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**Principles of Financial Planning:**

**Retirement Accumulation Planning**

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## ABOUT GREENE CONSULTING ASSOCIATES, LLC

Greene Consulting Associates was founded in 1979 and provides consulting and training services solely to the financial services marketplace. Located in Atlanta, Georgia, Greene Consulting has worked with the top providers of investment management and wealth management in both the United States and abroad. Focused on helping firms generate incremental revenue growth through more effective sales and relationship management strategies, Greene Consulting offers customized training programs in Financial Services Sales, a Sales Management program, Presentation Training that integrates proprietary products, and a comprehensive suite of online learning courses related to investments and wealth management.

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## Introduction

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| Welcome to Advising the Affluent Client – Retirement Accumulation Planning. One of the goals of this course is for its content to be as helpful ***for*** ***you*** as it is for ***your clients***. Toward that end, we invite and challenge you to get the very most from this course by making it personal. We strongly believe that understanding how to apply this knowledge to your personal life situation will not only enhance your own life, in a meaningful way, but can also kindle your enthusiasm for leveraging this knowledge to help clients and loved ones alike. | **GOAL**  This course should help you address ***your own*** retirement planning needs as well as those of ***your clients***. |
| Here’s your first invitation. Consider your own retirement for a moment. What retirement lifestyle do you dream of and when can you afford to retire? What specific steps have you taken to ensure you will not run out of money before you run out of life? If those questions give you pause, then congratulations - you are feeling what nine of every ten clients feel as they confront the enormity of retirement planning! | **CONSIDER YOUR OWN RETIREMENT**   * What retirement lifestyle do you dream of? * When can you afford to retire? * What specific steps have you taken? |
| Lets face it. It is easy to dream of one’s retirement. It takes courage and work to turn a dream into reality. The bridge between a dream and an accomplished reality is simply a ***plan***.  You need and your clients need a clear retirement accumulation plan. Your clear retirement accumulation plan, in turn, consists of nothing more than a series of specific steps you must begin ***now*** or your client must begin now to secure their future. Just as the GPS in your car guides you to your destination through a series of turns on the highway, an effective retirement accumulation roadmap guides your clients to their retirement destination through a series of financial terms. | The bridge between a dream and an accomplished reality is a ***plan***.  A clear retirement accumulation plan Steps you must begin taking now! |
| We suggest that you can best guide your clients after ***you*** have faced the same challenges ***they*** face.  When your client feels overwhelmed at the prospect of making the best decisions, you can assure them, you can assure them with moral authority that the same thoughtful, consistent roadmap you used to develop your own retirement accumulation plan can help them make wise decisions as well. This course is dedicated to giving you exactly that thoughtful, consistent roadmap. | **Experience is the best teacher.**   * Examining your own planning needs may better equip you to help others. * This course is dedicated to giving you a thoughtful consistent roadmap. |

## Learning Objectives

When asked to identify their primary financial goals or objectives, many of your clients will assign retirement planning the number one priority in their lives. Yet their actions often contradict that focus. This presents you with one of the stronger opportunities of your profession. However, the challenge in addressing this opportunity is getting clients to maintain their focus on planning for an event that may be remote, rather than allowing the immediacy of life and current financial demands to drain their resolve and resources.

Traditionally, planning for retirement primarily involved gathering and growing assets with advisors who assisted clients in developing an accumulation strategy and were valued for their expertise. Today, however, advisors should segment the process of retirement planning into two phases or stages:

* Pre-Retirement Accumulation Planning, and
* Post-Retirement Distribution Planning.

This particular course will focus on the first phase: Pre-Retirement Accumulation Planning.

Each phase requires a unique set of skills and abilities to address the needs clients typically have at each of these important points in their lives. In order to assist clients with these issues, we present the following objectives for this course.

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| **Objectives**  This course is designed to provide you with practical, real world strategies you can employ to increase your effectiveness in the pre-retirement accumulation planning process. Specifically, this course will help you to:   * Broaden your retirement accumulation planning expertise * Understand the key issues associated with this phase of retirement planning and how they can be resolved * Enhance your ability to guide clients in addressing their retirement accumulation needs |

## The Opportunity

Retirement planning currently represents one of the greatest areas of need among clients, offering a significant boost in productivity for advisors who gain the conversational competence to address this need with their clients and prospects.

DocumentationIcon_32px**Click the icon to view the references that indicate both the need and the opportunity.**

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| * The U.S. Census Bureau reports that the population of retirees is the fastest-growing segment of the American population. * Less than 2 of every 10 workers are “very confident” in having enough saved to live comfortably in retirement based upon The Employee Benefit Research Institute’s *2014 Retirement Confidence Survey®*. * The Investment Company Institute® announced that retirement assets reached $23 trillion as of December 31, 2013. * CNNMoney.com states that only 60% of workers over 40 who are eligible to participate in their 401(k) are actually doing so. * Fidelity Investments research shows that Baby Boomers on average can expect to be able to replace only 59% of their pre-retirement income while less than 57% can expect to receive a pension from their employer. * Retiree health costs and uncertainty over new health care laws increasingly rank among most retirees primary concerns. * The CDC’s National Center for Health Studies states that life expectancy has increased by more than thirty years in the last century. |

One might think that, given this information, most Americans would be actively planning toward their number one financial goal. However, The Employee Benefits Research Center found in their recent *Retirement Confidence Survey*® that ***only 4 out of 10 workers have even tried to calculate how much money they need to accumulate for retirement***.

Perhaps people are simply overwhelmed by the ongoing media coverage of issues like the continuing decline of the savings rate, the increasing income needs of current retirees, concerns regarding the future of Social Security, the increase in the numbers of retirees, health care costs, or the growing life expectancy and the resulting drain on resources. As an old adage of the financial services industry states: “The confused mind ALWAYS says No!” A strong case can be made that many people have simply run up the white flag as it pertains to their retirement. This tendency is apparent in a Met Life study, *Living Longer, Working Longer,* whichfound that the majority of those surveyed intended to, or were *resigned to*, work during their retirement.

Even though it would seem virtually impossible for clients and prospects to remain unaware of the dire forecasts around retirement planning, nearly all retirement services advertising uses idyllic images of travel or hobbies like the one pictured on this page. In the face of the differences between reality and those images, advisors must differentiate themselves by understanding the realities and how to plan for them in a way that makes the ideal attainable. That differentiation begins with understanding the client’s retirement lifecycle.

## Understanding the Retirement Lifecycle

The issues and concerns clients have regarding their retirement tend to shift as they age. This makes it possible for us to examine retirement planning in the context of a ***retirement lifecycle*** that can be divided into two stages: pre-retirement and post-retirement.

**Click the criteria to learn more**.

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| **Pre-Retirement Accumulation** | This stage is characterized by ***asset accumulation and growth***. For example, many clients in the pre-retirement phase will have “expectations” for their retirement and their concerns will revolve around issues like:   * "When can I retire?" or * "Can I afford to live in a beach-front home when I retire?” |
| **Post-Retirement Distribution** | As clients approach the actual point of retirement, their concerns begin to shift from accumulation and growth to income planning and health preservation***.*** In other words, their focus shifts to having adequate income for their living expenses, adequate insurance to help maintain their everyday health, and adequate protection against depleting their assets due to long-term illness.  As clients go through their post-retirement years, they may find that circumstances evolve in ways they had not anticipated. Their investment needs may change, as might their attitudes regarding their investments. Client life expectancies may become a factor in investing decisions. For example, a client may be well advised to consider conservative equity securities in their post-retirement portfolio to provide continued growth for a long life span in retirement.  They also begin to shift their concerns to what will happen after they die and become concerned about the transfer of their estates to heirs in the most tax-effective and beneficial ways. |

Advisors who recognize these differing needs and provide adequate solutions to the situation should thrive. On the following pages, we shall examine planning for retirement accumulation. Wise decisions during the accumulation period generally mean more income in retirement. The ideal retirement distribution plan is the natural consequence of an effective accumulation plan, launched as early as possible in a client’s career.

## The Five Key Issues of an Effective Retirement Plan

Many of the pre-retirees you encounter will have needs that share some collective themes. The most common issues they face are the five key issues listed below.

This course - *Retirement Accumulation Planning* - is the first of two courses focused on an effective retirement plan and will provide insights into the first four of the five key issues listed below. A separate course - *Retirement Distribution Planning* - will focus exclusively on the fifth key issue.

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| 1. Clear Retirement Plan 2. Sufficient Savings 3. Effective Investment Strategy 4. Tax-Efficient Savings Strategy 5. Effective Distribution Strategy |

## Key Issue 1 – Clear Retirement Plan

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| Let us pose perhaps the most important question in this process to you. How clear is your own retirement plan? If it is not crystal clear, then you are in the same boat as the majority of your clients! Or, put another way, if you haven’t had an opportunity to define success for your retirement accumulation plan, how will you know when you have achieved success? | **Consider Your Own Retirement**   * How clear is your own retirement plan? * How will you know when you have achieved success? |
| The difference between a *real plan* and a *mere hope* begins with specificity. For example, consider this statement, “I want to retire in comfort”. Folks that is a hope, a laudable hope to be sure, but ultimately just a to hope. Now consider this clear and specific statement, “I want to retire at age 65 with 80% of the purchasing power of my current income.” Your own successful retirement accumulation plan and that of your clients begins with a clear retirement accumulation plan! | **Be Specific**   * Specificity is key to a “real plan:”   + Nonspecific  “I want to retire in comfort”   + Specific  “I want to retire at age 65 with 80% of the purchasing power of my current income.” |

If you look up the word "goal" in Dictionary.com, you will see it defined as:

*The state of affairs that a plan is intended to achieve and that (when achieved) terminates the behavior intended to achieve it.*

Thus, a goal must contain sufficient "specificity" to allow a person to: 1) identify an appropriate plan of action; and 2) recognize when it is achieved.

However, when you begin conversations with clients or prospects about their individual retirement situations, they will typically describe their retirement goals with words such as, “I’d like to maintain my lifestyle; be comfortable, so to speak.” In other words, their response is likely to be nonspecific and inadequate for the purpose of creating a plan of action.

As you work with pre-retirees around this very important consideration, it is imperative that you help them achieve clarity:

* What specific objectives are there around the lifestyle they would like to accomplish?

***“The reason most people never reach their goals is that they don't define them, or ever seriously consider them as believable or achievable. Winners can tell you where they are going, what they plan to do along the way, and who will be sharing the adventure with them.”***

Dennis Watley – Senior Vice President, Kansas City Chiefs

* How much money, in today’s dollars, must they accumulate to meet their needs?
* When and where do they plan to live during retirement?

These and many more specific considerations make up their individual retirement reality. Once clarity is achieved, that clarity becomes your client’s clear retirement plan and should be formalized in writing.

## Key Issue 2 – Sufficient Savings

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| The failure to save adequately for retirement is a national epidemic in this country. The Employee Benefit Research Institute’s *Annual Retirement Confidence* Survey*®* found that only 69 percent of workers surveyed felt they were “doing a good job of preparing financially for retirement.”  At the same time, more than half those workers surveyed said that they’ve saved **less than $25,000** toward their retirement, excluding home equity and defined benefit plans. | **A National Epidemic\***   * 69% of workers felt they were “doing a good job of preparing financially for retirement.” * Yet over 50% said they had saved ***less than $25,000*** toward retirement   *\*Annual Retirement Confidence Survey, by the Employee Benefit Research Institute®* |
| Looking at your own retirement plan for just a moment, if you will. How will you determine how much you will need at retirement? How will you calculate the amount you need to save on a regular basis to actually fund your own retirement plan? When you can answer those personal questions confidently, you can guide your clients with confidence as well.  In this key issue - Key Issue 2 - we will suggest strategies for calculating sufficient savings. The primary strategy we respectfully suggest is courage - the courage to take responsibility for one’s own retirement and by doing so, take specific steps toward sufficient savings. | **Considering Your Retirement Plan**   * How will you determine how much you will need when you retire? * How will you calculate the amount to save on a regular basis (beginning now)? * Taking responsibility requires courage. |
| Conceptually, the calculation is quite simple. Determine how much capital you will need at your retirement age to generate your required income then subtract the projected resources you’ll have available at that time. The difference is the amount of additional money you need to save during the accumulation period. | **The Basic Calculation**  Capital Needed at Retirement  - Projected Resources  Additional Savings Need |

The Employee Benefit Research Institute® reports in its *2014 RCS Fact Sheet #6* that less than half of workers have even tried to calculate the amount they need to save to live comfortably in retirement. The report goes on to reveal, not surprisingly, that ***workers who have calculated a savings amount “tend to have higher levels of savings.”*** The mere calculation of the amount influences savings behavior!

The most critical question to answer in developing a sufficient savings plan is, "***What is the total cumulative amount I need to save?"*** Only when that question is answered does it become possible to set specific savings goals and select appropriate savings vehicles.

There are multiple methods for answering this question. Some methods start with expenses, preparing an individual expense budget and adjusting from there; the resulting adjusted budget is then used as the retirement income goal. Others start with current income and adjust it by anticipated changes to expenses, either by identifying specific expenses for which income will no longer be needed or by a rule-of-thumb percentage (e.g., 70-80% of current income).

Regardless of the method, the identified level of income is then adjusted for inflation to identify the level of income that will be needed upon retirement to maintain the current standard of living.

Once the future level of desired income is determined, we identify all potential sources of retirement income. These existing sources of income are subtracted from total income desired to identify the amount of additional retirement income needed (the shortfall). That shortfall will need to be generated by additional retirement accumulations.

Retirement income is usually generated by a combination of Social Security benefits, annuities, employer-sponsored retirement plans, and personal savings, such as IRAs. Employer-sponsored plans and IRAs are analyzed later in this course. Social Security and annuities are presented now.

## Social Security

The April 2014 Social Security Administration’s *Basic Facts* report discloses that the elderly derive almost four of every ten dollars of their income from Social Security. Ironically, a national survey conducted by the Financial Literacy Center[[1]](#footnote-1) for the Social Security Administration revealed that only 22% of financial advisors feel “very knowledgeable” about Social Security.

Social Security provides a powerful combination of lifetime payments, federal guarantees, and an inflation-adjusted income stream. The savvy advisor will develop expertise in this foundational retirement income benefit. We will help you develop expertise, and hopefully confidence, in Social Security retirement planning during the accumulation phase by focusing upon these aspects:

* Design and operation of Social Security
* Calculating retirement benefits
* Avoiding common mistakes
* Social Security financial solvency

### Design and Operation of Social Security

Social Security pays benefits, subject to eligibility rules, when a worker retires, becomes disabled, or dies. The worker’s spouse, former spouse, and children may also become eligible for benefits when the worker becomes entitled or dies. Understanding retirement benefits is our focus in this course.

Social Security retirement benefits give comfort to clients concerned about outliving their money and the potential ravages of inflation. Under current law, qualifying workers will receive an inflation-adjusted retirement benefit for life, no matter how long they live.

Before a worker can receive retirement benefits, he or she must have credit for a required amount of work in covered employment. 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. Once a worker is fully insured for retirement purposes, he or she remains fully insured for life.

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| Covered Employment  If Social Security and Medicare taxes are being withheld from your client’s paycheck, then their employment is covered employment. The following types of employment are not covered employment and hence, Social Security taxes are not withheld and the workers are not eligible for Social Security benefits.   * Railroad workers with their own retirement system outside of Social Security. * Federal government employees hired before 1984 do not pay Social Security taxes because they participate in a separate retirement system outside of Social Security. * State and local governments may opt out of Social Security and establish separate retirement plans for their employees. * Clergy may opt out of Social Security.   Noteworthy - Self-employment is also generally considered covered employment. |

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| Credit  A worker receives one ***credit*** for each $1,260 (2016, as indexed) in compensation earned from covered employment. A maximum of four credits can be earned each year.  A creditis also frequently and mistakenly referred to as a quarter of coverage. This can be confusing because a worker may earn four credits in the first quarter of the year. Hence, it is less confusing and more accurate to describe this requirement in terms of “credits” rather than “quarters.” |

Where does the money to pay benefits come from? Social Security is funded by payroll taxes assessed against employers, employees, and the self-employed.

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| Payroll Taxes  Employees pay Social Security taxes of 6.2% on compensation from covered employment up to a certain limit. That limit is called the taxable wage base. **The taxable wage base is $118,500 in 2016, as indexed. Here is an interesting observation - the taxable wage base has increased four times faster than inflation since the first taxable wage base was set at $3,000 in 1937.**  Employees also pay a Medicare tax of 1.45% of ALL compensation without limit. While our focus is not Medicare in this discussion, you should know how these taxes are assessed. A new tax - the 0.9% Medicare Surtax - is also payable by the employee on earned income in excess of certain thresholds. Employers are required to match the 6.2% Social Security tax and the 1.45% Medicare tax withheld from employees. Employers do not match the 0.9% Medicare Surtax.   |  | | --- | | **Example**  Anita Advisor earned $160,000 in 2016 as an employee of a national financial services firm. Remember that the Social Security taxable wage base is $118,500 (2016, as indexed). Anita will have $9,574 withheld from her pay as the following calculation illustrates.   * $7,347 Social Security tax (6.2% of $118,500) * $2,320 Medicare tax (1.45% of 160,000) * $9,667 Total Social Security and Medicare Tax Withheld   Anita’s employer must match this $9,667 and will send a check to IRS for $19,334. Her earned income is such that she is not subject to the 0.9% Medicare Surtax. |   Self-employed workers are both employee and employer. Hence, the self-employed have the dubious distinction of paying both the employee and employer portions of Social Security and Medicare taxes. The self-employed receive an income tax deduction for the employer portion of Social Security and Medicare taxes paid. |

The Social Security Administration deserves a special call-out for its operational efficiency. For every dollar paid out in benefits in 2013, less than one cent was used to pay administrative expenses according to Social Security’s official website in a report entitled, “*Social Security Administrative Expenses*.”

Calculating Retirement Benefits

The size of a client’s Social Security retirement check is based on average career earnings and retirement age. The calculation begins with the average, adjusted for inflation, of the highest 35 years of earnings. The average is expressed in monthly terms and is referred to as “average indexed monthly earnings” (AIME). We will refer to AIME as average earnings in this course. A worker’s average earnings are used to calculate their primary insurance amount (PIA). A worker’s monthly retirement payment may be less than PIA, exactly PIA, or more than PIA based upon the claiming age chosen.

