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At Lesemann & Associates we are dedicated to improving your fiscal health and prosperity. This year we have made some exciting changes to further that commitment by providing you with valuable information and insights in our monthly newsletter, on our website and social media platforms to keep you informed of important issues that may impact your financial health and well-being. Visit our website often, Like Us on Facebook or follow us on Twitter or LinkedIn to access a wealth of information, updated every week.

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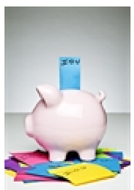
The Economics of Borrowing from Your 401(k)

When times are tough, that pool of dollars sitting in your 401(k) plan account may start to look attractive. But before you decide to take a plan loan, be sure you understand the financial impact. It's not as simple as you think.

The basics of borrowing



A 401(k) plan will usually let you borrow as much as 50% of your vested account balance, up to $50,000. (Plans aren't required to let you borrow, and may impose various restrictions, so check with your plan administrator.) You pay the loan back, with interest, from your paycheck. Most plan loans carry a favorable interest rate, usually prime plus one or two percentage points. Generally, you have up to five years to repay your loan, longer if you use the loan to purchase your principal residence. Many plans let you apply for a loan online, making the process quick and easy.

You pay the interest to yourself, but…

When you make payments of principal and interest on the loan, the plan generally deposits those payments back into your individual plan account (in accordance with your latest investment direction). This means that you're not only receiving back your loan principal, but you're also paying the loan interest to yourself instead of to a financial institution. However, the benefits of paying interest to yourself are somewhat illusory. Here's why.

To pay interest on a plan loan, you first need to earn money and pay income tax on those earnings. With what's left over after taxes, you pay the interest on your loan. That interest is treated as taxable earnings in your 401(k) plan account. When you later withdraw those dollars from the plan (at retirement, for example), they're taxed again because plan distributions are treated as taxable income. In effect, you're paying income tax twice on the funds you use to pay interest on the loan. (If you're borrowing from a Roth 401(k) account, the interest won't be taxed when paid out if your distribution is "qualified"--i.e., it's been at least 5 years since you made your first Roth contribution to the plan, and you're 59½ or disabled.)

...consider the opportunity cost

When you take a loan from your 401(k) plan, the funds you borrow are removed from your plan account until you repay the loan. While removed from your account, the funds aren't continuing to grow tax deferred within the plan. So the economics of a plan loan depend in part on how much those borrowed funds would have earned if they were still inside the plan, compared to the amount of interest you're paying yourself. This is known as the opportunity cost of a plan loan, because by borrowing you may miss out on the opportunity for additional tax-deferred investment earnings.

Other factors

There are other factors to think about before borrowing from your 401(k) plan. If you take a loan, will you be able to afford to pay it back and continue to contribute to the plan at the same time? If not, borrowing may be a very bad idea in the long run, especially if you'll wind up losing your employer's matching contribution.

Also, if you leave your job, most plans provide that your loan becomes immediately payable. If you don't have the funds to pay it off, the outstanding balance will be taxed as if you received a distribution from the plan, and if you're not yet 55 years old, a 10% early payment penalty may also apply to the taxable portion of that "deemed distribution."

Still, plan loans may make sense in certain cases (for example, to pay off high-interest credit card debt or to purchase a home). But make sure you compare the cost of borrowing from your plan with other financing options, including loans from banks, credit unions, friends, and family. To do an adequate comparison, you should consider:

- Interest rates applicable to each alternative
- Whether the interest will be tax deductible (for example, interest paid on home equity loans is usually deductible, but interest on plan loans usually isn't)
- The amount of investment earnings you may miss out on by removing funds from your 401(k) plan

See disclaimer on final page

How to Give Wisely and Well

These are a few of the organizations and agencies that publish reports and charity ratings, and/or give useful tips and information to consumers on choosing a charity and giving wisely:

- ***Better Business Bureau's BBB Wise Giving Alliance, www.bbb.org***
- ***Charity Navigator, www.charitynavigator.org***
- ***CharityWatch, www.charitywatch.org***
- ***Federal Trade Commission, www.ftc.gov***

Giving to charity has never been easier. You can donate the old-fashioned way--by mail--but you can also donate online, by text, or through social networking sites. According to the National Center for Charitable Statistics, over 1.4 million nonprofit organizations are registered with the IRS. With so many charities to choose from, it's more important than ever to ensure that your donation is well spent. Here are some tips that can help you become both a generous and wise donor.

