

THE SPECIALIST

ANSWERS TO TOUGH QUESTIONS ABOUT TAXES AND INVESTING

AFTER-TAX 401(k) CONTRIBUTIONS: NEW RULES PAVE THE WAY TO A ROTH IRA

BY ED SLOTT, CPA

In the past, converting after-tax dollars in an employer plan to a Roth IRA required a multi-step process using 60-day (indirect) rollovers. Investors had to have sufficient funds outside the plan to make up the 20% mandatory withholding that applied to the taxable portion of the distribution. And if not executed correctly, the rollover could be deemed a taxable distribution, which also may be subject to a 10% early-withdrawal penalty for participants younger than 59½.

A 2014 IRS ruling makes it easier for investors to move after-tax 401(k) contributions directly to a Roth IRA. The prospect of hassle-free Roth conversions may inspire some people to contribute additional after-tax money to their employer plans.

SAVING TO THE MAX

Unlike the case with a Roth IRA, there are no income restrictions for contributions to a 401(k), so higher-income individuals may jump at this chance to build a tax-free income source for retirement. The 2015 employee contribution limit to a 401(k) plan is \$18,000, or \$24,000 for those 50 and older. Yet the law actually allows an "overall limit" of \$53,000 or 100% of compensation, whichever is less, to be put into a 401(k) on a worker's behalf. This overall amount includes employer matches and employee after-tax contributions, if allowed.

The ability to make after-tax contributions to a 401(k) plan is not available to everyone; it depends on the individual plan. Generally, plan participants must maximize salary deferrals to traditional and/or Roth 401(k) accounts before they can add after-tax money to the mix. Highly compensated workers (salary above \$120,000 in 2015) are subject to additional rules based on the employer plan's overall participation rate.

THE WAY TO A ROTH

When you leave your employer, any after-tax 401(k) contributions can be transferred directly to a Roth IRA at the same time that pre-tax contributions are directed to a traditional IRA.

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Charles W. Bruton, Jr.

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

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CALCULATING YOUR RETIREMENT NEEDS

It's hard to reach your destination, unless you're clear on where you're going. Yet only 44% of workers have tried to calculate how much they will need to live comfortably in retirement.¹

People who have calculated their needs typically have higher savings goals than those who simply "guess." Moreover, workers who have done a retirement-needs calculation tend to be more confident in their ability to achieve their goals.²

HOW MUCH IS ENOUGH?

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, are no longer saving for retirement, and will not have work-related expenses such as commuting and business clothing.

Of course, the amount you need to save to generate this level of income will depend on a variety of factors. Here are four important considerations, but there are others as well.

Consider the value of your Social Security benefits. Social Security replaces only a percentage of pre-retirement income. For workers with high career earnings, Social Security generally pays a higher monthly *dollar amount*, but the *percentage of income replacement* is lower. The age when you claim Social Security will also affect your benefits. You can estimate your future Social Security benefits online using the Retirement Estimator at ssa.gov. Keep in mind that the estimate assumes current benefit levels; the most recent

trustees' report suggests that the program may be able to pay only 77% of scheduled benefits after 2033, unless Congress takes action.³

Be realistic when estimating investment returns. Higher earnings might enable your nest egg to grow faster during your working years, but it may be prudent to use a modest rate of return in your calculations. If you experience higher returns, you might consider it a bonus.

Your savings may need to last longer than you anticipate. A 65-year-old man has a 41% chance of living to age 85 and a 22% chance of living to 90. For a 65-year-old woman, the odds are 54% and 34%, respectively.⁴

Don't forget medical expenses. You may need more savings than you think to meet retirement health-care expenses, even with Medicare. According to an estimate based on current claims data, a healthy couple retiring in 2015 could spend an average of \$366,599 for medical expenses during retirement; a couple retiring in 10 years could spend \$421,083.⁵


You should also consider the kind of retirement lifestyle you envision. Perhaps you want to travel more, move to a different area of the country, or try new activities. Would these lifestyle choices require more income from savings?