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| Primary Insurance Amount (PIA)  A worker is not paid 100% of her average earnings when she retires. Average earnings are reduced through a formula to develop a worker’s PIA. The PIA is biased in favor of those with relatively lower earnings.  A deep dive into the PIA calculation is beyond the scope of this course. However, you should know that the largest percentage increases to PIA come from the bottom end of average earnings. For example, 90% of the first $856 (2016, as indexed) in average earnings per month is added to PIA, but only 15% of average earnings per month above $5,157 (2016, as indexed) is added to PIA. Average earnings above the taxable wage base ($118,500 in 2016) add nothing to PIA. |

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| Claiming Age  The age at which a worker applies for retirement benefits is the worker’s claiming age. A worker has three choices: 1) claim early and take a permanently reduced benefit; 2) claim on time at normal retirement age (age 65 to 67 depending upon year of birth) and receive a benefit of 100% of PIA; or 3) delay claiming and receive a permanently increased benefit.   1. Early - A worker may claim no earlier than age 62. Workers claiming at age 62 incur a permanent reduction from their PIA. Workers claiming after age 62 but before their normal retirement age will have their retirement benefit reduced for each month they claim early based upon a formula. A worker retiring at age 62 will incur a 20% reduction if their normal retirement age is 65 and a 30% reduction if their normal retirement age is age 67.  |  | | --- | | **Example**  Your client Earl’s full retirement age is 67 and his PIA is $2,000. If Earl retires at age 62, his monthly retirement benefit will be reduced by $600 (30%). Earl will receive a monthly benefit of only $1,400. Earl’s benefit WILL NOT increase to $2,000 when he reaches age 67. The reduction of benefits is permanent. |  1. On Time - A worker may claim at their normal retirement age and receive 100% of their PIA. 2. Delay - A worker may delay claiming beyond their normal retirement age and earn a permanent increase to their retirement benefit of as much as 8% per year (if born in or after 1943) for each year of delay through age 70. No increases are earned if claiming is delayed past age 70.  |  | | --- | | **Example**  Belinda was born in 1954 and has a normal retirement age of 66. Belinda’s PIA is $2,000. If she claims at age 66, her monthly retirement check will be $2,000 (100% of her PIA).  If she delays retirement until age 70, her monthly retirement check will permanently increase to $2,640, a 32% increase. The 32% increase is calculated as 4 years of delay at 8% per year. |   Social Security designs the early, on time, and delayed claiming amounts so that the present value of all future benefits for a client living to his expected actuarial age is approximately equal no matter what claiming age is chosen. |

### ****Avoiding Common Social Security Mistakes During the Accumulation Period****

Maximizing the future Social Security retirement benefit requires avoiding common mistakes during a client’s accumulation period. **Click each to learn more.**

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| **Mistake Number 1 - Failure To Work 35 Years** |
| If earnings during any year are zero, that zero becomes part of the average and reduces a worker’s retirement benefit. Hence, an able worker should consider working until there are at least 35 years with earnings from covered employment. This is especially true of the primary wage earner in a married couple but may be less impactful for the spouse with lesser earnings.   |  |  | | --- | --- | | Spouse with Lesser Earnings  **A spouse is usually entitled to the greater of his own retirement benefit or up to 50% of his wife’s benefit. Consequently, an analysis is required to determine if additional earnings years will actually benefit the spouse with lesser earnings.**   |  | | --- | | **Example**  **Jane has a PIA of $2,000 and is fully insured. Tarzan has a PIA of $800 and is also fully insured. Tarzan has only worked in covered employment for 20 years. When both Jane and Tarzan reach full retirement age, Tarzan will be entitled to a spousal benefit of $1,000 because he is married to Jane. His spousal retirement benefit will be higher than the benefit based upon his individual earnings.**  **If Tarzan chooses to work additional years in covered employment, he would have to increase his PIA to more than $1,000 to generate a higher retirement income than his spousal benefit as Jane’s husband.** | | |
| **Mistake Number 2 - Failure to Increase Average Earnings** |
| Here is an interesting opportunity. Even after all “zero” years have been replaced by earnings years, there may be even more to gain by continued employment. A worker’s average earnings generally increase when a new higher year of earnings replaces an older lower year of inflation-adjusted earnings. Frequently, a late career client may be in their top earnings years and, if so, this strategy could well increase the future monthly retirement benefit check. |
| **Mistake Number 3 - Failure to Check One’s Social Security Earnings Statement** |
| The impact of errors or omissions in one’s earnings statement is generally minimal if found and corrected early. An annual review of one’s Social Security benefit statement is advised. This simple step may avoid real problems 20 or 30 years in the future when records, or even the employer, may be difficult to locate. Social Security offers the following link to do just that: **http://www.ssa.gov/myaccount/** |

Your understanding of these foundational Social Security concepts, such as claiming age and mistakes to avoid, can help your clients in less obvious ways as well. The Pew Research Center’s January 13, 2013, *Sandwich Generation* report discloses that more than 1 in every 5 middle-aged workers provide financial support to a parent. Helping your client’s parent make the wisest Social Security choices could indirectly put dollars back into your client’s retirement accumulation savings!

There is a final benefit to Social Security that is not to be overlooked. All Social Security payments, including retirement benefits, are indexed annually for inflation through the use of cost-of-living adjustments (COLAs). There is comfort in the COLA for clients concerned about maintaining purchasing power.

### Social Security Financial Solvency

Will you receive your promised benefits from Social Security? This visceral worry may be on the hearts and minds of many, if not most, of your clients as they read predictions of doom and gloom in the headlines. Join us as we separate fear from fact.

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| **Client Fear**  Social Security will become insolvent. |

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| **Facts**  Complete insolvency is unlikely because of the very nature of Social Security. At its core, Social Security is a system of inter-generational wealth transfer through taxation. Every generation pays for the previous generation’s benefits through payroll taxes. As long as this nation has individuals working in covered employment, there will be a source of funding for Social Security benefit payments.  The Social Security Administration reports in its *Summary of the 2013 Annual Reports*, that until 2010, annual payroll taxes collected were more than annual benefits paid. The difference was invested in specialized Treasury bonds owned by the Social Security Old Age and Survivors Trust Fund.  The report further asserts that since 2010, more benefits were paid annually than taxes collected. The funding for the difference comes from the Trust Fund. The report also notes that, even if the current structure is not reformed, 100% of promised benefits will be paid through 2033 and approximately 75% of promised benefits will be paid from 2034 through 2087. |

What, then, are the planning implications for your clients? There are at least three potential responses: 1) assume everything will be fixed by Congress and that 100% of expected benefits will be paid; 2) assume the worst case and no benefits will be paid; or 3) strike a middle ground by assuming most, but not all, promised benefits will be paid. While an argument could be made for choice 3, ultimately your client’s wishes will drive which of these choices is most appropriate.

Our purpose in this Social Security discussion is to help raise awareness of these issues rather than to suggest specific client recommendations. Clients may present differing goals, life expectancies, income tax rates, and earnings histories. Social Security regulations and tax laws are subject to change. Hence, specific client questions should be directed to the Social Security Administration, an attorney, CPA, or CFP® professional.

## Deferred Annuities

How would your client react to a strategy that provided a guaranteed lifetime income in retirement, tax-deferred growth, and unlimited contributions during the accumulation period? An annuity can give your client all of those benefits and more. This course is centered upon accumulation planning, so an annuity that defers distributions to retirement, a deferred annuity, is our focus in the discussion that follows.

An annuity is simply a contract that provides a series of periodic payments to an individual referred to as the annuitant. While a detailed analysis of annuities is beyond the scope for this course, we will summarize select characteristics of this powerful retirement accumulation tool.

Annuities can be described in a number of different ways, as the following chart will demonstrate. **Click each to learn more.**

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| **When Will Annuity Payments Begin?** |
| An immediate annuity begins distributing annuity payments to the annuitant immediately after the annuity is purchased. In contrast, a deferred annuity begins distributions of annuity payments to the annuitant in the future. Generally, a client who has already contributed the maximum to any tax-deferred accounts may be a candidate for a deferred annuity. Deferred annuities can provide a guaranteed income stream at retirement and may resonate with clients concerned about running out of money before they run out of life.   |  | | --- | | Tax-Deferred Accounts  Tax-deferred accounts include employer-sponsored retirement plans, IRAs, and other plans/accounts. | |
| **How Long Will Payments Continue?** |
| An annuity may be structured as a lifetime annuity, an annuity for a fixed period of years, or a combination method, such as life with period certain.   |  | | --- | | **Example of Life with Period Certain Annuity**  Mrs. Stokes purchased a lifetime annuity with a 10-year period certain. Her annuity payments will continue for the longer of her lifetime or 10 years. If she dies within 10 years, annuity payments to her beneficiary will continue for the remainder of the 10-year period. | |
| **How Much Will I Receive Monthly?** |
| A fixed annuity pays a fixed amount over the distribution period and a variable annuity pays a varying amount over the distribution period. A fixed annuity may not always provide inflation protection (such protection may be available at additional cost) or give the annuity owner a voice in selecting investments. A variable annuity provides the annuity owner with a choice over annuity investments and may provide an opportunity to maintain an inflation-adjusted annuity payout. In a variable annuity, the payment fluctuates up or down based upon investment performance of the annuity’s investments. |

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| ***Compliance Alert***  ***Only licensed professionals may sell an annuity product. Check with your compliance department before discussing annuity planning with clients to avoid compliance issues!*** |

Deferred annuities provide the following noteworthy advantages coupled with equally noteworthy disadvantages.

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| Advantages  * Guaranteed lifetime income benefit is available that the annuitant cannot outlive * Income tax deferral - earnings are only taxed when distributed to the annuitant * Opportunity, but not guarantee, to keep pace with inflation through a wide range of variable investment options (if investing in a variable annuity)  Disadvantages  * No income tax deduction as with contributions to a deductible Traditional IRA * As with IRAs and certain employer-sponsored retirement plans, withdrawals prior to age 59½ may incur a 10% premature distribution penalty * Annual fees and expenses tend to be higher than IRAs or brokerage accounts * Restrictions on access to principal such as surrender charges for termination |

## Key Issue 3 – Effective Investment Strategy

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| **Video Script** | |
| **Script** | **On Screen Text** |
| You now have a clear retirement plan from the very first key issue discussed.  You have also developed a sufficient savings strategy from the second key issue we analyzed.  Now we examine the issue of having an effective investment strategy. An effective investment strategy is as closely linked to sufficient savings as are identical twins to each other.  An effective investment strategy evolves over time. For example, during your working lifetime, will your investment strategy be different in your 60’s versus your 20’s? If you’re like most, the desire for gain dominates the strategy in the early years of one’s career and the fear of loss becomes the dominant factor as we near retirement age.  For example, a portfolio heavily weighted toward high credit quality, fixed income securities is generally not appropriate for an early career client focus upon growth. Yet that same strategy, at least to some degree, may resonate for a 65-year-old client entering retirement.  One’s investment strategy simply must evolve to balance risk tolerance and return expectations as your client’s focus changes from early career growth to later career preservation. A vital tool in balancing risk and return during that evolution is asset allocation. | **Effective Investment Strategy**   * Evolves over time   + Early years  desire for gain   + Later years  fear of loss * Balances risk tolerance and return expectations as your client’s focus shifts over time   + Asset allocation is a vital tool |

In the late Twentieth Century, the majority of investors described themselves as “Aggressive” or “Growth-Oriented.” Growth at any cost was their mantra and their portfolios responded as you might expect in the late nineties. Fewer investors today would describe themselves the same way, but many early to mid-career clients should consider an Aggressive Growth model because of the long-term nature of their goal.

The best thing an advisor can do is to help clients analyze their previous behavior, current risk tolerances, and their investment needs relative to their goals, and then construct an asset allocation designed to meet those needs.

## Key Issue 4 - Tax-Efficient Savings Strategy

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| **Video Script** | |
| **Script** | **On Screen Text** |
| Would you stop to pick up $100 on the sidewalk? What if not $100 but $5,000 were on the sidewalk, and what if that $5,000 were on the sidewalk every single year in your retirement? The right income tax strategy can leverage retirement income in ways few advisors completely appreciate.  As one quick example, a Health Savings Account is not an IRA or employer-sponsored retirement plan, yet it provides a current year income tax deduction, earnings grow on an income tax-deferred basis, and the earnings are income tax-free when used to pay qualifying medical expenses.  That’s unheard of! Where else, in tax world, can you receive a current year income tax deduction, tax-deferred growth, and tax-free distributions? This is but one example of how the sophisticated use of the right tax strategy can save money for you and your clients in unexpected ways. | Tax-Efficient Savings Strategy   * A way to leverage retirement income * Example: Health Savings Account   + Current year income tax deduction   + Earnings are tax-deferred   + Earnings are income tax-free when used to pay qualifying medical expenses |
| Keep the focus on your own retirement plan as you analyze the tax-efficiency of your current course of action. Consider asking questions such as “How have I structured my own retirement plan to maximize my after-tax retirement income?” and “What *specifically* am I doing now to generate more after-tax income when I retire?” | **Questions to Ask Yourself**   * How have I structured my own retirement plan to maximize my after-tax retirement income? * What specifically am I doing now to generate more after-tax income when I retire? |

The government will take fewer taxes in retirement when wise tax choices are made during the accumulation period. The ideas we will share may give the shrewd advisor an opportunity to reduce not only a client’s regular income taxes in retirement, but potentially reduce more subtle erosion of retirement income as well.

***“You don’t pay taxes – they take taxes.”***

Chris Rock – American Comedian, Actor, and Playwright

In the pages that follow, we will address the “must know” dynamics of IRAs and employer-sponsored retirement plans. We will also dive beneath the surface of income tax efficiency and share specific strategies to dramatically reduce or avoid other retirement expenses, such as excess Medicare insurance premiums, after-tax medical costs, and the Net Investment Income tax.

## Retirement Savings Vehicles

Let’s begin with an overview of retirement savings vehicles.

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| **Overview** | Generally, vehicles used for retirement accumulation can be classified into three categories.  Click on each category to view more information. |
| **Personal Savings** | Personal Savings include all taxable savings vehicles, such as individual brokerage accounts and bank savings accounts. These accounts are not uniquely designed for retirement saving and typically offer no tax-deferral benefits. Therefore, they should generally be used as a secondary retirement savings vehicle, after the use of other more “tax-advantaged” vehicles has been exhausted.  However, there is at least one circumstance in which personal savings may be appropriate. A client wishing to invest in growth securities to achieve long-term capital gains income tax rates may find it beneficial to use personal savings as an investment vehicle.  Why? Earnings from tax-deferred accounts, such as employer-sponsored retirement plans and Traditional IRAs are generally taxed as ordinary income when distributed. Long-term gain from personally owned accounts would be taxed at preferential long-term capital gain rates if holding period requirements are met.  The top ordinary income tax rate is 39.6% (2016) while the top capital gains rate is 20% (2016). If your client can shift gain from ordinary income to capital gains, an income tax savings of approximately 20%[[2]](#footnote-2) (19.6%) may be achieved.  Hence, investments that produce ordinary income should generally be owned in IRA or employer-sponsored retirement plan form while it may be appropriate to earmark at least a portion of your client’s growth securities into an individual brokerage account. |
| **Individual Retirement Arrangements** | ***Individual Retirement Arrangements (IRAs)*** are retirement arrangements that include the following list:   * **IRA Plans Established by Individuals**   + Traditional IRA   + Roth IRA * **IRA Plans Established by Employers**   + Simplified Employee Pension (SEP IRA)   + Savings Incentive Match Plan for Employees (SIMPLE IRA ) |
| **Qualified and Other Employer-Sponsored Plans** | **“Qualified”** Plans must be established by employers and are subject to ERISA (Employee Retirement Income Security Act) requirements regarding eligibility, vesting, funding, etc. In general, contributions into these plans are not taxed until the funds are withdrawn and employers can claim a deduction for their contributions to these plans in the year the contribution was made.  The most common types of “Qualified Plans” are:   * Defined Benefit Plans, including the following:   + Traditional Defined Benefit Plans   + Cash Balance Plans   + Fully Insured Defined Benefit Plans * Defined Contribution Plans, including the following:   + Money Purchase Plans   + Profit Sharing Plans   + 401(k) Plans   + Stock Bonus Plans/ESOPs   Although not classified as “Qualified Plans,” similar plans are available to tax-exempt organizations and government employees. These include the following:   * **403(b) Arrangements** – These are for tax-exempt religious, charitable, or educational organizations. They allow employees to make elective deferral contributions similar to 401(k) Plans. * **Governmental 457(b) Plans –** These are deferred compensation plans that are available to public sector employees (state or local governments). Similar to 401(k) and 403(b) Plans, they allow employees to make salary deferral contributions. |

Because of the important role that IRAs, Qualified Plans, and other employer-sponsored plans play in saving for retirement, it is important that you have a solid understanding of how these tax-advantaged retirement savings vehicles work. Therefore, on the following pages we will examine these plans in detail, beginning with IRAs.

## Importance of Understanding IRAs

More than 25% of all retirement assets in the United States are held in IRAs. Almost $1.5 trillion in assets are owned in IRA form, based upon data from the Employee Benefit Research Institute®.[[3]](#footnote-3)

Without doubt, one of the most important retirement savings vehicles to understand for purposes of advising affluent clients is the IRA. Below are reasons why understanding an IRA is important:

DocumentationIcon_32px**Click the icon to view the reasons why understanding an IRA is important.**

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| * These arrangements are the most likely ones to be implemented by individuals, partners, or small businesses. Therefore, they are the ones in which your affluent clients are most likely to be involved and over which they have the most control. * The investment decisions of IRAs are ***entirely*** at the discretion of the individual owner. Therefore, this type of retirement arrangement offers significant opportunity for providing investment services to affluent clients. * The individual owner manages funding and distributions. Since there is no corporate plan administrator who can answer questions, as with many qualified plans, clients are likely to look to you and your organization for help in getting answers to their questions. * Employees often rollover assets from employer-sponsored retirement plans into an IRA when they change employers or retire. |

For these reasons, in examining retirement plans/arrangements, we will give primary focus to understanding IRAs.

While this course will not make you an expert on IRAs and you will certainly want to call upon IRA experts within your own organization for many client inquiries, it *will* give you familiarity with the most frequently asked questions associated with IRAs and equip you to dialog effectively with affluent clients.

## Advantages of an IRA

Why would your client consider an IRA? Clients are attracted to IRAs for at least four powerful advantages.

1. **Favorable Tax Treatment on Contributions** – Contributions to certain Traditional IRAs may be deductible on your client’s income tax return.
2. **Favorable Tax Treatment of Earnings –** Earnings are not taxed until withdrawn from the IRA. Therefore, the assets in the account grow faster without the erosion of annual tax liabilities. In the case of the Roth IRA, the earnings are generally not ever subject to tax, provided certain rules are followed.
3. **Bankruptcy Protection -** IRAs are generally exempt from an individual’s creditors in bankruptcy under federal law up to $1,242,475 (2015, subject to inflation adjustment before the end of 2016). Certain states have established higher exemption amounts. The bankruptcy protection is not absolute: the IRS may levy IRA funds to satisfy unpaid taxes.
4. **Not Prohibited by Participation in a Qualified Plan –** Although participation in an employer-sponsored plan may impact the deductibility of contributions to a Traditional IRA, participation in a Traditional IRA is not prohibited by participation in an employer-sponsored plan. **Thus, IRAs can be a valuable supplement to employer-sponsored plan savings.**

* In comparison, contributions to a Roth IRA are never affected by contributions to an employer-sponsored plan, but may be limited by the contributor's modified adjusted gross income.

## IRAs Established by Individuals

To make it easier to examine the rules that govern IRAs, let’s examine them in two groups: those that can be established by individuals and those that may only be established by employers. There are only two types of IRAs that may be established by an individual: 1) the Traditional IRA; and 2) the Roth IRA.

**Click on each category to learn more.**

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| **Traditional IRA** |
| Traditional IRAs, at times referred to as “regular IRAs,” are characterized as follows.   * Earnings on assets grow on a tax-deferred basis and are taxed only when withdrawals are made. * Contributions can be made (or a Traditional IRA may be established) as long as the taxpayer is under age 70½ on the last day of the tax year and has taxable compensation. * Mandatory withdrawals must begin no later than April 1 following the year in which the IRA owner attains age 70½. Failure to take required distributions results in a penalty of 50% of the under-distribution. * Distributions taken before age 59½ may incur a 10% premature distribution penalty.   Traditional IRAs may be either Deductible Traditional IRAs or Nondeductible Traditional IRAs.   |  |  | | --- | --- | | Deductible Traditional IRAs  Contributions to Traditional IRAs are generally deductible by the taxpayer up to the IRA contribution limits. However, when a taxpayer is an active participant in an employer-sponsored retirement plan, the deductibility is limited based upon adjusted gross income.  We will discuss the phase-out of deductibility of deductible Traditional IRA contributions subsequently in this course. Distributions of accumulated earnings and the original contribution are fully taxable as ordinary income. Capital gains income tax treatment is not available from any IRA withdrawal.   |  | | --- | | Original Contribution  Why is the taxpayer subject to income tax on the distribution of their original contribution? The taxpayer received a deduction on their income tax return when the original contribution was made. Consequently, the taxpayer must include the original contribution into income when distributed. | |  |  | | --- | | Nondeductible Traditional IRAs  Contributions to nondeductible Traditional IRAs are not deductible by the taxpayer. Distributions of deferred earnings are taxable to the taxpayer as ordinary income. Distribution of the taxpayer’s original contribution is income tax-free because the taxpayer received no income tax deduction for the contribution. | |
| **Roth IRA** |
| **Roth IRA**  The Roth IRA was created in the Taxpayer Relief Act of 1997 (TRA ’97) and is named after the Senator who was its longtime proponent, William V. Roth of Delaware. Like a Traditional IRA, to establish a Roth IRA, an individual must have taxable compensation. But the Roth IRA differs from the Traditional IRA in the following ways:   1. ***Contributions are not deductible*** on the individual’s income tax return. 2. ***Withdrawals of contributed funds and qualified withdrawals of earnings are free from federal income taxation***. Generally speaking, qualified withdrawals of earnings are those made at least 5 years after the first day of the tax year for which the initial contribution to a Roth IRA was made AND due to one of certain specified events (e.g., owner being 59½ or older) that will be discussed in more detail later in the course. 3. ***There are no age restrictions*** to establishing or contributing to the Roth IRA. A client of any age with taxable compensation may contribute to a Roth IRA as long as adjusted gross income does not exceed certain limits.   With the Traditional IRA, it may be possible to make tax-deductible contributions, but all account earnings and deductible contributions are subject to income taxation upon withdrawal. This is reversed with the Roth IRA. With the Roth IRA, no deduction is available for contributions, but qualified withdrawals are income tax-free. |

We revealed that there are really only two forms of the individually established IRA - Traditional and Roth. However, you may see variations on those two forms referred to as Spousal IRAs and Conduit IRAs. These variations are NOT separate types of IRAs.

