The Planning Quarterly

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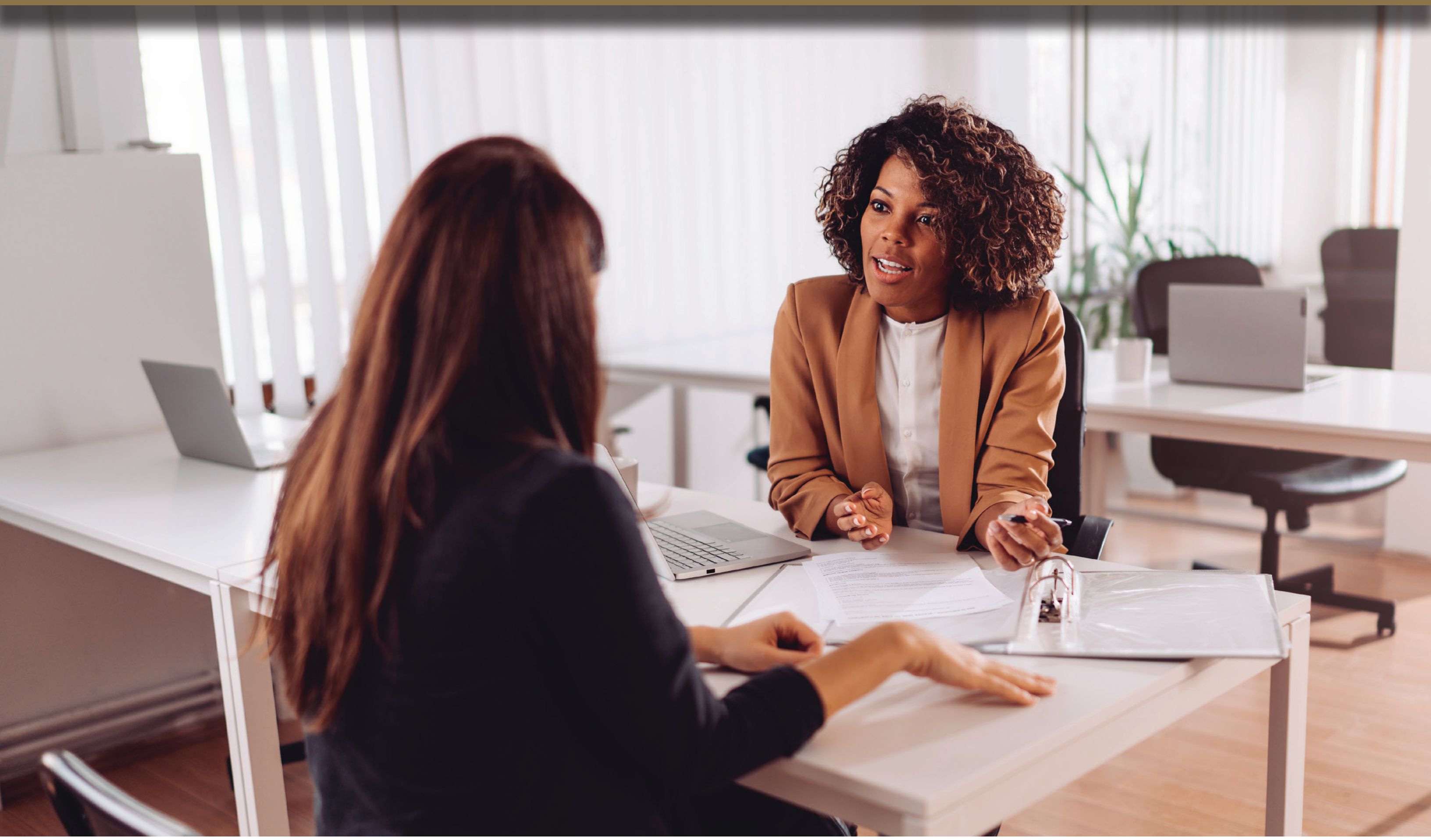

PEAPACK PRIVATE

Wealth Management

Welcome to the May 2022 edition of the Peapack Private Planning Quarterly. Planning challenges arise at every stage of life—the articles here highlight a few of them. This edition addresses timeless situations affecting you or your family members. Please reach out to our authors—or to any of our investment and planning professionals—with your questions. Our guidance can help you achieve your financial goals.

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Financial Discussions Before Marriage

By Dawn Brown, CFP™

A wedding is a day of celebrating two lives being joined together. According to a survey by The Knot, 2022 is expected to be a boom for weddings. Due to the pandemic, there were many cancellations and postponements of weddings. With the lifting of states of emergencies and many more businesses re-opening, the wedding business will not be left behind.

Before saying the vows and signing the matrimonial contract – yes, it is a contract – there are financial matters of the heart the parties should discuss to make sure both know what they are signing up for during married life. Planning a financially sustainable married life needs some upfront openness before exchanging the rings. Marriage will likely result in the merging of responsibilities, and it is only fair that each partner understands the finances of the other. Habits around money are based on their family upbringing. If money was not a topic of discussion in the house, it may be a hard conversation to commence. It also does not need to be done in one conversation. Consider it building blocks of knowledge to ground the relationship on a strong foundation.