Choose your charities

Choosing worthy organizations that support the causes you care about can be tricky, but it doesn't have to be time-consuming. There are several well-known organizations that rate and review charities, and provide useful tips and information that can help you make wise choices when giving to charity (see sidebar). To get you started, here are some questions to ask:

- *How will your gift be used?* It should be easy to get information about the charity's mission, accomplishments, financial status, and future growth by contacting the charity by phone or viewing online information.
- *How much does the charity spend on administrative costs?* Charities with higher-than-average administrative costs may be spending less on programs and services than they should, or may even be in serious financial trouble. Some charities who use for-profit telemarketers get very little of the money they raise, so ask how much of your donation the charity will receive.
- *Is the charity legitimate?* Ask for identification when approached by a solicitor, and never give out your Social Security number, credit card number, bank account number, account password, or personal information over the phone or in response to an e-mail you didn't initiate. There's no rush--take time to check out the charity before you donate.
- *How much can you afford to give?* Stick to your giving goals, and learn to say no. Legitimate fundraisers will not try to make you feel guilty, and will be happy to send you information that can help you make an informed decision rather than pressure you to give now.

Harness the power of matching gifts

Many employers offer matching gift programs that will match charitable gifts made by their employees. You'll need to meet certain guidelines--for example, your employer may only match your gift up to a certain dollar limit--and the charity may need to provide information. Check with your employer's human resources department or the charity to find out how you can maximize your donations through a matching gift program.

Put your gifts on autopilot

If you're looking for an easy way to donate regularly to a favorite charity, look into setting up automatic donations from a financial account. When donors contribute automatically, the charity benefits by potentially lowering fundraising costs and by establishing a foundation of regular donors. And you'll benefit too, because spreading out your donations throughout the year may enable you to give more, and will simplify your record keeping.

Look for new ways to give

Although cash donations are always welcome, charities also encourage other types of gifts. For example, if you meet certain requirements, you may be able to give stock, direct gifts from your IRA or other retirement account, real estate, or personal property (but check with your financial professional to assess potential income and estate tax consequences based on your individual circumstances). You can also volunteer your time, using your talents to improve the lives of others in your community. And taking a "volunteer vacation" can be a fun way to involve your family and meet other people across the country or world who share your enthusiasm for a particular cause.

Use planned giving to leave a legacy

You can leave an enduring gift through your estate. For example, you might leave a will bequest, give life insurance, or use a charitable gift annuity, charitable remainder annuity trust, or charitable unitrust that may help you give away the asset now, while retaining a lifetime interest--check with your financial or tax professional regarding any potential estate or tax benefits or consequences.

Keep good records

If you itemize when you file your taxes, you can deduct donations you've made to a tax-qualified charity, but you may need documentation. Keep copies of cancelled checks, bank statements, credit card statements, or receipts from the charity showing the charity's name and the date and amount of the contribution. For donations or contributions of $250 or more, you'll need a more detailed written acknowledgment from the charity. For more information and a list of requirements, see IRS Publication 526, Charitable Contributions.

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Life Insurance Tax Traps for the Unwary

If you take a loan against your cash value, the death benefit available to your survivors will be reduced by the amount of the loan. In addition, policy loans may reduce available cash value and can cause your policy to lapse. Finally, you could face tax consequences if you surrender the policy with an outstanding loan against it.

Life insurance has been recognized as a useful way to provide for your heirs and loved ones when you die. Lawmakers have long recognized the social significance of life insurance as a source of funds for widowed spouses and children, and have offered liberal tax benefits as an incentive to those who put their hard-earned dollars into life insurance policies. However, there are a number of situations that can easily lead to unintended and adverse tax consequences. Here are some of the life insurance tax traps you may want to avoid.

Policy loans

One area fraught with unintended tax ramifications involves life insurance policy loans. A number of different scenarios involving policy loans can result in unplanned taxes, but one of the most common situations arises when a policy is surrendered (cancelled) or lapses with an outstanding policy loan.

Generally, if a policy is surrendered or lapses while a loan is still outstanding, the loan balance becomes taxable to the policyowner as ordinary income to the extent the cash value exceeds the owner's basis (net premiums paid less any tax-free distributions received) in the policy--it's as if cash from the policy is distributed to pay off the loan.

Example: *You own a life insurance policy into which you paid premiums of $100,000 (your basis); the policy cash value is $200,000; and there is an outstanding policy loan of $150,000. You surrender the policy for $50,000 cash (the difference between your cash value and loan balance). However, much to your surprise, you'll have to include $100,000 as ordinary income for the tax year in which you surrender the policy ($150,000 loan balance + $50,000 cash - $100,000 premiums).*

Modified endowment contract (MEC)

Since 1988, if the total premiums paid during the first seven years of the policy exceed a maximum amount based on the death benefit, then the policy becomes a MEC. The tax-free treatment of the death benefit and the tax-deferred cash accumulation are generally the same for MEC and non-MEC life insurance, although the tax consequences for pre-death withdrawals are different.

For non-MEC policies, partial and full surrenders are taxed on a first-in, first-out basis, meaning cash value withdrawals are considered first coming from your investment in the policy (i.e., your premiums) then from any gain in the cash value (i.e., interest/earnings). Generally, policy loans from non-MECs are not subject to income tax.