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| Spousal IRAs  This may be the IRA solution for married clients when one spouse does not work outside of the home. While often referred to as another type of IRA, a “spousal IRA” is really just a Traditional or Roth IRA established for the spouse of the taxpayer.  One of the requirements for creating a Traditional or Roth IRA is that the individual must have taxable compensation. However, *an exception to this rule is made for spouses who file a joint tax return*: the taxable compensation of one spouse can be applied to the other spouse. This makes it possible for spouse “A” to qualify a spousal IRA for spouse “B” when spouse “B” has no taxable compensation (or insufficient taxable compensation to make full use of that year’s contribution limit). **Click** here **for an example**.   |  | | --- | | **Spousal IRA Example**  Sherlock and Irene are married and file married filing jointly. Irene is a world-renowned brain surgeon. She does not participate in any employer-sponsored retirement plan. Sherlock is a professional salt-water angler. They are each 45 years of age. Irene earned $1,400,000 in taxable compensation in the current year. Sherlock had a turbulent year and earned nothing.  Irene may establish a Traditional IRA for herself of $5,500 (2016). Her taxable compensation also qualifies a Spousal IRA of $5,500 (2016) for Sherlock.  Let’s consider a variation on this example. Assume the same fact pattern except Irene’s taxable compensation is now only $10,000. She may establish an IRA of $5,500 (2016) for herself. Irene’s taxable compensation now qualifies a Spousal IRA for Sherlock of only $4,500 (2016). There must be sufficient taxable compensation to cover contributions to both Irene’s IRA and Sherlock’s spousal IRA. | |

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| Conduit IRAs  A Conduit IRA is either a Traditional IRA or Roth IRA established through a rollover or direct transfer of funds from an employer-sponsored retirement plan. Conduit IRAs may be used when a participant retires or changes jobs.  In the case of job change, a participant in an employer-sponsored retirement plan may leave one employer and wish to transfer his or her 401(k) account into the new employer’s 401(k) Plan. There may be a waiting period before the employee is eligible to participate in the new employer’s 401(k) Plan. The participant may establish a conduit IRA to temporarily “park” the 401(k) money until it can be transferred to the new employer’s 401(k).  A retiring participant can also rollover or direct transfer a qualified plan account balance to a Conduit IRA in order to gain more investment choices.  test_tip_icon **Planning Tip**   |  | | --- | | Conduit IRA funds should not be commingled with any of the participant’s other IRA accounts. Commingling may cause the Conduit IRA funds to lose eligibility for qualified plan status. | |

## Traditional & Roth IRAs – Who Can Set One Up?

Anyone with taxable compensation can set up a Roth IRA. Age is not a factor for Roth IRA eligibility. Taxable compensation is also required to set up a Traditional IRA, but there is an age limit as well.

* All individuals with taxable compensation can contribute to a Traditional IRA prior to the calendar year they reach age 70½.
* No contributions to a Traditional IRA can be made in or after the year in which an individual reaches age 70½.

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| Taxable Compensation  Taxable compensation can generally be viewed as earned income. Earned income is income earned from personal services provided. Do not confuse taxable compensation with unearned income, such as stock dividends and interest. Dividends and interest are NOT forms of compensation - they are forms of investment income. IRA contributions MUST be based solely on the portion of taxable income that is received as compensation earned from personal services. But, as the following table illustrates, taxable compensation for IRA purposes includes income that is not always thought of as “earned.”   |  |  | | --- | --- | | **Taxable Compensation** | | | **Includes** | **Does Not Include** | | Wages, salaries, etc. | Deferred compensation received (compensation payments postponed from a past year) | | Alimony payments received | Property settlement received in a divorce  Child support | | Commissions | Pension or annuity income such as Social Security retirement benefits, IRA distributions, and qualified plan distributions | | Self-employment income including income to a general partner and net earnings from a sole proprietorship | Income to a limited partner in a partnership  Rental income  Portfolio income such as capital gains, interest income, and dividend income |   *Source: Adapted from IRS Publication 590.* |

### Traditional & Roth IRAs – Annual Contribution Limits

What is the maximum amount that can be contributed each year to Traditional and Roth IRAs? Various rules may impact an individual’s ability to deduct contributions (for Traditional IRAs) or to make any contributions at all (for Roth IRAs).

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| **Overview** | The following rules govern the maximum contribution to these account types and, because of the importance of these rules, the numbers in effect for the current year should be memorized. **Click each rule to learn more.** |
| **Annual Contribution Cannot Exceed** | Annual contributions of earned income cannot exceed the following limits:   |  |  |  | | --- | --- | --- | | **Year** | **Annual Limit** | **50 + Catch-Up Limit** | | 2016 | $5,500\* | $1,000\* |   *\* Annual limits indexed for inflation, in $500 increments.*  These maximums are for each individual. Thus, married individuals *each* receive this limit, even if one spouse is providing funding for the other through the Spousal IRA rules.  An additional $1,000 catch-up contribution is available for individuals age 50 and over (as of the end of the tax year). |
| **Multiple IRAs** | Contributions to multiple IRA accounts must be aggregated per taxpayer for purposes of complying with the above limits. In other words, the limit is for all Traditional and Roth accounts combined, not for each one separately. |

Try It!

**Using the tables above, answer the following questions, being sure to read the responses if you answer incorrectly.**

1. **In 2016, a single individual, aged 57, has taxable compensation of $1,500 plus dividends and interest of $30,000. The maximum this individual can contribute for 2016 to an IRA is:**

* $0

**Incorrect**. Try again.

* **$1,500**

**Correct**. The 2016 contribution must be the lesser of $6,500 (the $5,500 limit plus the $1,000 catch-up for persons over 50) or taxable compensation. Since the individual only has $1,500 of taxable compensation, then $1,500 is the maximum the individual can contribute.

* $5,500

**Incorrect**. Try again.

* $6,500

**Incorrect**. Try again.

1. **A married couple, filing a joint income tax return, has Modified Adjusted Gross Income (MAGI) of $85,000 for 2016. His taxable compensation is $84,000. Her taxable compensation is $1,000, which she placed in a Traditional IRA. She also has a Roth IRA. If the wife is 45 years of age, what is the maximum the husband can contribute to the wife’s Roth IRA in 2016?**

* $0

**Incorrect**. Try again.

* **$4,500**

**Correct**. When a married couple files a joint return, the taxable compensation of one spouse can be used to supplement the taxable compensation of the other spouse for the purpose of satisfying the contribution limits. But the contributions for both IRAs must be aggregated. The limit for 2016 is $5,500 and she has already contributed $1,000 to her Traditional IRA, thus the maximum contribution that can be made to her Roth IRA is $4,500.

* $5,500

**Incorrect**. Try again.

1. **A married couple, both aged 55, file separate income tax returns. He has no taxable compensation for 2016 and no modified AGI; she has $28,000 in taxable compensation and $29,000 of modified AGI. What is the maximum that can be contributed to his Traditional IRA?**

* **$0**

**Correct**. They must file a joint return for her taxable compensation to be used in determining the contribution limit to his account. Had they done so, she could have contributed up to $6,500 to his IRA, since he is 55 years of age. But since they filed separately and he has no taxable compensation, no contribution can be made for 2016 into his IRA. Note: She can contribute up to $6,500 into her IRA(s).

* $5,500

**Incorrect**. Try again.

* $6,500

**Incorrect**. Try again.

1. **Professor Moriarity is your client. He is eligible for either a Roth IRA contribution or a deductible Traditional IRA contribution. Which of the following circumstances is LEAST likely to favor a contribution to a Roth IRA?**

* His income tax rates in retirement will be higher than current year rates.

**Incorrect**. Try again.

* His income tax rates in retirement will be lower than current year rates.

**Correct**. Paying relatively high income tax rates now to produce tax-free income at relatively low income tax rates in the future will reduce his after-tax retirement income.

* His income tax rates in retirement will be the same as current year rates.

**Incorrect**. Try again.

## Excess Contributions

An ***excess contribution*** occurs for any year in which IRA contributions exceed the amount allowed. Thus, an excess contribution is an amount that is more than the smaller of:

* Taxable compensation, or
* The maximum annual contribution limit ($5,500 for 2016; $6,500 if age 50 or older).

There is a 6% annual excise tax penalty on excess contributions to an IRA. This penalty can be avoided if the excess contribution and any earnings attributable to the excess contribution are removed by the due date (including extensions) of the tax return for the year of the contribution.

If the excess contribution is not removed by the due date of the tax return (including extensions) for the year of the contribution, then it is subject to a 6% penalty for that year and for EACH successive year in which the excess contribution remains in the IRA.

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| **Excess Contribution Example**  In May 2016, Sue (age 45) contributed $5,500 to her IRA for 2016, but when the year ended, she only had $4,700 in taxable compensation for the year. Her excess contribution for 2016 is $800. Sue filed an automatic extension of time to file her 2016 Form 1040, which authorizes her to file the 2016 income tax return by October 15, 2017.  To correct the excess contribution, she must remove the $800 by October 15, 2017. The IRA deduction on her 2016 income tax return will be $4,700, not $5,500. If Sue fails to make this corrective action timely, she will owe a penalty tax of $48 (6% of $800) for 2016 excess contributions. |

## Premature Withdrawal Penalty

Traditional IRAs represent one of the vehicles intended by Congress as retirement accumulation tools. Hence, taking a taxable withdrawal from a Traditional IRA too early violates Congressional intent and may incur penalty.

How early is too early? A premature withdrawal is a distribution before the IRA owner’s age 59½. Premature withdrawal of taxable income from a Traditional IRA generally exposes the taxable portion of the withdrawal to a 10% penalty. This 10% penalty is in addition to any income taxes on the amount of taxable income withdrawn.

But what does your client do when they need liquidity? Here are just a few penalty-free ideas to consider.

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| **Alternatives to Taxable Traditional IRA Withdrawals Before Age 59½**   * Home equity line of credit * Loan from an employer-sponsored qualified plan such as a 401(k) Plan * Securities-based loan such as a brokerage account loan * Borrow from the cash value of a life insurance contract, subject to cautions.  |  |  | | --- | --- | | Cautions When Borrowing From Life Insurance Cash Value   * Extreme caution is warranted to avoid collapsing the policy through excessive borrowing. * The life insurance company will charge interest. * If the life insurance company does not require repayment of the loan and interest, the loan amount plus accumulated interest will reduce the death benefit paid to the client’s beneficiaries. * Generally, loans are income tax-free up to the total cash value. * A life insurance professional, CPA, or CFP® practitioner should be consulted before any loans are taken against the cash value of a life insurance policy.  |  | | --- | | ***Compliance Alert***  ***Only licensed professionals may sell life insurance products. Check with your compliance department before discussing life insurance issues with clients to avoid compliance issues!*** | |  * Withdrawal of amount contributed to a Roth IRA  |  | | --- | | Amount Contributed to a Roth IRA  A client’s original contributions to a Roth IRA may generally be withdrawn without tax at any time. The reason is simple - the client did not receive an income tax deduction for the contribution and any withdrawal of contributions is an income tax-free return of contributions. Be aware that withdrawal of any Roth IRA funds contributed from conversion of Traditional IRA to a Roth IRA may not be made for at least 5 years after the conversion. Withdrawal of converted funds before the expiration of 5 years will generally result in a 10% penalty. | |

If there are no other sources of liquidity for your client’s urgent need, there may be no alternative to a premature withdrawal from an IRA. However, careful planning may reduce or eliminate the 10% premature withdrawal penalty. The specific situations where an owner can make penalty-free withdrawals prior to age 59½ are listed below.

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| **Penalty-Free IRA Withdrawals Before Age 59½**   * Death * Disability *(the disability must be total and permanent or expected to result in death)* * A series of substantially equal periodic payments made over the owner’s lifetime * To the extent of unreimbursed medical expenses that exceed 10% of AGI * 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 |

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| Substantially equal periodic payments  By setting up a specific type of periodic payment based on the IRA owner's life expectancy (or joint life expectancy) that lasts for the *longer of 5 years or to age 59½*, it becomes possible for individuals to begin drawing upon their IRA without IRS penalty before reaching age 59½. These are sometimes referred to as ***72(t) payments***, named for the section of the Internal Revenue Code that permits this form of penalty-free payout. **Click** here **for examples.**   |  | | --- | | **Example 1**  Brian is age 50. He wishes to begin taking distributions from his Traditional IRA based upon his life expectancy. He will avoid the 10% premature distribution penalty if he continues taking substantially equal periodic payments until at least his age 59½.  **Example 2**  Allison is age 56. She wishes to begin taking distributions from her Traditional IRA based upon her life expectancy. She will avoid the 10% premature distribution penalty if she continues taking substantially equal periodic payments until at least her age 61. | |

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| First-time home purchase  A purchaser is considered a “first-time” homebuyer if the purchaser has not owned a home in the past two years. If married, both spouses must meet this requirement and each can take a penalty-free withdrawal for this purpose from their IRAs (up to a $10,000 lifetime maximum). Note that the withdrawal can be used to pay qualified acquisition costs for a first-time home purchaser who is the IRA owner, the spouse, the owner or spouse’s child, the owner or spouse’s grandchild, or the owner or spouse’s parent or other ancestor. |

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| Qualified Education Expenses  Qualified higher education expenses include tuition, fees, books, supplies, required equipment, and certain special needs services. If the student is enrolled at least half time, then room and board are also qualified expenses. |

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| Eligible Family Members  Eligible family members include the spouse, children, and grandchildren of the owner, or the children or grandchildren of the owner’s spouse. |

## Prohibited IRA Investments and Transactions

### Prohibited IRA Investments

IRA funds can be invested in a wide range of investments with the following exceptions:

* ***Generally,*** ***collectibles are NOT permissible investments***. Collectibles include items purchased as an investment, such as art, rugs, antiques, gems, stamps, and rare coins.

However, gold, silver, or platinum coins minted by the U.S. government or political subdivision thereof may be purchased by an IRA if purchased directly from the government. Please note that precious metal bullion is not considered a “collectible” and is an acceptable IRA investment.

* ***Life insurance may NOT be held in an IRA.***

### Prohibited Transactions

Certain transactions in an IRA are prohibited. If an IRA owner or beneficiary engages in a prohibited transaction, then immediate income taxation and potential premature distribution penalty will result. Examples of ***prohibited transactions*** include the following transactions between the IRA owner and the IRA:

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| * Borrowing money from the IRA * Selling property to the IRA * Receiving unreasonable compensation for managing the IRA * Using the IRA as security for a loan * Buying property for personal use with IRA funds |

## Review Exercise

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

1. **Which of the following statements is true?**

* Participation in a Traditional IRA is prohibited if modified AGI is above certain limits.

**Incorrect**. Participation is not prohibited by a person’s level of modified AGI, although the deductibility of the contribution might be phased out at certain modified AGI levels IF the person is also a participant in an employer-sponsored plan. Try again.

* The tax deductibility of contributions to a Traditional IRA is phased out if modified AGI exceeds certain limits.

**Incorrect**. The tax deductibility of contributions is contingent on two factors: modified AGI and whether an individual and/or the spouse is also a participant in an employer-sponsored plan. Try again.

* An employee is prohibited from participating in a Roth IRA if the employee also participates in an employer-sponsored plan.

**Incorrect**. Participation in an employer-sponsored plan does not prohibit individuals from participation in a Roth IRA. Try again.

* **Neither level of modified AGI nor participation in an employer-sponsored plan can prohibit an individual with earned income from making a contribution to a Traditional IRA.**

**Correct**. Anyone with taxable compensation can make a contribution to an IRA, although these factors may have bearing on the deductibility of the contribution.

1. **Generally speaking, an individual must be under age 70½ to make a contribution to a Roth IRA.**

* True

**Incorrect**. This is only true for the Traditional IRA.

* **False**

**Correct**. This is only true for the Traditional IRA.

1. **For 2016, the maximum contribution an individual aged 58 can make into a Traditional or Roth IRA is:**

* $2,500

**Incorrect**. Try again.

* $5,500

**Incorrect**. Try again.

* **$6,500**

**Correct**. For individuals aged 50 or over, the maximum contribution is $5,500 plus the catch-up contribution of $1,000.

* $7,500

**Incorrect**. Try again.

1. **Julie is trying to determine if she is eligible to make an IRA contribution, but she is not sure which sources of her income are considered “taxable compensation.” She gives you a list of her income sources for the current year and you point out which one is NOT “taxable compensation” for purposes of qualifying for an IRA. It is:**

* Salary from employment of $30,000.

**Incorrect**. Salary is taxable compensation. Try again.

* Alimony of $12,000 from her ex-husband

**Incorrect**. Alimony is considered taxable compensation. Try again.

* **$3,500 of interest from municipal bonds.**

**Correct**. Earnings and profits from property are not taxable compensation.

1. **Jack and Jackie are married and file jointly. Both are 35. They will jointly receive $98,000 this year (2016) in dividends and interest from investments. Jackie has started an interior design business and will have a net profit of $2,500. Jack does a little consulting and will have a net profit of $6,500. Jack wants to put the maximum contribution into a Roth IRA for Jackie and whatever else he can contribute into a Roth for himself. What would the two contributions be for 2016?**

* $4,500 to Jackie’s IRA, $4,500 to Jack’s IRA

**Incorrect**. Try again.

* $2,500 to Jackie’s IRA, $5,500 to Jack’s IRA

**Incorrect**. Try again.

* **$5,500 to Jackie’s IRA, $3,500 to Jack’s IRA**

**Correct**. Jackie qualifies for a $2,500 contribution based on her income, but Jack can make a spousal contribution of $3,000 to Jackie’s IRA. Jack has $6,500 of taxable compensation, but he “used up” $3,000 of it to fund Jackie’s IRA. Thus, Jack can contribute a maximum of $3,500 to his IRA.

* $2,500 to Jackie’s IRA, $6,500 to Jack’s IRA

**Incorrect**. Try again.

## How Much of a Traditional IRA Contribution is Deductible?

Contributions to a Traditional IRA are generally, but not always, deductible on an individual’s income tax return. The tax deductibility of those contributions is phased out if the individual meets ***two*** conditions:

1. The individual is an active participant in an employer-sponsored retirement plan

|  |
| --- |
| Employer-Sponsored Retirement Plan  This category includes all of the qualified plans - SEP IRAs, SIMPLE IRAs, and 403(b) Plans. We will analyze these plans subsequently in this course. |

**AND**

2. The individual’s Modified Adjusted Gross Income (MAGI) exceeds specified phase-out limits (described on the next page).

|  |  |  |
| --- | --- | --- |
| Modified Adjusted Gross Income  ***Modified Adjusted Gross Income*** is simply gross income reported on the income tax return less certain deductions plus certain adjustments.   |  | | --- | | Certain Deductions  Examples of deductions from gross income to arrive at adjusted gross income follow (this is not a complete list of deductions):   * Health Savings Account (HSA) deductions * Self-employed health insurance deduction, a portion of self-employment taxes paid, and contributions to self-employment retirement plans * Alimony paid (but not child support or settlement) * Deductible contributions to a Traditional IRA * Student loan interest paid on a qualified student loan for yourself, your spouse or your dependent |  |  | | --- | | Certain Adjustments  Examples of adjustments to AGI to determine MAGI include the following (this is not a complete list of adjustments).   * Deduction claimed for a regular deductible contribution to a Traditional IRA * Deduction claimed for student loan interest * Foreign source income excluded from U.S. income taxation * Deduction claimed for Health Savings Account (HSA) contributions | |

Many of your clients will participate in an employer-sponsored retirement plan. You need to understand when they can and cannot deduct contributions to a Traditional IRA. Why? If they cannot deduct their Traditional IRA contribution, a Roth IRA may be a better financial choice! For those reasons, the following detailed review is presented.