A comprehensive and systematic retirement-needs analysis could be an important step in pursuing a comfortable retirement. One way to start is by completing the simplified worksheet provided here. You may be surprised at the level of savings required to provide the retirement income you desire.

- 1-2) Employee Benefit Research Institute, 2014
3) Social Security Administration, 2014
4) Society of Actuaries, 2014
5) MarketWatch, May 1, 2014

A Rough Savings Estimate

Try this simple worksheet by plugging in your own numbers.



	Example	You
Annual retirement income desired	\$70,000	
Subtract expected retirement income from sources such as Social Security or a pension	- \$25,000	
Income you need to generate from savings and investments	\$45,000	
Savings needed to provide desired income for 20 years (line 3 x 15)*	\$675,000	
Savings needed to provide desired income indefinitely (line 3 ÷ 0.03)*	\$1,500,000	

***Assumes a 3% after-tax rate of return; the 20-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.

BRIDGING THE GAP WITH A SPOUSAL IRA

An IRA study found that women lag behind men when it comes to accumulating money for retirement (see chart). Though there may be multiple reasons for this disparity, the most fundamental is the continuing wage gap between men and women.¹

This gap tends to widen around the age when many women have children, which suggests that time away from the workforce may have a negative impact on a woman's career.² It also stands to reason that if a mother — or stay-at-home dad — is taking care of the children rather than working, she or he may not be contributing to a retirement account. The same situation could arise later in life if one spouse works while the other takes time off.

ADDITIONAL SAVING OPPORTUNITY

A spousal IRA, funded for a spouse who earns little or no income, offers an opportunity to help keep the retirement savings of both spouses on track. It also offers a larger potential tax deduction than a single IRA.

In 2015, an individual with earned income (from wages or self-employment) can contribute up to \$5,500 to his or her own IRA and up to \$5,500 more to a spouse's IRA — regardless of whether the spouse works or not — as long as the couple's combined earned income exceeds both contributions and they file a joint tax return. An additional \$1,000 catch-up contribution can be made by each spouse who is age 50 or older.

All other IRA eligibility rules must be met. So if a spousal contribution to a traditional IRA is made for

a nonworking spouse, she or he must be under age 70½ in the year for which the contribution is made. The age of the working spouse does not matter for purposes of the spousal IRA.

TRADITIONAL IRA DEDUCTIBILITY

If neither spouse actively participates in an employer-sponsored retirement plan such as a 401(k), contributions to a traditional IRA are fully tax deductible. However, if one or both are active participants, federal income limits may affect the deductibility of contributions.

In 2015, contributions to the IRA of an active participant will phase out with a modified adjusted gross income (AGI) between \$98,000 and \$118,000, but contributions to the IRA of a nonparticipating spouse will phase out with an AGI between \$183,000 and \$193,000. Thus, some workplace plan participants who earn too much to deduct an IRA contribution for themselves may be able to deduct an IRA contribution for a spouse who doesn't participate in an employer-sponsored retirement plan.

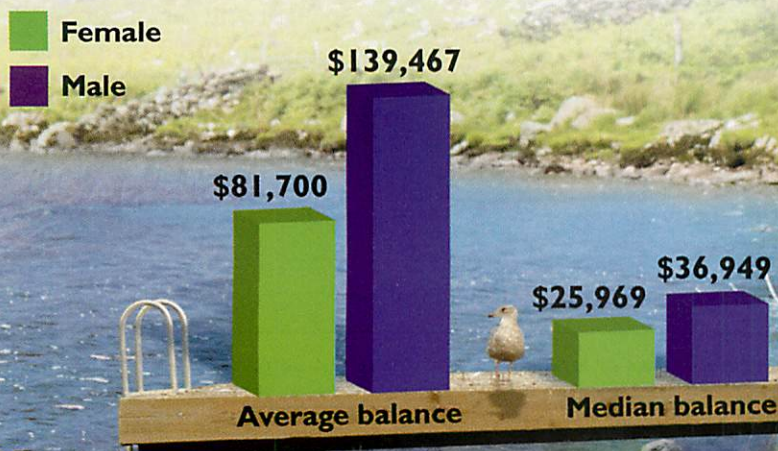
Annual required minimum distributions (RMDs) from traditional IRAs and most employer-sponsored retirement plans must begin for the year in which the account owner reaches age 70½. Withdrawals taken prior to age 59½ may be subject to a 10% federal income tax penalty, with certain exceptions as outlined by the IRS.

