



# American

## Financial Management Group

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Dear Friends,

Do you have sources of tax-free retirement income?

- Roth Accounts
- Municipal bonds
- 77 Accounts

You likely know of the first two, but 770 accounts are gaining in popularity for a host of reasons:

- Tax-free retirement income
- No negative investment performance
- Creditor protection
- No investment expenses after ten years

Employers are finding these interesting due to:

- Ability to select participants
- Ability to match contributions based on individual job performance
- No liability on company financials

If you are interested in learning more about these concepts, please call our office to see how these structures may benefit you.

Best Regards,

Jeff

### October 2015

Six Common 401(k) Plan Misconceptions

Taxes, Retirement, and Timing Social Security

2015 Year-End Tax Planning Basics

What is the Roth 401(k) five-year rule?



## Six Common 401(k) Plan Misconceptions

Do you really know as much as you think you do about your 401(k) plan? Let's find out.

### 1. If I leave my job, my entire 401(k) account is mine to keep.

This may or may not be true, depending on your plan's "vesting schedule." Your own contributions to the plan--that is, your pretax or Roth contributions--are always yours to keep. While some plans provide that employer contributions are also fully vested (i.e., owned by you) immediately, other plans may require that you have up to six years of service before you're entitled to all of your employer contributions (or you've reached your plan's normal retirement age). Your 401(k)'s summary plan description will have details about your plan's vesting schedule.

### 2. Borrowing from my 401(k) plan is a bad idea because I pay income tax twice on the amount I borrow.

The argument is that you repay a 401(k) plan loan with dollars that have already been taxed, and you pay taxes on those dollars again when you receive a distribution from the plan. Though you might be repaying the loan with after-tax dollars, this would be true with any type of loan.

And while it's also true that the amount you borrow will be taxed when distributed from the plan (special rules apply to loans from Roth accounts), those amounts would be taxed regardless of whether you borrowed money from the plan or not. So the bottom line is that, economically, you're no worse off borrowing from your plan than you are borrowing from another source (plus, the interest you pay on a plan loan generally goes back into your account). But keep in mind that borrowing from your plan reduces your account balance, which may slow the growth of your retirement nest egg.

### 3. Because I make only Roth contributions to my 401(k) plan, my employer's matching contributions are also Roth contributions.

Employer 401(k) matching contributions are always pretax--whether they match your pretax

or Roth contributions. That is, those matching contributions, and any associated earnings, will always be subject to income tax when you receive them from the plan. You can, however, convert your employer's matching contributions to Roth contributions if your plan allows. If you do, they'll be subject to income tax in the year of the conversion, but future qualified distributions of those amounts (and any earnings) will be tax free.

### 4. I contribute to my 401(k) plan at work, so I can't contribute to an IRA.

Your contributions to a 401(k) plan have no effect on your ability to *contribute* to a traditional or Roth IRA. However, your (or your spouse's) participation in a 401(k) plan may adversely impact your ability to *deduct* contributions to a traditional IRA, depending on your joint income.

### 5. I have two jobs, both with 401(k)s. I can defer up to \$18,000 to each plan.

Unfortunately, this is not the case. You can defer a maximum of \$18,000 in 2015, plus catch-up contributions if you're eligible, to all your employer plans (this includes 401(k)s, 403(b)s, SARSEPs, and SIMPLE plans). If you contribute to more than one plan, you're generally responsible for making sure you don't exceed these limits. Note that 457(b) plans are not included in this list. If you're lucky enough to participate in a 401(k) plan and a 457(b) plan you may be able to defer up to \$36,000 (a maximum of \$18,000 to each plan) in 2015, plus catch-up contributions.

### 6. I'm moving to a state with no income tax. I've heard my former state can still tax my 401(k) benefits when I retire.

While this was true many years ago, it's no longer the case. States are now prohibited from taxing 401(k) (and most other) retirement benefits paid to nonresidents. As a result, only the state in which you reside (or are domiciled) can tax those benefits. In general, your residence is the place where you actually live. Your domicile is your permanent legal residence; even if you don't currently live there, you have an intent to return and remain there.

