**Advising the Affluent Client:**

**Retirement Distribution Planning**

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## Introduction

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| **Video Script** | |
| **Script** | **On Screen Text** |
| What do most retirees fear more than death? [very short pause] Retirees and those nearing retirement fear running out of money more than death itself.  In an AARP survey taken of individuals aged 44 through 75, more than three of every five surveyed would choose death over running out of money in retirement.  You have what may be a once in a lifetime opportunity to address this appalling fear.  Our primary goal in this course is to share tools, techniques, and concepts aimed at creating an effective distribution strategy. In turn, an effective distribution strategy may help you help your clients make their money last a lifetime. | **Fear:**   * Three of every five clients fear running out of money more than death.\*   **Course Goals:**   * Create an Effective Distribution Strategy * Help you help your clients make their money more likely to last a lifetime   \* *AARP, July 2010 Bulletin* |
| So what’s in it for you? You may find that addressing your client’s deepest financial fear not only develops client confidence and loyalty to you, but also presents an opportunity to consolidate investments from other providers or offer other solutions such as annuities. | **Potential Benefits to You**   * Enhance client confidence and loyalty * Capture investment assets from other providers * Offer solutions such as annuities |
| One of the unique qualities of the course you are about to enter is coordination. The ideas you will find within this course, many of which are not commonly understood, do not exist in a vacuum.  They simply must be coordinated to function effectively. [repeat] As but one example, sixty thousand dollars or more may be added to a couple’s lifetime income stream by coordinating and timing distributions from Social Security, IRAs, qualified plans, and annuities. | **What is Unique About This Course?**   * Increase client retirement income dramatically through **coordination** and timing of distributions from:   + Social Security   + IRAs   + Qualified Plans   + Annuities |

An effective retirement plan is built upon 5 key issues spanning two distinct phases in the retirement lifecycle: the accumulation phase and the distribution phase. You gained competency in the first four of the five key issues in our previous course, Retirement Accumulation Planning. This course, Retirement Distribution Planning, completes your competency with a laser-like focus on Key Issue 5 - an Effective Distribution Strategy.

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| **5 Key Issues of Retirement Planning**   1. Clear Retirement Plan 2. Sufficient Savings 3. Effective Investment Strategy 4. Tax-Efficient Savings Strategy 5. Effective Distribution Strategy |

An effective distribution strategy gives increased confidence to your clients in their retirement income stream. Increased confidence may well reduce visceral client fears of running out of money. The following retirement tools and strategies will inform our discussion as we help you guide your clients to an effective distribution strategy:

* Managing Distributions from IRAs, Qualified Plans, and Other Plans
* Maximizing Social Security Benefits
* Minimizing Income Tax in Retirement

Managing Distributions from Traditional IRAs

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| Physicians must take the Hippocratic Oath. The Hippocratic writing *Epidemics* charges physicians to “to do good or to do no harm” in matters of a patient’s health. In matters of your client’s retirement plan health, you must understand the distribution requirements well enough not only to “do good” but also to avoid harm from the 10% and 50% IRS penalties. |

Competence in Traditional IRA distributions is a straightforward process involving the following concepts. **Click on each to learn more.**

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| **Required Beginning Date (RBD)** |
| The ***required beginning date (RBD)*** for distributions from a Traditional IRA is no later than April 1 following the year in which the IRA owner attains age 70½. If the April 1 beginning date is chosen, there must be two distributions in the year that includes April 1. One distribution is FOR the previous year and the second distribution is FOR the current year.   |  | | --- | | Example  Patricia attained age 70½ on January 1, Year 1. She elects to take a distribution from her Traditional IRA ***for*** Year 1 on April 1, Year 2. In effect, she is deferring her Year 1 distribution until April 1 of Year 2.  She must take another distribution by December 31, Year 2 ***for*** Year 2.  In Year 3 and all subsequent years, she is required to take only one annual distribution no later than December 31. | |
| **Required Minimum Distribution (RMD)** |
| It has been said that Congress and the IRS are anxious to begin taxing that deferred income cradled inside of Traditional IRAs. Consequently, distributions must commence no later than the required beginning date (RBD) in an amount equal to or greater than the required minimum distribution (RMD). The RMD is explained below.  Advisors serving affluent clients are expected to understand the basic RMD rules, IRS life expectancy tables, and RMDs for clients with multiple IRAs.  storm-red-and-yellow-th ***RMD Compliance Alert!***   |  | | --- | | Your firm may have a dedicated group tasked with providing official RMD calculations. Make your client aware that any RMD discussions between the two of you are informal and intended as general guidance only. As an added precaution, *contact your compliance department to determine your firm’s policy in this area.* |   Click on each of the following to learn more.   |  | | --- | | **Basic RMD Rules** | | The formula used to calculate the ***Required Minimum Distribution (RMD)*** follows:   |  | | --- | | **IRA Balance as of 12/31 of previous year divided by**  **Appropriate Divisor from IRS Life Expectancy Table** |   The appropriate divisor is based upon the life expectancy of the owner, the owner and spousal beneficiary, or the owner and non-spousal beneficiary. The account balance used to calculate the RMD is the account balance of the IRA on December 31 of the year immediately preceding the calendar year for which the RMD is due.  Each year's RMD is calculated by dividing the end of the previous year’s account balance by the current year's life expectancy factor that is found in the appropriate IRS table. ***Remember that there is no penalty for taking more than the RMD once your client reaches age 59½.*** RMD is best illustrated by example**.**   |  | | --- | | RMD Example  Ms. Ima Sayver owns a Traditional IRA. She is single, has no named beneficiaries, and turned age 70½ on August 1, Year 1. Therefore, she must compute her RMD for Year 1.  Given the following market values of the IRA and her life expectancy, what is her RMD for Year 1?  Value as of 12/31/Year 0 = $4,000,000  Value as of 12/31/Year 1 = $5,000,000  Life expectancy as of 12/31/Year 0 = 21 years  Life expectancy as of 12/31/Year 1 = 20 years  **Solution: Divide the previous year-end’s account balance by the current year’s life expectancy. Ima’s RMD is $200,000 calculated as $4,000,000 divided by 20 years.** | | | **How To Delay RMD - The QLAC Solution** | | A Qualified Longevity Annuity Contract (QLAC) may appeal to clients wishing to defer taxes by delaying RMD past the required beginning date (RBD) and those who fear running out of money if they outlive their life expectancy.  As much as 25% of a client’s balance in certain retirement plans may be used to purchase a QLAC. Annuity payments may be deferred beyond the normal RBD, but must begin upon reaching age 85. **Click** here **for more information on QLACs.**   |  | | --- | | 25%  The lesser of ***25%*** of the account balance or $125,000 (2016, as indexed) may be used to purchase a QLAC. The limits are lifetime limits rather than annual limits. |      |  | | --- | | Certain Retirement Plans  Defined Contribution category qualified plans, 403(b) Plans, Traditional IRAs, SEP IRAs, SIMPLE IRAs, and 457(b) Plans generally qualify for QLAC treatment. |  |  |  |  |  | | --- | --- | --- | --- | | More Information on QLACs  A QLAC is a deferred, fixed, lifetime annuity purchased anytime before a client’s age 85. Annuity payments must begin no later than the first day of the first month following the annuitant’s 85th birthday.   |  | | --- | | Deferred  Annuities may be immediate, meaning they begin making annuity payments within one year after purchase, or deferred, meaning that annuity payments begin more than one year after the purchase date. |  |  | | --- | | Fixed  Annuities may provide a fixed payment, which generally does not change for the life of the annuity, or a variable payment, which changes based upon the investment performance of the annuity’s investments. The fixed payments of a QLAC may be adjusted for inflation but may not be structured as variable payments. |  |  | | --- | | Lifetime  ***Lifetime*** annuities are paid over the annuitant’s lifetime rather than a certain term of years. Lifetime annuities are also referred to as “pure annuities.” | | | At the death of the annuitant, only two types of death benefit may be paid to the beneficiary, including: (1) a lump sum return of unrecovered premium, or (2) a life annuity. |   test_tip_icon **QLAC Caveats**   |  | | --- | | * **Interest Rate Sensitivity** - Fixed annuities are extremely sensitive to market interest rates and function most effectively in high interest rate markets. Low interest rate markets generally result in relatively low payouts. * **Lack of Liquidity** – QLACs are not permitted to build a cash surrender value. Clients should have sufficient liquidity outside of the QLAC for emergencies.   ***QLACs have retirement, tax, and investment considerations. Your client should consult with their CPA, CFP® certificant, and investment professional before purchasing a QLAC.*** | | | **IRS Life Expectancy Tables** | | A solid understanding of life expectancy tables can result in a lower RMD. A lower RMD has at least two potential advantages: (1) a higher IRA balance for the ultimate benefit of the surviving spouse, and (2) more flexibility in income tax planning.  The IRS publishes two life expectancy tables: (1) the Uniform Table, and (2) the Joint and Last Survivor Life Expectancy Table.   * Generally, the ***Uniform Table*** is required for calculating RMD. The Uniform Table assumes a beneficiary 10 years younger than the owner. This is true for all IRA owners whether single or married. This is also true even if the beneficiary is actually ***older*** than the owner spouse. Unmarried clients must generally use the Uniform Table. * Married clients may choose to use either the Uniform Table or the actual ***Joint and Last Survivor Life Expectancy Table*** to determine life expectancy in the RMD calculation. This option is available ***only*** if the sole beneficiary is the spouse. Whenever the beneficiary spouse is more than ten years younger than the owner spouse, the actual Joint and Last Survivor Life Expectancy Table yields a higher life expectancy than the Uniform Table, thereby lowering the RMD. | | **RMD for Multiple IRAs** | | Traditional IRAs, SEP IRAs, and SIMPLE IRAs are subject to the RMD rules. RMD for each IRA is calculated separately. However, after the total RMD from all IRAs is calculated, that total amount may be taken from any one or all of your client’s IRAs. The following example illustrates the point.   |  | | --- | | **Example of RMD for Multiple IRAs**  Your client Dana has RMD questions. Her account balances are as of the end of the previous year. Assume a 20-year life expectancy from IRS tables for calculation of RMD.   * $500,000 Roth IRA balance, RMD for current year = $0\* * $1,000,000 Traditional IRA balance, RMD for current year = $50,000 * $250,000 SEP IRA balance, RMD for current year = $12,500 * $100,000 SIMPLE IRA balance, RMD for current year = $5,000 * Total RMD from all IRAs = $67,500   Dana may distribute the $67,500 from any one of the non-Roth IRAs or spread the $67,500 distribution from among the non-Roth IRAs in any manner she chooses. ***Distributions from her Roth IRA will NOT satisfy Traditional, SEP, or SIMPLE IRA RMD requirements!***  \* *No RMD required during original owner’s lifetime for Roth IRA* | | |
| **Avoiding Penalties** |
| Imagine that you are the client for a moment. How credible is your advisor when he or she fails to warn you about penalties from IRA distributions? Here are two effective ways to maintain credibility with your clients: avoid the 10% premature withdrawal penalty and avoid the confiscatory ***50%*** penalty for taking distributions too late. A sobering example of waiting too late follows:   |  | | --- | | 10% Premature Withdrawal Penalty  Taxable distributions from a Traditional IRA taken before age 59½ are generally subject to a penalty of 10% of the taxable amount of the distribution. Exceptions to the 10% penalty follow:   * Death * Disability (The disability must be one that prevents any gainful employment and is expected to last a long time or result in death) * When distributions are set up as a series of substantially equal periodic payments * To pay for unreimbursed medical expenses that exceed 10% of adjusted gross income * To pay health insurance premiums after the owner has received unemployment compensation for more than 12 weeks * To pay the costs of a first-time home purchase(subject to a *lifetime* limit of $10,000) * To pay for the qualified expenses of higher education for the IRA owner and/or eligible family members * In response to an IRS levy   Detailed requirements for claiming these exceptions may be found at the following link: <https://www.irs.gov/taxtopics/tc557.html> |  |  | | --- | | Example - Waiting Too Late to Take Distributions  Your client Kayla reached age 70½ during Year 1. She took her RMD of $32,000 ***for Year 1*** on April 1, Year 2. Her distribution for Year 1 was timely, in the right amount, and incurred no penalty.  However, she forgot to take an RMD for Year 2 by December 31, Year 2. Assume the RMD ***for Year*** ***2*** was $30,000. Her penalty is a whopping $15,000 (50% of the amount under distributed for Year 2). |   Here is an opportunity to be a hero or heroine to Kayla. In the previous example, Kayla’s penalty ***could be*** waived by the IRS. IRS has waived the 50% penalty for reasons such as natural disaster, illness, death of a loved one, failure of an IRA custodian or Trustee to notify the IRA owner timely and accurately, and incarceration. Hopefully that last reason will not apply to your clients!  ***Your client should immediately consult with their tax attorney, CPA, or other tax professional as soon as the under distribution is detected. Your role here is to raise awareness only.*** |
| **Income Tax** |
| Traditional IRAs come in two basic flavors: (1) deductible, and (2) nondeductible.  All distributions from deductible Traditional IRAs are fully taxable.  Distributions from nondeductible Traditional IRAs are only partially taxable: each distribution includes an income tax-free return of original contribution. **Click** here **for an example.**   |  | | --- | | Example  Julius made nondeductible Traditional IRA contributions of $2,000 each year for 20 years.  His IRA now has a market value of $100,000. Julius is 66 years of age and plans to take a distribution of $10,000 from the IRA this year.  How much of the $10,000 will be taxable? The calculation follows:   * Cumulative nondeductible contributions - 20 years @ $2,000/year = $40,000 * Market value of the IRA = $100,000 * Percent of market value represented by contributions = 40% [$40,000/$100,000] * Dollar amount of current year withdrawal = $10,000 * Nontaxable return of contributions at 40% = $4,000 * Taxable withdrawal = $6,000 |   storm-red-and-yellow-th **Beware the income tax rate bracket trap!**   |  | | --- | | Be cautious in recommending the delay of the first RMD until April 1 of the year following the year your client reaches age 70½, in which case he or she must also take a second RMD by December 31 of the same year.  The combination of the April 1 RMD and the December 31 RMD within the same year may dramatically increase marginal income tax rates. | |

## Review Exercise

**Review your understanding of the preceding pages by answering the following questions.**

1. **Which of the following, if any, exactly describes the required beginning date for Traditional IRAs? Assume no Qualified Longevity Annuity Contract is involved.**

* **April 1st following the year in which the taxpayer reaches age 70½**

**Correct**!

* April 1st following the year in which the taxpayer reaches age 65

**Incorrect**. Try again.

* April 1st following the year in which the taxpayer reaches age 59½

**Incorrect**. Try again.

* None of the above

**Incorrect**. Try again.

1. **Why might a client find a Qualified Longevity Annuity Contract attractive?**

* **Ability to defer the required beginning date of a portion of taxable required minimum distributions (RMDs) until age 85 and establish a safety net of additional income in case the client outlives their life expectancy**

**Correct**!

* Flexibility to convert future taxable RMDs to tax free income beginning at age 85 and establish a safety net of additional income in case the client outlives their life expectancy

**Incorrect**. QLACs do not create tax-free income.

* Elimination of all RMDs during the client’s lifetime

**Incorrect**. RMDs are merely deferred, not eliminated.

* Ability to use low market interest rates to obtain superior returns

**Incorrect**. A QLAC purchased during a low interest rate market will generally underperform a QLAC purchased in a higher interest rate market.