The phase-out begins and ends with the following amounts of modified AGI, depending upon the filing status and whether or not both spouses actively participate in an employer-sponsored plan (remember, if a single taxpayer or both spouses (Married Filing Jointly) are NOT participants in an employer-sponsored plan, they can deduct their Traditional IRA contributions regardless of how high their income might be): **Click on the 2016 Single or HOH Filer number in chart to learn more.**

**Traditional IRA Modified AGI Phase-Out of Deductibility**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **All Parties in Employer-Sponsored Plan** | | | **Only One Spouse in Employer-Sponsored Plan** | | |
| **Year** | **Single or HOH Filer** | **Married: Filing Jointly** | **Married: Filing Separately** | **Participating Spouse Filing Jointly** | **Non-Participating Spouse Filing Jointly** | **Either Spouse Filing Separately** |
| 2016 | $61,000-$71,000 | $98,000-$118,000 | $0-$10,000 | $98,000-$118,000 | $184,000-$194,000 | $0-$10,000 |
| 2015 | $61,000-$71,000 | $98,000-$118,000 | $0-$10,000 | $98,000-$118,000 | $183,000-$193,000 | $0-$10,000 |

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| **Single - $61,000-$71,000 (2016)**  As an example, a single, 34-year-old client is an active participant in an employer-sponsored plan. If, in 2016, this person makes a $2,000 contribution to their IRA, then:   * With modified AGI of $45,000, the $2,000 contribution would be fully deductible. * With modified AGI of $67,000, the $2,000 contribution would generate an $800 deduction calculated as follows.  |  | | --- | | To the extent a client’s modified AGI encroaches into the phase-out range, a corresponding percentage of the deduction is lost.  The phase-out range of $10,000 occurs from $61,000 to $71,000 (2016).  The client has a modified AGI of $67,000, which encroaches into the phase-out range by $6,000.   * $6,000/$10,000 = 60% encroachment into the phase-out range * Therefore, 60% of the deductibility is lost. * Consequently, only 40% of the $2,000 contribution is deductible. |  * With modified AGI of $85,000, the $2,000 contribution would not be deductible at all. |

****Try It****

**Using the tables above, answer the following questions, being sure to read the responses if you answer incorrectly.**

1. **A married couple, filing jointly, has modified AGI of $88,000 for 2016. Both are active participants in an employer-sponsored plan. The wife makes a $5,500 contribution to her Traditional IRA. How much of her contribution is deductible?**

* **$5,500**

**Correct**. The phase-out for this situation takes place when modified AGI is between $98,000 and $118,000 (2016). Since their modified AGI is $88,000, her contributions are fully deductible.

* $3,300

**Incorrect**. Try again.

* $0

**Incorrect**. Try again.

1. **In the preceding example, suppose their 2016 modified AGI is $100,000. In this case, she may deduct how much of her contribution?**

* $5,500

**Incorrect**. Try again.

* **$4,950**

**Correct**. The phase-out range is $20,000. Their AGI encroaches into the phase-out range by $2,000 in 2016, which is 10% of the range. She loses deductibility for 10% of the contribution and may deduct 90% of the contribution.

* $550

**Incorrect**. Try again.

1. **Your client Kayla, age 39, is a professional real estate developer with average earnings of $800,000 annually. She is self-employed and is not an active participant in an employer-sponsored retirement plan. How much can she contribute to a Traditional IRA for 2016 and how much can she deduct?**

* $0 contribution and $0 deduction

**Incorrect**. Try again.

* $5,500 contribution and $0 deduction

**Incorrect**. Try again.

* **$5,500 contribution and $5,500 deduction**

**Correct**. High earnings do not limit the contribution to a Traditional IRA. Because she is not an active participant in an employer-sponsored retirement plan, she may deduct the entire contribution.

## How Does Modified AGI Limit the Roth IRA Contribution?

A contribution to a Traditional IRA is always permitted for an individual meeting the age and taxable compensation requirements, but the deductibility of the contribution is subject to the “active participant” and “modified AGI phase-out” restrictions.

Roth IRAs are different. Even for clients meeting the taxable compensation requirement (there is no age requirement), the ability to make a Roth IRA contribution may be reduced or eliminated based upon modified AGI. The phase-out ranges are summarized in the table below.

|  |  |  |  |
| --- | --- | --- | --- |
| **Modified AGI Phase-Out of Eligibility to Contribute to a Roth IRA (2016)\*** | | | |
| **2016 Roth IRA Contribution Eligibility** | **Single Filers** | **Joint Filers** | **Married Filing Separately** |
| 100% | Less than $117,000 | Less than $184,000 | $0 |
| 1% - 99% | $117,000 - $132,000 | $184,000 - $194,000 | $0 - $10,000 |
| 0% | Greater than $132,000 | Greater than $194,000 | Greater than $10,000 |

*\* Indexed for inflation in $1,000 increments*

If modified AGI falls below the bottom of the phase-out range, then the full Roth IRA contribution is authorized. If modified AGI exceeds the top of the phase-out range, then no contribution to a Roth IRA is possible.

Now let us equip you to answer the client question “How much can I contribute if I make more than the minimum but less than the maximum?” Clients with modified AGI within the phase-out ranges are allowed only partial Roth IRA contributions. To the extent a client’s modified AGI encroaches into the phase-out range, a corresponding percentage of eligibility is lost. **Click** here **for an example.**

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| **Example**  Charlene is age 40, files as a single taxpayer and has a modified AGI of $120,750 in 2016.  The phase-out for her filing status is $15,000 “wide,” spanning a range from $117,000 through 132,000 (2016). Charlene’s modified AGI exceeds the bottom of the phase-out range by $3,750 ($120,750 – $117,000). Hence, her modified AGI has encroached into the phase-out range by $3,750. In percentage terms, the encroachment is $3,750/$15,000, or 25%.  Because her modified AGI encroaches 25% into the phase-out range, she must reduce her contribution by 25%. The maximum Roth IRA contribution for an individual younger than age 50 in 2016 is $5,500. In Charlene’s case, we must reduce her maximum contribution by 25%, which results in a 2016 maximum Roth IRA contribution of $4,125 (75% of $5,500). |

test_tip_icon **Planning Tip**

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| There are two potential solutions if your client makes too much money to contribute to a Roth IRA - Designated Roth Accounts and the Backdoor Roth IRA.   |  | | --- | | Designated Roth Accounts  **Deferrals into a Designated Roth account (DRA) in a 401(k), 403(b), or 457(b) Plan are NOT subject to the adjusted gross income phase-out rules. Just as every sword has two edges, this option slices to your client’s advantage and disadvantage as well. There is no required beginning date for distributions from a Roth IRA; however, there is a required beginning date from DRAs in 401(k), 403(b), and 457(b) Plans.** |  |  | | --- | | Backdoor Roth IRA  Here is how to take advantage of the rules that allow conversion of a Traditional IRA to a Roth IRA. Your client simply makes a regular contribution to a Traditional IRA. Next, he or she immediately converts the Traditional IRA to a Roth IRA. Voila! Your client now has a Roth IRA. This strategy is not for all clients. Unwanted income taxes will result if your client has other Traditional, SEP, or SIMPLE IRAs. Be sure to involve your client’s CPA, CFP® professional, tax attorney, or other tax professional before this strategy is recommended. | |

## Review Exercise

1. **A single, 30-year-old, unemployed individual has $60,000 of investment income in 2016. The most this person can contribute to a Roth IRA account in 2016 is:**

* **$0**

**Correct**. Remember that a requirement to make a contribution to an IRA is that the owner must have taxable compensation. Since this individual is unemployed and has no taxable compensation, no contribution can be made.

* A partial contribution under $5,500

**Incorrect**. Try again.

* $5,500

**Incorrect**. Try again.

1. **A married couple, both in their 30’s, file a joint return in 2016 and have a modified AGI (MAGI)of $225,000. Husband’s MAGI is $200,000 while wife’s MAGI is $5,000. The husband participates in an employer-sponsored plan; the wife does not. Each has a Roth IRA. Can either of them make a contribution for 2016 to their Roth IRA?**

* Both can make a contribution.

**Incorrect**. Try again.

* The husband can make a contribution, but the wife cannot.

**Incorrect**. Try again.

* The wife can make a contribution, but the husband cannot.

**Incorrect**. Try again.

* **Neither can make a contribution.**

**Correct**. First of all, ignore their participation in an employer-sponsored plan. That only has relevance if we are looking at the deductibility of contributions to a Traditional IRA, not eligibility for making contributions to a Roth IRA.

Second, since their modified AGI is over the phase-out maximum, neither can make a Roth IRA contribution.

1. **Using the figures of the preceding question, can they make contributions to a Roth IRA if they file separate tax returns?**

* Both can make a contribution.

**Incorrect**. Try again.

* The husband can make a contribution, but the wife cannot.

**Incorrect**. Try again.

* **The wife can make a contribution, but the husband cannot.**

**Correct**. The husband cannot make a contribution since his modified AGI is over $10,000; but the wife can make a partial contribution since her modified AGI is less than $10,000.

* Neither can make a contribution.

**Incorrect**. Try again.

## Rollovers and Direct Transfers

### Rollovers

The term “IRA Rollover” describes the process by which an individual receives a distribution from his or her IRA and then rolls over or re-deposits the total amount of the distribution into a different IRA (or qualified plan) within 60 days. A rollover occurs whenever the individual has complete control over the funds for a period of time. A rollover completed within 60 days is considered a timely rollover. Timely rollovers do not result in penalty or income tax. Effective for 2016, only one IRA rollover per taxpayer per year is permitted with certain exceptions.

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| **Exceptions to One Rollover Per Year Rule**  An unlimited number of trustee-to-trustee IRA transfers and Traditional IRA to Roth IRA conversions is permitted. Trustee-to-trustee transfers are not technically rollovers. Traditional IRA conversion to a Roth IRA results in taxable income in the conversion year and hence, additional tax dollars paid to the IRS. |

Rollovers are not limited to only IRA-to-IRA rollovers. Certain qualified plan accounts can roll over into an IRA and certain IRAs may generally be rolled over into a qualified plan - these rollovers are not subject to the one rollover per taxpayer per year rule.

There will generally be no income tax consequence resulting from a rollover as long as pretax funds are rolled over timely into pretax accounts or Roth funds are rolled over timely into Roth accounts. The chart below illustrates selected income tax-free rollover opportunities between IRAs and qualified plans.

A complete list of permitted rollovers is available from the IRS at the following link: http://www.irs.gov/pub/irs-tege/rollover\_chart.pdf

|  |  |  |  |
| --- | --- | --- | --- |
| **Income Tax-Free Rollovers and Direct Transfers**  **Rollovers Assumed Completed Within 60 days** | | | |
| **From** | **To** | **Income Tax Consequence of Timely Rollover** | **Notes** |
| Designated Roth Account (DRA) | Roth IRA | None | DRAs are found in 401(k) Plans, 403(b) Plans, and 457(b) Plans. |
| Traditional IRA | Pretax Qualified Plan Account (non-DRA) | None |  |
| Pretax Qualified Plan Account (non-DRA) | Traditional IRA | None |  |

Rollovers may be subject to withholding taxes. Rollovers from an IRA are technically subject to a 10% withholding; however, the IRA owner may elect out of withholding. In contrast, rollovers from a qualified plan are subject to a mandatory 20% withholding. This is a trap for the unwary! Your client must re-deposit 100% of the rollover funds within 60 days to avoid penalty. **Click** here **for an example.**

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| **20% Withholding Trap Example**  Robert “Hasty” Smith is your client. Hasty executed a withdrawal from his qualified plan of $100,000 and the plan administrator withheld a mandatory $20,000 for estimated income taxes. Hasty received an $80,000 check payable to “Robert Smith.”  Hasty must deposit $100,000 into his IRA within 60 days to avoid penalty. However, let us assume that he only deposited $80,000 into his IRA within the 60-day window. Hasty must pay a $2,000 penalty (10% of $20,000) because his rollover was $20,000 short.  What happens when he files his income tax return? The $20,000 withheld from his qualified plan distribution will be counted as a payment of his income taxes and may result in a refund. The $2,000 penalty is neither deductible nor refundable. |

test_tip_icon **Planning Tip**

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| Avoid this 20% withholding trap by avoiding rollovers. Funds should be transferred using the “direct transfers” approach discussed below. |

### Direct Transfers

In stark contrast to the rollover, the qualified plan participant or IRA owner never has control of a direct transfer. Literally, the funds are transferred directly from one custodian or trustee to another custodian or trustee. The IRA owner or qualified plan participant is not permitted to control or access the funds at any time during the transfer.

Direct transfers may also be referred to as “direct trustee-to-trustee” transfers or “direct custodian-to-custodian” transfers. Unlike rollovers, there is no income tax withheld in a direct transfer from a qualified plan and there is no IRS limit to the number of direct transfers a client may execute per year. No income tax is due as a result of a direct transfer.

## Conversion/Rollover to a Roth IRA

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| **Video Script** | |
| **Script** | **On Screen Text** |
| When is it a good idea to convert a Traditional IRA or qualified plan account to a Roth IRA?  Conventional wisdom tells us it’s predominantly a question of income tax rates. If income tax rates will be higher in the future than they are today, then your client probably should strongly consider conversion. However, if future income tax rates are forecast much lower than todays rates then conversion may not be appropriate.  We respectfully suggest that the wisest decision requires a more sophisticated analysis. As you consider the ideas presented in this discussion, you may find that conventional wisdom isn’t wrong - it’s merely incomplete!  For example, consider your own situation if you will. Clearly, you would pay income tax on any previously untaxed amounts at conversion. But, how will conversion income affect other tax issues in the conversion year? Will your adjusted gross income rise so high that you’ll have to pay higher marginally income tax rates, pay other taxes or lose valuable income tax deductions and credits. This discussion will help you frame the conversion dialog with your files. | **When to Convert to a Roth IRA?**  **Conventional Wisdom – it is all about the tax rates**  **Wisest decision – requires a more sophisticated analysis**  **Consider Your Own Situation**   * **Will conversion income cause other tax issues or cause the loss of deductions or credits?** |

This is one of the major decisions that clients routinely face and merits a closer examination. We will approach this decision as any other financial decision - by comparing benefits and costs. Specifically, our discussion will begin with an overview followed by an analysis of significant factors in the conversion decision.

* Overview
* Benefits of conversion
* Costs of conversion
* Life expectancy
* Beneficiary designation

### Overview

Your client may convert account balances from a broad range of account types to a Roth IRA. The conversion results in inclusion of any untaxed amounts into income.

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| Broad Range of Account Types  The following account types are generally eligible for conversion into a Roth IRA:   * Designated Roth Accounts in 401(k), Roth 403(b), and Roth 457(b) Plans * Traditional IRAs * SEP IRAs and SIMPLE IRAs (subject to the two-year rule) * Non-Roth Accounts in Qualified Plans and 403(b) Plans  |  | | --- | | Two-Year Rule  SIMPLE IRAs may not be converted, transferred, or rolled into a Traditional IRA, Roth IRA, or SEP IRA during the first two years of the SIMPLE IRA. The two-year period begins with the first employer contribution to the employee’s SIMPLE IRA. The two-year rule prevents circumvention of the 25% SIMPLE IRA premature distribution penalty. If conversions of a SIMPLE IRA were allowed during the first two years, taxpayers would merely convert to other accounts in which the premature distribution penalty is only 10%. | |

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| Untaxed Amounts  In converting pretax funds to a Roth IRA, the owner is essentially making a withdrawal from the prior account, usually an early withdrawal (premature distribution). This would normally result in a 10% penalty to the extent of the taxable portion of the converted funds. However, no penalty is due if the owner meets the requirements in the tax year of the transfer.   |  | | --- | | Requirements   1. The conversion is a direct trustee-to-trustee transfer, or 2. If a rollover, the rollover is completed within 60 days.   An unlimited number of trustee-to-trustee transfers are allowed per year. Only one rollover per year is permitted. | |

This is how untaxed amounts are included in income for the year of conversion.

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| **Taxation of Rollovers/Conversions into a Roth IRA**  ***Taxable Portion includes:***   * Deductible (or pre-tax) contributions * Earnings on both deductible and nondeductible contributions   ***Nontaxable Portion***  The nontaxable portion consists of:   * Nondeductible (or after-tax) contributions made to the Traditional IRA |

**Click** here **for examples of Roth IRA conversions.**

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| **Roth IRA Conversion Examples**  **Example 1 – Conversion from a Qualified Plan**  Your client George (45 years of age) just accepted a position with a new employer. George has $500,000 in his previous employer’s 401(k) Plan. George made no after-tax contributions to the 401(k) Plan. He is in your office and asks if he should roll the $500,000 into a Roth IRA. His current income tax rate is 25%. If he converts to a Roth IRA, the additional income tax payable due to the conversion will be $137,000.  **Example 2 – Conversion from a Nondeductible Traditional IRA**  Your client George (45 years of age) owns a Nondeductible Traditional IRA with an account balance of $500,000. He contributed $120,000 in after-tax dollars to the IRA. The amount taxable at conversion is $380,000. The income tax payable due to the conversion will be 25% of $380,000, or $95,000.  Noteworthy - Had George also owned deductible IRA accounts in Example 2, the calculation would have been more complex and George would not have been able to exclude the full $120,000 in after-tax contributions from taxation at the conversion. |

### Benefits of Conversion

The promise of a tax-free income stream is usually the first and primary driver behind conversion of pretax qualified plan or Traditional IRA accounts to a Roth IRA. Clients expecting to pay higher income tax rates in retirement may benefit from conversion. However, as we will demonstrate subsequently, even clients expecting income tax rates to remain the same or drop slightly may also benefit from conversion.

The flexibility to take or avoid Roth IRA distributions during retirement is a second powerful benefit.

A third set of benefits includes the potential reduction of other costs, such as income tax on Social Security retirement benefits, minimization of the 3.8% Net Investment Income tax, and reduction of certain Medicare premiums. We will provide additional detail on these opportunities later in this course in “ Lowering AGI is a Good Thing - Roth IRA Unique Planning Opportunities.”

### Costs of Conversion

Income tax must be paid on any untaxed amounts for the year of conversion. However, the true tax cost may exceed merely the income tax payable on converted amounts. Because conversion may dramatically increase your client’s adjusted gross income in the conversion year, your client’s marginal tax rate may increase.

If that were not enough, the increase to adjusted gross income may cause the reduction or loss of itemized deductions and exemptions under the phase-out rules governing those deductions. Your client may also lose eligibility for education credits and student loan interest deductions. The moral of the story is that the income tax on the converted untaxed income may be just a part of the total tax cost!

test_tip_icon **Planning Tip #1**

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| Conversion may be a multi-year process rather than a single year event. Spreading the conversion over a number of years may save significant income taxes by avoiding increases to your client’s marginal income tax rate.   |  | | --- | | **Example**  Dennis wishes to convert his Traditional Deductible IRA to a Roth IRA. Assume Dennis files married filing jointly and has taxable income of $120,000. His marginal income tax rate is 25%. Further assume that his marginal income tax rate will increase to 28% when taxable income exceeds $150,000. Dennis could convert $30,000 without paying a higher income tax rate on converted funds. | |

test_tip_icon **Planning Tip #2**

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| If your client experiences a poor earnings year, then consider using the lower marginal tax rates in that year to save income taxes on conversion. For example, if your client’s average tax rate is 33% but that rate falls to 25% in the current year, then a $50,000 conversion would cost $4,000 less in income taxes. That savings is calculated as conversion income of $50,000 multiplied by the decreased tax rate of 8% (33% less 25%). |

### Life Expectancy

Longer life expectancy means collecting more tax-free Roth IRA income in retirement. Assuming that your client’s income tax rate is higher or approximately the same in retirement than in the conversion year, longer life expectancies provide greater after-tax income streams than shorter life expectancies.

