Investor Insights & Outlook

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Tax-friendly States for Retirees

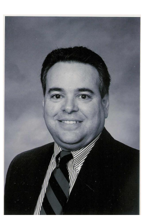
Federal taxes are the same wherever you choose to retire; however, state and local taxes add up depending on the state you pick to spend your retirement years. Taxes may apply to your retirement/pension income, purchases, real estate and social security benefits.

Taxes on individual and pension income differ from state to state. Seven states in the U.S. (Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming) currently do not tax individual income. On the other hand, California, District of Columbia, Hawaii, Iowa, Maine, New Jersey, New York, Oregon, and Vermont tax retirement income at a rate of 8% or higher. Pennsylvania and Mississippi exempt pension income completely, while states like Michigan and Maine exempt only a portion of pension income. If you estimate receiving considerable income in retirement, state income taxes could play a significant role in what you get to keep.

In addition to state taxes on retirement and pension income, retirees also need to look at sales tax charged on items they purchase. Sales tax varies from state to state with some states charging sales tax as high as 7%, while others adopt a "no sales tax" policy. Alaska, Delaware, Montana, New Hampshire, and Oregon have no state sales tax, while California has the highest sales tax rate of 8.25%. Retirees who rely only on a fixed source of income in retirement should also carefully consider property taxes and estate taxes when estimating their tax liabilities.

Source: 2011 CCH Whole Ball of Tax. The opinions herein are those of Morningstar, Inc. and should not be viewed as providing investment, tax, or legal advice. The information provided is as of October 2011. Please consult with your financial professional regarding such services.

Mezzasalma Advisors



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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!

What Is a Credit Score?

Ever wondered why your application for a credit card was declined? How the interest rates on your loans were determined? Or what those advertisements about getting your free credit report mean? All of these are related to one's credit score.

What is a credit score? It is a system that creditors, like banks, use to determine whether to extend credit to you, the consumer, based on the probability that you will repay the loan and make the payments when they come due. In addition, it is sometimes used to determine the interest rate on the loan. Generally, scores above 720 are considered excellent and you will qualify for most loans. If you have a score in the high 600s to 700s, you will qualify for most loans but not at the best interest rates. Consumers with scores below the mid-600s may not be able to qualify for credit cards loans, and even if they do, would have to pay unattractive rates. So what are the factors that determine your credit score and what steps can you take to improve it?

First, your payment history is the most important component of your credit score. If you have paid bills late or declared bankruptcy, this will lower your score. The best way to keep up with your monthly payments is to live within your means and only use credit cards if necessary. In addition, try to set up an emergency fund to protect you from unexpected expenses or changes in your income, like losing your job.

The second component looks at the amount you owe, or your debt-to-credit ratio. You should have some debt on your accounts to show that you are able to handle credit, but if the amount you owe is close to your credit limit, it is likely to have a negative effect on your score. In addition, some credit card issuers have been reducing lines of credit for customers who have not have any late payments, which will have the effect of increasing your debt-to-credit ratio so make sure to call your issuer to get this reversed if you are affected.

The length of your credit history looks at how long you have had a credit track record and considers the time since your accounts were opened and they were last used. Thus, even though you might have some inactive accounts, it is important not to close your oldest accounts especially if you have a relatively short credit history of less than 10 years.

Fourth, creditors look at whether you have inquired for new credit lately. Do not apply for too many accounts within a short period because it makes it look to creditors as though you are desperate for credit. If you need to make multiple inquiries for home or car loans, or for credit card applications, do it within a short period of time, between 14 to 30 days, so that it will be treated as a single inquiry. Speak to your financial advisor on the best ways to apply for new credit if you need to.

The last factor used in determining your credit score is the types of credit that you have. Try to have a good mix of different types of credit, including credit cards, car loans, and mortgages, which might take longer to establish depending on your current level of income. However, refrain from applying for too many credit cards because this may have a negative impact on your score.

To learn more about your credit score, go to Annualcreditreport.com and obtain a free annual credit report from any of the three major providers —Experian, TransUnion, or Equifax. You will not get your credit score with this free report but you will obtain qualitative information based on the five factors mentioned above, and learn whether you have any inaccurate information or unauthorized accounts. If you would like a more detailed report with your credit score, you can purchase the report from the providers.

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.

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In Case of Emergency

Nobody likes to think about the possibility of job loss, serious illness or other major expenses. But these are all possible in an uncertain world, and having an emergency fund in place can help if such situations arise.

An emergency fund is a money market, savings or checking account where you keep a specified amount of money to cover expenses. The important part here is that the money is stored in an investment vehicle that allows quick and easy access to funds. But you do not touch the money in this financially liquid account unless a real emergency pops up. No ifs, ands or buts.

Setting up an emergency fund is usually the first step toward building a solid financial plan. If you don't already have one in place, start building one as quickly as you can. It obviously takes perseverance to stash money from each paycheck into your emergency fund, but it may be well worth it one day.

How much cash should you put aside? Most financial advisors recommend to first aim to keep enough money in the fund to cover at least three months of expenses. However, as your take-home pay increases or your expenses grow, you may need to keep six months or even as much as a year's expenses in your fund.

Take it one step at a time. Once you've saved enough to cover three months of expenses, try for the six-month mark, and so on. Easier said than done, sure, but if you treat your emergency fund like any other must-pay monthly bill, it will undoubtedly grow over time.

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