Ideally a couple should begin discussing their financial life prior to planning a wedding date. Traditional wedding vows include the "for richer or for poorer" statement. Few really want to be experiencing the poorer scenario; therefore, some forward planning is the best choice. Here are some financial topics to discuss prior to the wedding day.

Financial Obligations

This should cover any outstanding loans and required payments such as child support and alimony.

Most students assume loans to finance college. According to U.S. News and World Report, the average student loan debt for the graduating class of 2020 was close to $30,000. It is important that couples know if student loans are held, the balances and the plans to repay once the current forbearance, which has been extended to August 31, 2022, ends. If either partner has child support payments or alimony, the amounts should be disclosed. This is particularly true if wages are being garnished to satisfy those obligations.

Credit card debt can be another burdensome debt to discuss. If one partner has a high balance on cards – will this be handled as a joint debt during marriage and paid down to help move towards other goals? Or will it remain that partner's sole obligation? Clarity at the beginning will help avoid any misconceptions if debts are revealed after marriage.

Credit Scores and Report

Understanding credit scores is important for planning for the future. Does the couple plan to buy a home or a car? Credit reports are easily ascertainable using annualcreditreport.com and can be purchased for a nominal sum. Some banks provide credit scores for free. A very good credit score, over 740, helps you to qualify for better interest rates when applying for a mortgage, auto loans and can even impact auto insurance rates. If one partner has a low score, they can take action to improve it before applying for joint purchases and getting a surprise from the unfavorable terms offered.

Spending and Saving Habits

Hints on how a future partner handles money usually becomes evident during the dating stage or during cohabitation. A partner who does a lot of impulse buying is not likely to change after a wedding without a discussion. To focus on goals they have for married life, it is important for the couple to discuss the goals and implement plans on how to achieve them.

The couple should also discuss the mechanics of paying bills and investing. Will they pay bills jointly, or will they divide responsibility? Even if only one person is responsible, they should both have knowledge of their finances.

Salary

Couples should be able to discuss their salaries as these are the funds that will be used to fund their future goals. It is also going to be revealed when they start to file joint tax returns, unless they choose the less favorable tax filing choice of married filing separately. Does one company offer better benefits that will save on expenses overall? By understanding the joint income flow they can begin to settle reasonable, achievable goals.