## Managing Distributions from Roth IRAs

Clients seeking income tax-free distributions of earnings are attracted to the Roth IRA. The flexibility to take or avoid taking distributions during the Roth IRA owner’s lifetime may also appeal to clients. We begin our discussion with a review of contributions and will then analyze earnings distributions.

***The owner of a Roth IRA can always withdraw regular contributions without penalty or taxation.*** “Regular Contributions” are nondeductible annual Roth contributions that do not include any rollovers, conversions, or earnings on invested assets in the Roth IRA. In addition, when funds are distributed from a Roth IRA, regular contributions are distributed first.

On a cumulative basis, once all regular contributions to a Roth IRA are distributed, then earnings are distributed. Distributed earnings may or may not be subject to taxation and penalty. There are three steps to determine the tax implications of a Roth IRA distribution attributable to earnings**:Click on each step to learn more.**

Step 1: Is It A Qualified Distribution?

Step 2: How Much of the Distribution is Attributable to Earnings?

Step 3: Does the 10% Premature Distribution Penalty Apply?

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| 1. Is it a “Qualified Distribution?”   ***If it is a qualified distribution, the earnings are NOT subject to tax or penalties and there is no need to go to steps 2 and 3.***  To be a qualified distribution, two conditions must be met:   |  |  | | --- | --- | | **Condition A:** At least 5 years must have passed since the first contribution to any Roth IRA (measured from the first day of the year for which the first Roth IRA contribution is made). **Click** here **for an example.**  **Condition B**: The owner is either:   * Age 59½ or older,  |  | | --- | | **Example**  Jill makes her first contribution of $5,000 into a Roth IRA on April 15, Year 2, for the Year 1 tax year. The “five-year rule” starts on January 1, Year 1, because she made the contribution for Year 1 timely by April 15, Year 2.  Remember that once the 5-year requirement has been satisfied for “regular contributions”, this requirement is deemed to have been satisfied for all subsequent regular contributions.  The 5-year requirement will be satisfied on December 31, Year 5. All regular contributions in the account as of that date and all future regular contributions are deemed to have met the 5-year requirement. |  * Deceased, * Disabled (the disability must be permanent and total or expected to result in death), OR * Taking a distribution up to $10,000 for a first-time home purchase.   Both conditions must be met for the distribution to be qualified. If it is qualified, then NO tax or penalty is due. | |

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| 1. How Much of the Distribution is Attributable to Earnings?   Withdrawals of earnings that are NOT qualified will be included as income on the income tax return. The distribution of Roth IRA contributions is never subject to income tax because the funds were contributed on an after-tax basis. |

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| 1. Does the 10% Premature Distribution Penalty Apply?   If distributions attributable to earnings are not “qualified distributions” we must determine whether or not the earnings portion of the distribution is subject to, or exempt from, a 10% penalty. Unless the distribution meets the requirements for one of the exceptions below, a 10% penalty is payable on the taxable portion of the distribution.   |  | | --- | | **Penalty Exceptions:**   * Death * Disability *(the disability must be total and permanent or expected to result in death)* * When distributions are set up as a series of *substantially equal periodic payments* * To the extent of unreimbursed medical expenses that exceed 10% of adjusted gross income * To pay health insurance premiums after the owner has received unemployment compensation for more than 12 weeks * To pay the costs of a *first-time home purchase* (subject to a *lifetime* limit of $10,000) * To pay for the qualified expenses of higher education for the IRA owner and/or eligible family members * In response to an IRS levy   Detailed requirements for claiming these exceptions may be found at the following link: <http://www.irs.gov/taxtopics/tc557.html> | |

**Click** here **for an example of how these rules apply.**

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| Example  In the summer of Year 1, James opened and funded a Roth IRA with an after-tax contribution of $4,000. He made a second after-tax regular contribution of $4,000 in Year 2. During Year 3, the account balance grew to $8,800. At the end of Year 3, he removed $8,200 for qualified tuition expenses.   * This is NOT a qualified distribution. It meets Condition #2, since it is for tuition expense, but it does not meet Condition #1 since it has been less than 5 years since the initial contribution. * Therefore, the amount distributed in earnings (i.e., the amount in excess of his contributions) is taxable. * In this case, there is a tax due on the $200 in earnings in excess of his total contributions of $8,000. But because it is for one of the permissible penalty-free situations, there is no penalty. |

How is the taxation of distributions impacted if the Roth IRA contains rollover or conversion contributions? **Click** here **to learn more.**

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| Taxation of Rollover/Conversion Contributions to a Roth IRA  Contributions to a Roth IRA from rollover or conversion of a Traditional IRA impact the order of distribution. Regular contributions are deemed distributed first, rollover/conversion contributions are deemed distributed next, and earnings are deemed distributed last.  Here is a noteworthy caution: the distribution of rollover/conversion contributions is subject to a 10% penalty (but no income tax) if distributed within 5 years of rollover/conversion. |

storm-red-and-yellow-th **Beware the 50% Penalty for Inherited Roth IRAs**

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| Distributions from Roth IRAs are not required during the original owner’s lifetime. However, RMD rules may apply to beneficiaries or new owners of inherited Roth IRAs. Failure to take the RMD timely from an inherited Roth IRA may result in a 50% penalty. Your client should consult with their tax professional to ensure any RMDs are taken timely. |

## Review Exercise

**Review your understanding of the preceding pages by answering the following questions.**

1. **Which of the following sequences correctly describes the order in which funds are distributed from Roth IRAs?**

* Earnings, rollover contributions, regular contributions

**Incorrect**. Try again.

* Rollover contributions, earnings, regular contributions

**Incorrect**. Try again.

* Regular contributions, earnings, rollover contributions

**Incorrect**. Try again.

* Regular contributions, rollover contributions, earnings

**Correct**!

1. **In Year 1, Margaret converted her Traditional IRA with a balance of $25,000 to a Roth IRA. Of the converted funds, $7,500 consisted of non-deductible contributions, thus $7,500 of the conversion amount was not taxed at conversion. Later in Year 1, she made an additional contribution of $4,000 to the Roth IRA and also contributed $4,000 in Year 2. In Year 3, at age 58, she withdrew $35,000 from the Roth IRA to make an investment in a ski resort in Colorado. Which of the following statements regarding the tax results of this transaction is correct?**

* The first $8,000 is withdrawn tax-free since this portion is attributable to after-tax contributions.

**Incorrect**. This is a correct statement of the tax results, but it is not the only answer.

* The next $7,500 was her basis when she converted the Traditional to a Roth IRA. It is non-taxable.

**Incorrect**. This is a correct statement of the tax results, but it is not the only answer.

* The next $17,500 was taxed at conversion. It is not included in her taxable income, but Margaret must pay a 10% penalty of $1,750 on this portion of the withdrawal.

**Incorrect**. This is a correct statement of the tax results, but it is not the only answer.

* The next $2,000 is attributable to earnings and this is a nonqualified withdrawal since Margaret is under age 59½. She withdrew the funds inside of the 5-year rule both for the conversion and for contributions, and she meets none of the exemption criteria. Thus, $2,000 would be subject to tax AND a 10% penalty of $200.

**Incorrect**. This is a correct statement of the tax results, but it is not the only answer.

* **All of the above are correct.**

**Correct**!

1. **Qualified distributions from Roth IRAs are income tax and penalty free. Which of the following most completely and accurately describes the requirements for a qualified distribution?**
2. The distribution must occur at least 5 years after the first contribution to the Roth IRA.

**Incorrect**.

1. The Roth IRA owner must be age 59½ or older, deceased, disabled, or taking up to $10,000 for a first-time home purchase.

**Incorrect**.

1. Neither a nor b

**Incorrect**.

1. Both a and b

**Correct**!

## Conversion to a Roth IRA

Is conversion of a Traditional IRA to a Roth IRA a good idea at retirement? In large measure, the same considerations that make conversion a good or bad decision during your client’s accumulation period also apply at retirement.

Please refer to “Advising the Affluent Client: Retirement Accumulation Planning” for an in-depth review of Roth IRA conversions.

## Executive Summary - Distributions from Qualified Plans

Why do you need to understand distributions from qualified plans? Over one-half of full-time workers in the United States participate in an employer-sponsored qualified retirement plan.[[1]](#footnote-1) If the prospect of a deep dive into qualified plan distributions seems daunting, let not your heart be troubled! Distributions from qualified plans generally follow the rules you already know from Traditional IRA distributions.

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| **Comparison**  **Characteristic** | **Qualified Plan** | **Traditional IRA** | **Notes** |
| Required Beginning Date (RBD) | No later than April 1st of the year following the later of reaching age 70½ or retirement. | No later than April 1st of the year following attainment of age 70½. | The RBD clock generally does not start running until after retirement in a qualified plan. |
| Required Minimum Distribution (RMD) | Account balance at end of prior year divided by life expectancy from IRS tables. | Same |  |
| Income Taxation | Distributions from non-Roth accounts follow deductible Traditional IRA rules.  Qualified distributions from Designated Roth Accounts (DRAs) generally follow Roth IRA rules. | 100% of distributions from a deductible Traditional IRA are taxable.  Distributions from nondeductible Traditional IRAs represent both a nontaxable return of contribution and a taxable distribution of earnings. | DRAs are subject to qualified plan RBD and RMD rules. |
| Too early | 10% of the taxable premature distribution if under age 59½ | same | Exceptions differ. **Click** here f**or a comparison.** |
| Too little, too late, the Under Distribution Penalty | 50% of the taxable amount under distributed based upon RMD. | same |  |

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| Comparison of Premature Penalty Exceptions  Exceptions that apply to IRAs and Qualified Plans   * Death, disability, series of substantially equal payments, IRS levy, and medical expenses in excess of 10% of adjusted gross income   Exceptions that Apply Only to Qualified Plans   * Separation from service after age 55 * Alternate payee under a qualified domestic relations order   Exceptions that Apply Only to IRAs   * Qualified higher education expenses * Qualified homebuyers ($10,000 lifetime maximum) * Health insurance premiums while unemployed   Specific requirements for meeting these exceptions and additional information is available at this IRS link: http://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics---Tax-on-Early-Distributions |

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## Managing Distributions from Qualified Plans

Your focus on managing distributions from qualified plans will help you identify opportunities for annuity and rollover solutions for clients whose needs may not be fully met from qualified plans. Qualified plan distributions are made out to be far more complex than they really are. The options listed below represent the most commonly available choices and requirements:

* Lump sum distribution
* Alternative distributions from Defined Benefit Plans
* Alternative distributions from other qualified plans

Be aware that individual qualified plans vary. Your client should contact their qualified plan administrator to clarify which choices are available. For example, plans such as Defined Benefit Plans, Cash Balance Plans, and Money Purchase plans generally prohibit distributions to active employees before age 62.