## Taxes, Retirement, and Timing Social Security



*\*This hypothetical example is for illustrative purposes only, and its results are not representative of any specific investment or mix of investments. Actual rates of return and results will vary. The example assumes that earnings are taxed as ordinary income and does not reflect possible lower maximum tax rates on capital gains and dividends, as well as the tax treatment of investment losses, which would make the return more favorable. Investment fees and expenses have not been deducted. If they had been, the results would have been lower. You should consider your personal investment horizon and income tax brackets, both current and anticipated, when making an investment decision as these may further impact the results of the comparison. Investments offering the potential for higher rates of return also involve a higher degree of risk to principal.*

The advantages of tax deferral are often emphasized when it comes to saving for retirement. So it might seem like a good idea to hold off on taking taxable distributions from retirement plans for as long as possible. (Note: Required minimum distributions from non-Roth IRAs and qualified retirement plans must generally start at age 70½.) But sometimes it may make more sense to take taxable distributions from retirement plans in the early years of retirement while deferring the start of Social Security retirement benefits.

### Some basics

Up to 50% of your Social Security benefits are taxable if your modified adjusted gross income (MAGI) plus one-half of your Social Security benefits falls within the following ranges: \$32,000 to \$44,000 for married filing jointly; and \$25,000 to \$34,000 for single, head of household, or married filing separately (if you've lived apart all year). Up to 85% of your Social Security benefits are taxable if your MAGI plus one-half of your Social Security benefits exceeds those ranges or if you are married filing separately and lived with your spouse at any time during the year. For this purpose, MAGI means adjusted gross income increased by certain items, such as tax-exempt interest, that are otherwise excluded or deducted from your income for regular income tax purposes.

Social Security retirement benefits are reduced if started prior to your full retirement age (FRA) and increased if started after your FRA (up to age 70). FRA ranges from 66 to 67, depending on your year of birth.

Distributions from non-Roth IRAs and qualified retirement plans are generally fully taxable unless nondeductible contributions have been made.

### Accelerate income, defer Social Security

It can sometimes make sense to delay the start of Social Security benefits to a later age (up to age 70) and take taxable withdrawals from retirement accounts in the early years of retirement to make up for the delayed Social Security benefits.

If you delay the start of Social Security benefits, your monthly benefits will be higher. And because you've taken taxable distributions from your retirement plans in the early years of retirement, it's possible that your required minimum distributions will be smaller in the later years of retirement when you're also receiving more income from Social Security. And smaller

taxable withdrawals will result in a lower MAGI, which could mean the amount of Social Security benefits subject to federal income tax is reduced.

Whether this strategy works to your advantage depends on a number of factors, including your income level, the size of the taxable withdrawals from your retirement savings plans, and how many years you ultimately receive Social Security retirement benefits.

### Example

Mary, a single individual, wants to retire at age 62. She can receive Social Security retirement benefits of \$18,000 per year starting at age 62 or \$31,680 per year starting at age 70 (before cost-of-living adjustments). She has traditional IRA assets of \$300,000 that will be fully taxable when distributed. She has other income that is taxable (disregarding Social Security benefits and the IRA) of \$27,000 per year. Assume she can earn a 6% annual rate of return on her investments (compounded monthly) and that Social Security benefits receive annual 2.4% cost-of-living increases. Assume tax is calculated using the 2015 tax rates and brackets, personal exemption, and standard deduction.

**Option 1.** One option is for Mary to start taking Social Security benefits of \$18,000 per year at age 62 and take monthly distributions from the IRA that total about \$21,852 annually.

**Option 2.** Alternatively, Mary could delay Social Security benefits to age 70, when her benefits would start at \$38,299 per year after cost-of-living increases. To make up for the Social Security benefits she's not receiving from ages 62 to 69, during each of those years she withdraws about \$40,769 to \$44,094 from the traditional IRA--an amount approximately equal to the lost Social Security benefits plus the amount that would have been withdrawn from the traditional IRA under the age 62 scenario (plus a little extra to make the after-tax incomes under the two scenarios closer for those years). When Social Security retirement benefits start at age 70, she reduces monthly distributions from the IRA to about \$4,348 annually.