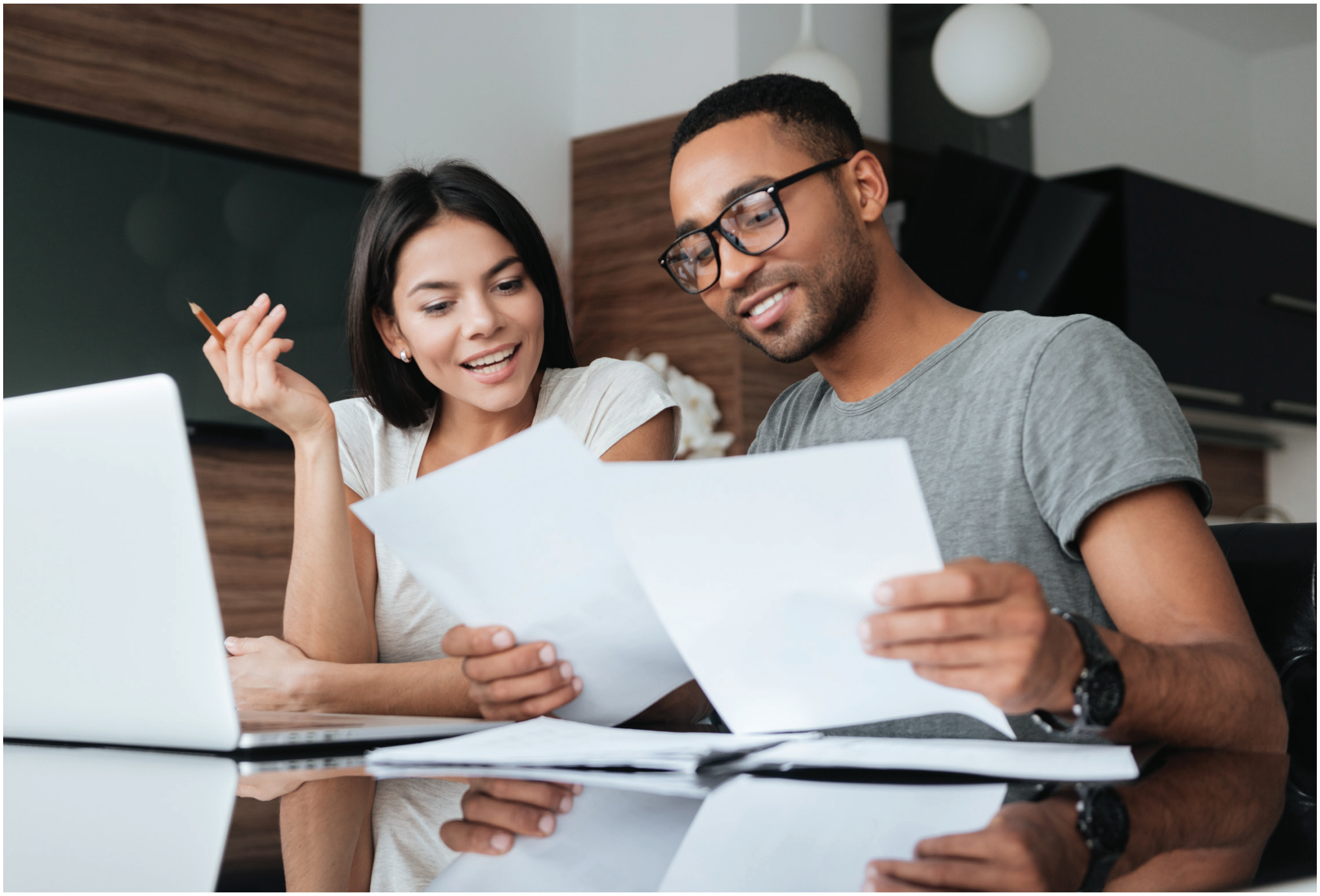
Assets

Currently held assets, like homes and rental properties are certainly advantageous. If either or both partners own a home, which will be the marital home? How will ownership be titled after the wedding? Are the couple participating in the company retirement plans or received stock options? Are investments accounts invested in ways with which they are both comfortable, or will they choose to have different asset allocations?

Having these upfront discussions, should also lead to the wedding celebration itself being handled with a reasonable budget. The Knot survey found that the average spent on weddings is about $34,000. Though some couples may receive parental contributions to the wedding, planning a ceremony with a high cost will impact what is available for the future. Additionally, with the joint finances a couple should decide how bills and investing will be handled.

These conversations should lead to the couple having a better understanding of how their partner feels about money, allowing them to put a plan together to build a future based on their shared goals. Primary reasons quoted for divorce – or just marital unhappiness – are financial problems and communication issues. By discussing these items upfront couples are putting themselves in a better position for the marriage to be long lasting.

One last thing to consider: request a professional Financial Plan as a wedding gift. It may not sound romantic, but it can be much more useful than another crystal vase.



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Navigating The Car Market

By Graham Richards

The Car Market

Car prices have reached an all-time high. The market for both new and used cars has been particularly impacted by the pandemic and concomitant supply chain issues. In 2020, as people rushed out of cities and relied less on public transport, more people needed personal vehicles for travel and their everyday needs. Meanwhile, labor shortages, microchip shortages, and other supply problems left car manufacturers unable to meet this surging demand. This is great news for car owners. If you have an extra car gathering dust in your garage, now is a great time to sell. Reach out to your dealer or look up your car's value online. You might be surprised how much your old car is worth.

This has not been good news for those looking to make a purchase. Last time you bought a car, you were probably offered plenty of incentives, discounts, and other perks by your dealer. Not in today's market. Dealers are taking advantage of the spike in demand. Next time you walk into a showroom, do not expect to haggle. Most new cars are selling for sticker price or higher for the most desirable models. If you do not take their offer, there is likely someone waiting in line behind you who will. Rest assured, new and used cars have likely reached their peak. While dealer inventory is not going to be at pre-pandemic levels any time soon, increased production and competition between manufacturers will allow for prices slowly to fall back into historic ranges. In the beginning of 2022, when the country was shocked by record inflation numbers, car prices actually declined slightly.

If you are in the market for a car, this article will provide information that can help you decide what the best option is based on your preferences. The first section will include the advantages and disadvantages of buying new and used cars, followed by the differences between leasing and financing a car, and the last section will explain differences relating to electric vehicles.