But that is not the whole story. If we broaden our perspective from your client to include your client’s heirs, then a slightly different picture may emerge. **Click** here **for an example.**

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| **Example**  Your client Marilyn, age 55, is a late-career professional in excellent health. She plans to retire at age 66. Marilyn converted her deductible Traditional IRA to a Roth IRA earlier this year. She expected to be in a higher income tax bracket in retirement and further expected to outlive her statistical life expectancy of 84 years.  Regrettably, she was killed last week after an inexperienced bungee jump technician dialed in the wrong setting on her bungee cord. In retrospect, did her untimely death make the decision to convert a poor financial decision? That depends entirely upon the income tax rates of her beneficiaries!  If her beneficiaries are in a higher income tax bracket than Marilyn, then the conversion decision remains an effective financial decision. However, conversion was not an effective financial decision if her beneficiaries are in a significantly lower income tax bracket. In that case, Marilyn will have paid a relative high income tax rate to provide income tax-free distributions to beneficiaries in relatively low income tax brackets. |

### Beneficiary Designation

Beneficiary designations are not the primary driver for the conversion decision for most clients. However, just as your client’s income tax rates impact the conversion decision, beneficiary income tax rates should be considered as well.

For example, if the beneficiary is a tax-exempt charity, the charity will receive fewer dollars after conversion to a Roth IRA than before conversion. This assumes that conversion-related income taxes were paid with Traditional IRA funds.

What if the beneficiary is a loved one, such as child or grandchild? In this case, the higher the beneficiary’s income tax rate, the more beneficial the inherited Roth IRA will be.

### Comparing Benefits and Costs

Your internal resources and your client’s CPA or CFP® professional should be consulted for your client’s specific needs and financial profile. An online calculator[[4]](#footnote-4) may also give general guidance in balancing costs and benefits.

## Life Happens – Accessing Cash or Reversing the Conversion to a Roth IRA

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| *“The best laid plans of mice and men often go astray.”*  - Paraphrased from Robert Burns’ poem *To A Mouse* |

Your client may have at least two more concerns even after a thorough analysis points toward the conversion of a Traditional IRA (or employer-sponsored retirement plan balance) to a Roth IRA. Although these concerns may not be articulated, your client may wonder, “What if I need cash for an emergency?” or “What if I change my mind after I pull the trigger on conversion?” You may be able to address those concerns using the following insights.

### What If I Need Cash for an Emergency?

Withdrawal of contributions from a Roth IRA are income tax-free. Income tax was paid at conversion and hence income tax on the converted funds will never be paid again. The key is to avoid penalty from those withdrawals. Converted funds may be withdrawn without penalty if the withdrawal is made AFTER five years from conversion. **Click** here **to learn more.**

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| Withdrawal of Converted Funds From a Roth IRA  There is an order of withdrawal from Roth IRAs that generally requires original Roth IRA contributions be withdrawn first (penalty-free). Next in the sequence, converted Roth IRA contributions are withdrawn (penalty-free if taken five years after conversion). Finally, after all original and converted contributions are withdrawn, earnings are withdrawn. Please refer to our previous discussion of Roth IRAs in this course for a reminder of when earnings may be withdrawn without income tax or penalty. |

### What if I Change My Mind?

It is possible to reverse the conversion in a process the IRS describes as “recharacterization.” The IRS defines recharacterization as a process that “allows you to ‘undo’ or ‘reverse’ a conversion to a Roth IRA.”

However, the clock is ticking! Recharacterization of a conversion must be made no later than October 15 of the following year. **Click** here **for an example.**  Noteworthy: A special restriction applies to recharacterization of employer-sponsored retirement plan conversions.

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| **Example**  Your client, Mr. Lestrade, converted a Traditional IRA to a Roth IRA on January 1, Year 1. If Mr. Lestrade changes his mind and wishes to reverse the conversion, he must do so by October 15, Year 2. Noteworthy: The October 15 deadline applies even if Mr. Lestrade does not file the automatic six-month extension of time to file his income tax return. |

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| Special Restriction – Recharacterization of Employer-Sponsored Retirement Plan to Roth IRA Conversion  If the conversion was funded from an employer-sponsored retirement plan, recharacterization is permitted. However the recharacterized funds may only transfer from the Roth IRA to a Traditional IRA - the funds cannot transfer back to the employer-sponsored retirement plan. |

## Review Exercise

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

1. **To rollover assets in 2016 without penalty from a Traditional IRA to a Roth IRA, the owner's modified AGI must not be over:**

* $100,000

**Incorrect**. Try again.

* $120,000

**Incorrect**. Try again.

* $150,000

**Incorrect**. Try again.

* **No limit**

**Correct**!

1. **In Year 1, Margaret converted her nondeductible Traditional IRA with a balance of $25,000 to a Roth IRA. She owned no other IRAs before the conversion. Of the converted funds, $7,500 consisted of non-deductible contributions, thus $7,500 of the conversion amount was not taxed at conversion. The remaining $17,500 was taxed at conversion. Later in Year 1, she made an additional contribution of $4,000 to the Roth and also contributed $4,000 in Year 2. In Year 3, at age 58, she withdraws $35,000 from the Roth to make an investment in a ski resort in Colorado. Which of the following statements regarding the tax results of this $35,000 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, $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 has withdrawn 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**!

## Should Your Client Contribute to a Roth IRA?

How will you respond when your prospective client asks, “Should I contribute to a Roth IRA?” Join us as we equip you for a clear and crisp response. The best fit for a Roth IRA contribution is a client placing a high value upon the following.

**Click on each scenario to learn more.**

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| **Tax-Free Income In Retirement** |
| The Roth IRA provides more after-tax income than the Traditional IRA when future income tax rates are significantly higher than current income tax rates. That would, of course, mean that taxable income actually rises in retirement. In this happy circumstance, your client gives up the income tax deduction for contributions at a relatively low income tax rate in exchange for tax-free income during retirement at a relatively high income tax rate.  That retirement outcome may be uncommon in reality so let’s examine a more likely scenario. Assume that income tax rates are moderately lower in retirement - the Roth IRA should still be considered!   |  | | --- | | **Example**  Your client Gertrude Greenbax is 35 years of age, has an adjusted gross income of $100,000, plans to retire at age 67, and wishes to contribute $5,500 annually to an IRA. Her current income tax rate is 25% and her income tax rate in retirement will be 15%.  Should she contribute annually to a deductible Traditional IRA or Roth IRA? She would accumulate just under $649,000 by retirement age if she chose the Roth IRA, while she would accumulate just over $651,000 in a deductible Traditional IRA (after accounting for income taxes). These results are based upon the referenced online calculator.  <http://www.bankrate.com/calculators/retirement/roth-traditional-ira-calculator.aspx> |   In the foregoing example, there was little difference in tax-adjusted account balances at age 67. Yet, no one’s money is safe when Congress is in session! Even a lackluster case for the Roth IRA begins to shine if Congress raises income tax rates. Regrettably, the reverse is also true. The income tax benefits of the Roth IRA may be lost or reduced if Congress significantly lowers income tax rates.  Here’s the bottom line: Use your internal resources or compliance-approved online calculators to run the numbers before automatically recommending a deductible Traditional IRA. |
| **Avoid Required Minimum Distributions in Retirement** |
| The Roth IRA is unique in that no distributions are required during the original owner’s lifetime. The reason is quite simple. The IRS collects no income tax when Roth IRA distributions are made. Virtually all other tax-deferred retirement vehicles, including qualified plans, are subject to required minimum distributions during the owner’s lifetime. |
| **Contribute Past Age 70½** |
| This benefit appeals to clients who choose to work in retirement and wish to continue saving on a tax-efficient basis. Unlike Traditional IRAs, contributions to Roth IRAs may be made at any age, even if past age 70½, as long as the individual has earned income. |
| **Leave an Income Tax-Free Legacy** |
| What better inheritance than income tax-free distributions for your loved ones? Roth IRA distributions remain income tax-free when taken by beneficiaries. A married client, at the death of the first spouse, can build an even larger income tax-free legacy for children or grandchildren.   |  | | --- | | Larger Income Tax-Free Legacy  As a little known insight, the owner of a Roth IRA may name her spouse as beneficiary and, at her death, her surviving spouse may rollover her Roth into an inherited Roth IRA for himself. The surviving spouse may choose to become the new owner or be treated as a beneficiary. This strategy requires that he becomes the new owner.  He is not required to take required minimum distributions during his lifetime. This is an opportunity to build an even larger income tax-free legacy for the couple’s loved ones, such as children or grandchildren. | |

To this impressive list of Roth IRA benefits, we will add more powerful savings opportunities on the following page.

## Lowering AGI is a Good Thing - Roth IRA Unique Planning Opportunities

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| **Video Script** | |
| **Script** | **On Screen Text** |
| [first - on screen text appears]  We disclosed earlier in our introduction to tax efficient savings strategies that as much as $5,000 could be found laying on the sidewalk through the appropriate use of creative tax strategies.  [1st bullet point appears] Here’s the real story behind what we are about to share that will support that $5,000. Roth IRA distributions reduce your adjusted gross income when compared to taxable IRA distributions. A lower gross income is an opportunity to save significant money in ways not commonly understood even by experienced advisors. We will share just three such opportunities beginning right now.  Your clients probably understand that the Roth IRA provides income tax-free distributions in retirement. But, your clients may not have been made aware that Roth IRA distributions can [2nd bullet point appears], reduce income taxes on Social Security retirement benefits, [3rd bullet point appears], minimize the 3.8% Net Investment Income Tax, [4th bullet point appears] and even cut Medicare premiums.  All of those savings are made possible by the reduction of Adjusted Gross Income through the use of income tax free Roth IRA distributions. [last line appears].  The combination of those annual savings could absolutely reach $5,000 or even more for some clients. Because these savings opportunities are not commonly understood, you may find that your knowledge will impress clients, amaze friends, and confound the competition. | **A Roth IRA provides more than just income tax-free income. In addition, a Roth IRA can:**   * Reduce adjusted gross income vs. Traditional IRA distributions, * Reduce income taxes on Social Security retirement benefits, * Avoid or minimize the 3.8% Net Investment Income Tax, and/or * Cut Medicare premiums   These combined annual savings could reach $5,000 or more for certain clients. |

Conventional wisdom holds that current and future income tax rates should be the driver in deciding between Roth and non-Roth contributions during the accumulation period. Conventional wisdom is not wrong; however, it may be superficial. There are other valuable and unique Roth IRA planning opportunities seldom appreciated by advisors much less articulated to clients.

Each of the three unique opportunities discussed below have a common theme – saving money by reducing a client’s adjusted gross income through Roth IRA distributions. Click each opportunity to learn more.

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| **Reduce Income Taxes on Social Security Retirement Benefits** |
| Social Security retirement benefits may or may not be taxable. Between 0% and 85% of retirement benefits must be included in gross income for tax purposes based upon a specialized calculation of AGI referred to as combined income.   |  | | --- | | Combined Income  The IRS revises adjusted gross income to determine how much of the Social Security benefit is included in gross income. We begin the calculation with adjusted gross income as it is normally calculated on the income tax return.  Adjusted Gross Income  + Nontaxable interest\*  + ½ of Social Security benefits  = Combined Income  *\*An example of nontaxable interest is municipal bond interest.* |     Here is how your client could save over $5,000 not just once, but annually in income taxes on Social Security retirement benefits.   |  | | --- | | **Example**  Your client Janine is in her first year of retirement and expects to withdraw $25,000 in taxable distributions every year during her retirement from her Traditional IRA.   * Because of her other (non Social Security) income, Janine falls in the 85% income inclusion range from the graph above and her income tax rate is 25%. * She must include $21,250 (85%) of the $25,000 in gross income on her income tax return and the income tax on the $21,250 (25%) will be just over $5,300.   If Janine could go back into time and contribute to Roth IRAs instead of Traditional IRAs, her income tax free $25,000 in annual distributions would NOT drive up AGI and hence, potentially none of the $25,000 in Social Security retirement benefits would have been included in gross income on her income tax return.   * Janine would have saved (potentially) over $5,300 annually in income taxes on her Social Security retirement benefits. | |
| **Avoid or Minimize the NIIT (Net Investment Income Tax)** |
| Your client could potentially save thousands of dollars by understanding the effect of Roth IRA distributions upon the NIIT.  The year 2013 ushered in an unprecedented Medicare tax on unearned income such as investment income. This tax may be referred to as either the 3.8% Net Investment Income Tax (NIIT) or the 3.8% Medicare Surtax. The NIIT is assessed against the lesser of AGI in excess of an indexed amount or net investment income.   |  | | --- | | Net Investment Income  Investment income is defined as taxable income from capital gains, interest, dividends, royalties, annuities, and rents. Expenses associated with the production of investment income are deducted to arrive at net investment income. Distributions from any IRA or qualified plan are not considered net investment income. |   Distributions from Traditional IRAs and most employer-sponsored retirement plans are not considered investment income subject to the NIIT. Yet such distributions can indirectly cause additional NIIT because they are included in a taxpayer’s income. Here is how that works.   * Distributions from Traditional IRAs and most employer-sponsored retirement plans increase a client’s AGI. * Increases to AGI may result in additional NIIT because the NIIT is assessed against the lesser of AGI in excess of a threshold amount or net investment income.   Roth IRA distributions are excluded from taxable income and consequently do NOT increase a taxpayer’s adjusted gross income. As a result, taxpayers taking Roth distributions instead of taxable distributions may reduce or even eliminate the 3.8% NIIT.  test_tip_icon **Planning Tip**   |  | | --- | | The NIIT is assessed only upon taxpayers with the following:   1. AGI above an threshold amount, **and** 2. Net investment income | |
| **Cut Medicare Insurance Premiums** |
| When would anyone ever overpay for health insurance premiums? Whenever they fail to take advantage of the Roth IRA to reduce those premiums that is when! Premiums for Medicare Parts B and D are means tested. Means testing is a term applied to the increase in premiums based upon an individual’s or couple’s income.  Medicare Part B covers physician services and outpatient care. Part B coverage requires payment of a monthly premium that varies dramatically based upon your client’s modified AGI. Joint income tax return filers with modest AGIs pay as little as $1,461 (2016) per year while higher AGI joint filers may pay over **320%** more annually ($4,678 (2016)).  Medicare Part D covers prescription drug costs and requires payment of a monthly premium as well. The monthly Part D premium is also means tested. The premium increases as modified AGI increases: a married couple’s annual premium can increase approximately $1,500 at higher AGI levels.  Roth IRA distributions do not increase modified AGI and, so far as Medicare Parts B and D premiums go, happiness is a low modified AGI!  The Crystal Ball   |  | | --- | | If the past is prologue to the future, means testing could spread to other Medicare premiums, such as Medicare Part A (hospital insurance), as well. | |

Our goal in this discussion is to raise your awareness rather than bog you down with the details of every possible permutation of the foregoing opportunities. The scope of this course does not permit an exhaustive presentation of all tax, Social Security, and Medicare variables that may apply to your client’s individual situation. We encourage consultation with your in-house experts before making specific recommendations to clients. In addition, your client should consult their CFP® Certificant, CPA or professional tax advisor before any planning decisions are made.

## Health Savings Accounts (HSAs)

Here’s an interesting strategy. What if your client could establish one account to pay medical expenses with tax-free dollars, receive an income tax deduction for contributions ***and*** create tax-deferred retirement income? The HSA, nicknamed “health care IRA” by some, has the potential to accomplish this impressive triple play. While not technically an IRA, the HSA combines the following benefits of both Roth and deductible Traditional IRAs.

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| * Earnings grow either income tax-free or income tax-deferred. * Withdrawal of contributions and earnings are income tax-free if used to pay for qualified medical expenses. * Tax-deferred earnings become taxable only when withdrawn for nonqualified expenses. A 20% penalty may apply to premature nonqualified distributions. * Contributions are deductible on a taxpayer’s income tax return and subject to annual limits. * If HSA funds are not required for medical expenses, distributions may be taken to supplement a client’s retirement income. |

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| Qualified Medical Expenses  The costs to diagnose, treat or prevent disease are qualified medical expenses. Medical services must be provided by a licensed physician, surgeon, dentist, or other certified medical practitioner. Premiums an individual pays for medical care insurance and qualified long-term care insurance are qualified medical expenses as well. |

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| 20% Penalty  The penalty for nonqualified withdrawals taken before age 65 is a confiscatory 20%. There is no penalty for nonqualified withdrawals taken on or after age 65 or as a result of death or disability. |

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| Annual Limits  An eligible individual may contribute and deduct a maximum of $3,350 (2016). Individuals age 55 or more may contribute an additional $1,000 (2016). Contribution limits are higher for HSAs established for an entire family.  *HSA contributions do not reduce a client’s maximum contribution to Traditional or Roth IRAs.*  An employer may also contribute to an employee’s HSA. Employer contributions are income tax-free to the employee. Combined employer and employee contributions must remain within the annual limits. |

To this impressive list we can add one benefit found in no IRA - **earned income is not required to contribute to an HSA**. However, in retirement accumulation planning, as in life itself, there is no free lunch. Whereas Traditional and Roth IRAs enjoy bankruptcy protection under federal law, bankruptcy protection of HSAs is based upon state law. Not all states exempt HSA balances from an individual’s creditors in bankruptcy.

When HSAs were enacted in 2003, relatively few individuals or families were eligible because a High Deductible Health Plan (HDHP) was required. HDHPs are still required; yet, as higher deductible health plans are increasingly adopted by employers, more clients and employers are adopting HSAs. Over 800,000 new HSAs were created between 2012 and 2013 according to the Employee Benefit Research Institute® [[5]](#footnote-5). Individuals covered by Medicare and those who can be claimed as a dependent on another taxpayer’s income tax return are not eligible for an HSA.

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| High Deductible Health Plan (HDHP)  HDHPs not only have a significantly higher deductible than previous traditional employer-provided group health insurance plans, but also protects the individual with a maximum limit to out-of-pocket expenses as well.  An HDHP for an individual must have a minimum annual deductible of $1,300 (2016) and a maximum out-of-pocket expense limit of $6,550 (2016).  Family limits include a minimum annual deductible of $2,600 (2016) and a maximum out-of-pocket expense limit of $13,100 (2016). |

The following example demonstrates the power of the HSA.

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| **Example**  Your client Bruce, age 35, contributed and deducted $5,500 to a deductible Traditional IRA for 2016. Bruce also qualifies for an HSA because he is covered under an HDHP and has no other health insurance. His IRA contribution does not reduce his maximum HSA contribution and any HSA contributions do not reduce his maximum IRA contribution.  He may contribute and deduct $3,350 (2016, as indexed) to an HSA. Assuming that Bruce makes annual contributions of $3,350 for the next 30 years and uses only one-half of each annual contribution for medical expenses, his HSA will grow to over $140,000 at a 6% annual net investment return.  The annual HSA contribution, in a 28% marginal tax bracket, also saves Bruce over $900 annually in federal income taxes. |

The HSA would be a powerful strategy even if it did not offer a potential addition to a client’s retirement income. However, at age 65, the 20% penalty for nonqualified withdrawals disappears and distributions may be taken penalty-free to supplement a retiree’s income. Taxable income will result to the extent withdrawals are taken for nonqualifying purposes.

## IRAs Established by Employers

Our discussion of “Key Issue 4 – Tax-Efficient Savings Strategy” continues as we change our focus from “IRAs Established by Individuals” to “IRAs Established by Employers.”

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| **IRAs:** Sponsored by Employers  SIMPLE IRA  SEP IRA  *my*RA |

Two of the least complex and least costly retirement plans offered by employers are Simplified Employee Pension Plans (SEPs) and Savings Incentive Match Plan for Employees (SIMPLEs). These plans have some qualified plan characteristics and are also governed by rules similar to the Traditional IRA. Their primary differences from IRAs are two-fold:

1. The ability to make much larger contributions.
2. The ability for employers to make deductible contributions.

We begin with a presentation of the SEP IRA. SEP IRA

Small business owners are attracted to the SEP for its simplicity, low set-up costs, and inexpensive annual administrative costs. With a SEP, individual IRAs are established for each employee. Self-employed individuals may open a SEP IRA, in which case the individual is both the employee and the employer. Once the employer makes contributions, these SEP IRAs are subject to the same rules regarding transfer, withdrawal and taxation as a Traditional IRA. Uniquely, the SEP IRA has been called the procrastinator’s retirement plan because of its liberal set-up deadlines.