It has been said that qualified plan distributions are more difficult to understand than nuclear physics, yet that need not be the case! Join us as we help demystify these options by clicking each of the following: **Click each option to learn more.**

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| **Take a Lump Sum Distribution** |
| If permitted by the plan document, lump sum distributions are generally permitted from qualified plans.  A client seeking absolute control over qualified plan funds may be attracted to a lump sum distribution of his or her vested account balance or vested accrued benefit at retirement. However, ***extreme caution*** must be exercised in two areas: 1) if the plan is a defined benefit plan, the guaranteed monthly pension payments are lost in exchange for the lump sum; and 2) taxes must be managed carefully to avoid a huge income tax bill.   |  | | --- | | Lump Sum Distribution  The IRS defines a *lump sum distribution* from a qualified plan as “the distribution or payment, within a ***single tax year***, of a plan participant's entire balance from all of the employer's qualified plans…”  A lump sum distribution may be in cash or in kind.   * A cash distribution is simply a check made payable to the participant. * An in kind distribution is the distribution of securities owned in the account rather than cash. |  |  | | --- | | Vested  ***Vesting*** refers to the process of the participant’s earning non-forfeitable rights to employer plan contributions and earnings thereon. |  |  | | --- | | Account Balance  The *account balance* is simply the value of a client’s account in a defined contribution category plan, such as a 401(k) Plan. |  |  | | --- | | Accrued Benefit  The *accrued benefit* is the monthly benefit available to the participant in a defined benefit category plan, such as a Traditional Defined Benefit Plan. An actuarial calculation is required to determine the lump sum payable. |  |  | | --- | | Defined Benefit Plans  *Defined Benefit Plans* include Traditional Defined Benefit Plans and Fully Insured Defined Benefit Plans. The most important qualified plans, including defined benefit plans, were discussed in the previous course “Advising the Affluent Client: Retirement Accumulation Planning.” |   When is a lump sum distribution taxable and when is it tax-deferred?   * If the participant receives the lump sum into a personal account such as a brokerage account or checking account, the distribution is taxable in the year received. This is seldom the wisest choice because income taxes will be due in the year of distribution for the entire taxable distribution * Participants choosing to rollover or directly transfer a lump sum distribution to an IRA, Rollover IRA or Conduit IRA may defer taxation until future taxable distributions are taken. ***This is generally the most tax efficient means of taking a lump sum distribution.***  |  | | --- | | Rollover IRA  An IRA established simply to hold qualified plan balances might be referred to as a ***Rollover IRA***. Rollover IRAs are frequently used when a participant does ***not*** intend to transfer the funds back to a qualified plan of another employer. A rollover IRA may be seen more frequently at retirement rather than during a client’s working career.  Remember that there are only two basic types of IRA, Traditional or Roth. A rollover IRA is NOT a separate category of IRA: it is merely the use of an IRA to hold former qualified plan assets over the long term. |  |  | | --- | | Conduit IRA  A "***Conduit IRA***" is established solely to receive a lump sum distribution from a qualified plan so that the plan participant has the option to rollover the funds to another qualified plan. The Conduit IRA may be more frequently used during a client’s lifetime than at retirement.  A Conduit IRA is NOT a separate category of IRA; it is merely the use of a Traditional or Roth IRA to ***temporarily*** hold former qualified plan assets until they can be transferred to another employer’s qualified plan. |   storm-red-and-yellow-th **Beware the 20% Withholding Trap!**   |  | | --- | | Note that any distributions paid directly to the plan participant are subject to **mandatory** 20% federal tax withholding. Only a direct transfer of funds from a qualified plan to another qualified plan or IRA will avoid the 20% withholding tax. Additional insights into rollovers and direct transfers follow subsequently in this course. | |
| **Alternative Distributions from Defined Benefit Plans** |
| Defined Benefit Plans\* for our purposes in this discussion include Traditional Defined Benefit Plans, Fully Insured Defined Benefit Plans, and DB/k Plans.  Instead of a lump sum distribution, a participant may choose to take the accrued benefit offered by the plan or use the present value of the accrued benefit to purchase an annuity.  Your client may be attracted to the accrued benefit payable from a Defined Benefit Plan for the following reasons:   * Monthly payments that are guaranteed for life * Protection from most personal creditors in the event of personal bankruptcy   An annuity purchased from a financial services company (as opposed to monthly payments from the qualified plan itself) may appeal to clients placing a high value on the following:   * Potential to increase rate of investment return and/or total payout * Ability to structure the annuity in ways not offered by the qualified plan   Be aware that an annuity may be purchased by the plan administrator directly through the participant’s plan on behalf of your client (not available in all plans) ***or*** directly by your client from a financial services company through a Rollover IRA.  The use of a Rollover IRA allows for continued income tax deferral of earnings as opposed to the immediate recognition of income required in lump sum distributions. Rollovers and transfers are discussed in greater detail subsequently in this course.  \* *These plans were discussed in our previous course “Advising the Affluent Client: Retirement Accumulation Planning.”* |
| **Alternative Distributions from Other Qualified Plans** |
| “Other qualified plans” for this discussion include Cash Balance Plans, Profit Sharing Plans, 401(k) Plans, Stock Bonus Plans, and ESOPs.  Here are your client’s alternative choices in these plans:   * Leave the money in the plan and take periodic distributions as needed * Rollover or transfer the account balances to a Rollover IRA and either 1) take distributions from the IRA as needed, or 2) purchase an annuity   ***Remember the required beginning date and required minimum distribution rules continue to apply!*** |
| **Choosing between a Lump Sum or Annuity Distribution** |
| ***Which to choose: lump sum or annuity?*** The answer to this question involves a review of the distribution options stated in the qualified plan, an analysis of the participant’s retirement needs, as well as a calculation of the tax consequences for each option.   * A key factor is **investment return**. Will the participant earn a higher return by taking the lump sum distribution and investing it elsewhere or would be the participant enjoy higher returns by leaving the money in the plan? * This decision involves both financial and non-financial issues. For example, what value does a participant place upon the freedom to use the funds as he or she chooses? Is it worthwhile to pay the taxes in a lump sum distribution to gain full access to the after-tax funds? Is the participant engaged in a high-risk occupation that makes civil suits likely? If suits are likely, the creditor protection accorded funds in qualified plans may be an important consideration.\*   Other issues involved in making this determination are listed below. **Click each to learn more.**   * The age of the participant * The health of the participant * The expected returns on investments * The current and anticipated marginal tax rates * The amount and timing of retirement income   \* *The proper use of Rollover or Conduit IRAs may preserve creditor protection.*   |  | | --- | | The age of the participant  ***The age of the participant*** affects the expected number of years of any periodic or annuity payments, potentially making periodic or annuity payments less favorable for older individuals. |  |  | | --- | | The health of the participant  ***The health of the participant*** may also affect the annuity payout period, making lump sum distributions a better choice for those individuals with chronic illnesses. |  |  | | --- | | The expected returns on investments  ***The expected returns on investments*** may be more favorable outside the plan than within, making a lump sum distribution more favorable. |  |  | | --- | | The current and anticipated marginal tax rates  ***The current and anticipated marginal tax rates*** (if they are higher) ***for the participant*** would favor the postponement of the recognition of income by periodic or annuity payments. |  |  | | --- | | The amount and timing of retirement income  ***The amount and timing of retirement income*** may necessitate a lump sum distribution if income is needed early in retirement. | |

storm-red-and-yellow-th **Spouses Have Rights!**

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| A spouse of the participant in certain plans, including Defined Benefit and Money Purchase Plans, has rights to plan benefits during the participant’s life and after the participant’s death. Your client should contact the plan administrator for additional information. |

## Slashing Income Taxes with Net Unrealized Appreciation (NUA)

What if you could save $20,000 or more in income taxes for your client? Your awareness of the net unrealized appreciation (NUA) technique could slash income tax rates by as much as 20%. On a $100,000 distribution, that saves as much as ***$20,000***. Here is how it works.

* Taxable distributions from qualified plans are generally taxed at ordinary income tax rates, with precious few exceptions.
* A quirk in the tax code allows (if not incents) employers and participants to invest in employer securities. Depending upon qualified plan type, the plan may invest from 10% to 100% of plan assets into employer securities.
* The NUA of those employer securities may be taxed at long-term capital gains rates instead of ordinary income tax rates as long we dot the i’s and cross the t’s.

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| Dotting the i’s and crossing the t’s for NUA   * If a qualified plan makes a lump sum distribution that includes employer stock, the unrealized appreciation of the stock is not taxable to the participant at the time of the distribution.[[2]](#footnote-2)  |  | | --- | | Unrealized appreciation  ***Unrealized appreciation*** is the difference between the value of the stock when originally contributed to the plan in the past and the value of the stock when distributed to the participant. |  * The NUA qualifies for long-term capital gains rates when the participant actually sells the stock, regardless of how long (or short) it is held after the distribution date. * Only a portion of the lump sum distribution of employer securities is taxed to the participant at ordinary income tax rates.  |  | | --- | | Portion  The *portion* taxed at ordinary income tax rates is the value of the stock when originally contributed to the plan by the employer. | |

Your primary role here is in helping your client work with the qualified plan administrator to identify potential NUA opportunities. From there, a follow-up with a CPA, Tax Counsel, or a CFP® certificant is suggested. **Click** here **for a detailed NUA example.**

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| **NUA Example**  Jack Hogan was a participant in the Aztec Industries Profit Sharing Plan. He did not contribute to the plan.   * He terminated employment at age 60 and a few weeks later the plan distributed 1,000 shares of Aztec stock to him with a current market value of $44,000. * The cumulative value of the contributions by the company attributable to the 1,000 shares of stock was $14,000. The net unrealized appreciation was $30,000 ($44,000 current market value less $14,000 value of employer contributions). * The plan also distributed $50,000 in cash to Jack, thus the total distribution was $94,000. * The distributions qualify as a lump sum distribution. * Jack is in a 28% marginal federal tax bracket for ordinary income tax purposes and a 15% bracket for capital gains tax purposes.   **What are Jack’s income tax *options* regarding the distribution?**   1. Pay ordinary income tax on the entire distribution – His total income tax bill will be $26,320 (28% of 94,000). No premature distribution penalty will apply because he is older than age 59½. 2. Pay capital gains tax on the NUA and pay ordinary income tax on the rest – His total income tax bill will be $22,420. This approach saves $3,900 in tax versus option 1. **Click** here **for the calculation.**  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Option 2 Tax Calculation   |  |  | | --- | --- | | 15% capital gains tax on $30,000 NUA | $ 4,500 | | 28% ordinary income tax on the $14,000 employer contribution | $ 3,920 | | 28% ordinary income tax on the $50,000 in cash | $14,000 | | Total tax – Option 2 | $22,420 | |  1. Pay capital gains tax on the NUA and rollover the cash to a Rollover IRA – **This approach captures long-term capital gains rates on the NUA and defers ordinary income tax to the greatest extent possible.** The current income tax cost would be $8,420 (15% of the NUA of $30,000 plus 28% of the $14,000 employer contributions). Income tax on the $50,000 in cash would be deferred until funds are distributed from the Rollover IRA. 2. Rollover the entire $94,000 distribution into a Rollover IRA – This approach defers taxes until future distribution. ***However, he will lose long-term capital gains rates on the NUA under this approach. All distributions from the Rollover IRA will be taxed at ordinary income tax rates.***   Careful calculations by a tax professional, assuming a variety of options, will assist in the client’s decision-making process that invariably must also take into consideration a number of personal, financial and estate planning objectives and concerns. |

storm-red-and-yellow-th ***Beware the IRA rollover of NUA securities!***

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| A rollover of employer securities to an IRA may result in the loss of long-term capital gains rates and NUA treatment. |

## Qualified Plan Rollovers and Transfers to IRAs

Thirteen of every fourteen dollars added to IRAs come from rollovers and direct transfers rather than contributions.[[3]](#footnote-3) The primary difference between a rollover and a direct transfer is access. Your client has access to the funds during a rollover. Clients have no access to the funds in a direct transfer. Other noteworthy differences between rollovers and transfers are illustrated below.

### Rollover from a Qualified Plan to an IRA

This type of rollover is characterized by the following:

* Your client receives a distribution from his or her qualified plan, then rolls over or re-deposits the total amount of the distribution into an IRA within 60 days.
* The qualified plan administrator is required to withhold federal taxes of 20% of the rollover amount.
* Failure to redeposit the entire amount within 60 days results in a 10% penalty and income tax on the amount NOT re-deposited.

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| 10% Penalty  Jane Dough received a $400,000 check from her qualified plan account balance on January 1 as part of a rollover transaction.   * The gross amount of the distribution was $500,000. * The plan administrator withheld 20% ($100,000) as required for federal tax purposes. * Jane re-deposited $400,000 timely (within 60 days) on February 28. * Jane will pay a penalty of $10,000 calculated as 10% of $100,000. * Jane will pay income tax on the $100,000 not re-deposited. She receives no income tax deduction for the $10,000 penalty. |

* There is no limit to the number of times funds may be rolled ***from*** a qualified plan to an IRA; however, only one rollover FROM an IRA is permitted per year per taxpayer.
* The individual has complete control over the funds for 60 days and can do whatever he or she pleases with the funds during the 60-day period.

### Transfers from a Qualified Plan to an IRA

The transfer of your client’s qualified plan balance directly from one institution to another is called a ***direct trustee-to-trustee transfer*** or ***direct custodian-to-custodian transfer.*** A transfer is characterized by the following:

* As in rollovers, there is no limit on the number of times during the year that an individual can make direct transfers from a qualified plan to an IRA.
* The account owner is not permitted to control or access the funds at any time during the transfer.
* There is no 20% withholding by the plan administrator.

