Norman J. Politziner's
Financial Planning

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Weigh Five 401(k) Options When You Leave A Job

If you have participated in a 401(k) plan where you work, you may have accumulated a tidy nest egg for retirement. But what happens to those funds if you switch jobs or retire? Typically, you will have at least five options:

1. Take a lump-sum distribution. If you have a pressing need for the money, you can arrange to have your investments sold and the proceeds paid to you in a single sum. However, beyond depleting your savings, this also may have negative tax consequences. Most or all of the money may be taxed at ordinary income rates, which can reach as high as 39.6%, and a large payout may result in other tax complications, including a 3.8% surtax on net investment income (NII).

And if you're younger than age 59½, you also may owe a 10% early withdrawal tax, unless an exception applies. You might not have to pay this penalty if you need the money for a divorce settlement or medical expenses, for example.

2. Arrange a series of payments. If your plan allows it, you might set up a system of periodic payments you receive on a monthly, quarterly, or annual basis. You also can simply withdraw money when you need it.

By taking distributions gradually, you spread out your tax payments and may pay less. For example, suppose that a lump-sum distribution would push you into the top 39.6% bracket—whereas with a series of payments, you may be taxed at a 35% rate or lower. This also could reduce your exposure to the NII surtax.

3. Roll over to an IRA. Another option is to transfer funds from a 401(k) to a traditional IRA in your name. As long as the rollover is completed within 60 days, you won't owe tax on the distribution, and you also won't be subject to the 10% penalty tax. In effect, you can take an interest-free loan from your savings for two months, although 20% of any money you withdraw will be withheld for potential taxes. If you repay the funds on time you can recoup that money when you file your tax return. If you miss the 60-day deadline, however, you'll owe income tax on the full amount.

A safer approach may be to use a trustee-to-trustee transfer, in which your funds go directly from the 401(k) to the IRA—your hands never touch the money—and there are no taxes.

If you roll over funds from your 401(k) to a Roth IRA instead of a traditional IRA, you'll owe tax on the amount of the conversion, just as if you'd transferred money from a traditional IRA to a Roth.

(Continued on page 4)

Seeking Wisdom On The Mountain Top

Every year I have been lucky enough to be invited to advanced planning conferences featuring world renowned speakers lecturing on a multitude of relevant topics. Last month I was in Santa Fe and here are some of the nuggets I collected.

Our economy is up. People are cautious and savings rate is up. Inflation is benign, securities are reasonably priced and corporate profits are up. But, government intrusion slows things down, creates uncertainty and takes away incentives. To address these additional regulatory burdens, Fidelity added 900 people to their compliance department. Federal debt is almost 130% of GDP, while state and local government unfunded pension liabilities reached $1,800,000,000.

The financial markets are relatively indifferent to what happens in Washington, DC.

Internationally, much of the world is doing well. The global middle class is growing; Indonesia and India are leading the way. Brazil and Venezuela are in trouble. China is growing, but, over the past few years, they have overbuilt their country. Vacant floor space is up 40% year over year. 50% of China's lenders are in trouble. Non-performing loans are staggering, corporate debt is huge and censorship is mounting.

The EU is in a state of flux. They have printed so much money to stimulate their economies that it may prove inflationary. And, to add another economic insult, the G20 has added 2,000 trade restrictions since 2008.

I wonder if some of the leaders believed Mark Twain when he wrote "To succeed in life you need 2 things – Ignorance and Confidence."

We shall see.

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The Certified Financial Transitionist (CeFT) designation is awarded to those who have completed a 3-part training process composed of a 1-day workshop, core training program (minimum of 24 hours of coursework over a 12 month period) and a 1.5 day exam process including a 2 hour proctored exam, role playing, case essays and more. One must be a CFP and have 5 years of direct client relationships. Statistics stated in the Seeking Wisdom article above are according to a former leading fund manager at a prominent mutual fund company in 2017.