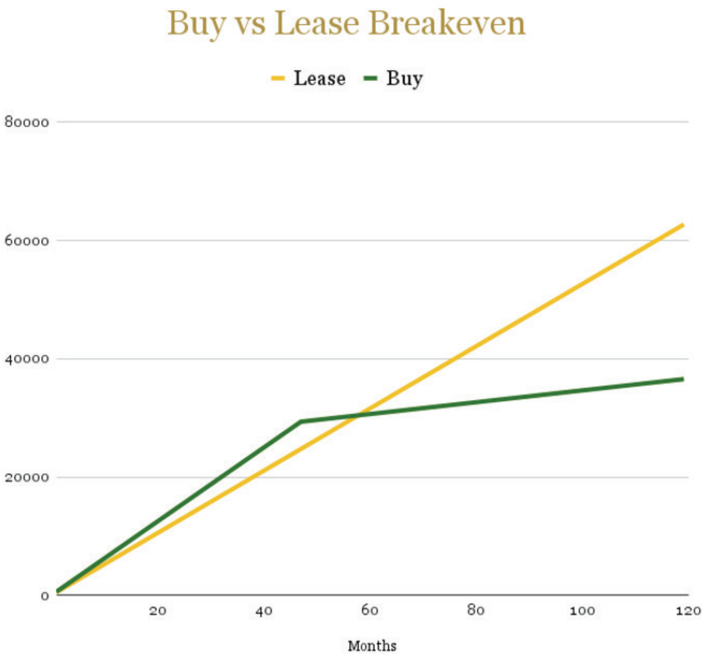
New vs Used

The first decision to make when buying a car is whether to buy new or used. The two main factors to consider when making this decision are: your budget and what you want from your car. Whether your budget is $20,000 or $200,000, you have options. If your main priority is a car that can reliably get you from point A to point B, and you do not want to be on the cutting edge of technology, most of the time buying used is in your best interest. Cars depreciate most rapidly for the first few years, after which, depreciation tends to flatten out. Buying a car that is a few years old is a great value because you are still getting some newer technology, but you are not losing money the second you drive off the lot.

Now suppose your budget includes a little more discretionary spending, and you want a little more luxury or performance. Still, do not immediately assume new is your only option. Oftentimes you can find a used higher-end car with the same or more features than a similarly priced new car. However, if you want the newest, safest, and best performing car, a new model is your only option. You will be paying a premium, but for many people the peace of mind of the best safety features, the newest technology, and the finest luxury are worth it.

Buy vs Lease

If you have decided on a new car, the next decision is whether to lease or finance your car. Both options have their pros and cons, and your decision will depend mostly on how much you plan to drive it and how long before you replace it. Before you decide, you must understand the difference between the two options. Leasing is essentially renting a car from your dealer. You make a monthly payment for the right to use the vehicle for a predetermined length of time. Once the lease ends, the car is returned to the dealer or may be purchased at a price determined in the lease agreement. Leases generally range from 36 to 48 months and will have a limit to the number of miles you can drive. When buying a car, you will either pay cash up front or finance the car with a loan. Loan payments will usually be more expensive than lease payments, but when the loan is paid off, you own the car. Which option should you choose?



Leasing is the best option if you always want the most up to date car, whereas buying will be cheaper in the long run if you plan to keep your car for most of its life. As you can see in the graph[1] above, the total cost of buying is higher than leasing at first, but the longer you own the car, the less money you will spend. This graph compares the total cost of multiple leases over ten years versus the total cost of financing a car over four years and paying for maintenance for the following six years. In this simplified case, the breakeven point is after about five years. The breakeven point will vary depending on the many factors of your lease or loan, but the general trend remains true.

"In the beginning of 2022, when the country was shocked by record inflation numbers, car prices actually declined slightly."

When you own, you have the choice to drive the car until the wheels fall off, save it for a new driver in your family, or sell it. However, buying comes with more uncertainty. The future value of your car and maintenance costs are out of your control. If you prefer less uncertainty, lease agreements will define exactly how much you will pay assuming you do not go over your mileage limit or cause excess wear on the car.

Electric Vehicles

In 2022 we have also faced record high gas prices, which might make you consider an electric vehicle (EV). While the principles discussed previously apply to EVs, there are other costs and savings to consider. One of the biggest advantages of an EV is eliminating your gas expense. To determine your savings, you will have to determine your expected increase in your electricity bill. In addition to saving on gas, your EV might be eligible for a $7,500 federal tax credit and other tax advantages depending on your state. For example, in New Jersey, zero emission vehicles are exempt from sales and use tax.

EVs also come with different risks. Unlike traditional internal combustion engines (ICE), EVs rely on a battery. An ICE, if well maintained, degrades slowly, but batteries degrade quickly. Battery degradation can cause a drastic reduction in vehicle range and therefore might cause faster depreciation. Because the market is relatively new, it is unclear how EVs will hold their value in the future.

Conclusion

Car shopping can be both exciting and stressful. Carefully consider the options discussed here, and whether you decide to buy new, used, or lease, you will enjoy many miles down the road. Happy driving!

[1] Data from https://www.edmunds.com/calculators/lease-vs-buy-calculator/

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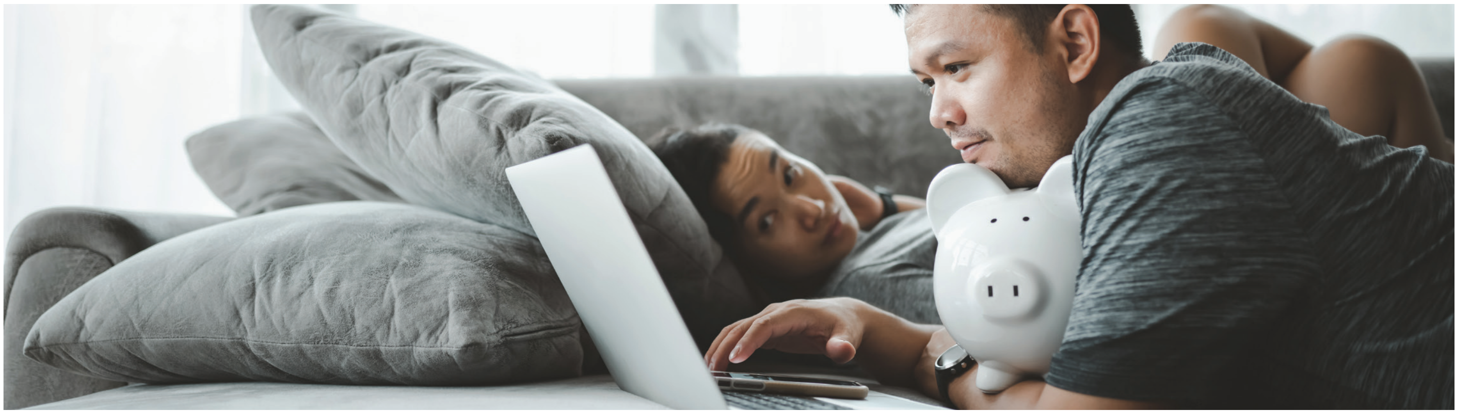
What About a Family Loan?

