YOUR Money AND Family Today

AMERICA's TAX SOLUTIONS™ NEWSLETTER

MAY 2015

WHAT TO EXPECT WHEN YOU'RE RETIRING

People often adopt financial strategies and investment behaviors that they take with them into retirement. Unfortunately, what worked for you during the accumulation phase of your life will not likely translate into a good distribution strategy during retirement. Many obstacles can disrupt your life and financial plans, causing anguish and resulting in lost opportunity. The good news is it's not too late to re-evaluate and perhaps make new choices when it comes to planning or improving your retirement distribution strategy. Just thinking about a distribution strategy today already puts you ahead of the game since most people focus only on accumulating assets.

Here are just a few common retirement mistakes to avoid:

Taking Social Security Benefits Too Early

There is certainly a temptation to take Social Security benefits immediately upon eligibility. However, if you can hold off and delay taking benefits until the age of 70, for example, your Social Security benefits may increase approximately 8% per year due to COLA adjustments (annual cost of living adjustments). With medical costs constantly rising in America, delaying benefits until you are at least 65 years old can help avoid the "Medicare gap" where your Social Security income could be stressed by out-of-pocket medical costs or premiums. Even if you retire at 62, Medicare does not become available until you are 65.

Missing IRS Deadlines and Incurring Penalties

If you have an IRA, 401(k) or other retirement plan, you must remember to follow the distribution rules to avoid penalties. The IRS has strict rules and if, for example, if you miss a required minimum distribution (RMD), the IRS imposes a **50%** penalty on the undistributed amount!

Another common mistake is missing the IRA 60 day deadline if you decide to do a rollover rather than a trustee-to-trustee transfer. Rollovers are only permitted once per year. If you choose to do a rollover, make sure that you adhere to the 60 day rollover deadline for re-depositing those IRA funds or it will be treated as a **fully taxable** distribution. Also, if you are under 59½, a 10% early distribution penalty would apply as well.

Not Saving Enough For Retirement

Many households will have to downsize and curb spending during retirement. Nobody wants to run out of money and have to re-enter the workforce at let's say age 75!

CONTINUED ON PAGE 2 ▸

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Even the most disciplined savers run into this problem but creating a distribution strategy today is necessary to ensure you are saving enough and will have enough money to maintain your desired standard of living during retirement. The harsh reality is, many people do not save enough for retirement and are faced with a rude awakening when they realize there is no "pension fairy" waiting to give them money after they retire. It is important to figure out what you need to do today to achieve your retirement goals tomorrow.

Excessive Post-Retirement Withdrawal Rate
You must have a budget and stick to it. When most Americans retire, they have no distribution strategy and thus, no budget parameters for drawing down their assets during their "decumulation" or distribution phase. Adjusting to a fixed income is difficult when you have been accustomed to mass consumption during your entire adult life.

One rule-of-thumb touted by some financial advisors is for a draw-down ratio that is "25 times," meaning, you will need a retirement portfolio that is 25 times the amount you withdraw during your first year of retirement. People essentially have to "re-learn" how to handle finances and adjust their strategies for their distribution phase.

Flawed Asset Allocation
Asset allocation and diversification are two different concepts. Diversification deals with fine distinctions within particular classes of assets whereas an asset allocation strategy broadly manages classes of assets.

You may have heard of the "Buffet Pyramid" which illustrates an asset allocation model. It basically divides asset classes by risk and shows by percentage how people should ideally allocate their assets by risk category: No Risk, Moderate Risk and High Risk. The pyramid illustrates, as we age, it is prudent to gradually become more financially conservative as we reach (or are already in) retirement because there is less time to make up for any losses on assets that are in the high or moderate risk categories.

Allocation strategies should be adjusted as people get older, but unfortunately many people find themselves with an "upside down" pyramid when they reach retirement.

RMDs and Beneficiaries

IRA funds may not sit and continue to grow tax-deferred forever. This is why the government requires owners to take annual required minimum distributions ("RMDs") after turning 70½. Most IRA owners are aware of this rule but what about RMDs for beneficiaries? How does that work?

If the beneficiary of an IRA is not an individual but rather an entity such as a charity, there are no RMDs but the entire IRA must be distributed using what is known as the "5-Year Rule." This means that the entire IRA must be fully distributed by December 31st of the 5th year following the IRA owner's death.

Non-spouse beneficiaries who inherit an IRA from an owner who died before his/her RBD, have the option to use the 5-year rule or may generally elect to use the life-expectancy payment option. Unless the 5-year rule is selected, RMDs from inherited IRAs must begin no later than December 31st of the year following the IRA owner's death.