We have distilled select advantages and disadvantages of rollovers/transfers for you in the chart below. **Click on** each **to learn more.**

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| **Advantages** |
| 1. **Potentially higher return** through the use of more investment choices and reduced fees.  |  | | --- | | More Investment Choices  A qualified plan is required to offer only a relatively few number of investment choices. In addition, legal fiduciary restrictions may further limit the type of investment choices available through a qualified plan.  In contrast, IRAs offer a virtually unlimited universe of choices including mutual funds, stocks, bonds, and exchange-traded funds.  Hence, a wider variety of client investment risk and return goals may be accomplished with IRAs when compared to typical qualified plan. |  |  | | --- | | Reduced Fees  The recurring investment and/or administrative fees charged by a qualified plan should be compared to IRA fees. Your client should be alert to any increases in fees charged to retirees by the plan.  Be aware that IRAs permit investment into ultra-low fee products, such as exchange-traded funds. |  1. **Continued tax-deferred growth** is possible because earnings are not taxed until distributed from the IRA in the future. 2. **Your client gains greater control** in that he or she may direct the IRA investments. Many qualified plans do not permit participant control of investment selections. 3. **Greater convenience** is achieved by consolidating all investment accounts into IRAs managed by one investment advisor. The benefits of convenience include: a) the simplicity of having all questions addressed to one person rather than among multiple investment providers; b) less opportunity for errors or omissions in the calculation and communication of required minimum distributions; and c) a streamlined recordkeeping/reporting process. 4. **Avoid RMDs for Designated Roth Accounts (DRAs)** by rolling over or transferring DRAs to a Roth IRA. 5. Continued bankruptcy protectionapplies to qualified plan funds held in a Conduit or Rollover IRA. This protection applies only so long as the funds are held inside of the Conduit IRA or Rollover IRA. Subsequent distributions to your client may become subject to his or her creditors in bankruptcy.  |  | | --- | | Continued Bankruptcy Protection  The Rollover IRA or Conduit IRA funds should not be commingled with any of the participant’s other IRA accounts. Commingling may cause the Conduit or Rollover IRA funds to lose eligibility for qualified plan status, including the loss of unlimited bankruptcy protection. | |
| **Disadvantages** |
| 1. Rollovers or transfers may result in the loss of capital gains treatment from net unrealized appreciation (see previous discussion). 2. Loans are not permitted from IRAs, while access to loans is generally permitted, but not required, in qualified plans. Contact the plan administrator to determine if loans are allowed from your client’s qualified plan. 3. Premature distribution penalties may apply longer. Distributions from Traditional IRAs before age 59½ may incur a penalty while distributions taken after age 55 from a qualified plan (if the participant has retired from the company) may generally be taken without penalty. |
| **Pre-Tax and Roth Considerations** |
| Rollovers and transfers are income tax-free as long as pre-tax accounts are transferred to pre-tax accounts and Roth accounts are transferred to Roth accounts.   * Rollover of pre-tax qualified plan accounts to Traditional IRAs, SEP IRAs, and other qualified plans are not generally subject to income tax at the rollover date. * Rollover of pre-tax qualified plan accounts to Roth IRAs will cause immediate income taxation of the full rollover amount. * Rollover of Designated Roth Accounts (DRAs) from qualified plans to Roth IRAs will not generally cause taxation of any of the amount rolled over. **DRAs are subject to the required minimum distribution rules while Roth IRAs are not.** |

## Managing Distributions from Annuities

 ***Compliance Alert!***

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| Only licensed professionals may sell annuity products. Check with your compliance department before discussing annuity planning with clients to avoid compliance issues! |

Clients fearful of running out of money during their retirement years may be intrigued by the lifetime payments of an annuity. An annuity is simply a contract to provide a series of periodic payments to an individual (the annuitant) for a period of time.

There is no free lunch however. Annuities have potential downsides including the following:

* Annuities may not provide an appropriate pool of emergency capital or sufficiently fund a client’s legacy goals for loved ones.
* Annuity cancellation or termination fees may be significant, especially in the early years of the annuity contract.
* Recurring annuity fees may be higher than IRA or qualified plan fees.
* Unlike qualified plan accounts, there is no federal guarantee in case of insurance company insolvency. Annuities are generally guaranteed within limits by associations sponsored by the individual states.[[4]](#footnote-4)

For our purposes in this discussion, we assume the annuity is an immediate annuity**,** meaning that annuity payments begin immediately after the purchase price is paid.

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| Immediate Annuity  An ***immediate annuity*** is characterized by the following:   * The annuitant (your client) pays the annuity provider an amount of money referred to as the premium. This represents your client’s cost of the annuity. The premium amount is calculated by the provider based upon actuarial life expectancy, market rates of return, and other factors. * The annuity provider (a financial services company) pays the annuitant over a period of time (frequently some variation of the annuitant’s lifetime). * For annuities paid over the annuitant’s lifetime, if the annuitant lives until age 100, the annuitant wins big. If the annuitant dies one month after purchasing the annuity, the annuity provider wins big. Additional detail is provided in the discussion that follows. |

Annuity payments can be an unchanging fixed amount (fixed annuity) or an amount that varies based upon investment performance (variable annuity).

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| Fixed Annuity  A ***fixed annuity*** pays a fixed, guaranteed amount for the duration of the annuity contract. The annuitant generally does not have control over the investment choices. |

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| Variable Annuity  A ***variable annuity***pays a variable amount for the duration of the contract based upon the investment performance of the annuity’s investment portfolio. The annuitant generally may select the investments from a list approved by the annuity provider. The annuity provider may not guarantee a specific monthly payout amount. |

A host of client income needs can be met with annuities. **Click on each to learn more.**

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| **Maximum Lifetime Payout Per Dollar Invested - Straight Life Annuity** |
| This choice may be appropriate for clients with the following needs:   * Maximum income for themselves during their remaining lifetime * No need to provide for loved ones at death * No need for a pool of emergency capital   A straight life annuity pays an income stream to your client for the remainder of his or her life and provides the ***highest monthly payout*** per dollar invested in the annuity contract. This type of annuity may also be referred to as a “pure annuity.”  The annuity payments stop at death and your client’s heirs receive nothing from the annuity. There is no residual value from a straight life annuity at the death of the annuitant. **Click** here **for an example.**   |  | | --- | | **Example**  A 60-year-old male purchasing a $100,000 immediate fixed annuity payable over his lifetime would receive $490 per month based upon 2015 fixed annuity rates. When he dies, the annuity payments will stop and his heirs will receive nothing. | |
| **Lifetime Payout with Guaranteed Years - Annuity with Period Certain** |
| Clients with a desire to receive an annuity payout for a guaranteed number of years may find this choice interesting. If your client dies prematurely, the remaining payments will be remitted to the beneficiary.  The cost is a slightly lower monthly payout than the straight life annuity. **Click** here **for an example.**   |  | | --- | | **Example**  A 60-year-old male purchasing a $100,000 immediate fixed annuity payable over his lifetime with a 20-year period certain would receive $460 per month based upon 2015 fixed annuity rates.   * In the event of his death in less than 20 years, the $460 monthly payments would continue to his beneficiary until the expiration of 20 years. At the end of 20 years, the payments will stop and the beneficiary will receive nothing more. * The cost of the 20-year period certain feature is the reduction of the monthly benefit by $30 versus the straight life annuity. | |
| **Lifetime Payout with Refund - Annuity with Refund** |
| This option may appeal to clients concerned about dying before they have at least been paid their investment into the annuity contract.  A life annuity with refund guarantees the return of the original investment used to purchase the annuity. If the annuitant dies before the original investment is paid out, his or her beneficiaries receive the remaining amount in a lump sum.  The monthly payout from a life annuity with refund feature results in a lower monthly payout than the straight life annuity. **Click** here **for an example.**   |  | | --- | | **Example**  A 60-year-old male purchasing a $100,000 immediate fixed annuity payable over his lifetime with refund would receive $459\* per month.   * In the event of his death after ten years (120 annuity payments), his beneficiary will receive a lump sum payment of $44,920 ($100,000 less $55,080 in annuity payments received over the 10-year period). * The cost of the refund feature is the reduction of the monthly benefit by $31 versus the straight life annuity.   *\* Based upon 2015 fixed annuity rates.* | |
| **Annuities for Married Clients - Joint and Survivor Annuity** |
| A married annuitant might choose this option if she wished to provide an income stream to her husband upon her death. In effect, a joint and survivor annuity is paid out over two lifetimes: the annuitant’s and the surviving beneficiary’s lifetime.  The monthly payout from this annuity may be significantly less than the monthly payout from a straight life annuity. The annuity payments stop completely at the second death and there is no residual value for distribution to other beneficiaries. **Click** here **for an example.**   |  | | --- | | **Example**  A 60-year-old male purchasing a $100,000 immediate fixed annuity payable over his lifetime with a 100% survivorship feature for his 60-year-old wife would receive $431\* per month for the rest of his life.   * In the event of his death, his surviving wife would begin receiving monthly payments of $431 per month until her death. * Annuity payments cease completely at the wife’s death and the annuity terminates with no residual value. * The cost of the joint and survivor 100% feature is the reduction of the monthly benefit by $59 versus the straight life annuity.   The survivorship feature can be structured at levels other than 100%. For example, a joint and survivor 50% annuity would result in the surviving spouse receiving a monthly benefit equal to 50% of the amount paid to the decedent spouse.  *\* Based upon 2015 fixed annuity rates.* | |
| **How to Maintain Purchasing Power** |
| Your client’s purchasing power can be maintained in at least two ways:   1. Investing in equity securities through a variable annuity. There is the potential, but not guarantee, to earn positive inflation-adjusted returns. 2. Purchasing a guaranteed cost of living adjustment feature in an annuity. |
| **Taxation of Annuities** |
| Annuities can be purchased with pre-tax funds or after-tax funds. Pre-tax funds (qualified money) include qualified plan and Traditional IRA assets. After-tax funds (nonqualified money) include personal savings accounts and (generally) Roth IRAs.  Why do you need to know where the purchase money comes from?   * Distributions from nonqualified annuities are taxable only to the extent of the earnings on the annuity contract. * Distributions from qualified annuities are 100% taxable. * Premature distribution penalties apply for distributions taken before age 59½ from nonqualified annuities. A limited number of penalty exceptions apply. * The 50% under-distribution for failing to take RMDs timely does NOT apply to nonqualified annuities because such annuities are not subject to the RBD and RMD rules. |

Be aware that the scope of this course does not permit an exhaustive analysis of all annuity investment, tax, and payout possibilities. Untold numbers of books have been written just on annuities. Our discussion is intended as a springboard for further discussion with your client, internal resources, and/or your client’s insurance professional, CPA, or CFP® professional.

## Managing Distributions from Other Retirement Plans

Your competence in IRA and qualified plan distributions will serve you well as we present other client retirement plans/arrangements you may encounter during your career. An overview of distribution requirements for those plans is only a click away! **Click each plan type to learn more.**

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| **SIMPLE IRAs and SEP IRAs** |
| These IRAs generally follow the same required beginning date and required minimum distribution rules as Traditional IRAs. Premature distributions penalties and related exceptions generally follow Traditional IRA rules with one exception - distributions from a SIMPLE IRA during its first two years are subject to a 20% (not 10%) premature distribution penalty. The 50% under-distribution penalty for failing to take RMDs timely is calculated as for Traditional IRAs. |
| **403(b) Plans** |
| These plans may only be established by tax-exempt organizations and public school districts. 403(b) Plans are not qualified plans, but generally follow qualified plan distribution requirements. Such plans may include deferral features, including Designated Roth Accounts, just as offered in 401(k) Plans.  Qualified plan required beginning date, required minimum distributions (RMD), premature distribution penalties, and penalties for under-distribution of RMD generally apply to 403(b) Plans. |
| **457(b) Plans** |
| These plans are formal, nonqualified deferred compensation plans for government employers and nonreligious charitable organizations. Employee deferrals are permitted, including deferrals into Designated Roth Accounts. Distribution rules follow qualified plan distribution requirements, including required beginning date, required minimum distributions (RMD), 10% premature distribution penalties, and 50% penalties for under-distribution of RMD. |

## Managing Distributions from Stock Options

Retiring employees with employer provided stock options may need your guidance. A complete review of stock options is beyond scope for this course; however, you need to know select aspects of nonstatutory and incentive stock options at a minimum.

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| Stock Options  A employer stock option is a written, legally binding commitment (referred to as a grant) to the employee (awardee). The grant specifies the exercise price, vesting period and expiration date.   * The price that must be paid to purchase a share of stock is referred to as the **exercise price**. * The period of time required before the option can be exercised is referred to as the **vesting period**.   The **expiration date** of the option is the last date the option can be exercised. |

***Nonstatutory stock options (NSOs)***, also referred to as nonqualified stock options, may be encountered more frequently than Incentive Stock Options. NSOs offer no special income tax treatment and are taxed as compensation income when exercised to the extent of the bargain element. Care should be taken to manage the recognition of income in the year exercised to prevent unanticipated income tax rate (bracket) increases.

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| Bargain Element  The ***bargain element*** is the difference between fair market value and purchase price on the exercise date. **Click** here **for an example.**   |  | | --- | | **Example**  Your client Allison was awarded 1,000 nonstatutory stock options on her employer’s publicly-traded stock. The option allows Allison to purchase stock at $20 per share.   * When the stock is trading at $30 per share, Allison exercised the stock option. She wrote a check to her employer in the amount of $20,000 and received stock with a fair market value of $30,000. * The bargain element is $10,000, calculated as 1,000 shares times $10 per share. She is taxed on the $10,000 as if it were compensation income. | |

## **Incentive stock options** (ISOs) may not be seen as often as nonstatutory stock options. Although more complex than NSOs, ISOs are highly valued for their long-term capital gains potential.

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| Incentive Stock Options  ***Incentive Stock Options*** are characterized as follows:  **ISOs are limited -** No more than $100,000 of ISOs can vest per person per year; any amount beyond $100,000 becomes nonqualified.   * The term of the option may not exceed 10 years and the employer’s Board of Directors must authorize the ISO. * ***The executive must remain an employee from the date of grant to within 90 days of the exercise date.*** * Notably, an ISO must be issued at or above fair market value on the date of the grant.   ISOs have ***tax benefits*** that include the following:   * Deferral of gain at exercise date and the conversion of ordinary income into capital gains. * No regular income tax is recognized at the grant date, and no regular income tax is recognized at the exercise date.\* Long-term capital treatment applies if the holding period requirementsare met**.** * Holding period requirements provide that the shares may not be disposed of within two years of the date of grant **or** one year after the option is exercised.   If the shares are disposed of prematurely, the special tax treatment will be lost and ordinary income will be recognized for the amount of the gain. If the shares are held for the required time period, any recognized gains will be treated as ***long-term capital gains***.  \* *A separate tax – the Alternative Minimum Tax - may apply. Consult your internal resources for additional information.* |

## Safe Withdrawal Rates

You client just stated, “I am very concerned about running out of money before I die, but I need a pool of capital for emergencies.” While there are a number of sources for a lifetime income stream (qualified plan, annuity, and Social Security), those sources may not always provide a ready pool of capital for your client’s emergency use.