1) *The Washington Post*, May 21, 2014

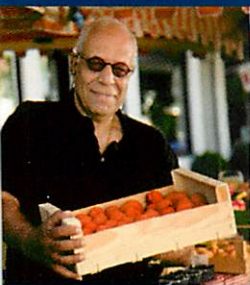
2) Pew Research Center, 2013

Lagging Balances

Average and median IRA balances, by gender



Source: Employee Benefit Research Institute, 2014 (2012 data)



STUDYING THE EARNINGS TEST

More than 2.7 million jobs were created in 2014, providing new opportunities for people of all ages.¹

This is good news, but what happens if you find a good job after you've already filed for Social Security?

You may have heard that the retirement earnings test (RET) could reduce your benefits. This shouldn't stop you from taking the right job, but it's important to understand this provision before you receive your first paycheck.

Here are the basics:

- The RET applies only if you are working and receiving Social Security benefits before reaching full retirement age (66 to 67, depending on birth year).
- If you are under full retirement age for the entire year in which you work, \$1 in benefits will be deducted for every \$2 in gross wages or net self-employment income earned above the annual limit (\$15,720 in 2015). Special rules, using a monthly limit, apply during the year you file for benefits.
- In the year you reach full retirement age, the reduction in benefits is \$1 for every \$3 earned above a higher annual limit (\$41,880 in 2015). Starting in the month you reach full retirement age, there is no limit on earnings or reduction in benefits.
- The Social Security Administration may begin to withhold benefits as soon as it determines that your earnings are on track to surpass the annual limit.

Even though the RET may seem like a stiff penalty, the deducted benefits are not really lost. Your Social Security benefit amount is recalculated after you reach full retirement age. For example, if you claimed benefits at age 62 and forfeited the equivalent of 12 months' worth of benefits by the time you reached your full retirement age (66), your benefit would be recalculated as if you had retired at 63 instead of 62. In this case, the benefit reduction would be 20% instead of 25%, and you would receive this higher benefit for the rest of your life.

The RET applies only to wages and self-employment income, not to income from investments, pensions, or withdrawals from retirement accounts. Keep in mind that, regardless of your age, you must pay Social Security and Medicare payroll taxes on your earnings.

1) U.S. Bureau of Labor Statistics, 2014

AFTER-TAX 401(K) CONTRIBUTIONS

(CONTINUED FROM PAGE 1)

For example, let's say your 401(k) account balance is \$100,000: \$80,000 of pre-tax dollars and \$20,000 of after-tax dollars. You could request a single \$100,000 distribution, with instructions for a trustee-to-trustee transfer of \$80,000 to a traditional IRA and \$20,000 to a Roth IRA.

Some plans may accommodate only one direct transfer per distribution. In this case, if you wish to separate pre-tax and after-tax money, you should directly transfer pre-tax funds to a traditional IRA and request a 60-day rollover of after-tax funds to a Roth IRA.

TAX DISTINCTIONS

Pre-tax contributions to a traditional 401(k) reduce a worker's current tax bill, but withdrawals are taxed as ordinary income. A Roth 401(k) is funded with after-tax money just like a Roth IRA, and qualified distributions are tax-free after age 59½ as long as the account satisfies the five-year holding requirement (under current law). By contrast, only the earnings on after-tax contributions to a traditional IRA are taxable when they are withdrawn.

With most tax-deferred retirement plans, you must take required minimum distributions (RMDs) once you reach age 70½. But a Roth IRA allows you to avoid RMDs during your lifetime. The money continues to accumulate tax-free until you need it, or you can leave this income-tax-free asset to your heirs. (Account beneficiaries are subject to RMDs.)



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.

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