



SOCIETY FOR FINANCIAL EDUCATION AND PROFESSIONAL DEVELOPMENT

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U C C E S S

Tax Planning as You Age

While tax planning should be a consideration through all phases of life, the nature of that planning changes as you approach retirement age. During your working years, your primary tax planning objectives are to reduce your current income taxes while saving for retirement. After decades of accumulating money, you now need to ensure you withdraw and manage that money properly. Here are some tips:

Rolling out of a 401(k) — If you don't want to leave your funds in your 401(k) plan, you should consider transferring your money to an individual retirement account (IRA). You can now transfer directly to a Roth IRA. While there are no income tax ramifications if you rollover from a 401(k) plan to a traditional IRA, you do have to pay taxes on the amounts that would be

taxable when withdrawn when converting to a Roth IRA (i.e., contributions and earnings in deductible IRAs and earnings in nondeductible IRAs). However, if you pay the income taxes from funds outside the IRA, you have essentially increased the value of your IRA, since you won't have to pay income taxes on qualified withdrawals.

If you own stock in your employer's company in your 401(k) plan, consider those assets separately. There is a provision in the tax

code that may save you a substantial amount of taxes. Instead of rolling over the company stock, have the shares distributed to you and put them in a taxable account. You will owe ordinary income taxes on the cost basis of those shares, which equals the price that was paid when the stock was purchased. (If you take the distribution prior to age 59½, you may also owe the 10% federal income tax penalty on the cost basis.) At this point, you do not pay taxes on any appreciation in

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Tax Planning

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the stock's value. When you sell the stock, provided you have held it for at least one year, you will owe capital gains taxes at a maximum rate of 20% on the net unrealized appreciation, rather than ordinary income taxes that would be paid on other traditional IRA distributions. If you have substantial appreciation in your company stock and are in a high marginal tax bracket, this strategy can save you a substantial amount of taxes.

Handling an inherited IRA — IRAs are becoming an increasingly significant asset for many people due to 401(k) rollovers and asset growth. Thus, it is becoming more likely that you will inherit an IRA. Don't immediately cash out an inherited IRA, which requires the payment of income taxes on the distribution. If you inherit a traditional IRA from a spouse, you can delay distributions until age 70½ and then take distributions over your life expectancy. No distributions are required during your life if it is a Roth IRA. If you inherit the IRA from someone other than your spouse, you must start taking distributions in the year following the owner's death, but you can take those distributions over your life expectancy. Make sure to investigate whether you are entitled to an

income in respect of a decedent (IRO) deduction, which is available when federal estate taxes are paid on IRA assets. This deduction can help offset income taxes due on distributions.

Dealing with a second home — If you plan on moving after retirement, you might want to acquire a home in that location before retirement. But first, be aware of the 1031 exchange rules. These rules allow you to sell one property and purchase another of like kind, deferring any gains. For instance, this tax rule can be used to help acquire a retirement home. Start out purchasing a small investment property. You can sell it at a later date and purchase a more expensive property, deferring the gains. You can continue this process until you eventually purchase your retirement home. However, before living in the home, you must first rent it out to defer the gain. While there are no clear-cut rules on how long the home must be rented, the Internal Revenue Service has validated a two-year period. After that, you can move into your retirement home and use it as your principal residence. As long as you live in the home for two of the last five years before selling, you could then sell the home and exclude \$250,000 of gain if you are single and \$500,000 of gain if you are married filing jointly.

When purchasing the second home, be sure to get a mortgage on that property rather than a home-equity loan against your principal residence. Interest is only deductible on \$100,000 of a home-equity loan, while the entire interest on a mortgage up to \$1,000,000 would be deductible.

Selling a business — Many business owners find that their business comprises a substantial portion of their net worth. Thus, when it comes time to sell that business, they naturally want to negotiate as large a selling price as

possible. But keep in mind that there are many ways to structure a sale. You might want to consider an installment sale, so the gain is recognized over a period of years rather than a single year. You may want to consider including a consulting contract for a period of years. If you are selling the business to employees, an employee stock ownership plan may make sense.

