

# THE PERSONAL PLANNER

Personal Financial Planning Tips for Today and the Rest of Your Life

## Heling Associates Inc.

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It's August and our very strange year continues. Meteorologically (I am, after all, an amateur gardener), periods of drought broken by torrential rains make gardening difficult. Similarly, as a financial advisor and investor, the ongoing prospect of economic turmoil stemming from a federal government default broken by reports of pending cross-aisle cooperation in Congress make planning and portfolio management difficult. The difference? The weather is an uncontrollable act of nature; the federal debt limit crisis is eminently controllable and only requires our elected officials to act collectively like adults. We'll see. If you're nervous, you should be, because there seems to be little consensus about what consumers and investors can do to protect themselves. Let's hope for the best.

Bruce R Heling, CFP CPA on July 27, 2011

### August 2011

Talking to Your Child about College Expectations

Medicare and Medicaid: Do You Know the Difference?

All about Indices

I'm buying a laptop online--will I have to pay sales tax?

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## Talking to Your Child about College Expectations



same page. Here are some talking points.

### Costs

For many families, the cost of college is the elephant in the room. You may want to start off by saying something like "we will have saved  $x$  by the time you start college, and after that, we should be able to contribute  $y$  each year." Financial professionals typically recommend that parents avoid promising to pay 100% of college costs, in case they experience an unforeseeable financial setback.

If your child is interested in schools that have significant price differences, you may say something like "we can come up with  $x$  each year from savings and income that should cover most of State U, but if you want to attend Private U, then you'll have to borrow the difference, which is  $z$ ." Then use an online calculator to show your child exactly what " $z$ " will cost each month over a standard 10-year repayment term. You're borrowing \$27,000 at 6.8%? That will cost you \$311 each month. The loan is \$45,000 at 8.5%? That will cost you \$558 each month. And so on. The idea is to take a big, abstract loan amount and translate it into a month-to-month reality.

Next, print out an amortization table showing the breakdown of principal and interest payments that will be due each year. Review the basic deferment and forbearance rules that govern under what circumstances borrowers can temporarily postpone their federal student loan payments. Finally, make sure to put that student loan payment into a larger financial context--there will be other items competing for your child's financial resources after college, like rent, food, utility bills, a car payment, etc. The goal is to help your child understand the

long-term financial impact of choosing the more expensive college. Even then, many 16, 17, or 18 year olds may be unable to fully grasp the seriousness of such an endeavor.

Ultimately, it's up to parents to help their child avoid going into too much debt. According to the *New York Times*, for the first time ever last year, student loan debt outpaced credit card debt in the United States, and this year it's expected to surpass a trillion dollars. Unlike most other types of debt, student loan debt generally cannot be discharged in bankruptcy, and in the case of default, the federal government can garnish your child's wages or intercept tax refunds to recover the money.

If there's any silver lining here, it's that many parents believe that kids get more out of college when they are at least partly responsible for its costs, as compared to having a "blank check" mentality. Being on a financial hook, even a small one, may encourage your child to live more frugally, choose courses carefully, and hit the books sufficiently. Later, if you have the resources, you can always help your child repay his or her student loans.

### Grades

Many parents consider going to college their child's first real job. But some students don't take academics as seriously as they should. You might say something like "we expect you to maintain a GPA of  $x$ , and if you don't, we may have to reconsider paying the tuition bill for the following year." Though you'll probably want to build in some wiggle room for the adjustment period that freshmen typically require, after a certain period of time your child needs to be serious enough about academics to make the college cost burden worthwhile.

### Course of study

Even if your child has no idea what career path to choose (and most high schoolers don't), ask about your child's likes and dislikes, strengths and interests. At a minimum, this information will help start the wheels spinning, and when coupled with new revelations and experiences later on, it can lead to potential career pathways.

## Medicare and Medicaid: Do You Know the Difference?



*Medicaid, not Medicare, is the primary payer of nursing home care in the United States. Although Medicare pays for short-term skilled nursing or rehabilitative care in a skilled nursing facility, it does not pay for extended care in a nursing home or for other custodial long-term care. Custodial care is help with daily activities such as eating, bathing, dressing, and using the bathroom. Some individuals need both short-term and long-term care; for example, someone who has suffered a stroke may receive rehabilitation services in a skilled nursing facility, but may later be admitted to a nursing home in order to receive custodial long-term care services.*

For more information, visit the Centers for Medicare & Medicaid Services website at [www.cms.gov](http://www.cms.gov).

Medicare and Medicaid were signed into law 36 years ago to protect older and poorer Americans against the high cost of health care. Ironically, it's the high cost of providing health care through these programs that now threatens federal and state budgets, leading to calls for Medicare and Medicaid reform. Although these programs are often lumped together, they function quite differently. Here's a look at the coverage each provides.

### What is Medicare?

Medicare is a health insurance program funded and run by the federal government that guarantees health coverage to older Americans. Medicare is not income-based. People who have paid Medicare taxes on their earnings are automatically eligible at age 65, but some people with disabilities qualify for Medicare coverage earlier than age 65, and people with end-stage renal disease qualify at any age.

