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Paying for Long-Term Care During Retirement

You may have spent a good part of your working years planning for a financially secure retirement. But many issues can arise during retirement that can impact your financial health as well as your quality of life. For instance, the cost of medical expenses due to a prolonged illness or injury can quickly deplete your retirement savings and affect your quality of life and your spouse's. As we get older, the prospect of long-term care becomes a real possibility. If you're retired, how will you pay for long-term care if faced with those expenses?

Retirement savings and income

An obvious source for paying long-term care expenses is current income you receive from a retirement pension or Social Security retirement income. However, using current income may prove insufficient, or impractical, given other household expenses.

You could use qualified retirement accounts such as a 401(k) or IRA, or investments you set aside as a retirement nest egg. But you may be spending savings otherwise needed for the current or future financial support of your spouse or other family members. And withdrawals from qualified retirement accounts are generally taxed as ordinary income, meaning the more you take out, the more you may have to pay in taxes.

If you have equity in your home, you may be able to tap into that to pay for long-term care. However, since your home is probably one of your most valuable assets, there are many issues to consider before using it to pay for long-term care. Should you sell your house or take out a home loan? If you decide to take out a loan, what type of loan will work best for you? Some loan options include a conventional home equity loan, a first mortgage, and a reverse mortgage.

Private insurance

Aside from paying for your long-term care out of your own pocket, you might share the cost through various insurance products. The most common of these is long-term care insurance, which typically pays for the cost of long-term care up to a specified dollar amount per day, such as $150, for a fixed period of time, such as three years. Most policies will pay for care provided in your home, in an assisted-living facility, and in a nursing home. But the premium for this type of insurance can be expensive and the policy usually doesn't cover the entire cost of care, meaning you'll probably still have to pay for a portion of your long-term care expenses out-of-pocket.

Other types of insurance may also be used to pay for long-term care. Cash value accumulations in life insurance or annuities can be accessed, either by cashing the policy in or by borrowing against the cash value. However, policy loans and cash value withdrawals may reduce the policy's death benefit or cause the policy to lapse. Also, some life insurance and annuities have built-in features or riders that allow access to amounts in excess of the cash accumulation value if it's used to pay for long-term care.

Medicaid and veterans benefits

According to the National Clearinghouse for Long-Term Care Information, Medicaid pays for about 49% of aggregate long-term care expenses. Medicaid is a federally funded program administered through the states that provides long-term care benefits for those who meet state-specific financial eligibility requirements, as well as certain health or functional criteria. However, retirees are often unable to qualify for Medicaid because their income or asset values exceed financial eligibility requirements. Aside from Medicaid, the Department of Veterans Affairs may provide long-term care for service-related disabilities for veterans who meet eligibility requirements.

Child not in college yet?

If you have younger children, the federal government's FAFSA4caster tool is for you. It provides families with an early estimate of eligibility for federal student aid, and allows families to transfer all of their data to the online FAFSA once their child is ready to apply for aid. You can check it out at www.fafsa4caster.ed.gov.

Eight Financial Aid Myths

Do you have a child going off to college next fall? The federal government's financial aid application (the FAFSA, which stands for Free Application for Federal Student Aid) is due as soon as possible after January 1, 2011. Here are some common myths about financial aid eligibility.

Myth #1: My child won't qualify for aid because our family makes too much money

Fact: While it's true that family income is the main factor that determines aid eligibility, it's not the only factor. The size of your family, the age of the older parent, and the number of kids you'll have in college at the same time all play into the equation. Even if you think your child won't qualify, you won't know for sure unless you apply, and it costs nothing to file the FAFSA. Besides, states and colleges typically require the FAFSA--in addition to any state and college specific forms--before they'll hand out their own aid.

Myth #2: The form is too hard to fill out

Fact: Years ago, the FAFSA was cumbersome to fill out. But ever since it went online at www.fafsa.ed.gov, it's easier than ever to submit. The online version has detailed instructions and takes you through step by step, asking only the questions that apply to you. If you need help, there are customer service representatives standing by with whom you can chat online. There is also a toll-free number you can call with questions: 1-800-4-FED-AID. All advice is free. Once you submit the form, it only takes about one week to process (compared to four to six weeks for a paper FAFSA).

