The Specialist

ANSWERS TO TOUGH QUESTIONS ABOUT TAXES AND INVESTING

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Rollover Roulette: Don't Take Chances with Retirement Assets

By Ed Slott, CPA

When you leave your employer — to change jobs or step into retirement — it's important to consider what will happen to the savings in your workplace retirement plan. Some people choose to transfer some or all of these assets to an IRA.

IRAs typically offer a larger selection of investments (some with lifetime payout options), withdrawal flexibility, and a chance to consolidate retirement accounts so they are easier to manage. Even so, it might make more sense to leave the money in your former employer's 401(k) plan or transfer the funds to your new employer's plan.

It's possible that your 401(k) plan offers access to investments that can't be replicated in an IRA (or can't be replicated at a similar cost). You may also want to think twice about executing an IRA rollover if any of the following scenarios could affect your retirement planning.

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You might want (or need) to retire early. Distributions from a 401(k) plan prior to age 59½ are subject to a 10% federal income tax penalty, but there's an exception for distributions following separation from service at age 55 or older (age 50 for qualified public safety employees). By contrast, you cannot avoid the 10% early-distribution penalty on IRA withdrawals until you reach age 59½ (unless a different exception applies).

You expect to delay retirement. Once you reach age 70½, you must begin taking required minimum distributions (RMDs) from your tax-deferred retirement accounts each year, whether you need the money or not, or face a 50% penalty on the amount that should have been withdrawn.

If you continue working into your 70s, you can wait to take minimum distributions from your current employer's 401(k) plan until after you retire, but you still must take RMDs from other tax-deferred accounts.

Your Roth 401(k) hasn't passed the five-year test. A Roth 401(k) distribution that hasn't satisfied the five-year holding requirement is not qualified (eligible for a tax-free and penalty-free distribution) yet, so be aware that rolling those dollars to a new Roth IRA restarts the clock if you do not already have a Roth IRA.

Continued on page 4

If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.

How Much Should You Save for Retirement?

Saving for retirement can be daunting, but as with any long-term project, it may help to have a plan. Yet less than half of current workers have tried to estimate how much savings they will need to live comfortably in retirement. Those who do try to estimate their needs tend to set higher savings goals and are more confident that they can enjoy a comfortable retirement.[1]

Though every situation is different, one common guideline is that you may need to replace 70% to 80% of your pre-retirement income. This typically assumes that you will have paid off your mortgage, will be in a lower tax bracket when you retire, won't be saving for retirement, and will not have work-related expenses, such as for commuting and business clothing.

If your retirement is 20 or 30 years away, it might be difficult to project your retirement income needs and living expenses, but it may help to start with some rough numbers. If retirement is nearer, projecting income and expenses should be easier.

Here are some tips to consider.

Estimate your Social Security benefits. You can calculate your future Social Security benefits using the Retirement Estimator at *ssa.gov*. Keep in mind that this tool assumes current benefit levels; the 2016 trustees' report suggests that the program may be able to pay only 77% of scheduled benefits after 2035, unless Congress takes action.[2] On the other hand, your future benefit may rise as your salary increases and the Social Security Administration makes cost-of-living adjustments.

Be realistic about investment returns. Higher returns might enable your nest egg to grow faster, but it may be more prudent to use a modest rate of return in your calculations. If you experience higher returns, you might consider it a bonus. Remember that all investing involves risk, including the possible loss of principal, and there is no guarantee that any investment strategy will be successful.

Consider your retirement lifestyle. Perhaps you want to travel more, move to a different area of the country, or engage in new activities. Would these lifestyle choices require more retirement savings?

Prepare for a long retirement. Your retirement may last 25 or more years. According to recent mortality tables, a healthy 45-year-old man would have a 45% chance of living to age 90 and a 27% chance of living to age 95. The odds of living to 90 or 95 are 56% and 37%, respectively, for a healthy 45-year-old woman.[3]

Factor in medical expenses. Modern medical care has contributed to longer life expectancies, but costs continue to rise. A couple who retired at age 65 in 2015 could spend an average of $259,000 on medical expenses in retirement (including Medicare and Medigap premiums, out-of-pocket expenses, and median prescription drug expenses).[4] Future retirees might face even higher medical expenses.