Medicare offers three main types of coverage. Part A covers inpatient hospital care, as well as short-term skilled nursing care, hospice care, and home health care under certain conditions. Part B covers medical services such as doctor's visits, outpatient care, and laboratory tests. Part D covers prescription drugs. If you or your spouse has paid Medicare taxes while working, you generally won't pay a premium for Medicare Part A coverage, but you'll pay a premium if you want to enroll in Part B or in some (but not all) Part D plans. You'll also need to pay certain out-of-pocket costs such as deductibles, co-payments, or coinsurance costs, depending on the types of coverage you have.

### What is Medicaid?

Medicaid is a health insurance program funded by both the federal government and state governments to provide coverage to Americans of all ages who have low incomes and no health insurance. States administer their own Medicaid programs under federal guidelines. They must cover individuals on public assistance, but they may also opt to cover other groups and establish eligibility requirements. Children, families, people with disabilities, and older individuals may all receive Medicaid.

If you're eligible for Medicaid, you may have to pay a small co-payment when receiving medical services, but most of your health-care costs will be covered.

### Can you be eligible for both Medicare and Medicaid?

Yes--if you're eligible for both programs, you're

known as a "dual eligible" beneficiary. Generally, individuals who are eligible for both programs are older or disabled (or both) and need help paying their Medicare costs because they have very low incomes. Medicaid covers premiums, deductibles, co-payments, coinsurance, and other Medicare costs and provides some health benefits that Medicare does not. Individuals in nursing homes are often dual eligible beneficiaries, and that's partly behind the misconception that Medicare pays for nursing home or other long-term care (it does not--see sidebar); instead, Medicaid is the primary payer of nursing home bills. Because many older individuals cannot afford the high cost of nursing home care and exhaust their savings, they eventually become eligible for Medicaid.

Medicare	Medicaid
Primarily age-based; individuals age 65 and older qualify, along with some individuals with disabilities	Primarily means-based; individuals of any age with low incomes who meet eligibility requirements may qualify
The federal government runs Medicare, and the program is the same for all Americans	State governments run programs under federal guidelines, so programs vary from state to state
Financing comes from federal funds; partly financed through payroll taxes and premiums	Financing comes from federal, state, and local revenue
Medicare Part A provides coverage for hospital stays; Medicare Part B covers the cost of doctor's bills, laboratory costs, and some outpatient costs; Medicare Part D covers some prescription drug costs	Broader coverage of health costs than Medicare, including inpatient and outpatient care, prescription drugs, laboratory costs, family planning, and nursing home care (types of coverage may vary from state to state)
Medicare beneficiaries may pay deductibles, co-payments, coinsurance costs, and premiums	Medicaid generally pays all approved charges, though a small deductible or co-payment may be required

## All about Indices



***Before investing in a mutual fund, you should carefully consider its investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing. And don't forget that any investment involves risk, including the possible loss of principal, and there can be no assurance that any investment strategy will be successful.***

***To produce a figure that indicates the value of the aggregated securities, an index divisor is typically applied to produce a more manageable figure that is easier to quote than the index's actual value.***

No doubt you've seen headlines reporting that a particular index is up or down. But do you know how an index works, and why understanding the nuts and bolts of a specific index can make a difference to your portfolio?

An index is simply a way to measure and report the fluctuations of a securities market or a particular segment of a market. An index is developed by a company that sets specific criteria to determine which securities are included in the index--factors such as a company's size or location, or the liquidity of its stock. For example, the S&P 500 is a collection of large-cap U.S.-based companies that Standard and Poor's considers to be leading representatives of a cross section of industries.

The company that develops the index tracks the performance of its components and aggregates the data to produce a single figure that represents the index as a whole. Virtually every asset class has at least one index that tracks it, but because of the size and variety of the stock market, there are more stock indexes than any other type.

### **How indices are used**

In addition to providing valuable information needed to monitor how a particular market is faring, an index can serve as the basis for mutual funds or exchange-traded funds that attempt to replicate its performance; that process is known as indexing. An index also can be used as a benchmark for funds that invest in the same asset class, regardless of whether a fund includes the same specific securities. Finally, some investment products do not attempt to replicate an index's performance but represent a bet on the index's general movements, though such investments can be challenging and are not appropriate for every investor.

### **You can't invest in an index**

You cannot invest directly in an index. You could always purchase each and every security in the index and do the necessary trading to ensure that the portfolio continues to mirror the index, but the financial services industry has saved you the trouble. As noted above, investment products such as index mutual funds and exchange-traded funds are used by investors to try to capture a particular market's performance.

However, an index-based investment may not match the return of an index exactly. One reason is what's known as "tracking error." Costs such as taxes, operating expenses (even minimal ones), and transaction costs can differ among mutual funds. As a result, your return

may be slightly different from that of the index or even other funds based on the same index, even though most index funds try to keep tracking error to a minimum.