Reviewing your estate plan — As you approach retirement, it's a good time to review your entire estate plan. While the estate tax exemption is large (\$5,340,000 in 2014), estate-planning strategies should still be considered. Those with large estates probably don't want to leave their entire estate to their spouse. While that will avoid estate taxes on the first spouse's death, estate taxes may be owed after the second spouse's death if the estate is larger than the estate tax exemption. While changing estate tax exemption amounts can make it more difficult to plan, you should still consider leaving part of your estate to other heirs. If you don't want to make outright distributions in case your spouse needs the assets, you can set up a trust (commonly referred to as a credit shelter or bypass trust) to hold those assets. Your spouse can then use the income and even some of the principal, with the remaining assets distributed to your heirs after his/her death. This preserves the use of your exclusion amount. You may also want to add a disclaimer provision to your estate-planning documents, detailing what happens if one of your heirs disclaims his/her inheritance. This provides a way for heirs to decide after your death how much should be placed in various trusts.

These are only a few situations to consider as you approach retirement age. Please call your financial advisor if you'd like to discuss your specific situation in more detail.

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A Budget Is Your Savings Plan's Best Friend

Your budget holds your savings plan together and is the key to maintaining healthy savings. A budget also shows you where your money is going every month so that you can ensure you are bringing in more than is going out and saving enough to meet your goals.

4 Steps to Creating a Budget and Sticking to It

 **Track where your money goes** — If you don't know already, it may take 3–4 months for you to get a really good idea of where you spend money and how much you spend. You can track your expenses using your bank statements, receipts, or logging it into a journal or smartphone app. Add up the total for each month and then average it out.

 **Put your budget on paper** — Once you've tracked your expenses, put your budget on paper. In the expenses column, include all expenses: groceries, gas, housing, clothing, entertainment, gifts, and so on. In another column, input your income. If you have a salary, you can input how much you receive each paycheck; but if your income varies, you can use the average of the last three months. Subtract your expenses from your income to see how much money you have left every month. If you have a negative number, you know you need to make some changes in your budget.

 **Keep looking for ways to increase your savings** — Almost all expenditure categories offer potential for savings. With essential expenses with fixed amounts, such as your mortgage, taxes, and insurance, you may be able to refinance your mortgage, find strategies to help reduce taxes, or comparison shop your insurance to reduce premiums. Essential expenses that vary in amount, such

as food, medical care, and utilities, can usually be reduced by altering your spending or living habits. Discretionary expenses, such as entertainment, dining out, clothing, travel, and charitable contributions, typically offer the most potential for spending reductions.

 **Reevaluate** — It is critical to reevaluate your budget after the first few months to ensure that it fits your needs and goals. If you find that you are continuously spending more money than budgeted for necessities, adjust your bud-

get. Once you get past the first few months with a new budget, reevaluate every six months or as needed.

Having a budget is key to saving money. Without one, it is easy to spend money blindly. A pair of shoes here, a power tool there, a toy for your child — it all adds up. If you don't decide where to spend your money and how much to spend each month, chances are you will not be saving. Please call your financial advisor if you'd like to discuss this in more detail. ○○○

Multiple Plans for Retirement

Instead of preparing just one plan for retirement, you may want to prepare three different plans to give you an idea of what could happen under different scenarios.

A bare bones plan — This plan would envision a subsistence-level retirement, just meeting your basic needs with no luxuries. This plan helps you determine the minimum amount needed to just survive during retirement. While this might not be a particularly pleasant view of retirement, it does give you an idea of the minimum amount needed.

A moderate plan — This plan adds some fun expenditures to the bare bones plan, including travel, entertainment, and dining out. This plan would involve increased levels of savings to support the additional expenditures but would assume modest rates of return on savings.