By Cynthia Aiken, MBA, CFP™



As interest rates rise in the current economic environment, borrowers may start looking for alternatives to typical lending sources. What about borrowing from family members? Over the ages, families have supported each other through intra-family loans. Whether parents or grandparents lend to their offspring or siblings lend to one another, family loans can provide needed funds to those closest to us.

Loan or Gift?

There is a difference between a family loan and a gift – particularly for tax purposes. The IRS requires that the lender in a family loan charge interest or the transfer of funds will be considered a gift. Furthermore, there will be reporting of loan income and expense on federal income tax returns - the lender receives interest reported as taxable income and the borrower may be able to deduct the interest expense as an itemized deduction, depending on how the loan proceeds are used.

A family loan should be documented in a loan agreement between the lender and the borrower with key pieces of information: amount being borrowed, appropriate interest rate, repayment schedule with payment frequency, amount of payment, payoff date and any penalty for early (or late) repayment. If this is a large loan, it is wise to engage an attorney to provide guidance and/or to write the loan agreement.

On the other hand, a gift up to the annual exclusion amount of $16,000 in 2022, is non-taxable. If the gift exceeds this threshold, it will count against the donor's estate exemption amount – currently $12,060,000 – and must be reported on IRS Gift Tax Form 709.

Interest Rates on Family Loans

The minimum interest rate on a family loan required by the IRS – known as the Applicable Federal Rate (AFR), is set by the government every month on loans larger than $10,000. If a loan is $10,000 or less, no interest is required for tax purposes. The IRS publishes a set of AFRs each month that can be found online at https://www.irs.gov/applicable-federal-rates.

AFRs are broken into rates for three time periods: short-term (three years or less), mid-term (up to nine years) and long-term (more than nine years). The length of the loan must correspond to the appropriate AFR. The April 2022 rates are short-term 1.26%, mid-term 1.87% and long-term 2.25%.

Advantages of Family Loans

Family loans have advantages over conventional loans from banks or other financial institutions. A family member with poor credit or a limited credit history, may find it difficult to get a personal, student, business or mortgage loan. With a family loan there is no formal application process, credit check or income verification and no origination fees, closing costs or expenses. Most importantly, the repayment terms and interest rate may be more attractive. Because this is not a conventional loan, the interest rate is likely lower and the repayment schedule can be flexible, tailored to the borrower's income flows while still meeting the lender's income needs. If the borrower faces a financial hardship, such as – job loss or high medical expenses, then the repayment schedule can be adjusted to accommodate a longer repayment. Some family lenders feel that a repayment schedule with regular payments can encourage the borrower to practice fiscal discipline.

Drawbacks of Family Loans

If the debt is repaid in full and on time, then everyone is happy. However, if a debt is unpaid, family dynamics can lead to strain or conflict. The unpaid debt may create a hardship for the lender particularly if the lender needs the funds back and has difficulty recouping losses associated with the loan.