Mary's after-tax income in each scenario is approximately the same during the first 8 years. Starting at age 70, however, Mary's after-tax income is higher in the second scenario, and the total cumulative benefit increases significantly with the total number of years Social Security benefits are received.\*

## 2015 Year-End Tax Planning Basics



### **AMT "triggers"**

*You're more likely to be subject to the AMT if you claim a large number of personal exemptions, deductible medical expenses, state and local taxes, and miscellaneous itemized deductions. Other common triggers include home equity loan interest when proceeds aren't used to buy, build, or improve your home; and the exercise of incentive stock options.*

### **Required minimum distributions**

*Once you reach age 70½, you generally must start taking required minimum distributions (RMDs) from traditional IRAs and employer-sponsored retirement plans (an exception may apply if you're still working and participating in an employer-sponsored plan). Take any distributions by the date required--the end of the year for most individuals. The penalty for failing to do so is substantial: 50% of the amount that should have been distributed.*

As the end of the 2015 tax year approaches, set aside some time to evaluate your situation and consider potential opportunities. Effective year-end planning depends on a good understanding of both your current circumstances and how those circumstances might change next year.

### **Basic strategies**

Consider whether there's an opportunity to defer income to 2016. For example, you might be able to defer a year-end bonus or delay the collection of business debts, rents, and payments for services. When you defer income to 2016, you postpone payment of the tax on that income. And if there's a chance that you might be paying taxes at a lower rate next year (for example, if you know that you'll have less taxable income next year), deferring income might mean paying *less* tax on the deferred income.

You should also look for potential ways to accelerate 2016 deductions into the 2015 tax year. If you typically itemize deductions on Schedule A of Form 1040, you might be able to accelerate some deductible expenses--such as medical expenses, qualifying interest, or state and local taxes--by making payments before the end of the current year, instead of paying them in early 2016. Or you might consider making next year's charitable contribution this year instead. If you think you'll be itemizing deductions in one year but claiming the standard deduction in the other, trying to defer (or accelerate) Schedule A deductions into the year for which you'll be itemizing deductions might let you take advantage of deductions that would otherwise be lost.

Depending on your circumstances, you might also consider taking the opposite approach. For example, if you think that you'll be paying taxes at a higher rate next year (maybe as the result of a recent compensation increase or the planned sale of assets), you might want to look for ways to accelerate income into 2015 and possibly defer deductions until 2016 (when they could potentially be more valuable).

### **Complicating factors**

First, you need to factor in the alternative minimum tax (AMT). The AMT is essentially a separate, parallel federal income tax system with its own rates and rules. If you're subject to the AMT, traditional year-end strategies may be ineffective or actually have negative consequences--that's because the AMT effectively disallows a number of itemized deductions. So if you're subject to the AMT in 2015, prepaying 2016 state and local taxes

probably won't help your 2015 tax situation, and, in fact, could hurt your 2016 bottom line.

It's also important to recognize that personal and dependency exemptions may be phased out and itemized deductions may be limited once your adjusted gross income (AGI) reaches a certain level. This is especially important to factor in if your AGI is approaching the threshold limit and you're evaluating whether to accelerate or defer income or itemized deductions. For 2015, the AGI threshold is \$258,250 if you file as single, \$309,900 if married filing jointly, \$154,950 if married filing separately, and \$284,050 if head of household.

### **IRA and retirement plan contributions**

Deductible contributions to a traditional IRA and pretax contributions to an employer-sponsored retirement plan such as a 401(k) could reduce your 2015 taxable income. (Note: A number of factors determine whether you're eligible to deduct contributions to a traditional IRA.) Contributions to a Roth IRA (assuming you meet the income requirements) or a Roth 401(k) plan are made with after-tax dollars--so there's no immediate tax savings--but qualified distributions are completely free of federal income tax.

For 2015, you're generally able to contribute up to \$18,000 to a 401(k) plan (\$24,000 if you're age 50 or older) and up to \$5,500 to a traditional or Roth IRA (\$6,500 if you're age 50 or older). The window to make 2015 contributions to an employer plan generally closes at the end of the year, while you typically have until the due date of your federal income tax return to make 2015 IRA contributions.