The dream retirement — This plan incorporates all your desires for retirement, perhaps extensive travel, relocation, or expensive hobbies. On the income side, this plan would require the largest savings level and assume the best-case scenario for portfolio returns.

Please call your financial advisor if you'd like help assessing your retirement plans. ○○○

Investment Tax Strategies

With marginal tax rates of up to 39.6%, taxes can seriously erode your investment's total return. Consider these strategies, which can help you reduce income taxes:

✓ **Consider your holding period before selling.** Gains on investments held for one year or longer are taxed at the capital gains tax rate of 15% or 20% (0% if you are in the 10% or 15% tax bracket), rather than ordinary income tax rates. Thus, before selling an investment, review your holding period.

✓ **Review realized gains and losses before year-end.** If you have realized gains but are holding investments with losses, you might want to sell them before year-end to offset those gains. You can offset all of your capital gains plus take an additional \$3,000 of loss against ordinary income.

✓ **Specifically identify which shares you are selling.** If you purchased an investment over time, you may have varying basis amounts for different shares. Your gain or loss will be determined by which shares you sell. Thus, you should assess your overall tax situation, decide whether you want a higher or lower gain or loss, and

then designate which shares you want to sell.

✓ **Donate investments with large capital gains to charitable organizations.** You can deduct the fair market value of the investment (provided you held it over one year) as a charitable contribution, subject to limitations based on your adjusted gross income. By donating the investment, you do not pay capital gains taxes on the gain.

✓ **Keep track of your investments' bases so you don't overpay taxes.** For instance, reinvested dividends are part of your cost basis since income taxes were paid when the dividends were received. For inherited assets, the cost basis is typically the value on the date of the previous owner's death.

✓ **Consider tax-deferred or tax-exempt investments.** The interest income from municipal bonds is typically exempt from federal income taxes and possibly state and local income taxes. Contributions to 401(k) plans and IRAs can grow on a tax-deferred or tax-exempt (for Roth IRAs) basis. This deferral of income taxes can make a significant difference in the ultimate size of your portfolio. ○○○



Caring for an Aging Parent

If you are helping an aging parent financially, review the tax laws to determine whether you qualify for some tax relief. The key is to determine whether you can deduct your parent as a dependent. To do so, your parent's gross income can't exceed the exemption amount, and you must provide over half your parent's support.

What happens if you share your parent's support with your siblings or other relatives? If the combined total equals more than half your parent's support and each person contributes at least 10% toward care, you can file a multiple support declaration. Even though more than one person contributed to the support, the parent can only be claimed by one person.

If you claim your parent as a dependent, any medical expenses paid for your parent can be claimed as a medical deduction on your tax return. Your total medical expenses, including your parent's expenses, must still exceed 10% of your adjusted gross income before you can take the deduction. If your parent lives with you and you must obtain outside care to go to work, you may be able to claim the dependent care credit. Also look into whether your employer offers a flexible spending account for elder care. ○○○

Financial Thoughts

The difference in average annual full-time earnings between young adults ages 25 to 32 with a college degree and those in the same age group with only a high school diploma is \$17,500 (Source: *Time*, April 28, 2014)

Nationwide, it is 38% cheaper to buy versus rent a home. The average credit score for approved mortgage applicants is 755. Approximately 92% of mortgage borrowers opt for a fixed-rate

mortgage (Source: *Money*, May 2014).

The average length of retirement for those turning 65 in 2014 is 19 years. The average 401(k) balance at the end of 2013 was \$89,300, up 16% from 2012 (Source: *Money*, May 2014).

Approximately 55% of individuals with a household income under \$100,000 say they are living paycheck to paycheck, while 37%

of those with a household income over \$100,000 indicate they are living paycheck to paycheck. This financial stress impacts relationships, with money being the top source of marital stress and the source of couples' most serious arguments — 41% of respondents indicated that they argued about money at least once a month (Source: *Money*, April 2014). ○○○