As the Lender…

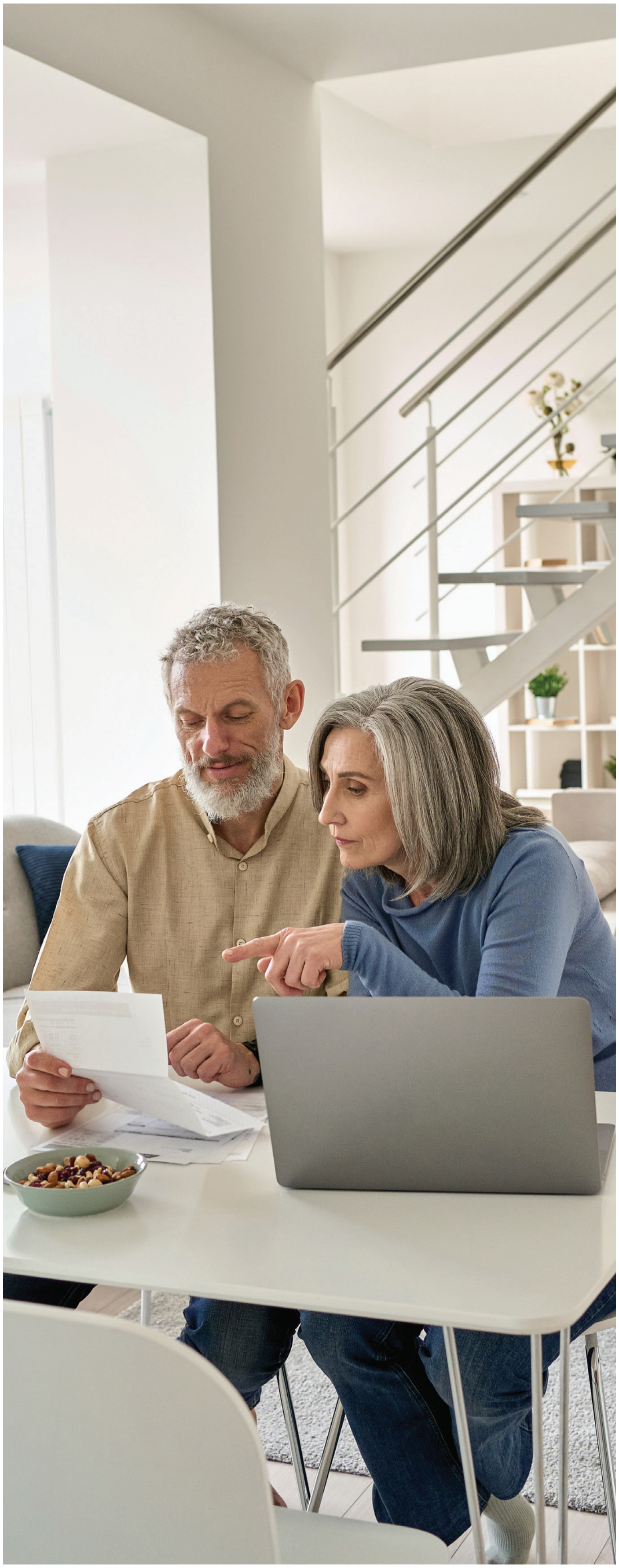
If approached by a family member asking for a loan, you should hit pause and review your finances before agreeing to be a lender. Although you may be eager to help your family member, ask yourself if you have enough cash on hand to make the loan and cover your near term needs or whether dipping into savings or retirement accounts hinders your longer term or retirement plans.

If you decide to lend the money, then document the loan in writing. A written agreement clearly signals to the borrower that you are serious about being repaid, and the document can help prove in court that you expected repayment of the debt. If the borrower is married or has a partner, include that person in the conversation. If possible, use collateral to secure the loan. For example, if lending for a home purchase, then get a lien on the property. Maintain records reflecting the true loan transactions including timely payments. To facilitate that process consider using the software mentioned below and setting up a payment plan on autopay. Review the situation with your tax advisor so that you fully understand the legal and tax consequences. Communicate with the borrower and be willing to say no.

Feel free to ask the borrower the purpose of the loan. Think through the downside of this situation. If the borrower stops making payments, will you charge late fees or take collateral? Would you be willing to use a third-party loan servicer and report payments to the credit bureaus? How will you handle the loan if the borrower becomes ill, injured or disabled? Are you willing to sue your family member, or would you absorb the loss? Will a loan default impact your financial situation or the inheritances of other family members?

As the Borrower…

Are you comfortable asking the lender for a loan and are you willing to explain the loan purpose? Do you feel that you have a reliable source of income and cash reserves if you can't make payments for a few months? Understand that if the lender does not report payments to the credit bureaus, there will not be credit rating improvement or building of your credit history.

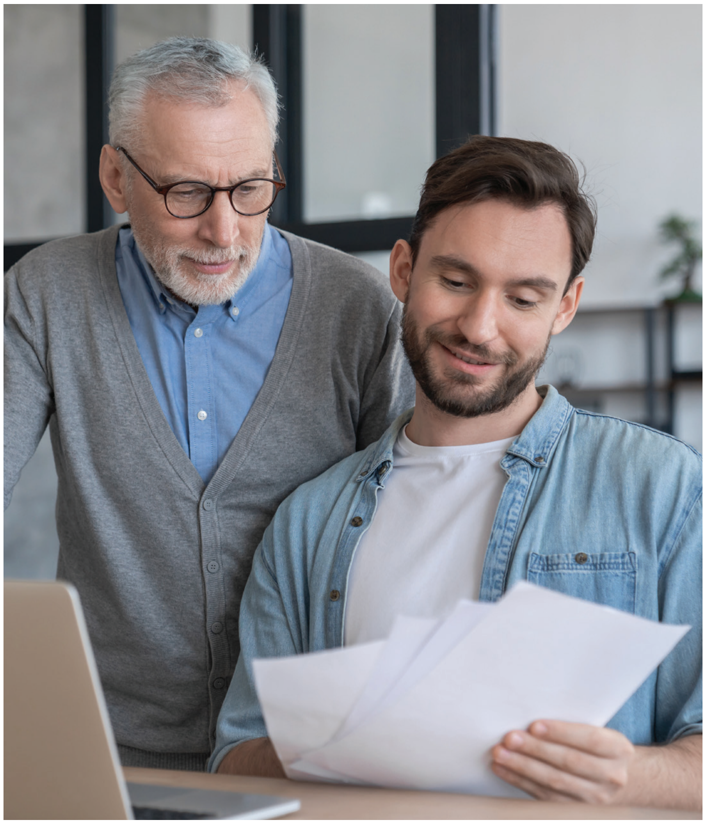


Tax Issues?