But any withdrawals (including loans and partial or full surrenders) taken from the cash value of a MEC are treated as coming from earnings first and are taxed as ordinary income to the extent the policy's cash value exceeds your basis. In addition, if the policyowner is under age 59½, a 10% tax penalty may be assessed on the amount withdrawn from a MEC that's includible as income unless an exception applies.

Example: *You purchased a cash value life insurance policy with a single premium of $100,000, making the policy a MEC. The policy cash value has grown to $150,000. If you take out a loan of $75,000 against the cash value, you will have to include $50,000 of the loan amount as ordinary income ($50,000 of the total amount borrowed represents gain in the policy).*

Estate planning

Generally, the life insurance death benefit is includible in the estate of the policyowner and may be subject to federal and/or state estate tax. Often, attempts to remove the policy from the owner's estate create problems. A quick solution has the owner transferring ownership of the policy to another person or an irrevocable life insurance trust (ILIT), in an attempt to remove the policy from the estate. However, if an insured owns a policy on his or her own life and gives the policy to another person, trust, or entity and then dies within three years of the transfer, the death benefit will be included in the estate of the insured/transferor, subject to possible estate tax.

Issues may arise when the policyowner, insured, and beneficiary are three different parties. If the insured is the first to die, the policy proceeds are considered a gift from the owner to the beneficiary, subject to potential gift tax. Generally, the owner and insured should be the same, or the owner and beneficiary should be the same party.

Unintended ownership issues may result if the insurance policyowner and insured are different parties, and the owner is the first to die. If the policy owner did not name a successor owner, then the policy will be subject to probate, including possible creditors' claims and unnecessary costs. To avoid this scenario, the owner should name a successor owner.

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Should I be worried about recent municipal bankruptcies?

Municipal bonds have received a lot of attention recently, in part because their tax advantages could become more valuable in 2013. However, they also have come under scrutiny because of some widely publicized bankruptcy filings by local governments.

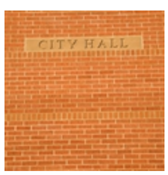
Economic problems, lower investment returns, and cuts in federal aid have led to an increase in the number of local governments filing under Chapter 9 of the U.S. bankruptcy code. They included the single largest U.S. municipal bankruptcy on record (Stockton, California, one of three municipalities in the state to file for bankruptcy in a single month).

Despite the increased pace of filings, muni bankruptcies are still extremely rare. From June 2011 to June 2012, only 17 municipalities or local government entities filed for bankruptcy in federal courts. Compare that to the 9,285 Chapter 11 filings by businesses during the same time.*

One way to check on your muni holdings is to use information available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA®) database, available at http://emma.msrb.org . You'll need to know the bond's CUSIP number; this nine-digit identifier can be found on a trade confirmation or brokerage statement. The information available generally includes the revenue sources pledged to repay a bond and whether any bond insurance, letter of credit, or other guarantees have been provided for its repayment.

The database doesn't include all municipal offerings, and though it's updated yearly, information can become outdated. The bond's current credit rating from one of the three major ratings agencies can suggest its most recent status. However, remember that a high credit rating doesn't reflect or guarantee a bond's market value or liquidity.

*According to the Administrative Office of the U.S. Courts.



Are municipal bonds still a good investment?

That may depend on your situation. Bond prices generally have benefitted greatly over the last few years from low interest rates, and munis have been no exception. Also, income from munis is generally exempt from federal income taxes; that has enhanced their after-tax return relative to corporate bonds or U.S. Treasuries, especially since Treasury yields are at historically low levels.

Some munis, known as private activity bonds, may be subject to the alternative minimum tax. However, if there is no further legislative action to avert impending tax increases scheduled for 2013, the tax advantages of munis are likely to become even more valuable. If investors in higher tax brackets adjust their portfolios to try to minimize next year's tax bite, increased demand for munis might have a positive effect on prices. (There are no guarantees that will happen, of course, especially given the uncertainty over whether there will be a political bargain to avert the so-called "fiscal cliff.")

Because many local governments are struggling to balance their books, bankruptcy filings by local governments have increased in the last year. However, they are still extremely rare. According to statistics from the Administrative Office of the U.S. Courts, from June 2011 to June 2012 there were only 17 muni bankruptcy filings compared to 9,285 Chapter 11 filings for businesses, though some analysts have expressed concern that the number could pick up if economic hard times, cuts in federal aid, underfunded pension obligations, and challenges in global credit markets continue to take a toll. So far, dire predictions of disaster in the muni market haven't come to pass, but the situation is worth keeping an eye on.

Also, remember that current low interest rates won't last forever. Because bond prices move in the opposite direction from interest rates, when rates do begin to go up, the increase likely will affect the value of all of your bond holdings, including municipals.

Though transparency in muni markets has increased in recent years, bonds can be more challenging to research on your own than stocks. If you're unsure about whether munis are a good investment for you, or whether you should rethink their role in your portfolio, don't hesitate to get expert help.

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