Sole spousal beneficiaries have additional options that non-spouse beneficiaries don't have. If the original owner dies **before** the RBD, a surviving spouse generally can elect to treat it as his or her own, roll it over to his or her own plan, choose the life-expectancy payment option or use the 5-year rule.

CONTINUED ON PAGE 3

CONTINUED FROM PAGE 2

If an IRA owner dies **after** his or her RBD, the surviving spouse may generally elect to treat it as his or her own, roll it into his or her own IRA or use the life-expectancy payment option. The difference under this last option will be that distributions will be based on the **longer** of the deceased spouse's remaining life expectancy (non-recalculated) or the remaining life expectancy of the surviving spouse (recalculated).

It is important to keep in mind that the IRA custodial agreement is a binding contract that determines what distribution options are available to beneficiaries. An IRA plan document may not offer all of the beneficiary distribution options mentioned in this article.

Simplifying IRA Lingo

Sometimes terminology gets confusing with respect to IRAs. Here are just a few definitions of IRA terms and concepts that are commonly asked about:

RBD: The Required Beginning Date or RBD is the date that required minimum distributions must begin for all IRA owners, which is April 1st of the year following the year an owner turns 70½. If your RBD happens to fall on a holiday or weekend, the RBD will be the following business day.

RMD: The Required Minimum Distribution or RMD is the ***minimum*** amount an IRA owner must withdraw each year from an IRA after his or her RBD. An IRA owner can always take out more than the RMD. There are no RMDs for ***owners*** of Roth IRAs but beneficiaries of inherited Roth IRAs are still subject to RMD rules.

ROLLOVER: A rollover is when assets are withdrawn from a retirement plan and then re-deposited into the same or other eligible plan. This is a reportable transaction for an IRA owner and it must be completed within 60 days. There is a 1 per year limit regardless of how many IRAs you have.

TRUSTEE-TO-TRUSTEE TRANSFER: This is a transfer of IRA funds that are sent, usually electronically, from an IRA and received directly by another IRA. Unlike a rollover, there is no limit to the number of trustee-to-trustee transfers each year.

CONVERSION: A conversion is when a traditional IRA (or SEP or SIMPLE IRA) is changed into a Roth IRA. The character of the funds is changed and income taxes will become due on the converted amount in the year of the conversion.

RECHARACTERIZATION: The term recharacterization is used when referring to a traditional IRA that has been converted to a Roth IRA but the owner wants to "undo" the conversion. Recharacterization is also used to refer to a Roth IRA contribution that an owner wishes to change into a traditional IRA contribution.

RECONVERSION: When an IRA owner converts a traditional IRA to a Roth IRA, then recharacterizes it to "undo" that conversion, but later decides that the conversion to a Roth IRA was a good idea after all, the traditional IRA is now going to be reconverted from a traditional IRA to a Roth IRA. *You cannot convert and reconvert during the same tax year or, ***if later,*** during the 30-day period following a recharacterization. If you reconvert during either of these periods, it will be a failed conversion.

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Using Net Operating Loss (NOL) as a Tax Strategy for Roth Conversions

NOL calculations are complicated so this illustration is only intended to give you a general idea of how it may operate as a Roth conversion tax strategy for a business owner. You should always consult with your personal tax professional regarding your situation.

Assume a sole proprietor has $150,000 in net business losses and $80,000 in net operating losses for the year. Assume the business owner also has a SEP IRA with over $150,000. He then converts $80,000 of his SEP IRA to a Roth. Because the Roth conversion is taxed as ordinary income, he uses that Roth "income" to offset the net operating business loss:

INCOME	
Spousal Wages	$65,000
Dividends	$5,000
Total income	**$70,000**

***NOTE:** *personal deductions and non-business deductions in excess of non-business income are **not** allowed in NOL calculations.*

DEDUCTIONS	
Net business losses	($150,000)
NOL for tax year	($150,000)
Net business losses	($80,000)
Income from Roth conversion	$80,000
Net taxable income	**$0**

In this example, the owner may be able to convert $80,000 of his SEP IRA without creating taxable income.

If a company has a net operating loss, it may apply this tax relief in one of two ways:

1) it can apply the net operating loss to its past tax payments and receive a tax credit; or
2) it could apply the net operating loss to future income tax payments, reducing the need to make payments in future periods. The terms of the tax relief and how it can be applied varies by jurisdiction but usually the NOL can be applied to the past 2 or 3 years or to future years (carry forward).

About America's Tax Solutions™

COMPLIMENTS OF:
Marc H. Weiss

Archer Weiss Insurance & Financial Services, Inc.
21515 Vanowen Street, Suite 200
Canoga Park, CA 91303
(800) 831-2901 TOLL FREE
(818) 610-8560 PHONE
(818) 888-1312 FAX

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