If the lender charges more than the AFR, there are no negative tax consequences; interest income must be included on the lender's income tax return. On the other hand, if the family loan is interest-free or carries a rate below AFR, the loan is subject to IRS scrutiny and any "forgone interest" – the estimated interest that should have been charged per the IRS rule – is deemed a gift for federal tax purposes. Forgone interest may be subject to gift taxes and treatment as interest income on returns. There are some exceptions to the forgone interest rule, so check with your tax advisor.

If the lender decides to forgive a family loan, the unpaid principal and interest will be treated as a gift for tax purposes. There are no tax consequences to the borrower if the lender forgives the loan. The lender should not consistently forgive accrued interest each year; this repeated forgiveness may be a factor in determining whether there is a bona fide loan. Likewise, there should not be a prearranged schedule to forgive the loan.

If the lender is charging interest and the borrower defaults on the loan, there will be tax consequences for both parties. An uncollected loan that is written off unwillingly is viewed as a cancellation of debt and is a tax deduction for the lender and taxable income to the borrower. Seek advice from your tax advisor regarding cancellation of debt.



Online Tools to Help

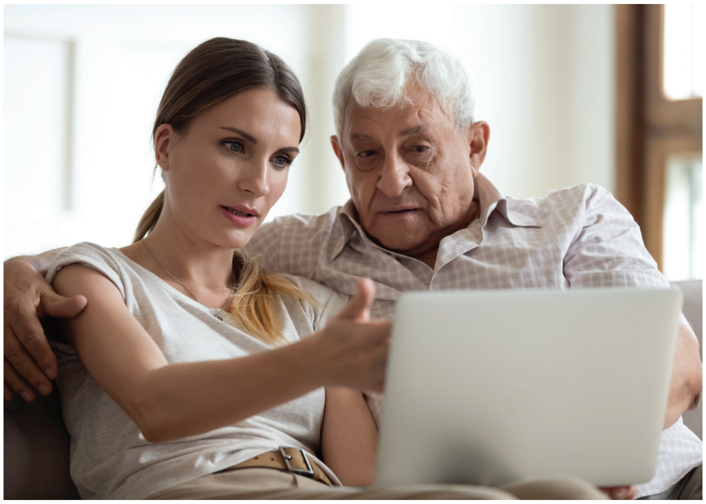
Keep records! Beyond the original loan agreement, it is important to maintain records reflecting the payments of interest and principal. You can find sample promissory notes online or check **LoanBack** – an online site offering tools to personalize loan agreements and track payments. If the family loan is for a home mortgage, explore **National Family Mortgage** – an online service that can help you create and service the loan. Please note that neither site provides legal advice.

Alternatives to Family Loans

If a Family Loan doesn't seem like the right funding source for your family, there are other ways to help a family member receive the funds needed. A family member with a strong credit rating could co-sign a loan with a bank or financial institution. The co-signer must be comfortable with the borrower's ability to repay the loan because if the borrower defaults, the co-signer is on the hook for repayment. Another method is to add the borrower as an authorized user on the family member's credit card. This would enable the borrower to join the primary cardholder's credit card account to make purchases. The account should be added to the borrower's credit report and the primary cardholder's good credit helps the borrower improve creditworthiness. If the borrower is seeking funds for a business purpose, an SBA (Small Business Administration) loan may offer terms that will are more attractive than typical bank financing.

Bottom Line

A family loan can be a big win for the lender and borrower, but careful evaluation of the pros and cons may prevent a sour family relationship. Document the loan agreement and the payments to prevent misunderstandings. Always review a family loan in consideration of your financial situation and with the help of your financial professionals.



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A Better Back Door Roth IRA

By Claire E. Toth, JD, MLT, CFP™

By now, most investors have heard of Roth IRAs. Many are familiar with the phrase Back Door Roth IRA. Now we have the Mega Back Door Roth. Those who fit a specific set of criteria can contribute as much as $40,500 to a Roth IRA or 401k this year. Importantly, the SECURE Act 2.0, now pending in Congress, would end this technique at the end of 2022—this may be a serious case of use it or lose it.

Before diving into the weeds on this technique, let's take a step back to examine the landscape. Ideally, a retiree meets cash flow needs from accounts carrying different tax consequences. Money from traditional retirement accounts—think IRAs, 401ks, and the like—usually comes out as one hundred percent ordinary income. Money from taxable investment accounts is some combination of untaxed return of principal, dividends, and capital gains (or losses). Funds from a Roth IRA (or Roth 401k) can pay retirement expenses one hundred percent tax free. Robust financial planning helps retirees mix and match cash flow sources to achieve optimal after-tax results. The challenge for many higher earners is building up a meaningful Roth account balance.