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| Procrastinator’s Retirement Plan  Most employer-sponsored retirement plans require set-up before the end of the tax year in order to make a tax-deductible contribution for that year. The SEP IRA may be set up as late as the due date of the income tax return, including extensions.   |  | | --- | | Tom T. Tardy is your client. He’s panicked because he needs to set up a retirement plan for his business, fund a contribution, and deduct the contribution on his Year 1 income tax return. But Tom has a problem. Today’s date is now September 30 of Year 2!  You have a solution. Tom may set up and fund a SEP IRA by October 15, Year 2 and take the income tax deduction on his Year 1 income tax return. | |

**Click each benefit and restriction to learn more.**

SEP Benefits

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| **Ease of set-up and administration** |
| Establishing and administering the plan is a fairly simple process. Because the contributed funds are owned and managed by the employees, the employer has no ongoing administrative and fiduciary responsibilities regarding contributed funds. |
| **Positive income tax implications** |
| The employer can deduct the employer contribution as a business expense. The employee receives the employer contribution on a pre-tax basis, with no deduction to claim on his or her tax return for the employer’s contribution. The employer contribution is not subject to Social Security, Medicare, or unemployment taxes. |
| **Flexibility regarding contributions** |
| There is no requirement to make employer contributions on an annual basis. But when they are made, there can be no discrimination in favor of the more highly compensated employees in terms of the rate of contribution. The same rate must be used for all participating employees. |
| **High contribution limits relative to a Traditional IRA** |
| The employer may contribute up to 25% of the first $265,000 of an employee’s compensation or $53,000 for 2016 (adjusted annually for inflation), whichever is less, without generating current federal income tax to the employee. For self-employed participants, business income is used in place of compensation. The $265,000 compensation limit will be adjusted in future years for inflation in $5,000 increments. The $53,000 limit will be indexed for inflation in $1,000 increments. |

SEP Restrictions

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| **Employees are not allowed to make salary reduction contributions** |
| In a SEP IRA, only employer contributions are permitted - employee salary reduction deferrals are not allowed. However, prior to January 1, 1997, a SEP IRA could have included a salary reduction arrangement (known as a SARSEP) whereby employees could elect to defer compensation and have the funds placed in an IRA. While a SARSEP created prior to that date may continue to function, new SARSEP plans cannot be created. They have been replaced with SIMPLE Plans. |
| **All eligible employees must be covered** |
| The employer cannot exclude employees who:   * Are 21 years of age or older * Are employed for at least 3 of the immediately preceding 5 years * Earn at least $600 (in 2016, as indexed) in the current year |

Employee deferrals are not permitted in a SEP. However, employee deferrals were permitted in a previous version of the SEP, the Salary Reduction SEP (SARSEP). New SARSEPs were not allowed after 1996, but SARSEPs existing as of that date may continue to operate.

## SIMPLE IRA

A small business owner may consider the SIMPLE IRA for its deferral opportunities (not available in the SEP) and relatively administrative costs when compared to qualified plans.

A SIMPLE IRA is an employer-sponsored retirement plan that allows the employee (including self-employed individuals) to make pre-tax compensation deferrals. The employer is also required to make contributions. Once established, the SIMPLE IRA offers very appealing benefits, although it also has noteworthy restrictions.

**Click each benefit and restriction to learn more.**

SIMPLE Benefits

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| **Ease of set-up and administration** |
| Compared to Qualified Plans (e.g., 401(k) or Profit Sharing), this is a much simpler and less costly plan to establish and administer. |
| **Deductibility of employer contributions** |
| Just like the SEP IRA, the employer’s contributions are deductible on the company’s return. The employer contribution is not included as taxable income to the employee and is not subject to Social Security, Medicare, or unemployment taxes. |
| **Deferral of employee compensation** |
| Employees are able to defer compensation on a pre-tax basis up to the annual limits listed below and do not report the income until funds are removed from the IRA. The employee is subject to Social Security and Medicare taxes on the compensation deferred. The employer is subject to Social Security, Medicare, and unemployment taxes on the compensation deferred. |
| **High contribution limits relative to a Traditional IRA** |
| Employees are able to defer compensation into the SIMPLE IRA at the following limits, which are significantly higher than those available with a Traditional IRA (but significantly lower than 401(k) deferral limits). Those age 50 and over can also make additional “catch up” deferrals (if the plan permits), in the amounts indicated below.  **Simple IRA Annual Employee Elective Deferral Limits**   |  |  |  | | --- | --- | --- | | **Year** | **Annual Limit** | **“Catch Up” Limit** | | 2016 | $12,500\* | $3,000\* |   *\*Indexed for inflation in $500 increments.* |

SIMPLE Restrictions

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| **Some companies are restricted from implementing a SIMPLE IRA.** |
| To be eligible to start a SIMPLE IRA, a business must meet two requirements:   * Employ 100 or fewer employees who received at least $5,000 in compensation in the previous year, and * Not maintain another employer-sponsored plan. |
| **Employer contributions are required.** |
| Employers are required to make contributions, but have some flexibility in choosing between two methodologies:   * Match participating employee deferrals dollar-for-dollar, provided the match does not exceed 3% of the employees’ compensation (on compensation up to $265,000, as indexed in 2016). If this method is chosen, the employer has the further flexibility to elect a lower matching contribution of not less than 1% in any two out of five years. Employees must be notified of the matching amount before the beginning of each new plan year.   **AND**   * Contribute a fixed 2% of employee compensation (on compensation up to $265,000 for 2016) on behalf of all employees, whether the employees elect to make any contributions themselves or not. This translates into a maximum employer contribution per employee of $5,300 (2016). |
| **All eligible employees must be covered.** |
| The employer must allow participation by all employees who meet the following criteria:   * The employee received at least $5,000 in compensation from the employer during any 2 years prior to the current year.   **AND**   * The employee is reasonably expected to receive at least $5,000 in compensation during the calendar year for which contributions are to be made.   Exceptions to this requirement are employees who are covered under a collective bargaining agreement or non-resident aliens who receive no U.S. source of earned income. |
| **Early withdrawal penalty is increased in first two years of participation.** |
| Here is a rule that your clients simply must know. If early withdrawals occur (i.e., distributions prior to age 59½) within the 2-year period following the date of the employee's first participation, the 10% IRS penalty tax is increased to 25% unless an exception applies (e.g., death, disability, etc.). Premature distribution penalties from other types of IRAs incur a smaller penalty of only 10%. The SIMPLE IRA 25% penalty may not be avoided by rolling over a SIMPLE IRA to another type of IRA within the 2-year period described above. |

## Review Exercise

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

1. **In general, once they are funded, the rules governing transfer, withdrawal, and taxation of SEPs are basically the same as for Traditional IRAs.**

* **True**

**Correct**.

* False

**Incorrect**.

1. **Indicate whether or not the following features are characteristic of SEP IRAs:**

**The employer is required to make an annual contribution.**

* True

**Incorrect**.

* **False**

**Correct**.

**All eligible employees must be covered.**

* **True**

**Correct**.

* False

**Incorrect**.

**New Plans may include a salary reduction arrangement.**

* True

**Incorrect**. Prior to January 1, 1997, a SEP IRA could have included a salary arrangement (known as a SARSEP), but this is no longer available for new plans.

* **False**

**Correct**. Prior to January 1, 1997, a SEP IRA could have included a salary arrangement (known as a SARSEP), but this is no longer available for new plans.

1. **Indicate whether or not the following features are characteristic of SIMPLE IRAs:**

**If the employee is making a contribution, the company must make a contribution of some type in that year, regardless of the funding method being used by the company.**

* **True**

**Correct**. The employer can either contribute a fixed 2% for all eligible employees, or match up to 3% of employee contributions. Therefore, if the employee is making a contribution, either methodology requires a contribution by the employer.

* False

**Incorrect**. The employer can either contribute a fixed 2% for all eligible employees, or match up to 3% of employee contributions. Therefore, if the employee is making a contribution, either methodology requires a contribution by the employer.

**All eligible employees must be covered.**

* **True**

**Correct**.

* False

**Incorrect**. Try again.

**New Plans may include a salary reduction arrangement.**

* **True**

**Correct**. A SIMPLE IRA is essentially a salary reduction agreement that allows the employee to reduce compensation and directs the employer to contribute the deferred compensation into the employee's IRA account.

* False

**Incorrect**. A SIMPLE IRA is essentially a salary reduction agreement that allows the employee to reduce compensation and directs the employer to contribute the deferred compensation into the employee's IRA account.

**For 2016, the maximum elective deferral for employees under the age of 50 is $5,500.**

* True

**Incorrect**. For 2016, the maximum elective deferral for employees under the age of 50 is $12,500. An additional $3,000 is allowed for employees who are 50 years of age or over.

* **False**

**Correct**. For 2016, the maximum elective deferral for employees under the age of 50 is $12,500. An additional $3,000 is allowed for employees who are 50 years of age or over.

## Government Sponsored IRA - *my*RA *| my* Retirement

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| **Overview** | The National Institute on Retirement Security, in its June 2013 report entitled “*The Retirement Savings Crisis: Is It Worse Than We Think?”* reveals that only about 45% of the households in the United States own retirement account assets.  The “*my*RA” is a U.S. government Roth IRA intended to promote retirement savings among those with no retirement savings. Think of *my*RA as a “starter Roth IRA.” The program is open to all taxpayers meeting Roth IRA eligibility requirements (discussed previously in this course).  Roth IRA rules generally apply with certain exceptions. **Click on each of the following to learn more**. |
| **Investment Choice is Limited** | In 1909, Henry Ford said of his Ford Model T automobile, “Any customer can have a car painted any color that he wants, so long as it is black.”  The federal government may have been channeling the famous automaker when it decided to limit the investment choice in *my*RA to one - only a Specialized Treasury Bond may be purchased.  The bonds are purchased directly from U.S. Treasury through payroll deduction from employee paychecks.   |  | | --- | | Specialized Treasury Bond  According to the U.S. Treasury “*my*RA earns interest at the same rate as investments in the government securities fund available to federal employees.”  The bonds used in *my*RA are a new creation and are structured as follows:   * Nonmarketable (does not trade in the market, can only be redeemed by the Treasury) * Principal is protected, the bonds are guaranteed by the U.S. Treasury * Interest is paid at a variable rate equal to the rate paid on Thrift Savings Plan (TSP) Government Securities Investment Fund bonds. | |
| **Fees and Costs** | There are no investment fees and no cost will be borne by the employer. Employer matching is not required. |
| **Transfer at $15,000** | The account must be transferred to a private sector Roth IRA when the account balance reaches $15,000 or after 30 years of participation. |
| **Coordination with Traditional and Roth IRAs** | The *my*RA does not increase the aggregate limit that may be contributed to all  IRAs ($5,500 plus an additional $1,000 if age 50 or above, 2016 as indexed). |

## Employer-Sponsored Qualified Plans

Why do you need to know about employer-sponsored qualified plans? Here are just a few of the reasons.

* Rollover opportunities may depend upon client perceptions of your qualified plan competence.
* They present a singular opportunity to discuss ways to enhance retirement savings with clients from across the spectrum - from small business owners to employees of Fortune 100 firms.
* These plans represent a significant part of existing retirement assets for many employees.
* Qualified plan investments should be coordinated with IRA and personal savings investment strategies.

Our presentation of qualified plans on the following pages is intended to build your confidence and competency without burdening you with minutiae. Let us begin with an understanding of the often-misused term “qualified plan.”

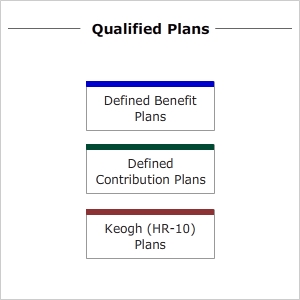
A qualified plan is an employer-sponsored retirement plan that qualifies for special tax treatment under a special section of the Internal Revenue Code. Only plans governed by this special section[[6]](#footnote-6) are referred to as "qualified," although there are other retirement savings arrangements that provide tax advantages. Qualified plans have the following characteristics:

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| Other Retirement Savings Arrangements  A number of arrangements, accounts, or plans provide income tax deferral, income tax-free distribution, or deduction of contributions. These plans are not qualified plans and include Traditional IRAs, Roth IRAs, 403(b) plans, SEP IRAs, and SIMPLE IRAs. |

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| **Qualified Plan Characteristics**   * They provide tax-deferred savings for retirement. * They must be written programs that are communicated to all employees. * They cannot be biased toward the highly compensated. * Employees must be fully vested within specified guidelines. * When employees leave, they may keep their funds in the plan if their vested account balance is greater than $5,000, they may be able to roll the assets over to the new employer's plan if the new employer's plan permits it, or they may roll the assets over into an IRA. * Distributions must generally begin by April 1 of the year after the participant’s age 70½. * Assets held in qualified plans are protected under federal law without limit from most creditors in the event of client bankruptcy. |

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| Vested  Vestingis the process by which a qualified plan participant obtains non-forfeitable rights to his or her account balance or accrued benefit attributable to employer contributions. Remember that employees are always and immediately vested in their own deferrals.  Vesting schedules are commonly used as an incentive for employees to stay with the employer. The employee becomes vested in employer contributions only after completing a period of employment - the plan may define the process of vesting as incremental or all at one time. Once the participant becomes fully vested, all past employer contributions are fully non-forfeitable for the participant, and all future contributions become immediately non-forfeitable. |

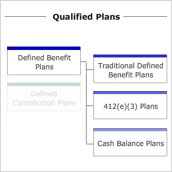
## Types of Qualified Plans

While this list is not exhaustive, the Qualified Plans under consideration in this course are shown in the diagram below. As illustrated below, Qualified Plans may be broken into two broad categories. Click on the icons in this chart to learn more. You should become familiar with Traditional Defined Benefit Plans and 401(k) Plans at a minimum.

**Click on each category to learn more.**

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| **Defined Benefit Plans** |
| These plans define the benefits (fixed monthly payments) received by employees at retirement. The amount of the payment is typically a function of an employee’s years of employment and compensation level while employed. The benefit is targeted in advance and these plans are usually non-contributory***.***   |  | | --- | | **Non-Contributory**  The employee does not contribute to the cost of the plan in a non-contributory plan. If the employee contributes a portion of the cost, the plan is referred to as a contributory plan. | |
| **Defined Contribution Plans** |
| These plans define the procedures under which contributions may or may not be made by the employee or employer to each employee’s account. At retirement, the amount of income paid or assets available to the employee are primarily determined by size of contributions, length of time contributions have to grow and investment performance. |

## ****Defined Benefit Plans****

These plans define the benefits (fixed monthly payments) received by employees at retirement. The amount of the payment is typically a function of an employee’s years of employment and compensation level while employed. As shown in the illustration below, there are three types of Defined Benefit Plans (often referred to as “DB Plans”).

**Click on each plan to learn more.**

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| **Traditional Defined Benefit Plans** |
| Here is an often-overlooked opportunity. While these plans are viewed as the sole province of only the largest, most financially sound employers, there is a potential need on the other end of the spectrum. A small business owner/employee may find the Traditional DB Plan an impactful strategy to fund a retirement plan with tax-deductible contributions. Especially for the owner/employee beginning to save for retirement late in life, a Traditional DB Plan may offer much higher tax-deductible contribution limits vs. a Defined Contribution Category Plan. There is an ominous caveat, however. Because federal law requires broad employee participation in most qualified plans, the small business owner will need to analyze the cost of including other employees in the plan.  Plan participants may treasure Traditional DB Plans while large employers may rightly fear these plans. The plan participant receives a guaranteed income for life at retirement that may even be adjusted annually for inflation in some plans. Plan sponsors bear enormous investment risk. How big is enormous? General Motors at one time had a $10B (that’s B as in billion) unfunded liability to its defined benefit plan due in part to subpar investment performance.  The amount of the employee’s retirement income payment is typically a function of an employee's years of employment and compensation level while employed. The benefit can be reasonably estimated in advance and the maximum benefit is subject to statutory limits. The funding of the plan is usually the sole responsibility of the employer; however, a variation of the plan - the DB(k) Plan - allows participant deferrals.   |  | | --- | | Limits  The maximum annual benefit that can be funded for a benefit beginning at age 65 (in 2016, as indexed) is the lesser of $210,000 or 100% of the average compensation earned over the three highest paid consecutive years. These limits are referred to as the “Section 415(b)” limits. The limits are lower for retirement before age 62 and higher for retirement after age 65. |  |  | | --- | | DB(k) Plan  **Courtesy of the Pension Protection Act of 2006, plan participants may make salary deferrals into a specialized version of the Traditional Defined Benefit Plan known as the DB(k) Plan. The employer is allowed, but not required to, make DB(k) Plans available. DB(k) Plans are designed to require less sponsor cost vs. traditional DB Plans to encourage adoption by small to medium-sized business owners.** |   **As in any qualified plan, taxation of withdrawals from the plan is deferred until withdrawn by the plan participant. Employers are subject to at least a quarterly funding obligation, regardless of the company’s profitability.**  The Employee Benefit Research Institute (EBRI), in its August 2011 Notes, Vol. 32, No. 8, reports a free fall in employee participation rates in private sector Defined Benefits Plans. In 1979, 38% of private sector employees participated in these plans and by 2008, the participation rate had plummeted to 15%. This plummet can be attributed to the increasing lack of such plan offerings by employers. By 2011, only 1 in 10 private sector employers offered a Defined Benefit Plan.[[7]](#footnote-7)  Here is a key takeaway. A client currently participating in a Defined Benefit Plan should carefully consider the retirement accumulation impact of changing jobs if the new employer does not offer a DB Plan.  Annual employer contributions are required. |
| **412(e)(3) Fully Insured Defined Benefit** **Plans** |
| A Fully Insured Defined Benefit Plan is simply a Traditional DB Plan funded exclusively with life insurance and/or annuity products. Employers are attracted to fully insured plans because investment risk is shifted from the plan sponsor to an insurance company, costs of plan set-up and administration are less than a Traditional DB Plan, and the contribution levels are typically higher in the early plan years than in a Traditional DB Plan. For those reasons, the Fully Insured DB Plan may also appeal to the small business owner/employee.  Annual employer contributions are required. |
| **Cash Balance Plans** |
| Cash Balance Pension Plans are functionally a hybrid of defined benefit plans and defined contribution category plans. The employer makes contributions to the plan based on actuarial calculations (like a DB Plan). Each employee’s non-segregated account accumulates based on contributions and interest “credits.” Like a defined contribution category plan, these plans pay out benefits at retirement based on how much money has accumulated in the account. Typically, the employer guarantees the interest rate (which is usually modest due to short-term rate assumptions and guarantees).  Cash Balance Plans have been the subject of controversy in recent years since many large companies have amended their Defined Benefit Plans to Cash Balance Plans. These amendments tend to significantly reduce future benefit accruals for older/shorter-term employees. Why the change? Cash Balance Plans are much less expensive to administer and pose far less investment risk to the employer. Annual employer contributions are required. |

## Personal Defined Benefit Plans

Is your self-employed client frustrated by the low contribution and deferral limits in qualified plans and IRAs? Surprisingly enough, a variation of the “old-time traditional” Defined Benefit Plan named the “Personal Benefit Plan” is a potential solution.

***Self-employed clients may be able to save a*** *tax deductible $150,000 or more* ***annually using Personal Defined Benefit Plans!***

|  |  |
| --- | --- |
| $150,000 Or More  The maximum annual benefit that can be paid to a participant at his or her age 65 (in 2016, as indexed) is the lesser of $210,000 or 100% of the average compensation earned over the three highest paid consecutive years.  Therefore, the maximum contribution to the Personal Defined Benefit Plan is the amount required to fund the maximum annual benefit for the life of your client.  Annual contribution amounts are determined by an actuary, based upon your client’s current age, retirement age specified in the plan, compensation, income replacement formula in the plan, and investment performance. **Click** here **for an example.**   |  | | --- | | Example  A 55-year-old client wishing to retire at age 65 with a $210,000 annual benefit for life would have to make annual (fully deductible) contributions of approximately $193,000 per year over a 10-year period. A 6% portfolio return is assumed. | |

Conventional wisdom would have us believe that risk-savvy employers (and their advisors) should run, not walk, away from sponsoring Defined Benefit Plans. Why? The expenses and risks chronicled on the previous pages are daunting to businesses with large numbers of employees. While conventional wisdom may be all well and good for a large corporation, such “wisdom” may fail us when advising certain self-employed clients.