What if there was a way to receive a lifetime income stream **and** keep an emergency pool of capital for lifetime use or, at death, fund a legacy?

We present the safe withdrawal rate for your consideration. A withdrawal rate from a portfolio is considered a “safe withdrawal rate” if it can be withdrawn over a client’s lifetime, including adjustments for inflation, ***without depleting the portfolio***. The safe withdrawal rate was considered about 4% by many over the last two decades.[[5]](#footnote-5) This rate was considered safe because the portfolio return was assumed to equal 4% plus inflation. This concept is best illustrated by example.

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| **Example**  Patricia needs an inflation-adjusted pretax income stream of $30,000 annually from her portfolio to supplement her other retirement income sources.   * Her portfolio must have a minimum value of $750,000 based upon a 4% withdrawal rate. * The portfolio value is calculated as $30,000 divided by 4%. * Patricia may withdraw an inflation-adjusted $30,000 for the remainder of her life, no matter how long she lives, assuming a portfolio return equaling at least 4% plus inflation. * Patricia’s heirs will receive a portfolio valued at $750,000 at her death. |

Generalizations about the safe return are just that - generalizations. The 4% safe rate may not indeed be safe for conservative investors in low interest rate markets.[[6]](#footnote-6) So what is the solution? One approach is to factor in retirement age, asset allocation, inflation assumptions, legacy goals and lifespan into the recommendation of a truly safe withdrawal rate. The calculation of a safe withdrawal rate may use a number of methods, including capital preservation, capital exhaustion, or a hybrid of the two.

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| Capital Preservation  ***Capital preservation*** is literally the preservation of the entire capital pool (portfolio) by distributing only the return from the portfolio. At your client’s death, the entire value of the portfolio remains available for distribution to heirs or charities.   * The dramatic advantage is an income stream that simply cannot be outlived. Your client can never run out of money in a capital preservation distribution method. * The equally dramatic disadvantage is that more capital, much more capital, is required for this method than the Capital Exhaustion or Hybrid methods. |

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| Capital Exhaustion  ***Capital Exhaustion*** is what your client is describing when he or she says “I want to die exactly at the date I run out of money and I want the check to the undertaker to bounce.”  The monstrous risk is that she may be wrong about her date of death and outlive her money. The attraction of this method is that it requires far less capital than the capital preservation method. Capital Exhaustion is also referred to as Capital Depletion. |

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| Hybrid Method  The ***Hybrid Method*** may give your client the best of both worlds and includes characteristics of Capital Preservation and Capital Exhaustion. For example, a distribution plan designed to provide income until age 100 with a $250,000 remaining portfolio balance results in the following:   * Less capital required than Capital Preservation * Less risk of running out of money than Capital Exhaustion * Access to an emergency pool of capital during life * Greater probability of leaving a financial legacy to heirs |

## Social Security Retirement Benefits

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| **Video Script** | |
| **Script** | **On Screen Text** |
| You are about to enter a thorough dive into Social Security Retirement benefits. We dedicated a major portion of this course to Social Security and here’s why. There are three core reasons for our focus here and those reasons include fear, an unequaled income guarantee, and an urgent need for guidance [repeat].   * First, we’ll address fear. Social Security retirement benefits address a heartfelt fear: the fear of running out of money. * Second is an unequaled income guarantee. No other source of retirement income offers a guaranteed income stream for life, annual inflation adjustments, and a guarantee by the full faith and credit of the United States Government. * Third, expert guidance is urgently needed because of the complexity of the choices and the uncorrectable mistakes that can be made. As but one example, less than one client in ten even comes close to claiming benefits at the best age financially. Here’s another example - failing to use some of the creative strategies you’ll see can cost nearly $100,000. The Social Security Retirement benefits decision is the most important financial decision many clients will make during their life. | **3 Core Reasons for Our Focus Upon Social Security Retirement Benefits**  **1) Address a heartfelt fear:**   * Running out of money   **2) Provide an unequaled income guarantee:**   * Income that cannot be outlived * Annual inflation adjustments * U.S. Government guarantee   **3) Urgent need for guidance:**   * Your clients need expert guidance through one of the most important financial decisions of their lifetime. |
| So, other than the nobility of serving your fellow man, how will you benefit financially from this discussion? Why is a working knowledge of Social Security vital to your retirement age clients?  Savvy financial advisors recognize that those clients reaching retirement age need guidance and may seek it elsewhere if needed.  We know that only about 1 in 5 advisors assess their own competence as “highly knowledgeable” in Social Security. Think through this startling fact for a moment. This is a huge opportunity to outshine your competition by showcasing your competency.  How about loyalty? If someone showed you how to add tens of thousands or more to your annual income, how loyal would you be to that advisor?  Finally, you may have the chance to evaluate all of your client’s investments, including those you do not currently manage, as you guide them through the impact of Social Security decisions to their overall retirement distribution plan.  And oh, by the way, this knowledge could very well help you and those you love in getting the most from Social Security also! We invite you to begin your study right now! | **Why Social Security is Important for Your Practice:**   * Clients may seek Social Security guidance elsewhere if not provided * Opportunity to outshine your competition * Increased client loyalty * Provide opportunities for asset gathering |

## Maximizing Social Security Benefits

Ten thousand people reach age 65 every day in the United States and that trend is expected to continue through the year 2029[[7]](#footnote-7). Alarmingly, four of every ten men and about five of every ten women choose to retire early[[8]](#footnote-8) and thereby leave tens of thousands of dollars or more on the table.

In the game of poker, one often leaves money on the table when one plays unwisely. In the game of Social Security, we will illustrate how to take the maximum number of dollars possible off of the table. Playing the Social Security game wisely requires the following:

* Claiming benefits at the right age
* Understanding spousal benefits
* Taking advantage of creative claiming strategies

## Age Matters! Early, On Time, or Delayed Benefit Collection

How about an annual raise of about $22,000 for the rest of your life? What if you could show your clients how to capture that raise as well? Read on to find out how.

The maximum monthly retirement benefit at normal retirement age is $2,639 (2016, as indexed). That monthly benefit translates into an annual benefit of almost $32,000. Collecting retirement benefits too early (age 62) slashes the benefit to only about $20,000. Delaying until age 70 catapults the annual benefit to nearly $42,000. The spread from age 62 to age 70 is about $22,000 (2016).

Before going deeper, we need to establish context. A fully insured worker reaching normal retirement age (age 65-67), receives 100% of their “Primary Insurance Amount”(PIA). The chart below discloses the pitfalls and opportunities of choosing to retire early, on time, or on a delayed basis. **Click each choice to learn more.**

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| Fully Insured  Retirement benefits are earned only if a worker is *fully insured*. A worker is generally fully insured for retirement benefits if he or she has forty credits**.** One creditis earnedfor each $1,260 (2016, as indexed) in compensation from covered employment. A maximum of four credits can be earned per year. Once a worker is fully insured for retirement purposes, he or she remains fully insured for life. |

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| “Primary Insurance Amount”(PIA)  The Social Security retirement benefit received at normal retirement age is a worker’s primary insurance amount and will be referred to as “PIA” frequently in this course. |

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| **Early Retirement Age – Permanent Reduction of Benefits** |
| ***Collecting Social Security benefits at the earliest possible age is among the worst financial decisions possible unless there is simply no alternative.***  The earliest a worker can begin receiving retirement benefits is age 62. At age 62, retirement benefits are permanently reduced by as much as 30% based upon the worker’s birth year and claiming age.\* The claiming age is simply the age at which a worker claims benefits from Social Security.  A worker born in or after 1960 receives only 70% of PIA if retirement benefits are collected at age 62. Yet, according to the October 2013 *AARP Bulletin*, 41% of men and 46% of women voluntarily choose a lifetime of drastically-reduced benefits by claiming and collecting benefits too early!  Notably, the worker’s benefit will NOT increase to 100% of PIA when the worker reaches normal retirement age. The reduction is permanent.  \* *http://www.socialsecurity.gov/retire2/agereduction.htm* |
| **On Time - Normal Retirement Age (NRA) – 100% of PIA** |
| A worker claiming and collecting retirement benefits at normal retirement age (age 65 through 67)\* receives 100% of their PIA. Here is a sobering observation - only about one of ten workers wait until normal retirement age to claim retirement benefits according to the October 2013 *AARP Bulletin*.  \* *http://www.ssa.gov/oact/progdata/nra.html* |
| **Delayed Retirement Credits – The Big Raise** |
| ***Waiting to collect Social Security benefits until age 70 ranks among the wisest possible financial decisions for many clients.***  Here is why:   * A ***delayed retirement credit*** is available for those choosing to delay collection of Social Security benefits beyond NRA. * The delayed retirement credit is applied to every year of delay from NRA until age 70. * Workers born in or after 1943 will receive an 8% increase for each year of delay and could earn as much as a ***32%*** ***permanent increase*** to retirement benefits.\* * The increase becomes even more dramatic when we compare collection of benefits at age 70 to collection of benefits at age 62. The cumulative annual increase can reach well over 70%. **Click** here **for an example.**  |  | | --- | | **Example – Comparison of Benefit at Age 62 to Benefit at Age 70\***  Charlene was born in 1950, which means her NRA is age 66. We will assume her PIA is $2,500 at NRA.   * If she chooses to claim and collect benefits at age 62, her permanently reduced benefit will be $1,875 per month (a 25% reduction from PIA). * If she chooses to delay collection of benefits until her age 70, her permanently increased benefit will be $3,300 (a 32% increase to PIA). * ***The difference between the two benefits is*** $1,949 ($3,300 - $1,875), which is ***76%*** of $1,875.   \* *Based upon 2016 law.* |   *Yet, the* ***dilemma*** *of many can be described by the following client statement:*  *“I want to stop working at normal retirement age, but delay collection of benefits until age 70 to gain delayed retirement credits. How do I make ends meet until age 70?”*  *You will receive ideas to address that very question in just a few more pages.*  \* *http://www.ssa.gov/retire2/delayret.htm*  test_tip_icon **Planning Tip**   |  | | --- | | Choosing to delay collection of retirement benefits beyond age 65 may require coordination with Medicare choices. Medicare information is available at the following link:[*http://www.medicare.gov/sign-up-change-plans/get-parts-a-and-b/when-sign-up-parts-a-and-b/when-sign-up-parts-a-and-b.html*](http://www.medicare.gov/sign-up-change-plans/get-parts-a-and-b/when-sign-up-parts-a-and-b/when-sign-up-parts-a-and-b.html) | |

Choosing the Right Social Security Collection Age

A lifetime of careful retirement planning can be undone with the wrong age choice. A less-than-ideal retirement planning effort can be vastly improved by the right age choice.

Choosing the collection age is fully within your client’s control and should contemplate, at a minimum, the factors in the chart below. **Click on each factor to learn more.**

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| **Life Expectancy** |
| The Social Security Administration designs the early retirement, normal retirement, and delayed retirement benefit payments to have approximately equal present values based upon ***average life expectancy***.  Clients in poor health with short life expectancies may fare better by claiming and collecting benefits as early as possible. Clients with average or better health may be better served by waiting until NRA or age 70. Interestingly enough, the Social Security Administration\* confirms that about one-third of all retirees reaching age 65 will live until age 90.  It is mathematically possible to calculate a breakeven age that balances the expected return from future higher benefits against the cost of giving up benefits today. A retired Social Security administrator analyzes breakeven ages under varying assumptions at the following link: [*http://www.onefpa.org/journal/Pages/When%20to%20Start%20Collecting%20Social%20Security%20Benefits%20A%20Break-Even%20Analysis.aspx*](http://www.onefpa.org/journal/Pages/When%20to%20Start%20Collecting%20Social%20Security%20Benefits%20A%20Break-Even%20Analysis.aspx)  \*When To Start Receiving Retirement Benefits (2014). Social Security Administration. Retrieved from https://www.ssa.gov/pubs/EN-05-10147.pdf |
| **Market Rates of Return** |
| The delayed credits of up to 8% per year were established during a period of near historic highs in fixed income rates of return. The simple question to ask here is, “Will I earn a greater return by taking reduced benefits early and investing the proceeds or will my return be greater if I wait until 70 to claim and collect?” In most market cycles, it’s tough to beat an 8% return guaranteed by the U.S. Government. |
| **Cost-of-Living Adjustments (COLAs)** |
| The case for delaying until age 70 becomes even stronger when cost-of-living adjustments (COLAs) are considered. You are aware that delaying the collection of benefits until age 70 can increase annual benefits by as much as 32% versus collection of benefits at normal retirement age (well over 70% versus collecting at age 62). But the increase is actually even higher as a result of the COLA impact. Here is why:   * The annual COLA is based upon a variation of the Consumer Price Index and is calculated each year beginning with the worker’s age 62. * COLAs are cumulative and serve to increase PIA even if benefits are collected later than age 62. * Because the worker’s benefit at age 70 is higher than previous ages, the COLA itself provides more dollars to the worker when benefits are delayed until age 70. * The annual increase in just the COLA from delaying until age 70 versus taking benefits at age 62 can exceed $1,000\* annually.   \*Floyd, Elaine (2013). 3 Ways to Raise Your Social Security Benefit. Heintzberger|Payne. Retrieved from http://heintzbergerpayne.com/wp-content/uploads/2014/07/Horsesmouth-2014072512403983.pdf |
| **Cash Flow** |
| The joys of delayed claiming and collection of benefits until age 70 may seem unreachable if your client is dead set on early retirement and simply must have cash flow from Social Security retirement benefits.  One approach to this challenge is to consider creative claiming strategies and/or other techniques to bridge the income gap until age 70. We will analyze both of these potential solutions later in this course. |
| **Survivorship Benefits** |
| Delayed retirement credits may also serve to increase survivorship benefits at the death of the worker. The surviving spouse of the deceased worker may receive 100% of the benefit being received by the worker at the worker’s death. This impact is not always mentioned in discussions of “breakeven” ages for waiting to claim benefits. |
| **Income Taxes** |
| As much as 85% of Social Security benefits may be included in gross income on your client’s income tax return. Consequently, the income tax rates at early, on time, and delayed claiming ages should be considered. |

## Bridging the Income Gap Until Age 70

You and your client have concluded that waiting until age 70 to claim and collect Social Security retirement benefits is a wise decision. However, your client wishes to stop full-time work at age 66. Where will the resources needed to live from age 66 to age 70 be found?