Roth IRAs[1]

With most retirement plans, contributions go in before paying taxes, reducing current taxable income. There is no current tax on growth within the account, but all distributions come out taxed at ordinary income rates. Think of this as a bet that your tax rates in retirement will be lower than in your high-earning years. You must begin taking distributions from most retirement accounts once you turn 72.

A Roth account—whether a 401k or an IRA—flips this script. Contributions do not reduce income, because they are made with after-tax dollars, rather than the pre-tax contributions to traditional 401ks. Funds in the Roth grow tax free, and if taken out for qualified retirement purposes, come out tax free. Better yet, there is no requirement that you take any distributions during your lifetime. A Roth account is a bet that your taxes in retirement may be higher than they are today. Because no one knows for sure where any given person's tax rates will head, having funds in both types of retirement accounts is sound planning.

Investors are limited in Roth IRA contributions, both in absolute dollars and in income levels at which contributions can be made. In 2022, the maximum Roth IRA contribution is $6,000 ($7,000 if age 50 or over). Moreover, to make that size contribution, an individual's income cannot exceed $129,000; a married couple's cannot exceed $204,000.

Many workplace retirement plans have a Roth component. A participant can always direct some of the annual contributions to the Roth. Most high earners prefer to take the maximum possible tax break and direct the entire contribution ($20,500 in 2022; $27,000 if age 50 or older) to the traditional component.

The bottom line is Roth contributions are often best made early in a career, before earnings (and financial obligations) ratchet up. Early contributions also permit more time for appreciation. None of this advice helps mid-career high earners.

Backdoor Roth IRAs

Those who cannot make a direct Roth IRA contribution and choose not to make a Roth 401k contribution can consider a so-called Backdoor Roth IRA. This is an indirect way to fund a Roth IRA. Anyone with a traditional IRA can convert some or all that IRA to a Roth IRA. The trick is that any pre-tax dollars in the conversion are immediately taxable. If there are after-tax IRA contributions, those after-tax dollars come out pro rata, slightly reducing the tax bill. Roth conversions can be a useful technique for those who retire a few years before claiming Social Security. Early retirees typically consume taxable assets and are in a low tax bracket; they can make sizable Roth conversions for relatively low tax cost. Of course, those in high earning years may choose to make small annual conversions, to prime the pump.

Someone without a traditional IRA can also make backdoor IRA contributions. She can establish a new IRA, contribute $6,000 (or $7,000) in after tax dollars to it, and immediately convert the dollars to a Roth IRA. In that situation, there are no pre-tax dollars to convert.

[1] For a comprehensive overview of Roth IRAs, see Cynthia Aiken, "Time to Consider a Roth IRA!" in the August 2021 issue of The Planning Quarterly.

Mega Backdoor Roth IRAs and 401ks

If the stars line up, a high-income earner can functionally contribute as much as $40,500 to a Roth IRA or 401k in 2022. Here are the considerations and requirements for this to work. Employers are required to restate their 401k plans every six years, so if your plan doesn't have the necessary components, ask when the next restatement will occur and push for these provisions to be included.

- This strategy only makes sense for those already contributing the maximum to their 401k plans. If that contribution level is out of reach and you want to build up a Roth account, simply direct some of your contribution to the Roth 401k.
- The plan must allow after-tax contributions beyond the maximum traditional contribution of $20,500 (or $27,500). Close to half of 401k plans at larger and mid-sized companies do.
- The plan must permit either in-plan Roth conversions or in-service distributions to current employees. The after-tax contributions need to move into a Roth bucket as soon as possible. Until they do, any growth on those dollars remains subject to the traditional 401k rules—taxed as ordinary income when distributed.
- The participant must have the funds available to make after-tax contributions.

Practical considerations intrude. First, that $40,500 amount is the maximum an employer and employee together can contribute above the employee's usual 401k contribution limit. A typical employer 401k match is three percent of salary, so long as the employee contributes at least six percent. For example, if the employee earns $250,000 annually, the employer 401k match is $7,500 (three percent). The $40,500 must be adjusted downward for that match. Employer contributions are always pre-tax and stay in the traditional portion of the 401k.

The 401k match is formulaic. However, if the employer contributes to a profit-sharing or cash balance retirement plan, the contribution allocated to the employee is more difficult for the employee to determine—check in with the benefits department for guidance.

Second, understand precisely how to roll those contributions out to a Roth IRA or to make an in-service conversion. Some plans require employees to have reached a certain age—often 55, but sometimes 59-1/2—before permitting distributions. Many 401k plans charge $40 or $50 for each distribution. If an employee makes all after tax contributions at once, from her annual bonus or similar, a one-time fee is not onerous. If the contribution/distribution is going to happen every two weeks, the employee might want to consider alternatives, such as an annual roll out. That foregoes some but not all potential Roth earnings.

The in-service conversion process also varies. Some plans automate it; others require a paper trail for every conversion. Employees who choose this option should verify the conversion occurs as planned.

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