### **Important notes**

The Supreme Court has legalized same-sex marriage nationwide, significantly simplifying the federal and state income tax filing requirements for same-sex married couples living in states that did not previously recognize their marriage.

A host of popular tax provisions (commonly referred to as "tax extenders") expired at the end of 2014. Although it is possible that some or all of these provisions will be retroactively extended, currently they are not available for the 2015 tax year. Among the provisions: deducting state and local sales taxes in lieu of state and local income taxes; the above-the-line deduction for qualified higher-education expenses; qualified charitable distributions (QCDs) from IRAs; and increased business expense and "bonus" depreciation rules.

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### What is the Roth 401(k) five-year rule?

The Roth 401(k) five-year rule determines when you can begin receiving tax-free qualified distributions from your 401(k) plan Roth account.

While it's similar to the five-year rule that applies to Roth IRAs, there are important differences.

Withdrawals from your Roth 401(k) plan account--including both your contributions and any investment earnings--are completely tax and penalty free if you satisfy a five-year holding period *and* one of the following also applies:

- You've reached age 59½
- You have a qualifying disability, or
- The withdrawal is made by your beneficiary or estate after your death

The five-year holding period begins on the first day of the calendar year in which you make your first Roth 401(k) contribution (regular or rollover) to the plan. For example, if you make your first Roth contribution to your company's 401(k) plan in December 2015, your five-year holding period begins on January 1, 2015, and ends on December 31, 2019.

If you participate in 401(k) plans maintained by different employers, your five-year holding period is determined separately for each plan. But there's an important exception. If you make a direct rollover of Roth dollars from your prior employer's plan to your new employer's plan, your five-year holding period for the new plan will be deemed to start with the year you made your first Roth contribution to the prior plan.

For example, Beth made Roth contributions to the Acme 401(k) plan beginning in 2011. In 2015, she changed jobs and began making Roth contributions to the Beacon 401(k) plan. Her five-year holding period for the Acme plan began on January 1, 2011, and ends on December 31, 2015. Her five-year holding period for the Beacon plan began on January 1, 2015, and ends on December 31, 2019. In 2015, Beth decides to make a direct rollover of her Acme Roth account to Beacon's 401(k) plan. Because of the rollover, Beth's January 1, 2011, starting date at Acme will carry over to the Beacon plan, and any distributions she receives from her Beacon Roth account after 2015 (rather than 2018) will be tax free (assuming she's at least age 59½ or disabled at the time of distribution).



### How do I compare my health insurance options during open enrollment?

The decisions you make during open enrollment season regarding health insurance are especially

important, since you generally must stick with the options you choose until the next open enrollment season, unless you experience a "qualifying" event such as marriage or the birth of a child. As a result, you should take the time to carefully review the types of plans offered by your employer and consider all the costs associated with each plan.

With most health insurance plans, your employer will pay a portion of the premium and require you to pay the remainder through payroll deductions. When comparing different plans, keep in mind that even though a plan with a lower premium may seem like the most attractive option, it could have higher potential out-of-pocket costs.

You'll want to review the copayments, deductibles, and coinsurance associated with each plan. This is an important step because these costs can greatly affect what you end up paying out-of-pocket. When reviewing the costs of each plan, consider the following:

- Does the plan have an individual or family deductible? If so, what is the amount that will have to be satisfied before your insurance coverage kicks in?
- Are there copayments? If so what amounts are charged for doctor visits, specialists, hospital visits, and prescription drugs?
- Will you have to pay any coinsurance once you've satisfied the deductible?

You should also assess each plan's coverage and specific features. For example, are there coverage exclusions or limitations that apply? Which expenses are fully or partially covered? Do you have the option to go to doctors who are outside your plan's provider network? Does the plan offer additional types of coverage for vision, dental, or prescription drugs?

In the end, when reviewing your options, you'll want to balance the coverage and features offered under each plan against the plan's overall cost to determine which plan offers you the best value for your money.