The simplified worksheet below could help you start estimating your retirement needs, but you may benefit from professional advice and a more thorough cash-flow analysis. Although there is no assurance that working with a financial professional will improve investment results, a professional who focuses on your overall objectives can help you consider strategies that could have a substantial effect on your long-term financial situation.

1) Employee Benefit Research Institute, 2016
2) Social Security Administration, 2016
3) American Academy of Actuaries and Society of Actuaries, 2016 (based on a nonsmoker in excellent health)
4) Employee Benefit Research Institute, 2015

A Basic Idea

This worksheet might give you a general idea of the savings needed to generate your desired retirement income.

	Example	You
Annual retirement income desired	$80,000	
Subtract expected retirement income from sources such as Social Security or a pension	– $30,000	
Income you need to generate from savings and investments	$50,000	
Savings needed to provide desired income for 25 years (line 3 x 17.4)*	$870,000	
Savings needed to provide desired income indefinitely (line 3 ÷ 0.03)*	$1,667,000	

*Assumes a 3% after-tax rate of return; the 25-year factor is rounded.

This hypothetical example is used for illustrative purposes only. Rates of return will vary over time, particularly for long-term investments. Investments seeking to achieve higher rates of return involve a higher degree of risk. Actual results will vary.

Taxing Social Security Benefits

A recent study by the Social Security Administration projected that an average of 56% of households receiving Social Security benefits will owe federal income tax on some or all of their benefits during the period from 2015 to 2050.[1] This typically applies to taxpayers who have other substantial income, such as from a pension, investments, or employment.

The formula for determining the tax liability of benefits is somewhat complicated but may be worth taking time to understand. Whether you are already receiving Social Security or projecting your future retirement income, knowing how much of your benefits might go toward taxes is important for realistic planning.

Combined Income

The tax liability for Social Security benefits depends on your "combined income," sometimes referred to as modified adjusted gross income (MAGI). For most people, this is adjusted gross income plus tax-exempt interest (such as from municipal or Treasury bonds) plus one-half of your Social Security benefits.

If your combined income exceeds a "base amount" of $25,000 ($32,000 for joint filers), you may owe federal income tax on up to 50% of your Social Security benefits. If your combined income exceeds a higher base amount of $34,000 ($44,000 for joint filers), you may owe tax on up to 85% of your benefits. Single-filer base amounts apply to those filing as head of household, qualified widow/widower, or married filing separately if spouses did not live together during the year. If you are married filing separately and lived with your spouse, the base amounts do not apply, and you will probably pay taxes on all your benefits.

The taxable portion of your benefit would be included with other ordinary income and taxed at your marginal rate.

Increasing Tax Liability

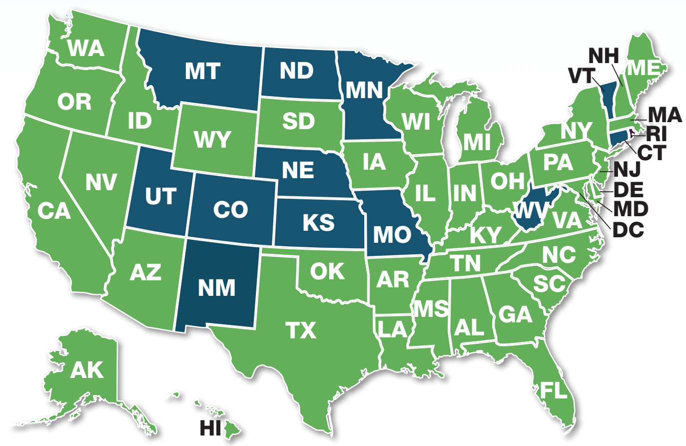
The combined income thresholds, which were set in 1983 and 1993 and intended for high-income beneficiaries, have never been indexed for inflation. This has increased the percentage of beneficiary households who are subject to taxes on their benefits from 8% in 1983 to 52% in 2015. For those whose benefits are taxed, the average percentage of benefits that goes toward paying taxes is expected to rise from 11.9% in 2015 to 14.7% in 2050.[2] Adjusting these base amounts is among the many provisions considered in broader Social Security reform.[3]

State by State

In addition to federal income taxes, 13 states tax Social Security benefits. Some follow federal rules, while others have unique guidelines. Keep in mind: States that tax Social Security benefits may have other tax provisions that are favorable for retirees.