Myth #3: If my child applies to a more expensive school, we'll get more aid

Fact: Not necessarily. The federal government determines your expected family contribution, or EFC, based on the income and asset information you provide on the FAFSA. Your EFC stays the same, no matter what school your child applies to. The difference between the cost of a particular college and your EFC is your child's financial need. The more expensive the college, the greater your child's financial need. But a greater financial need doesn't automatically translate into a bigger financial aid package. Colleges aren't obligated to meet 100% of your child's financial need (if they don't, you've been "gapped" in college parlance). Keep in mind, too, that there are annual borrowing limits on federal Stafford and Perkins Loans. Once your child has borrowed the maximum amount for the year, his or her only chance for more aid has to come from grants, scholarships, and/or work-study jobs.

Myth #4: My child probably won't qualify for aid because of mediocre grades

Fact: The federal government does not take grades into account when determining aid eligibility. However, colleges will consider a strong academic record when awarding certain merit scholarships.

Myth #5: A minority student has a better chance of getting aid

Fact: The federal government does not consider race when determining aid eligibility. It doesn't collect this type of information.

Myth #6: I lost my job shortly after I filed the FAFSA, but there's nothing I can do about it now

Fact: If your financial circumstances change after you file the FAFSA, you can ask the financial aid officer at your child's school to revisit your aid package; the officer has the authority to make adjustments if there have been material changes to your family's income or assets. If you have a material change that you can support with documentation, politely request a "professional judgment review" in a letter addressed to the financial aid officer. There are no guarantees, but you won't know if you don't ask.

Myth #7: We own our home, so my child won't qualify for aid

Fact: The federal formula for determining aid does not take home equity into account (it also excludes retirement accounts, cash value life insurance, and annuities from consideration). However, colleges typically consider home equity when distributing their own institutional aid.

Myth #8: Our smart/athletic/talented child will likely get a scholarship to cover most, if not all, college costs

Fact: A vast majority of financial aid officers believe that parents overestimate the amount of scholarship and grant money their children will receive. While it's true that some students end up getting a free ride (or close to it), they're in the minority. Scholarships can fill the gap, but they probably shouldn't be relied on as the main funding source.

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First Milestones Mark Need for Financial Advice

With each life milestone, a financial professional can help you develop a clear picture of your current financial situation, work with you to articulate and prioritize your financial goals and timelines, and recommend strategies and products that are appropriate for your objectives.

If you're just starting out, you might not give much thought to working with a financial professional. You may associate the process with retirement--a retirement that seems so far off that more immediate concerns take precedence. The fact is, though, a financial professional can prove to be a valuable resource to those just starting out. And, while there's never a bad time to seek professional advice, early life-changing events make it especially important to take stock of your financial situation.

Starting a career

It may seem counterintuitive--when you're starting out, it's often more about future potential and possibilities than focusing on the present. But this is actually the perfect time to begin building a relationship with a financial professional. It's also the perfect time to establish good financial habits, like building an adequate cash reserve, starting to save on a consistent basis, and establishing a good credit history. You may need help implementing a spending plan (aka "budget") that will help you to meet current financial needs and still enable you to make progress toward your future goals.

It's not all about the future, though. A financial professional can help you get the most out of your paycheck by working with you to maximize the value of tax-advantaged benefits offered by your employer, including employer-provided health coverage or a qualified retirement plan. In addition, you may need help with issues as common as paying back student loans, or as complicated as understanding employer stock options.

Getting married

You know you need financial help when key words used to solemnize the occasion include "…for richer or poorer…" There's the immediate financial aspects of a wedding (paying for everything), but--more importantly--there's the long-term financial challenges that come when two individuals combine their finances. Like the ghosts of boyfriends and girlfriends past, you each bring your own financial history, attitudes, and habits (both good and bad) to the union.

A financial professional can help you define your goals as a couple. You'll want to come up with a joint spending plan to help you achieve these goals, and decide on the mechanics of day-to-day money management. For example, will you combine your bank accounts or keep them separate? In cases where you and your spouse aren't on the same page, a third party can listen to all concerns, identify underlying issues, and help you find common ground. A professional can also work with you to make sure that you're making the most efficient use of employer benefits, including health insurance and qualified retirement plans, that you have adequate life insurance coverage, and that the investments you choose are appropriate for your goals, time frames, and risk tolerance.

Beginning a family

The period of time following the birth of a child is both exciting and stressful. It's time to completely reevaluate your financial situation, starting with your goals. For example, in addition to saving for your own retirement, it's time to start thinking about saving for your child's college education. Your existing spending plan is likely to be the victim of suddenly decreased income (if there's to be a stay-at-home spouse) or a significant new expenditure (child care). If nothing else, you need to account for the additional ongoing expenses that come with parenthood (e.g., baby formula, food, diapers, clothing).

