (and again, the premature distribution penalty tax may apply if you haven't yet reached age 59½).

What is UBIT?

UBIT, as noted earlier, stands for "unrelated business income tax." While not common, it can apply to your traditional (and Roth) IRA. In simple terms, if your IRA regularly conducts a trade or business (for example, your IRA buys and operates a bakery), then the income from that trade or business (less any expenses directly connected with carrying on the trade or business) is subject to UBIT. The IRA is taxed on the income (unrelated business taxable income, or UBTI) at trust tax rates.

The term "trade or business" has been broadly interpreted to apply even if an IRA doesn't directly conduct a business, but instead invests in a pass-through entity, like a partnership, that conducts a trade or business. If an IRA invests in a partnership that conducts a trade or business, then the IRA must calculate its UBTI based on its share of the partnership's gross income and deductions.

As you can see, a self-directed IRA can provide you with almost unlimited investment flexibility, but also presents some traps for the unwary. Carefully weigh the benefits and risks to determine if it's the right choice for you.

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Am I liable for unauthorized transactions on my debit card?

It depends. Federal law provides consumers with protection against most unauthorized credit- and debit-card transactions.

Under federal law, consumer liability for unauthorized credit-card transactions is limited to $50. However, many banks and credit-card companies offer even more protection for credit cards in the form of "zero liability" for unauthorized transactions.

For unauthorized debit, rather than credit, transactions, the rules get a bit trickier. For the most part, you won't be held responsible for any unauthorized debit-card withdrawals if you report the lost card before it's used. Otherwise, the extent of your liability depends on how quickly you report your lost card. If you report your lost debit card within two business days after you notice your card is missing, you'll be held liable for up to $50 of unauthorized withdrawals. If you fail to report your lost debit card within two days after you notice your card is missing, you can be held responsible for up to $500 of unauthorized withdrawals. And if you fail to report an unauthorized transfer or withdrawal that's posted on your bank statement within 60 days after the statement is mailed to you, you risk unlimited liability.

The good news is that some banks and credit-card companies are offering the same "zero liability" protection to debit-card users that they offer to their credit-card users. This zero liability protection, however, does come with exceptions. In order to have zero liability for unauthorized debit-card transactions, consumers may be required to report the loss of their card "promptly" (typically, no more than two days after they learn of the card loss or theft). In addition, a consumer may need to exercise "reasonable care" to safeguard his or her debit-card information. For example, an individual who gives someone else his or her debit card and PIN could be held responsible for any unauthorized transactions.

It's important to remember that, unlike credit cards, debit cards directly link to your financial accounts. As a result, you should act quickly and call your bank or credit-card company as soon as you learn of any unauthorized transactions on your account.

What is this new chip-card technology I've been hearing about in the news?

In recent years, data breaches at major retailers have increased across the United States. As a way to counteract these data breaches, many U.S. credit-card companies have started implementing a more secure chip-card technology called EMV (which is short for Europay, Mastercard, and Visa).

Currently, most retailers use the magnetic strips on the back of your debit or credit card to access your account information. Unfortunately, the information contained in the magnetic strips is easily accessed by hackers. In addition, the magnetic strips use the same account information for every transaction. So once your card information is stolen, it can be used over and over again.

With the new EMV technology, debit cards and credit cards are embedded with a computer chip that generates a unique authentication code for each transaction. So if your card information is ever hacked, it can't be used again--it's a "one-and-done" scenario.

While many developed nations moved to EMV technology years ago, U.S. retailers have previously been unwilling to shoulder the costs. Fortunately, there is good news for U.S. consumers on the horizon.

Beginning in 2015, many large retailers will switch to the new EMV technology by installing payment terminals designed to read the new chip-embedded payment cards. It may take additional time, however, for smaller retailers to adopt this latest technology.

Along with EMV, even more advanced encryption technology is being developed that will increase security for online transactions and payments made with smartphones. In fact, new mobile payment options like Apple Pay and Google Wallet could eventually make paying with plastic entirely obsolete.

In the meantime, in the wake of these data breaches, you should make it a priority to periodically review your credit-card and bank account activity for suspicious charges. If you typically wait for your monthly statements to arrive in the mail, consider signing up for online access to your accounts--that way you can monitor your accounts as often as needed.

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