Tax Social Security benefits

Don't tax benefits



Source: Kiplinger, 2015

If you are already receiving Social Security benefits, you should receive Form SSA-1099 each January, listing the amount of benefits you received in the previous year. If you expect to owe federal income taxes, you can pay estimated taxes with Form 1040-ES, have additional taxes withheld from other income, or request to have taxes withheld directly from your Social Security benefits by completing Form W-4V, Voluntary Withholding Request.

1–2) Social Security Administration, 2015
3) accountingweb.com, February 24, 2016

Why You Need a Will... Even If You're Not a Prince

The unexpected death of famed musician Prince in April 2016 put the importance of a will in the national spotlight. Prince, who apparently died *intestate* — without a legal will — left an estate worth an estimated $150 million to $300 million. The disposition of those assets will now be up to the state of Minnesota and may take many years to be resolved.[1]

Expressing Your Wishes

Regardless of your estate's value, a will can help ensure that your assets are distributed according to your wishes. It enables you to name an executor for your estate and can be an effective way to designate a guardian for minor children.

If you die without a valid will, the state could decide how your assets will be distributed. Typically, assets go to the surviving spouse and children, but state laws and distribution formulas vary widely. When the deceased dies intestate and leaves no spouse or children, as was the case with Prince, the situation becomes more complicated.

Having a will does not avoid probate, the legal process by which assets are distributed. However, a will could make probate more efficient and less expensive.

Personal Property

You can bequeath tangible assets such as jewelry or works of art in a will, but it may be more convenient to list whom you want to receive specific assets in a *personal property memorandum*. This is not a legal document, so it does not have to be witnessed or notarized and can easily be changed.

In most states, you can make the memorandum a legal document by referring to it in your will. Even if your state does not consider it legally binding, your heirs will have a clear indication of your intentions. You cannot use a memorandum to bequeath real estate or intangible property such as money, bank accounts, securities, and copyrights.

Advance Preparation

Preparing a legal will does not have to be time-consuming or expensive, but you should consider consulting an estate planning professional who is familiar with the laws of your state. Be sure to tell your executor and beneficiaries where to find the signed copy of your will and other legal documents. Don't forget to update your will when major life events occur, such as a change in marital status, the birth of children or grandchildren, the purchase or sale of a home or other significant assets, and when tax laws change.

1) *Forbes*, April 27, 2016

Ed Slott is a professional speaker and the creator of several public television specials, including "Ed Slott's Retirement Road Map." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.

Rollover Roulette

(Continued from page 1)

No matter how long those dollars were in the 401(k) plan, you'll have to wait five more years until a distribution from your new Roth IRA will be qualified and tax-free.

You own appreciated company stock in your 401(k). Distributions from 401(k) plans are generally subject to ordinary income taxes, but a special net unrealized appreciation (NUA) rule applies when you receive a distribution of employer stock from your plan: You pay ordinary income tax only on the cost of the stock at the time it was purchased for you by the plan. Any appreciation in the stock receives more favorable long-term capital gains treatment, regardless of how long you've owned the stock. These special NUA rules do not apply if you roll the stock over to an IRA, so all distributions would generally be taxed at higher ordinary income tax rates.

You are subject to a lawsuit, judgment, or collections. Under federal law, 401(k) plans offer virtually unlimited protection from creditors (assuming the plan is covered by ERISA; solo 401(k)s are not), whereas IRAs are protected from creditors only if you declare bankruptcy. Any IRA creditor protection outside of bankruptcy depends on the particular laws of your state.