With children in the equation, having adequate health insurance, life insurance, and disability income insurance takes on new significance, and you may want to work with someone to evaluate your needs, obtain appropriate coverage, and make sure your beneficiary designations reflect your wishes. It's also time to establish an appropriate estate plan--including a will, health-care proxy, and durable power of attorney--or to update an existing estate plan. A financial professional can help walk you through some of the issues involved, and can help you find an attorney if you don't have one already.

Need for advice grows over time

If you're like most people, your financial needs will grow more complex over time. As that happens, your need for financial advice will increase as well. By starting early, you're able to build on a solid financial foundation. With each life milestone, a financial professional can help you develop a clear picture of your current financial situation, work with you to articulate and prioritize your financial goals and timelines, and recommend strategies and products that are appropriate for your objectives.

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Ask the Experts

Can I roll over my traditional 401(k) plan distribution to a Roth IRA?

In general, yes, but there are some important exceptions. You cannot roll over required minimum distributions (RMDs). You also cannot roll over hardship distributions from your 401(k) plan, or certain periodic payments you receive from the plan. Most other distributions are eligible for rollover.

A rollover of regular 401(k) assets to a Roth IRA is similar to a conversion of a traditional IRA to a Roth IRA (and it's often referred to as a conversion). You'll need to pay taxes on the amount you roll over to the Roth IRA, except to the extent your distribution includes your own after-tax contributions (you receive those back tax free). But a special rule applies to rollovers in 2010 only--you can elect either to pay all of the conversion taxes in 2010, or instead include half of the resulting income from the conversion on your 2011 federal tax return, and the other half on your 2012 tax return.

Your rollover can be either direct (the 401(k) plan transfers the funds directly to your Roth IRA for you) or indirect (the plan distributes the funds to you, and then you roll the funds over to the IRA within 60 days). A direct rollover is almost always the best way to transfer the funds. If you choose to make an indirect rollover, you run the risk of missing the 60-day deadline. More importantly, the plan will be required to withhold 20% of the taxable portion of your distribution for federal income taxes. If you want to roll over the full amount of your distribution, you'll need to come up with other funds to make up for the 20% that was withheld (you'll get credit for those withheld funds when you file your income tax return).

Qualified distributions from your Roth IRA will be tax free. To be qualified, your distribution must satisfy a five-year holding period *and* must be made after you reach age 59½, become disabled, or have qualifying first-time homebuyer expenses (up to $10,000 lifetime). The five-year holding period begins on January 1 of the year you first opened *any* Roth IRA (either by a regular contribution, rollover, or conversion).

(Note: special rules apply if you inherit a 401(k) plan account or IRA.)

Can I roll over my Roth 401(k) plan distribution to a Roth IRA?

Yes. You can roll your Roth 401(k) plan distribution over to a Roth IRA. Your rollover can be direct (the plan transfers the assets to the Roth IRA on your behalf) or indirect (you receive the distribution and then roll it over to the Roth IRA yourself within 60 days). Your rollover will be tax free regardless of whether your distribution from the Roth 401(k) plan is qualified or nonqualified.

But whether your Roth 401(k) plan distribution is qualified or nonqualified is important for determining the taxation of future distributions from the Roth IRA. A distribution from a Roth 401(k) plan is qualified if you satisfy a five-year holding period *and* the distribution is made after you attain age 59½, become disabled, or have qualifying first-time homebuyer expenses (up to $10,000 lifetime). The five-year holding period begins on January 1 of the year you first started participating in that particular employer's Roth 401(k) plan.

If you receive a qualified distribution from your Roth 401(k) plan and roll it over to your Roth IRA, the entire amount rolled over is treated as a nontaxable contribution to the Roth IRA. You can withdraw this amount tax free from the Roth IRA at any time. Only additional earnings will be subject to the Roth IRA's five-year holding period.

But if you receive a nonqualified distribution from your Roth 401(k) account and roll it over to a Roth IRA, only an amount equal to your contributions to the Roth 401(k) plan, not the investment earnings, are treated as a nontaxable contribution to the Roth IRA. The investment earnings rolled over, along with any additional investment earnings, will be subject to the Roth IRA's five-year holding period.

IRS regulations provide that separate five-year holding periods apply to Roth 401(k) accounts and Roth IRAs. That is, you don't get to carry over your Roth 401(k) holding period to your Roth IRA. Your Roth IRA five-year holding period begins on January 1 of the year you first establish *any* Roth (by regular contribution, rollover, or conversion). (Special rules apply to inherited Roth IRAs.)

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