Using RMDs To Buy Life Insurance

It's a fact of tax-deferred investing for retirement. Eventually—within a year of reaching the age of 70½—the Internal Revenue Service expects you to begin pulling your savings out of retirement accounts and paying income tax on your withdrawals. These "required minimum distributions" (RMDs) are mandated for 401(k)s and other employer-sponsored plans, as well as for traditional IRAs (but not Roth IRAs).

Yet while there's no way around taking these mandatory distributions, if you use the money to buy life insurance you may be able to provide substantial tax-free benefits to your family.

Although the money you contribute to tax-deferred retirement accounts can grow without current tax erosion, RMDs must begin by April 1 of the year after the year in which you turn 70½. Then you have to take an RMD by December 31 every year thereafter. These RMDs generally are taxed at ordinary income tax rates as high as 39.6%.

If you're still working full-time and don't own the company, you may be able to postpone withdrawals from a plan sponsored by that employer until retirement. But this exception doesn't apply to IRAs.

The amount of the RMD is based on life expectancy tables and the value of your accounts on the last day of the previous year. For example, if you're age 75, the value of all your accounts is $500,000, and your spouse, who is the sole beneficiary, isn't more than 10 years younger than you are, the RMD under the tables is $21,834.

The penalty for *not* taking RMDs is equal to 50% of the amount you should have withdrawn (or the difference between the required amount and any lesser amount you did withdraw). For instance, if you failed to take any distribution in the example above, the penalty is $10,917, plus regular income tax. In addition, taking an RMD can trigger other tax complications. You might be subject to the 3.8% "net investment income" (NII) tax.

But what if you were to use the money to buy life insurance? Suppose that, in our example, you use the RMD amount, after paying tax on the withdrawal, to acquire a life insurance policy with a death benefit of $500,000. Further suppose that you pay a total of $200,000 in premiums before you die. Your family still comes out ahead by $300,000, and none of the $500,000 in proceeds from the life insurance is subject to income tax.

Choose the policy carefully to reduce the risk that your family will have less money with life insurance than if you invested the premiums somewhere else.

You could sweeten the deal by transferring ownership of the policy to an irrevocable life insurance trust, thus removing the value of the life insurance proceeds from your taxable estate. That could save your family from federal estate tax as well. ●

5 'Other' Retirement Saving Ideas

Usually, experts will tell you that the best way to save for retirement is by putting money into a 401(k) plan, an IRA, or another well-known retirement saving vehicle. And they're usually right. But you may not have access to a 401(k), and the contribution limits for IRAs are relatively low. Or those options may not appeal to you for other reasons.

That doesn't mean you can't save for retirement. Here are five other possibilities you might consider:

1. Brokerage accounts: Unlike when you sell a holding from inside a tax-deferred retirement plan, the sale of stocks, bonds, or mutual funds in a brokerage account may result in current taxes. But the maximum tax bite for assets held longer than one year is only 15% or 20% for investors in the top ordinary income tax bracket. That's much better than the taxes you'll rack up when you eventually withdraw money from your retirement plans. Those distributions will be taxed at rates as high as 39.6%.

2. Annuities: An annuity is a contract with a financial institution that provides you with income for a term of years or for your lifetime. There are many kinds of annuities, and the amount you receive may be fixed or variable, perhaps depending on the performance of investments. You'll be taxed only when payments are made, but annuity income is taxed at ordinary income rates.

3. Real estate: There are no guarantees, but real estate investments may appreciate in value and provide steady income. If you own investment real estate (for example, a commercial building or an apartment complex), you can rent it to tenants and receive regular income. You also may be able to deduct certain expenses, including depreciation, to offset the tax due on that rental income. When you finally sell the property, any appreciation will be taxed at the rates for capital gains.