Ideal candidates for the Personal Defined Benefit Plan have these characteristics:

* Self-employed with no employees

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| No Employees  The Personal Defined Benefit Plan is fully subject to ERISA’s employee participation rules. These rules require that a number of non-owner employees must be covered under the plan. Because plan coverage is expensive and fraught with investment risk, the ideal client has no employees or only a spouse and/or children as employee(s). |

* Inability to accumulate sufficient retirement accumulation savings using other accumulation vehicles such as IRAs or 401(k) Plans
* Consistent yearly discretionary cash flow sufficient to make required annual contributions into the plan

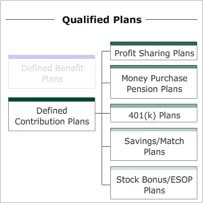
Financial decisions are based upon an analysis of advantages versus disadvantages and this decision is no different. **Click each to learn more.**

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| **Advantages** |  | **Disadvantages** |
| * Annual tax deductible contributions of $150,000 or more * Ability to accumulate approximately $2,400,000 in a single employee/owner plan under current IRS regulations |  | * Start-up fees of $2,500 or more and recurring annual expenses of $1,250 or more may be necessary * Annual funding is generally required to avoid penalties, although the plan can be amended or terminated within certain guidelines * The IRS generally mandates at least 5 years of plan funding * Plan coverage for non-owner employees may be compulsory |

Virtually no other tax-deductible retirement accumulation plan can rival the Personal Defined Benefit Plan for the ideal client willing to accept the plan’s noteworthy disadvantages.

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| Personal Defined Benefits Plans are subject to ERISA, IRS, and Department of Labor regulations. Your client, if an owner, may be regarded as a fiduciary by plan regulators, with a fiduciary’s legal responsibilities. An ERISA attorney should be consulted as part of the planning process. |

## Defined Contribution Plans

These plans do not define the benefits the employee receives upon retirement. Rather, they define the procedures under which contributions **may or may not** be made by the participant or employer to each participant's account. Contributions are not always guaranteed in Defined Contribution Plans. Benefits upon retirement depend on the amount of plan contributions, how long they have to grow and the investment performance of the funds that are contributed. This shift of investment responsibility from the employer and reduced cost are the primary reasons these plans have become much more popular with employers than DB Plans. Our focus in this discussion is on the most widely available Defined Contribution Plans.

**Click on each plan to learn more.**

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| **Profit Sharing Plans** |
| Profit Sharing Plans are a popular type of plan because they have the greatest employer flexibility. They were initially developed to encourage employees to work hard for the corporation to be profitable, with the expectation that the company would contribute money into the employees’ accounts when corporate profits were realized. Employer contributions to a Profit Sharing Plan are generally discretionary in that the employer decides if, when, and how much to contribute. Annual contributions are not required.  Compared to Defined Benefit Category Plans, Profit Sharing Plans are relatively inexpensive to set up and administer. **Employees bear investment risk in this type of plan since the investment performance of plan assets directly affects the amount of their retirement benefits. As in any qualified plan, pre-tax contributions, growth, and earnings of plan assets are not taxed until withdrawn by the plan participant. Contributions are subject to statutory** limits**.** Employer contributions are required on a substantial and recurring basis, but not every year.   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Limits  In 2016, the limit is the lesser of $53,000 (as indexed for CPI) or 100% of compensation. There is also a limit of $265,000 (2016, as indexed) of compensation that can be used for purposes of determining contributions.  Employer deductions are generally limited to 25% of covered payroll; thus, most plans limit employer contributions to 25% of each employee’s compensation to a combined employer/employee maximum contribution of $53,000 (2016). Employer contributions are allocated to participants based upon compensation.  **Click** here **for an example.**   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | **Example**  Brian, Christian, Kayla, and Allison participate in their company’s Profit Sharing Plan. Their company elects to provide a 10% profit sharing contribution in 2016. The chart below illustrates the allocation to each participant.   |  |  |  | | --- | --- | --- | |  | **Compensation** | **10% Profit Sharing Contribution (2016)** | | Brian | $300,000 | $26,500\* | | Christian | $250,000 | $25,000 | | Kayla | $250,000 | $25,000 | | Allison | $250,000 | $25,000 | | | *\* Compensation above $265,000 (2016) may not be used to calculate contributions or benefits in a qualified plan.* | | |
| **Money Purchase Plans** |
| The rate of contribution to a Money Purchase Plan is **fixed**. Once the employer fixes a percent of compensation that is to be placed into the plan, the employer must make that tax-deductible contribution each year, even if there are no profits for the year.  As in any qualified plan, taxation of contributions and earnings of plan assets in the plan are deferred until withdrawn. Employees bear investment risk in this type of plan since the investment performance of plan assets directly affects the amount of their retirement benefits.  These plans are subject to the same contribution and deduction limits as Profit Sharing Plans. Annual employer contributions are required. |
| **401(k) Plans** |
| What priority would you place on gaining competency or enhancing competency in the second most popular retirement savings vehicle in this country? The 401(k) Plan is second in popularity only to the IRA. The American Benefits Council reports that almost 8 of every 10 workers has access to a Defined Contribution Category Plan and most of those are 401(k) Plans.[[8]](#footnote-8)  Our presentation of 401(k) Plans reflects the driving need to develop or expand your expertise in this essential retirement accumulation vehicle. The following six factors should be part of your core competency. Click on each to learn more.   1. Investment Control and Risk  |  | | --- | | Investment Control and Risk  The qualified plans discussed thus far give little investment choice to a plan participant - the employer makes all or virtually all investment decisions regarding contributions or benefit accruals. In stark contrast, the 401(k) offers the participant the opportunity to direct his or her investment choices.  Employees bear investment risk in these plans since the investment performance of plan assets directly affects the amount of their retirement accumulation. |  1. Deferral and Matching  |  |  | | --- | --- | | Deferral and Matching  401(k) Plans allow employees to defer compensation into individually designated separate accounts for their retirement. The employees always own (vest in) 100% of their own deferrals and any earnings thereon. If the employer makes matching contributions, there may be a requirement that an employee fulfill a specific period of service before fully vesting in any employer contributions and the earnings thereon.  How about a little free money for your client? If a 401(k) Plan offers matching contributions, the participant should defer at least the amount required to receive the full amount of any employer matching contributions.  The maximum employee deferral is $18,000 (2016) for plan participants under the age of 50. Participants age 50 or more are entitled to an additional $6,000 (2016) deferral. The deferral limit must be coordinated with deferrals in certain other employer sponsored retirement plans.   |  | | --- | | Coordinated  The sum of all deferrals into 401(k) Plans, 403(b) arrangements, SARSEPs, and SIMPLEs may not exceed the annual maximum employee deferral limit (as indexed). | |  1. Contribution and Deduction Limits  |  | | --- | | Contribution and Deduction Limits  A 401(k) Plan is subject to IRC Section 415(c) contribution limits:   * Annual additions to a participant’s account are limited to the lesser of $53,000 (in 2016, as indexed) or 100% of compensation including all *employee* deferrals, after-tax *employee* contributions, *employer* contributions, and any forfeitures from other participant accounts. The additional deferral for participants age 50 or more increases the limit by $6,000, from $53,000 to $59,000 (2016). * There is also a limit, called the covered compensation limit, of $265,000 (2016, as indexed) to the amount of compensation that can be used for purposes of determining *employer* contributions.   The employer's deduction for contributions made to the plan is generally limited to 25% of the covered compensation of all plan participants. Employer contributions are required on a substantial and recurring basis but not every year. |  1. Basic Taxation  |  | | --- | | Basic Taxation  Income taxes on the participant’s pretax deferrals, employer contributions and earnings thereon are deferred until withdrawn by the plan participant. The participant pays only Social Security and Medicare taxes on deferrals - no income taxes are paid on amounts deferred into the 401(k).  In general, distributions from qualified plans are taxed as ordinary income. |  1. Beating the Tax Man, Boosting After-Tax Income  |  |  |  |  | | --- | --- | --- | --- | | Beating the Tax Man, Boosting After-Tax Income  While distributions from 401(k) Plans are usually taxed as ordinary income, you should know two exceptions to that general rule that could dramatically boost after-tax retirement income. Those exceptions include the Designated Roth 401(k) Account (income tax-free income) and investing in employer securities (taxation of gains at preferential long-term capital gain rates).   |  | | --- | | Designated Roth 401(k) Accounts  Designated Roth 401(k) Accounts (DRAs) may be included at the employer’s discretion in any 401(k) Plan. Similar to a Roth IRA, deferrals into a DRA are made with after-tax dollars and qualified withdrawals, including earnings, during retirement will not be subject to income tax.  Distributions of earnings from a DRA are qualified (income tax-free) provided the participant has reached age 59½ and has been in the plan at least five years. Noteworthy and unlike a Roth IRA, minimum distributions are required during the owner’s lifetime based upon qualified plan rules. The annual employee elective contribution is $18,000 in 2016 with an additional $6,000 in 2016 if age 50 or over.  Designated Roth 401(k) Accounts (DRAs) may be included at the employer’s discretion in any 401(k) Plan. Similar to a Roth IRA, deferrals into a DRA are made with after-tax dollars and qualified withdrawals, including earnings, during retirement will not be subject to income tax.  Distributions of earnings from a DRA are qualified (income tax-free) provided the participant has reached age 59½ and has been in the plan at least five years. Noteworthy and unlike a Roth IRA, minimum distributions are required during the owner’s lifetime based upon qualified plan rules. The annual employee elective contribution is $18,000 in 2016 with an additional $6,000 in 2016 if age 50 or over. |  |  |  | | --- | --- | | **Investing in Employer Securities**  Qualified plans may invest in the securities of the employer. Employer securities distributed to the retiree in a lump sum at retirement are taxed, at least in part, at long-term capital gains. This tactic is commonly described as “net unrealized appreciation.”  If the employee has the option to invest in employer securities, the future income tax benefits should be considered. However, the income tax “tail” should not wag the investment diversification “dog.” Investing into employer securities should be appropriate to your client’s portfolio diversification strategy first and foremost - the tax benefits should merely be a factor in the investment decision process.   |  | | --- | | Net Unrealized Appreciation  Investment of plan assets into employer stock is more commonly found in 401(k), Profit Sharing, Stock Bonus, and ESOP Plans than in other qualified plans. In 401(k) Plans, it is not uncommon for employers to make matching contributions in employer stock.  If the stock itself (versus cash in lieu of stock) is distributed to a participant, the participant can utilize net unrealized appreciation (NUA) preferential tax treatment. If a qualified plan makes a lump sum distribution that includes employer stock, the unrealized appreciation of the stock (the difference between the value of the stock when contributed to the plan and the value of the stock when distributed) is not taxable to the participant at the time of the distribution as long as two conditions are met:   1. The distribution is made after the participant's attainment of age 59½, and 2. The participant’s separation of service from the employer-plan sponsor, or is made posthumously within one year of death.   The NUA is subject to income tax at a long-term capital gains rate when the participant actually sells the stock, regardless of how long it is held after the distribution date. Note that the cost basis of the stock is treated as ordinary income at the time of the distribution. | | |  1. Solo 401(k) For the Small Business Owner  |  |  | | --- | --- | | Solo 401(k) For the Small Business Owner  What if your small business owner client seeks to establish a qualified plan but is highly averse to cost, complexity, and risk? Be sure you are familiar with an intriguing variation of the 401(k) Plan dubbed the Solo 401(k).   |  | | --- | | Solo 401(k)  This qualified plan may be ideal for the single owner/employee business or a business in which the only two employees are husband and wife. Solo 401(k) Plans may also be referred to in the popular press as “Individual 401(k) Plans” or “Uni-K Plans.” The employee may make deferrals and, in addition, the business may make tax-deductible contributions as well. The solo 401(k) Plan is subject to the same contribution limits as the regular 401(k) Plan. Set-up and annual administrative costs are among the lowest of any qualified plan, yet more expensive than related costs of a SEP IRA or SIMPLE IRA. Solo 401(k) Plans may also offer the equivalent of Designated Roth Accounts. |   If your client is open to nonqualified plans as well, consider the SEP IRA and SIMPLE IRA also. | |
| **Stock Bonus/ESOP Plans** |
| **A Stock Bonus Plan is very similar to a Profit Sharing Plan, but the participant accounts are invested in stock of the employer company. Employer contributions to the plan are either stocks or contributions of cash that the plan uses to purchase employer stock. These contributions are tax-deductible to the employer.**  An ESOP is a type of Stock Bonus Plan. However, an ESOP is designed to allow the ESOP Plan to borrow money from a lending institution. The plan uses the loan proceeds to purchase employer stock. The employer makes tax-deductible contributions to the ESOP Plan (within certain limits), which the ESOP then uses to pay interest and principal on the loan. This enables the employer to borrow funds and repay both principal and interest with tax-deductible dollars.  Employeesbear investment risk in these plans since the investment performance of plan assets directly affects the amount of their retirement benefits. ESOPs **can broaden stock ownership, which may make takeover more difficult, may incent employees, increase marketability of shares, but may dilute the primary owners’ ownership percentage.**  **As in any qualified plan, taxation to the participant of contributions and earnings of plan assets are deferred until withdrawn by the participant. In addition, participants in a Stock Bonus Plan or ESOP can elect net unrealized appreciation treatment with respect to employer securities.**  These plans are subject to the same funding and deduction limits as Profit Sharing Plans. Employer contributions are required on a substantial and recurring basis, but not every year. |

Try It

**To check your understanding, answer the following:**

1. **An employer contributes 15% of compensation into a Defined Contribution Plan. If an employee’s 2016 annual income is $300,000, how much can the employer contribute into the plan for the employee?**

* 46,000

**Incorrect**. Try again.

* 45,000

**Incorrect**. Try again.

* **39,750**

**Correct**. While the employer can contribute up to $53,000 for an employee, the employer cannot base the contribution on compensation above $265,000. Therefore, the most that can be contributed is 15% of $265,000, or $39,750

## Corporate and Keogh Sponsors of Qualified Plans

A corporation may sponsor any of the qualified plans. Unincorporated sponsors, called Keogh sponsors, may not adopt Stock Bonus or ESOP Plans. Why? Keogh sponsors, such as sole proprietorships and partnerships, do not manifest ownership of the business through stock certificates and hence, cannot adopt any qualified plan that requires employer stock.

Keogh Plans are substantially similar to qualified plans sponsored by corporations, except the business owners or partners deduct their plan contributions on their personal tax return, while non-owner employees do not report the contributions on their behalf either as income or as a deduction.

Plans adopted by an incorporated business may be referred to as either Keogh Plans, HR-10 Plans, or Keogh (HR-10) Plans.

## Pre-Retirement Distributions from Qualified Plans

Distributions to a qualified plan participant who is still employed by the sponsor and still participating in the sponsor’s qualified plan are called **in-service withdrawals.** The qualified plan administrator is generally required to withhold 20% for taxes from the amount of the in-service withdrawal, unless the distribution is transferred to an eligible retirement plan by means of a direct rollover.

In general, Defined Benefit, Cash Balance, Target Benefit, and Money Purchase retirement plans do not permit in-service withdrawals before age 62. Other qualified plans may allow in-service withdrawals. The table below identifies which retirement plans may allow in-service withdrawals. In many cases, the plans are not required to offer in-service withdrawals, merely permitted to do so. Your client should check with the plan administrator to determine availability of in-service withdrawals.

|  |  |
| --- | --- |
| **Type of Plan** | **In-Service Withdrawals?** |
| Defined Benefit | Not permitted until age 62 |
| Cash Balance | Not permitted until age 62 |
| Money Purchase | Not permitted until age 62 |
| Target Benefit | Not permitted until age 62 |
| Profit Sharing | After 2 years |
| Section 401(k) | After 2 years with exceptions |
| Stock Bonus | After 2 years |
| ESOP | After 2 years |

|  |  |
| --- | --- |
| Exceptions – Taking In-Service Distributions from a 401(k) Plan  In-service withdrawal of pre-tax and Roth deferrals are only allowed for the following:   * Attainment of age 59½ * Due to disability * Due to a hardship  |  | | --- | | Hardship  In order to qualify for a *hardship*withdrawal***,*** the participant must have an immediate and heavy financial need (such as for medical expenses, college tuition payments, purchase of a primary residence, or prevention of eviction). The participant must have also exhausted all other reasonable resources, including loans and distributions from qualified and nonqualified plans.  Remember that hardship withdrawals are subject to the 10% premature distribution penalty unless they meet one of the specific penalty exceptions covered subsequently in this course. |   In-service withdrawal of employer contributions may be distributed for any of the following reasons:   * The employer contributions have been in the account for two years * Attainment of age 59½ * Disability * Hardship |

The entire in-service distribution from a qualified plan will generally be taxable as ordinary income. In-service withdrawals from qualified plans or Section 403(b) Plans may also be subject to a premature distribution penalty of 10% of the taxable amount withdrawn, although there are various exceptions to the 10% premature distribution penalty, as discussed on the next page.

## Qualified Plan Premature Distribution Penalty

A 10% penalty will generally be levied against any plan withdrawal by a participant if the distribution is made before the participant’s attainment of age 59½. However, there is no penalty for the following premature distributions from qualified plans if made:

|  |
| --- |
| * To the estate or the beneficiaries following the participant’s death * As a result of the participant’s total and permanent disability * Withdrawals are substantially equal annual installments spread over the participant’s life expectancy, or the joint life expectancy of the participant and a designated beneficiary. The payments under this exception, except in the case of death or disability, must continue for at least five years or until the employee reaches age 59½, whichever is the longer period. This exception only applies after separation from service. * After your separation from service in or after the year you reached age 55 (age 50 for public safety employees). * For payment on an IRS levy * For the purpose of paying medical expenses in excess of 10% of the participant’s Adjusted Gross Income * Pursuant to a judicial decree under a Qualified Domestic Relations Order |

In the case of the substantially equal annual installments exception, the payments must continue for the later of the participant’s attainment of age 59½ or 5 years. For example, if the participant commences the installments at age 57, then the participant must continue withdrawing payments until reaching age 62 (5 years later).

Please note that there are differences between the above list of exceptions and those for the IRA premature exceptions discussed previously.

## Tax-Exempt Organization Arrangements and Governmental Plans

Tax-Exempt Organizations

and Government Plans

403(b) Plans

Government

457(b) Plans

The preceding page concluded our discussion of qualified plans. Our focus now changes to nonqualified plans sponsored by tax-exempt organizations and the government. Why should you know this material? An affluent client may have a background with employment in a tax-exempt organization or in the public sector!

**Click each type to learn more.**

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| **403(b) Arrangements** |
| Nonprofit organizations (NOs) are now allowed to sponsor 401(k) Plans but were not allowed to do so in the not-so-distant past. However, CNOs in the past were allowed to sponsor a 401(k) look-alike plan called the 403(b) Arrangement. Public school systems and churches may also generally sponsor 403(b) Arrangements.   |  | | --- | | Nonprofit Organizations  In this course, “nonprofit organizations” include tax-exempt religious, charitable, or educational organizations compliant with Internal Revenue Code Section 501(c)(3). |   403(b) Arrangements resemble 401(k) Plans in these ways:   1. The deferral and contribution limits are the same, 2. Designated Roth Accounts may also be offered in 403(b) Arrangements, and 3. Qualified Plan required minimum distribution rules apply.     403(b) Arrangements differ from 401(k) Plans in these ways:   1. The 403(b) is not a qualified plan, and 2. Investments are restricted vs. the 401(k) Plan.  |  | | --- | | Restricted  Funds may generally be invested only in annuity contracts or mutual funds. | |
| **Governmental or “Public” 457(b) Plans** |
| A Governmental 457(b) Plan (also referred to as a Public 457(b) Plan) is a deferred compensation plan that is limited to public sector employees (state or local governments that meet the statutory requirements listed in Section 457). While 457 Plans are not Qualified Plans, they allow employees to make salary deferral contributions similar to 401(k) Plans. The deferral may not to exceed the lesser of (a) $18,000, with an additional $6,000 if age 50 or over, or (b) 100% of the participant’s compensation (in 2016).  These plans offer a “double dipping” and potentially a unique “triple dipping” opportunity for employee deferrals. Let’s start with understanding the “double dip.” Contributions to a Governmental 457(b) Plan have no impact upon deferral limits in other salary reduction plans such as 401(k) and 403(b) Plans. If an employee has the ability to contribute to both a 401(k) Plan and a Governmental 457(b) Plan, then neither plan takes into account the deferrals of the other for purposes of staying within the maximum deferral limits. This effectively doubles the annual deferral limit for such an employee.  If your client likes the “double dip,” he or she may love the “triple dip.” During the last three years of employment, a 457(b) participant age 50 or older may defer an additional special catch-up amount of up to another $18,000 (2016, as indexed). The age-related $6,000 deferral may not be taken in the same year as the special catch-up deferral.   |  | | --- | | **Example**  Henrietta (age 60) earns $100,000 annually as an employee of a government agency that sponsors a 457(b) Plan. She is in her last three years of service before retirement. She also earns $30,000 annually as an employee of a private corporation that sponsors a 401(k) Plan.  She may defer a maximum of $60,000 of her salary in 2016 as follows.   * $24,000 Private Corporation 401(k) Plan (includes age-related $6,000) * $18,000 Government 457(b) Plan standard deferral * $18,000 Government 457(b) Plan special catch-up contribution   During any year she uses the $18,000 457(b) special catch-up contribution, she may not use the age-related $6,000 457(b) catch-up. |   Employers can add a Roth feature to a Governmental 457(b) Plan as of 2011. In a Roth 457(b), employees elect to designate their salary deferrals as Roth contributions. Such deferrals are made on an after-tax basis, but retirement distributions of such funds and the earnings on them will not be taxed. Unlike a Roth IRA, there are no modified AGI limits that phase out eligibility for participation. Also unlike a Roth IRA, distributions are required during the owner’s lifetime based upon required minimum distribution rules. |

## Unlimited Income Tax Deferral – The Spigot Trust

A high net worth, high-income prospect is in your office seeking fresh ideas to defer income into her retirement years. She’s been singularly unimpressed with the stale advice received from her current advisor.