Here are just a few thoughts to help bridge the income gap from actual retirement date to collection of Social Security retirement benefits at age 70. **Click on each to learn more.**

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| **Work Part-Time** |
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| **Qualified Plan and IRA Distributions** |
| Penalty-free distributions from Traditional IRAs, Roth IRAs, and Qualified Plans may generally begin at any age after 59½. There is no restriction on the amount that can be withdrawn. The distributions can be front-loaded, or increased, during the gap and then reduced at age 70 when Social Security retirement benefits start. |
| **Creative use of Life Insurance Policies** |
| ***Only licensed professionals may offer life insurance and annuity products. Contact your compliance team for guidance before discussing these ideas with your client. Your client’s insurance professional, attorney, CPA, and/or CFP® professional should be involved in this dialog.***  The cash value of a life insurance policy can supplement retirement income in at least three ways: 1) tax-free exchange for an annuity; 2) partial withdrawal of the cash value; and 3) borrowing against the cash value.   |  | | --- | | Tax-Free Exchange  A life insurance policy with a cash value can generally be exchanged for an annuity in a transaction referred to as a “***tax-free exchange***.” The cash value of a life insurance policy is generally that amount that would be received by the policy owner if the owner cancelled (surrendered) the policy.  Tax-free exchanges are permitted under a special IRS provision contained in Internal Revenue Code Section 1035. Such an exchange may be referred to as a “Section 1035 Exchange.”  **An exchange should be considered ONLY if life insurance protection is no longer needed and after consultation with your internal compliance team and *your client’s insurance professional, attorney, CPA, and/or CFP® professional.*** |  |  | | --- | | Partial Withdrawal of the Cash Value  The cash value may generally be withdrawn income tax-free up to the amount of the investment in the policy. Investment in the policy is generally defined as premiums paid less the sum of dividends and previous partial withdrawals received.  ***Extreme care*** must be taken to avoid the “surrender squeeze.” The surrender squeeze results when so much of the cash value is withdrawn that the policy collapses and the life insurance coverage is lost. |  |  | | --- | | Borrowing Against the Cash Value  How many people would sign up for loans in which no interest or principal had to be repaid during their lifetime? This alluring strategy may be available in your client’s life insurance policy contract. Noteworthy - the loan amount and any unpaid interest are deducted from the death benefit at the insured’s death.  Loans from most\* life insurance policies are not subject to income tax. Interest must be paid or accrued on life insurance policy loans. Interest charges may generally be paid from policy dividends at the discretion of the policy owner. The loan proceeds may be used in a number of ways, including investment into a portfolio, deposit into a short-term savings account, or purchase of an annuity.  *\*Different rules apply to certain policies called “Modified Endowment Contracts.” Consult an insurance professional, attorney, CPA, or CFP® practitioner for additional guidance.* | |
| **Reverse Mortgage** |
| This opportunity is simply not to be overlooked. The beauty of the reverse mortgage lies in the homeowner’s receipt of an income tax-free source of income coupled with no mandatory repayment of the mortgage during the homeowner’s lifetime.  The Federal Housing Administration (FHA) is one of the underwriting sources for reverse mortgages (referred to as Home Equity Conversion Mortgages by FHA). **Click** here **for FHA reverse mortgage requirements.**   |  | | --- | | FHA Reverse Mortgage Requirements   * The homeowner must be age 62 or older. * The home must be mortgage-free or there needs to be significant equity in the home. * The homeowner must reside in the home. | |
| **Downsize and Live on the Tax-Free Proceeds** |
| Married homeowners may receive as much as $500,000 in 2016 ($250,000 for single taxpayers) in tax-free gains at the sale of a residence. Qualification requirements are simple - the residence must generally be owned by the homeowner(s) and used as the principal residence for at least *2 out of the 5 years* preceding the sale. |

***Your compliance team and your client’s insurance professional, attorney, CPA, or CFP® practitioner should be consulted before any of these bridging ideas are recommended.***

## Correct a Faulty Claiming Age Decision

You may find yourself advising clients and prospects that were either misinformed or unaware of the planning opportunities contained in this course. A potential, if not common, client angst is the realization that age 62 was NOT a wise claiming age decision. We chronicled the reasons to avoid claiming at age 62 earlier in this course and recall them for you now.

* Locks in a lifetime of permanently reduced retirement benefits for the worker
* May lock in a lifetime of permanently reduced survivor benefits for the worker’s spouse
* Disqualifies the use of filing a restricted claim for spousal benefits
* May result in reduction of benefits for income earned in excess of thresholds until after normal retirement age

All may not be lost; there are two potential fixes. While these fixes may not be as effective as making the right claiming age decision in the first place, they could provide a measure of help. **Click on each potential fix to learn more.**

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| **The Do Over** |
| A client gets a once in a lifetime “do over” within the first 12 months after first claiming a retirement benefit. Clients within the 12-month window may repay all benefits received and the claiming age “clock” is reset as if no claim for benefits were filed. |
| **Suspend at Normal Retirement Age** |
| This idea is for clients beyond the 12-month window or those without the wherewithal to repay benefits.  Upon reaching normal retirement age, your client can suspend benefits until age 70 and earn delayed retirement credits. This approach may restore much of your client’s PIA as illustrated by the following example:   |  | | --- | | **Example**  Assume your client Joe’s PIA at normal retirement age is $2,000. Joe claimed and began collecting a reduced benefit of $1,500 at his age 62.  If Joe suspends benefits from age 66 until age 70, he will earn delayed retirement credits of 32% (8% per year). His retirement benefit at age 70 will be $1,980 (a 32% increase to the $1,500). | |

Understanding Social Security Spousal Benefits

The spouse of a worker may collect a spousal benefit on the worker’s record even if the worker’s spouse has never worked outside of the home. A spousal benefit can only be collected if the worker has claimed a benefit. The spousal benefit can be as high as 50% of the worker’s PIA if both spouses are of normal retirement age. **Click** here **for an example.** However, if spousal benefits are claimed before normal retirement age, the 50% benefit is reduced dramatically.

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| Record  A worker’s record is their individual record of earnings from covered employment during their entire lifetime. Covered employment is any employment in which Social Security taxes are withheld. |

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| Example  John and Mary are married and age 66 (their full retirement age). John has never worked outside of the home. Mary filed for retirement benefits immediately upon reaching age 66. Her PIA is $2,600. John may claim and receive a monthly spousal benefit of $1,300 (50% of $2,600) based upon Mary’s record. |

The spouse must be at least age 62 ***or*** caring for an eligible child to collect a spousal benefit. **Click** here **for an example.**

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| Eligible Child  The worker’s child under the age of 16 or any age if disabled before the age of 22 is an eligible child. |

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| Example  Samuel and Kitty are married. Kitty is age 66 (her normal retirement age) and collecting retirement benefits.  Samuel can collect spousal benefits on Kitty’s record if he is at least age 62. It would be better for him to wait until his normal retirement age to file for spousal benefits because his benefit would be be significantly larger.  Assume Samuel is only age 40. He is eligible for a spousal benefit on Kitty’s record ONLY if he is caring for an eligible child of Kitty’s. |

How are spousal benefits calculated if the worker’s spouse worked outside of the home and has an individual record? Social Security pays a benefit to the spouse based upon his or her individual record first and then, to the extent a spousal benefit is greater, pays an additional amount as a spousal benefit. **Click** here **for an example.**

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| Example  Sherlock and Irene are married and age 66 (their full retirement age). They each filed for Social Security retirement benefits immediately upon reaching age 66. Sherlock is the primary wage earner with a PIA of $2,600 on his record. Irene’s PIA is $1,000 based upon her record.  Irene will receive $1,300 per month calculated as follows:   * $1,000 on her record * $300 as a spousal benefit on Sherlock’s record |

test_tip_icon **Planning Tip**

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| ***The largest retirement spousal benefit is generally 50% of the worker’s benefit and is paid only when the worker has claimed a retirement benefit and both the worker and the spouse of the worker have reached full retirement age.*** |

## Creative Claiming Strategies for Traditional Married Couples

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| **Legislative Alert**  The Bipartisan Budget Act (BBA) of 2015, signed into law November 2015, severely curtailed two creative claiming strategies. One of those strategies, File and Suspend, remains available for qualifying clients until April 30, 2016. The second strategy, Filing a Restricted Claim, remains available for clients reaching age 62 by December 31, 2015. The dialogue that follows analyzes how these strategies have customarily worked and how they are impacted by the BBA of 2015. |

Before the BBA of 2015, a traditional married couple could have found as much as $60,000 or more in “free money” merely by separating the claiming date from the collection date. This feat was accomplished through two creative claiming strategies: (1) File and Suspend and (2) Filing a Restricted Claim. In the discussion that follows, we illustrate these sophisticated concepts through a series of straightforward examples. You may be reminded of specific clients or prospects as you consider the examples.

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| Traditional Married Couple  Purely for purposes of the Social Security discussion in this course, we define a ***traditional married couple*** as two heterosexual spouses of approximately the same age in a long-term, legally-wedded union. This distinction is made so that we may subsequently share strategies for other couples, such as those in a second family or same gender marriage. |

Our analysis in this section of the course focuses on three types of traditional married couple. **Click each to learn more.**