4. Small businesses: You might start a business and run the company yourself,

Dynasty Trusts: A Gift That Keeps On Giving

Would you like your assets to last forever? Of course, there are no guarantees, but a “dynasty trust” could help you preserve wealth for your heirs indefinitely. As the name implies, this type of trust is designed to span several generations, barring drastic changes in applicable laws or your family’s financial circumstances.

Under a common law principle known as the “rule against perpetuities,” trusts normally are required to have a beginning, middle, and an end. This rule was adopted in many states, establishing an expiration date for trusts of 21 years after the death of a potential beneficiary who was alive at the time of the trust’s creation. California and other states have adopted a variation of that rule with a limit of about 90 years. Delaware is among the few states that have repealed the rule completely and actively encourage people to set up dynasty trusts in those states.

With a dynasty trust, you transfer selected assets—perhaps stocks, bonds, real estate, or a combination of those—to a trust managed by an independent trustee. The trust can be created as an “inter vivos” transfer during your lifetime or a testamentary transfer through your will. Once established, the trust is irrevocable—you give up control over the assets and the right to change beneficiaries.

The trustee invests the trust assets. Depending on the terms of the trust, income may continue to accumulate within the trust or it could be paid out to beneficiaries, usually your descendants. You might name your adult children as the initial beneficiaries, to be followed by your grandchildren and great-grandchildren. The trustee also may have discretion to invade the trust principal for the health, education, support, and maintenance of beneficiaries or for other reasons.

By letting you designate the ultimate beneficiaries of the trust at the outset, this arrangement gives you some control over where the assets end up. In addition, a dynasty trust could help you protect some kinds of assets from creditors.

But a dynasty trust also may help reduce potential estate taxes. Under current rules, everyone is entitled to a generous estate and gift tax exemption of $5.49 million in 2017, which is indexed for inflation, and likely will rise in future years. This exemption is “portable” between spouses, which enables you to use any leftover amount not used when your spouse died. Similarly, while there is a generation-skipping transfer tax (GSTT) that applies to most transfers that skip a generation, including those made to a trust, that same exemption amount applies to the GSTT.

When you transfer assets to a dynasty trust, the transfer is potentially subject to federal gift tax—if its value exceeds $5.49 million. But future appreciation of those assets won’t be taxed, and that growth could benefit multiple generations of your heirs.

For example, suppose you and your spouse transfer $10 million to a dynasty trust. That gift isn’t taxed because it is less than the total $10.98 million combined exemption that you and your spouse are allowed. But by the time both of you have died, suppose the assets have grown to be worth $5 million more than your combined exemption would have covered. Without a dynasty trust, your family would have to pay a 40% estate tax, or $2 million. The estate tax bill for the dynasty trust is zero.

Of course, there are other considerations, including income taxes, which the trust must pay each year on investment earnings. For this reason, dynasty trusts often are funded mainly with assets that don’t produce current income—growth stock that doesn’t pay dividends, for example, or tax-free municipal bonds. Life insurance policies also could be transferred to a dynasty trust.

Just keep in mind that these trusts are complex arrangements, and you’ll need the help of an experienced estate planning specialist to create one that can benefit your family for generations to come. ●

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or you could invest in someone else’s enterprise. The tax law provides a special exclusion for investments in “qualified small business stock” (QSBS) if you meet certain requirements. Such investments bring the chance of a big payoff, but they also can be risky. Many small businesses fail within their first years of operation.

5. Life insurance: Although life insurance technically isn’t an investment for retirement, it could provide benefits that help fund your retirement. Typically, a policy offers protection for your spouse in retirement if you should die, and you can borrow against the cash value of some kinds of insurance. An added benefit is that life insurance proceeds are completely exempt from income tax. You may also be able to take withdrawals or arrange a tax-free exchange to an annuity or a long-term care insurance policy.