You can show her how to ***defer hundreds upon hundreds of thousands of dollars or more in income*** for retirement using a “Spigot Trust.” The potential income tax deferral from Spigot Trust earnings is limited only by your client’s contributions, which are not limited by law!

This trust functions as an income spigot by turning income distributions off during the retirement accumulation phase and turning income distributions on during the distribution phase of retirement.

The Spigot Trust is an irrevocable charitable trust technically referred to as the Net Income with Make-up Charitable Remainder UniTrust (NIMCRUT). We will refer to the NIMCRUT by its more client-friendly nickname, the Spigot Trust, in this discussion.

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| NIMCRUT  A ***Net Income with Make-up Charitable Remainder UniTrust (NIMCRUT)*** is simply a variation of the basic Charitable Remainder Trust.  A basic Charitable Remainder Trust works in the following ways:   * Your client (the donor) contributes assets (the initial contribution) to an irrevocable Charitable Remainder Trust. * After initial contribution, the Charitable Remainder Trust distributes an annual payout to a non-charitable beneficiary (generally your client if retirement accumulation is the goal). * A charity of your client’s choosing receives the remainder of the trust when the trust terminates (generally at the death of your client).   **Click** here **for more information on Charitable Remainder Trusts.**   |  | | --- | | More Information on Charitable Remainder Trusts   1. The trust can provide income for one or more beneficiaries. Frequently, only the donor or the donor and his/her spouse are named as the income beneficiaries, so as to avoid gift tax issues associated with naming anyone else. 2. The trust can be written to terminate upon the death of the income beneficiary (referred to as the non-charitable beneficiary) or upon their combined deaths if more than one. Alternatively, the trust can be written to terminate at the end of a specific number of years, not to exceed 20 years. 3. The annual payout to the income beneficiary(ies) cannot be less than 5% or more than 50% of the value of the trust. Depending upon the type of the Charitable Remainder Trust selected, the annual payout is either fixed at the initial contribution date or varies based upon the trust’s value. 4. At time of trust creation, the charity must have an actuarial expectation to receive at least 10% of the initial contribution to the trust.   ***This list is not all-inclusive. Contact a Trust Attorney for additional information.*** | |

Prospects for a Spigot Trust have typically exhausted all traditional methods of retirement accumulation and tend to place a high value upon the following:

**Click on each to learn more.**

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| **Charitable Giving** |
| A genuine charitable intent is a virtual prerequisite for Spigot Trusts. These trusts are, at their heart, Charitable Irrevocable Trusts in which a charity will receive the assets remaining in the trust at some future event, such as the death of your client.  The Spigot Trust can be impactful for accumulating income for future payment to your client. Yet, you will want to clearly communicate that the assets remaining in the trust at the termination of the trust will be lost to the family forever. However, this downside can frequently be addressed using a Wealth Replacement Trust.   |  | | --- | | Wealth Replacement Trust  A *Wealth* ***R****eplacement* ***T****rust* owns life insurance used to replace some of the family wealth eroded by charitable gifts. The beneficiaries of wealth replacement trusts are customarily family members of the insured. | |
| **Building a Supplemental Retirement Income Stream** |
| Clients or prospects with significant net worth and cash flow, especially those who have become successful late in life or who have procrastinated in retirement accumulation saving, may be attracted to the Spigot Trust’s ability to accumulate significant amounts of supplemental retirement income. **Click** here **for an example.**   |  |  |  |  | | --- | --- | --- | --- | | **Example**  ***Note – There is an abundance of Spigot Trust design choices. This example denotes but one of those design choices.***  Your client Allison (age 46) established a Spigot Trust in the current year by contributing $1,000,000 in highly-appreciated Coca-Cola stock to the trust.   * ***The Trust document requires that Allison receive the lesser of current year income*** *(defined as dividends and interest)* ***OR 5% of trust assets*** every year until her age 65***.*** The 5% is called the “stated payout percentage.” * What happens if the income generated by the trust is less than 5% in any year? In that case, Allison receives a payout of less than 5%. To the extent Allison receives less than 5% in any year, the amount under distributed is tracked for potential payout to Allison during her retirement years. * The stated payout percentage must be selected when the trust is created, cannot be changed, and must range from a minimum of 5% to maximum of 50%.   The following happens next:   * The trustee may or may not choose to sell the Coca-Cola stock. Since the trust is income tax exempt, no capital gains taxes are paid by the trust if the Coca-Cola stock is sold. * From Allison’s age 46 to age 65 (20 years), the Trust invests only in growth securities paying no dividends. The Trust invests in no interest income generating securities.  |  | | --- | | No dividends  We acknowledge that it may be difficult to avoid all dividends; however, we assume *no dividends* merely for the purpose of keeping this example as simple as possible. |  * Average annual return during this period is 8%, derived 100% from growth in the market value of the portfolio. * The Trust receives no “income”; hence, Allison receives no payout from the Trust from her age 46 through age 65.   The Spigot Trust magic starts with the following:   * Because the Spigot Trust is an income tax exempt entity, the 8% annual return compounds tax-free. * By Allison’s age 65, the market value of the trust will have grown to approximately $4.3MM. * The trustee will change the investment allocation of the trust to generate at least 5% in income annually beginning at Allison’s age 65. * Allison, beginning at her age 65, will receive approximately $215,000 (5% of $4.3MM) annually for the rest of her life.   But there’s more! Remember all of those years during which Allison received no payout?   * The payout she did not receive is referred to as an under-distribution. * The under-distribution may be paid out periodically to Allison during her retirement years as a supplemental distribution *in addition to* the 5% payout percentage stated in the trust document.  |  | | --- | | Under-distribution  The IRS refers to the *under****-****distribution* as the “Make Up Account.” Hence, the official IRS name for the Spigot Trust is the Net Income with **Make-Up** Charitable Remainder UniTrust. |   **Caveat** - The under-distribution can only be paid out to Allison in those retirement years for which trust income (interest and dividends) exceeds the stated payout percentage of 5%.   * Not all market cycles will be ideal for this strategy. Specialized investment techniques may be required for the Spigot Trust to function effectively in low interest rate market environments. * Note that the trust investment strategy must change from growth to income upon Allison’s retirement.  |  | | --- | | Specialized investment techniques  *Specialized investment techniques* may include the use of deferred annuities, zero coupon bonds, and other methods to time the flow of income into the Spigot Trust.  ***Attention: Consult with your internal compliance team and a Trust Attorney before discussing specialized investment techniques with clients.*** | | |
| **Tax Reduction** |
| The following taxes are reduced or deferred through the use of the Spigot Trust:   * An income tax charitable itemized deduction is generally available for a portion of your client’s contribution to the NIMCRUT. Unless limited otherwise, the deduction may be taken in the year of contribution. If limited, the unused deduction may be carried forward for as long as five years. * Trust earnings are not taxed while in the trust; hence, the portfolio grows on a tax-deferred basis. * Assets remaining in the trust may be included in your client’s gross estate if your client, as the noncharitable beneficiary, dies before the trust terminates. However, the estate will receive a full charitable deduction for the assets distributed to charity. |
| **Avoiding Qualified Plan Restrictions** |
| Spigot Trusts are not subject to ERISA qualified plan rules. Therefore, your client enjoys the following advantages relative to qualified plans:   * No limit on how much that may be contributed to the Trust * No requirement to make annual contributions to the Trust * No premature distribution penalty for payouts before age 59½ * No required minimum distributions and hence, no penalties for failing to take distributions following the attainment of age 70½. |

The Spigot Trust, although impressive, is not retirement accumulation Utopia. The sobering disadvantages of this strategy include the following:

* Spigot Trusts are irrevocable. Amounts remaining in the trust at the trust’s termination go to charity and are lost to the family forever.
* Specialized investment techniques may be required for the trust to function effectively in low interest rate markets.
* Spigot Trust agreements are often scrutinized by the IRS, thus due diligence should be taken in drawing up the agreement.
* Hard-to-value assets, such as closely-held business interests, are not generally appropriate.
* Income distributions from the trust to the non-charitable beneficiary are generally taxed at ordinary income tax rates.

test_tip_icon **Planning Tip**

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| The Personal Defined Benefit Plan discussed earlier in this course should also be considered if your client is self-employed. |

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| Consult with your internal compliance team before discussing Spigot Trusts with prospects or clients. Spigot Trusts are complex strategies and should be designed and drafted by an experienced Trust attorney. |

Try It

**To check your understanding, answer the following:**

1. **The ideal Spigot Trust prospect is characterized by how many of the following?**

* Need for supplemental income stream in retirement

**Incorrect**. The statement is correct but not the only correct statement.

* A genuine charitable intent

**Incorrect**. The statement is correct but not the only correct statement.

* A need to reduce income tax and future estate taxes

**Incorrect**. The statement is correct but not the only correct statement.

* **All of the above**

**Correct**.

## Nonqualified Deferred Compensation Arrangement

***Nonqualified Deferred Compensation Arrangements (NQDCAs)*** are typically implemented by employers to provide tax-advantaged deferred benefits to supplement existing retirement benefits for a select group of employees/executives.

NQDCAs may be characterized by the following:

* NQDCAs are not restricted by ERISA requirements applicable to qualified retirement plans; thus, they can offer more flexibility to employers in terms of plan design.
* An NQDCA allows the employee to defer a certain portion of his/her compensation to a later date, thereby also deferring the income tax liability on the compensation.
* Employer contributions may also be made to NQDCAs without restriction by qualified plan limits.
* Any earnings/growth in the value of the deferred amount is also not taxed to the employee until he or she receives the funds. Thus, the NQDCA allows the employee to leverage the investment return on their compensation and time receipt of compensation when it is more advantageous or specifically needed, i.e., to supplement retirement income.
* The employer can deduct the amount of compensation deferred only when it is ultimately paid to the employee.

test_tip_icon **Planning Tip**

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| The employee’s NQDCA account does not have the security of the protection offered by a qualified plan. Payment to the employee generally depends on the sustainability of the employer’s business. In the event of employer bankruptcy, an employee’s NQDCA balance is generally treated as that of an unsecured creditor. |

## Stock Options

The National Center for Employee Ownership reports that 36% of employees in public companies own stock through an employer stock ownership plan. While an exhaustive review of stock options is beyond the scope for this training, your understanding of stock option basics will leverage your credibility in this popular accumulation strategy.

The potential for income deferral from options appeals to those clients expecting a lower income tax rate in retirement. An employer **stock option** can be described as a contract (the grant) to sell employer stock to an employee at a specified price (the grant price) after a certain period of time (the vesting period). The employee benefits if the fair market value of the stock rises above the grant price. On the other hand, if the price of the stock goes down, the employee loses nothing.

Employer stock options are offered in a number of versions. Two of the most common versions are Nonqualified Stock Options (NSOs) and Incentive Stock Options (ISOs).

Nonqualified Stock Options (NSOs) are “nonqualified” because they do not qualify for the special tax incentives available through ISOs. They can be viewed simply as deferred compensation.

* As a result of law changes, NSOs now tend to be issued with a grant price equal to fair market value on the grant date. Previously, NSOs were frequently issued with a grant price below fair market value on the grant date.
* When the options vest, the employee may exercise the option by paying the grant price and receiving the stock.
* The employer generally receives an income tax deduction to the extent the employee recognizes income.
* Compensation income will be recognized at the exercise date to the extent that the market price exceeds the grant price. The employee is subject to income tax, Social Security tax (potentially), and Medicare tax on the income recognized.

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| **Example**  Gertrude was awarded 1,000 NSOs on Acme. The fair market value of Acme stock was $50 per share on the grant date and the grant price was $50 per share. The NSOs vest in 10 years.   * Gertrude exercised her options 3 years after the vesting date when the fair market value of Acme was $75 per share. * She paid $50 for each share and received Acme stock worth $75 per share. Her gain was $25 per share multiplied by 1,000 shares for a total gain of $25,000. As of the exercise date, $25,000 is treated as compensation income, not capital gain. * She will pay federal ordinary income as high as 39.6% in 2016 plus state income tax, plus (potentially) Social Security plus basic Medicare. The combined tax rate could easily exceed 50%! |

Incentive Stock Options (ISOs) offer the potential for long-term capital gains treatment as opposed to compensation income. ISOs tend to be awarded to executives rather than rank-and-file employees.

* ISOs provide the optimum income tax result when your client is not subject to the Alternative Minimum Tax. While a detailed review of the AMT is beyond the scope of this training, please be aware of this issue. The client’s CPA or other tax professional should be consulted before the exercise of ISOs!

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| Alternative Minimum Tax (AMT)  The AMT system is designed to ensure all taxpayers pay at least a minimum percentage of income tax. One of the ways the AMT accomplishes this goal is by disallowing certain income exclusions for AMT purposes, such as the exclusion of gain on exercise of ISOs. The AMT, when it applies, is paid in addition to the taxpayer’s regular income tax amount. |

* An ISO must be issued at or above fair market value on the date of the grant. No more than $100,000 of ISOs can vest per person per year; any amount beyond $100,000 becomes NSOs. The term of the option may not exceed 10 years and the employer’s Board of Directors must authorize the ISO.
* Here’s a costly yet all too common mistake to avoid. The executive must remain an employee from the date of grant to within 90 days of the exercise date. Violation of this rule causes the options to be treated as NSOs.
* The employer receives no income tax deduction at any time in connection with ISOs.
* No income to the employee is recognized for regular income tax purposes at the grant date or the exercise date. Only when the shares are sold will gains be subject to taxation. The gains are taxed as long-term capital gains if certain holding period requirements are met.

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| **Example**  Hamlet was awarded 1,000 ISOs of Acme stock. The fair market value of Acme stock was $50 per share on the grant date and the grant price was $50 per share. The ISOs vest in 10 years.   * Hamlet exercised his options on the vesting date when the fair market value of Acme was $75 per share. He was not subject to the Alternative Minimum Tax. * He paid $50 for each share and received Acme stock worth $75 per share. His gain was $25 per share multiplied by 1,000 shares for a total gain of $25,000. The gain is not taxed at the exercise date. * He may defer recognition of the gain until he sells the shares. He will pay long-term capital gains tax on the gain in the year of sale. |

## Review Exercise

**Select the correct answer for the following questions.**

1. **For-profit corporations may implement 403(b) Arrangements.**

* True

**Incorrect**. Similar to 401(k) Plans in features, 403(b) Arrangements are only permitted for tax-exempt religious, charitable, or educational organizations.

* **False**

**Correct**. Similar to 401(k) Plans in features, 403(b) Arrangements are only permitted for tax-exempt religious, charitable, or educational organizations.

1. **Sarah, age 35, has come to you with a question. She works for the water authority, which is a government agency. Her municipality has set up a Public 457(b) Plan for all its employees and Sarah is eager to participate. Her only problem is that she also contributes to a 401(k) Plan and plans on contributing the maximum amount to it this year ($18,000 in 2016). She’d like to make contributions to the Public 457(b) this year as well, but doesn’t want to incur penalties on her 401(k). What can she do?**

* To avoid going over the maximum contribution limit, Sarah needs to either reduce her contributions to her 401(k) or not participate in the 457(b) this year.

**Incorrect**. Try again.

* Sarah can participate in the 457(b) Plan as long as she pays taxes on her contributions.

**Incorrect**. Try again.

* **Sarah can contribute the maximum to both without penalty.**

**Correct**. Sarah can contribute the maximum to both plans ($18,000 each in 2016, as indexed) because contributions to the Public 457(b) Plan will NOT affect her contribution limit to her 401(k) Plan.

* Sarah is not allowed to participate in a 457(b) if she already makes contributions to a 401(k).

**Incorrect**. Try again.

1. **Your client Mary was granted ISOs by her employer exactly 9 years ago. On the grant date, the fair market value of the stock was $100 per share and the grant price was $100 per share. She plans to retire in exactly one year. The ISOs vest in exactly one year. Her employer’s stock has a current fair market value of $250 per share. Which of the following should not be a factor in Mary’s decision to exercise the ISOs?**

* Consult her CPA to determine any alternative minimum tax liability before exercising the ISOs

**Incorrect**. Try again.

* Remember that she must exercise the ISOs at least 90 days before she retires to obtain ISO income tax treatment

**Incorrect**. Try again.

* Assuming she exercises the ISOs, decide whether to sell the shares immediately after exercise or continue to hold the shares to defer long term capital gains taxes

**Incorrect**. Try again.

* **Plan the exercise of the ISOs with her employer’s Chief Financial Officer to maximize the company’s income tax deduction from the exercise**

**Correct**. The employer receives no income tax deduction associated with ISOs.

## Conclusion

The North Star[[9]](#footnote-9) guiding our discussion on the preceding pages was based upon the following three goals:

1. Broadening your retirement accumulation planning expertise.
2. Elevating your understanding of the key issues associated with this phase of retirement planning and how they can be resolved.
3. Enhancing your ability to guide clients through the retirement accumulation planning process.

We hope you have taken advantage of this course to better plan your own retirement accumulation. We further hope that you will use that personal process as a springboard to better advise your clients.

Entire books have been written on many of the individual topics presented to you in this course. We have worked with focus and diligence in bringing you the vital concepts you simply must know while avoiding a love-fest with details of lesser importance. Because many of these concepts are deep, wide, and subject to statutory change, we strongly encourage follow-up with your firm’s internal technical and compliance resources as you develop alternatives and make recommendations to clients. Consultation with your client’s CPA, CFP® Certificant or other financial professional is recommended where appropriate as well.

This concludes your course on retirement accumulation planning. 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 leveraging this knowledge to assist your clients!

1. *Financial Advisors’ Role in Influencing Social Security Claiming, November 2011.* [↑](#footnote-ref-1)
2. *The Net Investment Income Tax (NIIT) may reduce this difference to about 16% instead of approximately 20%. Not all clients are subject to the NIIT. The NIIT is discussed subsequently in this course.* [↑](#footnote-ref-2)
3. *May 2014, Issue Brief No. 399* [↑](#footnote-ref-3)
4. *http://www.bankrate.com/calculators/retirement/convert-ira-roth-calculator.aspx* [↑](#footnote-ref-4)
5. *Health Savings Accounts and Health Reimbursement Arrangements: Assets, Account Balances, and Rollovers, 2006–2013, EBRI Issue Brief #395, January 2014.* [↑](#footnote-ref-5)
6. *Internal Revenue Code Section 410(a)* [↑](#footnote-ref-6)
7. *\*Bureau of Labor Statistics, Monthly Labor Review, December 2012.* [↑](#footnote-ref-7)
8. *401(k) Fast facts, Updated April 2014* [↑](#footnote-ref-8)
9. *The North Star was used by ancient mariners to navigate reliably to port and avoid becoming hopelessly lost at sea.* [↑](#footnote-ref-9)