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| **Only One Spouses Works Outside of the Home – The File and Suspend Election** |
| Before the BBA of 2015, the File and Suspend election was ideal for marriages in which only one spouse worked outside of the home, the spouses were about the same age, and the wage-earning spouse wished to work until age 70.  File and Suspend was a windfall for many and here is how it worked: the worker **filed** for (claimed) benefits and then immediately suspended collection of those benefits.  There were at least two potentially lucrative reasons to elect File and Suspend:   1. Qualified the worker’s spouse to receive spousal benefits on the worker’s record, and 2. Earned delayed retirement credits on the worker’s record.   As you consider this concept, remember that spousal benefits generally could only be paid if the worker had *claimed* benefits. **Click** here **to see how this powerful election once generated as much as $60,000 in “free” benefits.**   |  | | --- | | **Example - Free $60,000**  Your clients Fred and Farrah Franklin, both aged 66, look to you for financial advice.   * Neither Fred nor Farrah have claimed or collected Social Security retirement benefits previously. Farrah has been the sole breadwinner while Fred has not worked outside of the home. Age 66 is their normal retirement age. * Farrah’s monthly retirement check, calculated on her own record, would be $2,500 if she filed and began collecting benefits at age 66. However, the allure of a permanent increase of 32% to her monthly retirement check has motivated Farrah to delay retirement until age 70.   The couple could use additional cash flow for the next four years, but there is a problem. Fred has no record upon which he may claim his own Social Security retirement benefits and, under the general spousal benefit rules, ***he is not eligible for a spousal benefit on Farrah’s record until she files for her own benefits.***  How do they get the cash flow they need for the next four years?   * Farrah can file for retirement benefits on her own record and immediately suspend the collection of her benefits. Because Farrah has now filed, Fred may now file a claim for spousal benefits on his wife’s record. * He will immediately begin receiving spousal Social Security retirement benefit checks of $1,250 monthly, plus cost-of-living adjustments. Meanwhile, Farrah earns an annual 8% delayed retirement credit to her own benefit until her age 70.   The net result is a beautiful thing.   * Fred collects $60,000 in free money (48 months @ $1,250 per month) from spousal benefits. * If that were not enough, Farrah’s retirement benefit jumps from $30,000 annually at age 66 to nearly $40,000 at age 70! This represents a 32% raise courtesy of her delayed retirement credit. |   The File and Suspend Strategy was virtually eliminated by the BBA of 2015. ***File and Suspend is now available for new filings only if your client has reached full retirement age AND files and suspends by April 30, 2016.*** Those clients previously filing and suspending are grandfathered in under the previous law and will not lose file and suspend benefits.  test_tip_icon **Planning Tip**   |  | | --- | | **April 30, 2016, is the filing deadline for the File and Suspend strategy for eligible clients. Be sure your clients know the power and the deadline of File and Suspend!** | |
| **Both Spouses are Wage Earners, One Makes More – Filing a Restricted Claim** |
| Filing a Restricted Claim is most effective for two-income marriages in which one spouse has a significantly higher PIA than the other spouse, the primary wage-earner wishes to collect benefits at normal retirement age, and there is a desire for the lesser earning spouse to collect spousal benefits.  A Restricted Claim allows one spouse (generally the lesser earning spouse) to choose between collecting retirement benefits on her own record OR collecting spousal benefits on her husband’s record.  Either husband or wife can use this strategy.   * For example, assume Jack and Jill are married. Jill is the primary wage earner and Jack earns less. When Jack applies for retirement benefits, he is deemed to apply for benefits on his own record unless he specifies otherwise. Jack can specify otherwise and avoid the “deeming” trap by filing a claim that is restricted to only his spousal benefits on Jill’s record.   **Click** here **to see an example of how this strategy may add up to $70,000 or more in lifetime retirement income.**   |  | | --- | | **Example - Filing a Restricted Claim**  Mrs. Sarah and Mr. Charles Magnussen are your clients. They are each 66 years of age (their normal retirement age). Both spouses were wage earners, yet Charles was the primary breadwinner. Both Sarah and Charles were born before 1953.   * Charles filed for retirement benefits on his record immediately upon reaching age 66. He will receive monthly checks of 100% of his PIA of $2,500. * Sarah’s PIA on her own record at age 66 is $1,275. * Sarah has a filing choice - she can receive $1,275 monthly by filing a claim for retirement benefits on her record ***or*** receive a 50% spousal benefit ($1,250) monthly by filing a restricted claim for spousal benefits on Charles’ record.   Counter-intuitively, Sarah should file a Restricted Claim for spousal benefits of $1,250/month instead of filing for her own benefit of $1,275/month. Here is why:   * She will earn delayed retirement credits of up to 32% (8% per year until her age 70) on her own benefit. Why? She is not taking benefits from her own record; she is taking spousal benefits from Charles’ record. * Because of the delayed retirement credits, her retirement benefit on her own record will grow to almost $1,700 per month (132% of $1,275) by her age 70. * At age 70, Sarah should file for retirement benefits on her own record.   The net result is dramatic.   * Sarah will gain over $400 per month for life ($4,900 annually) beginning at age 70 as a result of the delayed credits. If she lives until age 85, she will have gained over $73,000! * What is her cost? Her only cost is the $25 per month she will give up from age 66 until age 70. That is a total cost of only $1,200 (48 months at $25/month).   The dramatic net result is produced because Sarah collects only spousal benefits restricted to Charles’ record.   * She is NOT required to collect any benefits from her own individual record. * As a result, Sarah receives a substantial income stream for four full years from Charles’ record while earning delayed retirement credits on her own record. |   storm-red-and-yellow-th ***Cautionary Example***   |  | | --- | | **Kayla and Drew are married. They have both worked their entire career and Kayla’s PIA is significantly higher. Drew may file a Restricted Claim for spousal benefits as soon as he reaches normal retirement age. *A Restricted Claim for spousal benefits may not be filed before normal retirement age.***  **If Drew files for spousal benefits before normal retirement age, his claim is automatically paid from his own record. He is *forever* barred from filing a Restricted Claim for spousal benefits on Kayla’s record.** |   ***The BBA of 2015 impacted the Restricted Claim strategy - only those clients reaching age 62 by December 31, 2015 (born before 1953), are eligible for the strategy.*** Such individuals may subsequently file a restricted claim for spousal benefits when they reach full retirement age.  Thankfully, individuals filing a Restricted Claim before enactment of the BBA of 2015 are grandfathered in under the old laws and will not lose their Restricted Claim benefits. |
| **The Power Couple – Combining File and Suspend with a Restricted Claim** |
| |  | | --- | | Strategies that combine File and Suspend with filing a Restricted Claim have now been virtually eliminated by the BBA of 2015 for many workers. The few remaining clients eligible for this combined strategy should strongly consider taking action before eligibility runs out! Please refer to the “File and Suspend” and “Restricted Claim” discussions above. |   Here is an intriguing strategy for financially successful couples in which each spouse has high earnings. For such couples, the combination of File and Suspend with filing a Restricted Claim can leverage Social Security retirement benefits to unprecedented heights.  The combination approach works best for married clients of approximately the same age with high individual PIAs. Clients fitting this profile may enjoy Social Security retirement benefits as follows:   1. Husband earns delayed credits on his individual record, 2. Wife earns delayed credits on her individual record, and 3. Wife\* collects free spousal benefits on husband’s record beginning at her NRA.   Here is the seismic takeaway: ***both spouses are earning delayed retirement credits AND simultaneously one spouse is receiving current spousal benefits!***  The combination approach is best illustrated by example.   |  | | --- | | Example  Perry and Marilyn Gregson are your clients. They are age 66 (their normal retirement age). Neither Perry nor Marilyn have claimed or collected Social Security retirement benefits previously. Perry’s PIA is $2,600 and Marilyn’s PIA equals $2,000. Perry plans to work until age 70 to earn delayed retirement credits but Marilyn wishes to stop working now. They need income to replace a portion of Marilyn’s income from employment.  Here is what happens next in the combination strategy.   * Perry claims and suspends the benefit on his record in the current year (his age 66, his NRA). He earns delayed retirement credits because his benefits are suspended. * Marilyn files a Restricted Claim for spousal benefits on Perry’s record. * Marilyn earns delayed retirement credits on her record because she has not filed for benefits on her record.   Assume that Perry and Marilyn wait until age 70 to claim and collect benefits on their individual record. The financial results follow.   * Marilyn receives spousal benefits on Perry’s record of over $62,000 (50% of Perry’s PIA for the four years from age 66 through age 70). * Perry’s annual retirement benefit grows by about $10,000 ***for life*** as a result of his delayed retirement credits (32% of his age 66 benefit). * Marilyn’s annual retirement benefit grows by about $8,000 ***for life*** as a result of her delayed retirement credits (32% of her age 66 benefit). | |

Creative Claiming Strategies for Nontraditional Married Clients

You may have an opportunity to assist “second family” clients or those in same gender marriages. **Click on each of the following to learn more.**

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| **Second Families** |
| How does “free college funding” sound? While this will not be possible for all clients, here is a great way to fund college in second marriages for which there is a significant difference in spousal ages. Join us as we illustrate by example.   |  | | --- | | **Example**  Assume John is 66 (his normal retirement age) and Lynn is 45.   * This is John’s second marriage and Lynn’s first marriage. The have one child named Pauline. Pauline just celebrated her 11th birthday. * Neither John nor Lynn has other children. John claimed and is now receiving Social Security retirement benefits.   Here is what you need to know:   * Pauline is generally entitled to as much as 50% of John’s benefit until she reaches age 18. * Pauline could collect over $100,000\* in benefits over the next 7 years.   \**Depending upon John’s PIA.* |   ***But wait, there is more!***  Lynn has rights also. In an earlier discussion, we revealed that spousal benefits on the worker’s record could generally be paid only if the worker’s spouse was at least age 62. By that standard, Lynn would not be eligible for a spousal benefit on John’s record for another 17 years (from her age 45 to age 62).  You have great news for Lynn. There is an exception to the general rule - a spouse of the worker who is caring for a child of the worker may collect a spousal benefit until the child reaches age 16. Therefore, Lynn (age 45) may claim a spousal benefit on John’s record for the next five years (until Pauline reaches age 16). |
| **Oops** |
| What if your clients have been married to each other for life, are nearing retirement age, and have a young child? Whether that blessed addition to the family was planned or an “oops”, the same exceptions that apply to second families apply here as well. |
| **Same Gender Marriage** |
| Federal law, including Social Security regulations, recognizes spousal rights of legally married same gender couples: the spouses are entitled to the same rights and benefits accorded to legally married heterosexual spouses. As a result of a 2015 Supreme Court decision, all states must permit same gender couples to legally marry. |

Creative Claiming Strategies for Single, Divorced and Widowed ClientsWhy do shrewd advisors need to understand the implications of Social Security for single, divorced, and widowed clients?

* In a seismic shift from two generations ago, 5 of every 10 adults are choosing to remain single.[[9]](#footnote-9)
* The CDC recently reported that for every two marriages there is one divorce.[[10]](#footnote-10)
* About 14 million people in the U.S. are widowed.[[11]](#footnote-11)

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| **Single Clients** |
| The popular press gives scant attention to claiming strategies for single workers. While the opportunities for creativity are limited, you should be aware of at least one. Single clients reaching age 66 by April 30, 2016, are eligible for the File and Suspend retroactive lump sum option.   |  | | --- | | Retroactive Lump Sum Option  The ***retroactive lump sum option*** allows an eligible individual to file for benefits, suspend those benefits, and then collect a lump sum of all suspended benefits at a future date. |   Regrettably, single clients did not escape the ax of the BBA of 2015.   * The File and Suspend Strategy and retroactive lump sum option were virtually eliminated by the BBA of 2015 for those workers younger than age 66 on April 30, 2016. * File and Suspend is available for new filings only if your client has reached full retirement age AND files and suspends by April 30, 2016.   Those clients previously filing and suspending are grandfathered in under the previous law and will not lose File and Suspend benefits. In addition, an individual reaching age 66 on or before April 30, 2016, is also grandfathered into the **retroactive lump sum option**.**Click** here **to see how this approach could generate a lump sum payment of well over $100,000. Be aware that this strategy can also be used by married clients, subject to the BBA of 2015.**   |  | | --- | | **Example – File and Suspend “insurance policy” for single clients**  Your client Sherlock is single. Sherlock reached age 66 before April 30, 2016. His normal retirement age is 67. His PIA at age 67 is $2,600. He elects to File and Suspend payments at his age 67.  Here are the results.   * At his age 70, he is entitled to claim a lump sum benefit of all suspended payments from age 67 through age 70. * He may request and receive a retroactive lump sum payment at any time after age 67. He will receive a check of well over $93,000\* if he chooses to do so at his age 70. * Sherlock will NOT receive delayed retirement credits for the months included in the retroactive lump sum payment.   \**$2,600 per month @ 36 months = $93,600.* |   storm-red-and-yellow-th  **Caution**   |  | | --- | | If a client chooses to request a lump sum, he or she will earn ***no delayed retirement credits*** for the months represented by the retroactive lump sum payment. | |
| **Divorced Clients** |
| Eligible divorced clients may have rights to Social Security benefits on their former spouse’s record using the restricted claim strategy previously discussed.   * ***In the wake of the BBA of 2015, the Restricted Claim strategy remains a powerful option for clients reaching age 62 by December 31, 2015***. Such individuals may file a Restricted Claim for spousal benefits when they reach full retirement age. * Clients who are younger than age 62 on December 31, 2015, are no longer eligible for the Restricted Claim strategy.  |  | | --- | | Eligible Divorced Clients  ***Eligible divorced clients*** must meet 5 criteria:   1. Currently unmarried, 2. Divorced at least two years, 3. Married to the worker at least 10 years, 4. Both of the spouses must be at least age 62, and 5. Ineligible for a higher benefit based upon their individual record. |   Interestingly enough, your divorced client is eligible for benefits even if their former spouse has not claimed benefits.  Your divorced client may receive current monthly benefits on his or her former spouse’s record ***AND*** simultaneously earn delayed retirement credits on his or her individual record. While that may sound too good to be true, it simply requires the filing of a Restricted Claim at your client’s normal retirement age. **See the power of this approach by clicking** here.   |  | | --- | | **Example – Filing a Restricted Claim – Divorced Client**  Tom and Katie are divorced. Katie remains unmarried and she meets all five of the criteria listed above.   * Katie and Tom are both age 62. * Katie’s PIA at her normal retirement age (66) is $1,400. * Tom’s PIA at his normal retirement age (66) is $2,600.   Katie has a choice - she can file for retirement benefits on her own record and accept a permanent reduction in her benefits or she can wait until her normal retirement age and file a Restricted Claim for spousal benefits on Tom’s record.  The advantages to Katie’s filing a Restricted Claim at her age 66 follow:   * She will earn delayed retirement credits on her record of up to 32% (8% per year until age 70). * She will receive a $1,300 monthly spousal benefit on Tom’s record from her age 66 until her age 70. Noteworthy - this is only $100/month less than the benefit she could collect if claiming on her own record during this same 4-year period. * She should file for benefits on her record at her age 70, generating a monthly income for life of about $1,850.   What just happened as a result of Katie’s filing a Restricted Claim?   * She receives a $5,400 annual raise ***for life*** by waiting until age 70 to claim her own benefits. * Katie’s cost in securing this lifetime annual raise is a mere $4,800; the $100 per month she gave up from her age 66 to age 70. * She receives over $62,000 in “free” spousal benefits on Tom’s record ($1,300 per month for the 4 years from age 66 through age 70). | |
| **Widows and Widowers** |
| Picture this scene from a movie if you will. A recently widowed client is in her advisor’s office. She is deeply worried about the loss of her husband’s Social Security income, even as she struggles to deal with her grief.  How would she react to a doubling of her monthly Social Security payment?  A spouse with no individual earnings record is entitled to collect a spousal retirement benefit of as much as 50% of the worker spouse’s PIA while the worker is alive. But when the worker dies, the surviving spouse may be entitled to a survivors benefit equal to ***100% of the workers benefit at death***. **Click** here **for an illustration.**   |  | | --- | | **Example**  Mr. Jonathan and Mrs. Mary Small are your clients. They are both age 74 and have been married for 40 years. Jonathan is collecting a retirement benefit of $2,800 per month on his record and Mary is collecting a spousal retirement benefit on his record of $1,400 per month.  Regrettably, Jonathan was killed yesterday in a Class V whitewater rafting mishap. Mary is now entitled to a survivorship benefit of $2,800 per month (plus cost-of-living adjustments) for the rest of her life.  Here is what just happened. Mary switched her 50% spousal retirement benefit to a survivor’s 100% benefit! She gains almost $185,000\* in additional benefits if she lives until age 85.  *\*Calculated as $1,400 per month extra for 10 years.* |   This story illustrates a little understood benefit of delaying the collection of benefits until age 70. Because your widow or widower collects 100% of the benefits you were collecting at death, their survivorship benefits increase when you delay until age 70!  The most dramatic impact is felt when the surviving spouse has no individual record. However, as long as the surviving spouse’s record has a significantly lower PIA than that of the deceased spouse, there is potential for a weighty increase in payout. Widows and widowers enjoy a slight age advantage also - survivorship benefits are generally available as early as age 60 (50 if disabled). |

## Reduction of Benefits - Working in Retirement

Benefits are reduced for workers choosing to ***retire before normal retirement age*** (NRA) if they earn excess income. The reduction is based upon two earnings tests: earnings before NRA and earnings during the year of NRA. There is no reduction of benefits for income earned in the years after normal retirement age.