### **Indices don't stay static**

Though an index adheres to a set of guidelines for selection of the securities it includes, the company that oversees the index generally reviews the security selection periodically. For example, some indices are rebalanced if an individual security grows so large that it dominates the index. Others have a limit on how much of the index can be devoted to a particular sector or industry, and rebalance if the proportion gets skewed. And in some cases, an index is altered because of serious problems with one of its components (for example, Flowserve Corp. replaced Washington Mutual Inc. in the S&P 500 after WaMu was closed by the Office of Thrift Supervision in 2008).

### **Weight watching**

Even indices that include the same securities may not operate in precisely the same way. Why? Because different indices may weight the relative importance of the same securities in different ways. The way an index is weighted determines how much of each individual security is included in it--for example, how many shares of stock. That weighting in turn can affect the overall index's performance.

Some indices are weighted based on market capitalization; the companies with the highest market cap (total value of stock outstanding) make up a larger share of the index than companies with a smaller market cap. As a result, those companies can have a disproportionate impact on the performance of an index weighted by market cap. For example, a 10% decline in the price of the largest company in the S&P 500 index would affect the index's overall return more dramatically than a 10% drop in the price of a much smaller company, because the S&P 500 is weighted by market cap.

Other indices are weighted by price; the most expensive stocks receive greater weight than lower-priced stocks. The Dow Jones Industrial Average, which includes 30 large, blue-chip industrial stocks and is commonly referred to as the Dow even though there are several Dow indices, is price-weighted. A relatively new approach to weighting an index is to use certain fundamental attributes, such as dividends or cash flow, as the basis for weighting the stocks that comprise the index.

## Ask the Experts

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### I'm buying a laptop online--will I have to pay sales tax?

There are currently five states that do not have a sales tax: Alaska, Delaware, Montana, New Hampshire, and Oregon. If you live in one of the other 45 states, or in the District of Columbia, you're probably legally responsible for paying some form of sales or use tax on your laptop purchase. And, to complicate matters even further, many municipalities assess a sales tax as well.

That doesn't mean an online merchant will collect the tax on your purchase from you, though. States can only force a merchant to collect state sales tax if the merchant has a significant enough physical presence in the state (think stores, distribution centers, corporate offices). This isn't unique to online merchants--the same rules apply to any out-of-state company that you purchase goods from.

So, it's entirely possible that you could order a laptop online from Company A, a company with an in-state sales staff, and have to pay sales tax as part of the purchase, but order the same laptop online from Company B, a company with no in-state connection, and not have to pay

sales tax as part of the transaction. Of course, a merchant can voluntarily collect sales tax for a state, even if they're not required to do so.

Just because the merchant doesn't collect sales tax doesn't necessarily mean that you're off the hook, however. Most states that impose a sales tax also have a related use tax. Essentially, a use tax means that if you should have paid sales tax on a purchase, but didn't because the merchant wasn't required to collect the tax, you're responsible for reporting the purchase yourself and paying the appropriate amount of tax.

The details vary from state to state--some states include the use tax calculation on state income tax returns, while others use separate forms. Of course, because the use tax relies on individuals self-reporting their purchases, and states have a limited ability to enforce compliance, it probably isn't surprising that many consumers simply do not report their online purchases.



### Can I deduct state sales tax on my federal income tax return?

If you itemize deductions on Schedule A of IRS Form 1040, you are generally able to deduct state and local taxes, including income tax, real property tax, and personal property tax. For 2011, if it works to your benefit, you can elect to deduct state and local general sales tax in lieu of state and local income tax. One thing to keep in mind: if your total itemized deductions don't exceed your standard deduction amount (for 2011, as an example, a married couple filing a joint federal income tax return would typically be able to claim a standard deduction of at least \$11,600), you generally won't get any additional tax benefit from deductions you claim on Schedule A.

When claiming a deduction on Schedule A for state and local sales tax, you have two options. You can deduct the amount that you *actually paid* in sales tax, as evidenced by receipts that you have accumulated showing amounts paid. Alternatively, you can use tables published by the IRS that are based on average consumption in each state, and factor in modified adjusted gross income and number of

exemptions. Even if you use the optional tables, you're still generally able to deduct the sales tax on certain specified items, like cars and boats.

One caution here: special rules apply to married couples who file separate federal income tax returns. If both you and your spouse elect to deduct state and local sales tax in lieu of income tax, and your spouse elects to use the optional state sales tax tables, you'll have to use the tables as well.

Things can get a little more complicated if you lived in more than one state during the year, or if the sales tax rate for the state in which you live changed during the year. Currently, the ability to deduct state and local sales tax in lieu of income tax expires at the end of 2011. And, if you're subject to the alternative minimum tax, the AMT rules may limit the deductions available to you, including the deduction for state and local taxes.

For additional information, talk to a tax professional, and see IRS Publication 600, *State and Local General Sales Tax*, and the instructions for IRS Form 1040, Schedule A.