These are a few ways to think outside the box in deciding how to fund your retirement. Talk with your advisor about the ideas that will work best for you. ●

Annuities and real estate investments are income-generating investments that may offer attractive yields and distribution growth rates, but they are complex investments with unique tax characteristics and significant risks. As a result, annuities and real estate investments may not be suitable for all clients. It is important to understand all the features, characteristics and risks of any particular investment offering under consideration. Consult with a tax advisor before investing in annuities and real estate.

Asset allocation cannot eliminate the risk of fluctuating prices or uncertain returns. Diversification does not assure a profit or guarantee against loss.

This Type Of Trust Is A Failure

Trusts come in many shapes and sizes, but you could divide them into two broad groups—grantor trusts and non-grantor trusts. There's also a third type, however—the "intentionally defective grantor trust," or IDGT, that is designed to break tax rules for estate planning purposes.

With a grantor trust, the grantor —the person who creates it—retains considerable power over how it's administered, including the rights to amend, revoke, or terminate the trust. The grantor also maintains control over the trust assets. Typically, the grantor is a beneficiary of the trust income and principal. For instance, the grantor could be the primary beneficiary, with other family members entitled to the remainder. The grantor also can act as the trustee responsible for administering the trust.

With non-grantor trusts, however, grantors give up all of those rights. They aren't entitled to the income or the principal and, usually, payouts from the trust go to other family members. Also, the grantor cannot be the trustee of a non-grantor trust.

Now consider the tax implications. Because grantors retain control over grantor trusts, they're taxed for the income the trusts produce. For grantors in higher tax brackets—including the top bracket, with its 39.6% tax rate—the income tax consequences can be significant. In contrast, income earned by a non-grantor trust is taxed to the trust itself, not to the grantor.

But that can be a problem because trusts pay comparatively high tax rates. For instance, that top 39.6% rate kicks in when trust income exceeds $12,500 in 2017. Compare that to the $470,700 threshold for the top rate for a married grantor who files a joint return, or $418,400 for a single filer. That can translate into very high taxes for a non-grantor trust.

But that's where an IDGT may come to the rescue. As long as the grantor retains certain powers, the grantor, rather than the trust, will be taxed on trust income—even if none of that income goes to that person. An IDGT trust is set up so that it will purposely fail to qualify as a non-grantor trust, thus avoiding the higher taxes that come with the non-grantor designation.

What about estate and gift taxes? Money you transfer to an IDGT is treated as a taxable gift, but there's a current individual exemption of $5.49 million in 2017 that could reduce or eliminate your tax liability for the gift. (There also are other ways to structure this transfer so that it's not considered a gift at all.) In addition, the assets you transfer into the trust are no longer in your taxable estate, whose value will be reduced further by the annual taxes you pay on trust assets.

But IDGTs are complex arrangements, and you'll need the help of an experienced estate planning professional to create a trust that fits your needs. Seek expert assistance. ●

Weigh Five 401(k) Options

(Continued from page 1)

4. Roll over to a new 401(k). If you're changing jobs and your new employer provides a 401(k), you may be allowed to transfer your savings into a 401(k) account sponsored by the new employer. Your new company also might offer the option of converting to a Roth 401(k)—here, too, you would owe income tax on the amount you convert to a Roth account.

This kind of rollover also must be completed within 60 days to avoid tax liability. A trustee-to-trustee transfer may be your simplest choice.

In deciding where or whether to move your savings, you may want to compare the investment offerings of the various possibilities. For instance, you might opt to use an IRA if it provides more investment flexibility or better selections than you'd get in the new employer's plan.

5. Keep the funds where they are. Finally, your existing 401(k) might let you leave your money where it is. This option has been discouraged in the past, because you no longer work for the employer and might have concerns about access to your account, but recently it has become more common.

Once again, your preference may depend on the investment choices available through your plan. If you've had good success with the investments in your old employer's plan, you might decide to stay the course. At the very least, you can retain the status quo until you decide on your next step.

Of course, everyone's situation is different. Your financial advisor can help you analyze the particulars of each option so that you can make an informed decision. ●

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