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| Earnings Before NRA  This test applies to the worker choosing to claim and collect benefits before NRA: $1 in benefits will be deducted for each $2 of earnings in excess of the annual limit of $15,720 (2016, as indexed). **Click** here **for an example.**   |  | | --- | | **Example**  Randy Retiree (age 64) began taking Social Security retirement benefits at age 62. His NRA is age 65. Randy’s retirement benefit, calculated without regard to the earnings test, would have been $18,000 per year. In the current year, Randy earned $10,000 MORE than the annual limit referenced above. Therefore, Randy’s retirement benefit will be reduced by $5,000 - he will receive only $13,000 in the current year. | |

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| Earnings During the Year of NRA  The penalty is much less severe in the year of the worker’s NRA. In the calendar year in which the worker or beneficiary attains the NRA, $1 in benefits will be deducted for each $3 of earnings above the annual limit of $41,880 (2016, as indexed). Only earnings before the month in which the worker or beneficiary attains the NRA are counted. **Click** here **for an example.**   |  | | --- | | **Example**  Dana Decamp began taking Social Security retirement benefits during the year in which she reached age 65 (her NRA). Dana’s benefit, calculated without regard to the earnings test, would have been $18,000. In the current year, she earned $10,000 MORE than the annual limit referenced above. Therefore, Dana’s retirement benefit will be reduced by $3,333 - she will receive only $14,667 in the current year. | |

Noteworthy - any benefits reduced by the earnings test may not be completely lost, they may be recoverable in future years. The recovery calculation can become somewhat complex but for those wishing to know more, **click** here.

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| **Example of Recoverable Benefits**  Your client Brian began collecting retirement benefits on his record at age 62. He was born in 1954 and because he claimed and collected at age 62, he incurred a permanent reduction of his PIA of 25%.   * His NRA is age 66. During the 5-year period from age 62 through age 66, his retirement benefits were **reduced** as a result of the earnings tests by the **equivalent of 12 months of benefit payments**. * When Brian reaches his NRA of 66, his monthly retirement benefit will be recalculated as if he first claimed benefits at age 63 instead of age 62. * Why age 63? He lost the equivalent of 12 months of benefit payments as a result of the earnings tests. That “lost” 12 months is added back to his claiming age (62) so that his new claiming age becomes age 63.   How does this recalculated claiming age help Brian? The recalculated claiming age of 63 means his early retirement decrease to PIA becomes only 20% instead of 25%.  Therefore, his benefit payment will increase at age 66 by 5% (based on a separate Social Security formula) of his PIA. If he lives long enough, he will recover all of the reduced benefits. |

test_tip_icon **Planning Strategy**

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| The earnings test does not apply to unearned income such as investment income, dividends, interest, rents, annuity payments, and distributions from IRAs or qualified plans. |

## Minimizing Income Tax in Retirement

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| *“The hardest thing in the world to understand is the income tax.”*— Albert Einstein, physicist |

Your mission, should you choose to accept it, is to introduce your client to tax management ideas to boost after-tax income. Be sure to involve your internal income tax resources or your client’s CPA in this process. The number and variety of strategies to manage income tax are legion. However, you may find that at least one of the ideas in this discussion will ignite client interest.

With all due respect to Mr. Einstein, income tax in retirement can not only be understood, it may be managed as well. The ideal retirement distribution plan is, to some degree, a balancing act. We must balance distributions from Traditional IRAs, Roth IRAs, Qualified Plans, and Social Security benefits not only against each other, but also against income taxes.

The discussion below introduces a select few tax management opportunities. **Click on each of the following to learn more:**

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| **How About a 0% State Income Tax Rate?** |
| State income taxes can siphon off as much as 9% of your client’s taxable income. Other states have no state income taxes at all. Even among those states that levy an income tax, special tax breaks for retirees (such as exclusion of Social Security benefits from taxable income) may be available. **Click** [here](http://www.kiplinger.com/slideshow/retirement/T055-S001-top-10-tax-friendly-states-for-retirees/index.html) **for more information.**  As part of your distribution dialog with retiring clients, an analysis of the long-term savings possible from moving to another state may be impactful. ***Be aware*** some states have other taxes (such as taxes on investment assets) that could offset income tax savings. |
| **Conversion to a Roth IRA** |
| Even if conversion to a Roth IRA is appropriate, the conversion should be timed to minimize income tax costs. The taxable income generated by conversion of a pretax qualified plan account balance or Traditional IRA to a Roth IRA may cause two unwanted income tax consequences: (1) a higher income tax rate bracket and (2) increased taxation of Social Security benefits. As much as 85% of a client’s Social Security benefits may be taxable based upon a client’s combined income.   |  | | --- | | Combined income  Combined income is adjusted gross income from the income tax return plus tax-exempt interest plus ½ of Social Security benefits received. | |
| **Tax-Free Dollars to Pay Health Care Costs – Health Savings Account (HSA)** |
| Distributions from an HSA to pay for a wide range of qualified medical expenses are income tax-free. Distributions for qualified medical expenses on account of the HSA owner, his or her spouse, and unmarried dependents are generally permitted.   |  | | --- | | Qualified Medical Expenses   * Long-term care insurance premiums * Health insurance premiums including Medicare premiums, continuation of coverage premiums under COBRA, and certain health insurance premiums paid while receiving federal or state unemployment compensation. * A wide range\* of medical and mental health care costs including physician services, hospital services, prescription drugs, and medical equipment.   \**Refer to IRS publications 969 and 502.* |   A complete discussion of the HSA is available in the companion course “Advising the Affluent Client: Accumulation Planning.”  test_tip_icon **Planning Tip**   |  | | --- | | Remember that after your client reaches age 65, distributions from HSAs may be taken for nonmedical purposes without penalty. Nonmedical distributions will be subject to income tax. Nonmedical distributions before age 65 will result in both income taxation and a 20% penalty. | |
| **Balancing Taxable and Nontaxable Distributions** |
| The judicious use of nontaxable income sources could keep your client from paying unnecessary income tax on Social Security benefits. As much as 85% of Social Security benefits may be included in taxable income based upon whether your client takes taxable or nontaxable distributions.   * If your client is nearing the 50% or 85% threshold for inclusion of Social Security benefits into taxable income, consider taking any additional income needed from Roth IRAs or Designated Roth Accounts instead of taking taxable distributions. * Coordinate income tax rate planning with distribution selection. In a high-income year, tap the Roth IRA or Designated Roth Account. In a low-income year, tap the Traditional IRA or non-Roth Qualified Plan account. * Do not pay for medical expenses with taxable distributions if HSA funds are available. * Remember that municipal bond income may trigger additional income tax on Social Security benefits as a result of the combined income formula.   The common theme here is management of future income tax events rather than trying to deal with the consequences after distributions have been taken! Your client and his or her CPA may appreciate you for emphasizing this planning ethic. |

 ***Alert!***

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| Your internal resources, CPA, CFP® practitioner, and/or tax attorney should be consulted before recommendations are made to your client. |

## Legacy Matters - Estate/Beneficiary Distribution Planning

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| ***“A well-drafted estate plan is your assurance that the taxes and costs associated with your death will be minimized. A good estate plan also keeps the process of settling your estate as simple and efficient as possible. Most importantly, your estate plan will ensure that your assets will be used to benefit the people or institutions that you choose, in the amounts that you choose.”***  - Gloria Cole, Attorney, Weston, MA |

As your clients move through their retirement, their legacy goals may become more and more preeminent in their thinking. Let’s take a look at the basic issues most people should consider. **Click on each issue to learn more.**

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| **Beneficiary and Heir Considerations – Family and Charities** |
| Any decisions a client may want to make about how his or her assets are distributed after death must be made in advance. The following list covers some of the issues your clients may be concerned about:   * Minor children or grandchildren – Those individuals not able or of legal age to receive assets. * Spendthrift concerns – The client believes one of the heirs needs to have money doled out as opposed to receiving lump sums. * Surviving spouses – The spouse has no experience or ability to make decisions about managing an estate. * Beneficiary designations – remember that beneficiary designations in an IRA, qualified plan, or life insurance will generally override provisions in a will! |
| **Estate Taxes** |
| Estate taxes may be assessed by the IRS and/or your client’s state taxing authority. While the federal exemption of $5,450,000 (2016, as indexed) protects most estates from federal taxation, be aware that some states begin taxing a decedent’s estate at only $1,000,000 in estate value. **Click**[here](http://wills.about.com/od/stateestatetaxes/a/stateestatetaxchart.htm)**for more information.**  Keep in mind that nearly every asset your clients own OR control is included in their taxable estates; e.g., their home/s, investments, retirement plans, personal property, business interests, insurance death benefits if individually owned, and some forms of trusts where they serve as trustee or have power over trust assets. Planning may be needed to minimize these taxes. |
| **Required Estate Planning Documents** |
| Estate planning includes making tough decisions about how you (or your client) wish to be treated if incapacitated, to whom you will distribute your financial legacy at death, and what method will be used to make distributions to your heirs. During a client’s retirement distribution phase, these needs should be addressed with an estate planning attorney. Typical documents required include wills and trusts, durable powers of attorney and living wills (advance directives).   |  | | --- | | Wills and Trusts  Whether federal estate taxes are an issue to a family or not, intestacy (not having a will) can be a significant problem. While studies have shown that the vast majority of Americans know that having a will is the most important single step they can take in their financial life, 60-75% of all people in this country die without one. The lack of a properly executed will or trust can cause delays in the distribution of the estate, squabbles amongst the family, legal contests to the probate process, and other costly and frustrating issues. |  |  | | --- | | Durable Powers of Attorney  Your client may delegate to someone the power to transact financial affairs or manage medical treatment in the event of their own incapacity using a durable power of attorney. |  |  | | --- | | Living Wills (Advance Directives)  A living will is not a will. A living will, or advance medical directive, establishes the circumstances under which you wish to be maintained on life support. An advance medical directive is generally valid only if you are incapacitated. For example, if you have no brain wave activity, do you wish to be allowed to die or do you wish to be kept on life support? | |
| **Stretch IRAs** |
| The death of an IRA owner serves up an opportunity to gain income tax deferral for another three generations if the beneficiary is a grandchild. The concept is simple - generally an inherited IRA may be distributed over the life expectancy of the beneficiary. This strategy should be considered whenever the surviving spouse will not need the decedent’s IRA. Implementation of this strategy can be complex and professional tax advice is required. |

 ***Caution!***

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| **Remember that only a licensed attorney may provide legal advice. Consult your compliance team for guidance before discussing these issues with your client.** |

## Conclusion

Throw a large rock into a small pond and the ripples spread out then cross back over each other. Distribution planning is very much like that, decisions in one area impact choices in other areas. Our goal in this course is to raise your awareness of how distribution decisions in one area, such as Social Security benefits, impact a host of other decisions as well.

Use your awareness to guide clients safely past common mistakes in distribution decisions. **Click** here **for a PDF of common mistakes along with recommendations for avoiding them.**

We hope this course has deepened your skills in recognizing and responding to client distribution planning needs. While we have provided you with an in-depth overview of different retirement plans and the rules associated with them, it is up to you to begin using this knowledge to assist your clients.

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| 10 Common Retirement Distribution Mistakes | | |
| **Mistake** | **Potential Consequences** | **Remedy** |
| 1. Collecting Social Security too early | Loss of $20,000 or more annually for life | Use bridging ideas to delay collectionof benefits until age 70, if appropriate. |
| 1. Failing to use creative Social Security claiming strategies | Loss of $60,000 or more over a lifetime | Familiarize yourself with the concepts to open the dialog and engage experts to assist. |
| 1. Failing to balance tax-free Roth distributions with taxable distributions | Additional income taxes on Social Security benefits and higher overall income tax rates | Engage internal resources or client’s tax professional to balance the distributions. |
| 1. Using a rollover instead of a direct transfer | Income tax and penalty if 60 day deadline is missed  20% withholding if funds originate from a qualified plan | Use a direct transfer. |
| 1. Failure to protect net unrealized appreciation (NUA) | Loss of long-term capital gains treatment | Contact the plan administrator to determine if NUA exists.  Avoid rollover or transfer of NUA to an IRA.  Engage internal resources or client’s tax professional to ensure all requirements are met. |
| 1. Failure to plan the exercise of ISOs | Loss of long-term capital gains treatment | Ensure holding period requirements are met  ISOs should be exercised within 90 days of termination of employment. |
| 1. Commingling rollover or conduit IRAs with other IRAs | Potential loss of unlimited protection from personal creditors in bankruptcy | Keep rollover or conduit IRA funds separate from other IRA funds. |
| 1. Failing to consider a Roth IRA conversion | Loss of balancing ability between taxable and tax-free distributions | Consult with a tax professional to analyze all of the issues. |
| 1. Taking premature distributions | 10% premature distribution penalty PLUS income tax | Wait until age 59½ (IRAs) or age 55 (qualified plans if separated from service) or (preferably) take funds from other sources. |
| 1. Failing to take RMD timely and fully | 50% under distribution penalty | Ensure the RMD is taken timely and calculated by a trustee, custodian, CPA, or other tax professional. |

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