Financial Strategies for Retirees©

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Taxes

Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands: Taxes are enforced exactions, not voluntary contributions.

-- Learned Hand, US Appeals Court Judge

Diversification
“Don’t put all your eggs in one basket”

Long recognized as valuable for investing.

How about your income and taxes ?

Diversification is protection against ignorance.
– Warren Buffet

Tax Diversification:
Gives You Flexibility to use Various Tax Strategies

Taxable Accounts

- Use investments that can earn long term capital gains
  - Stocks
  - Mutual Funds & ETFs
  - Real Estate
  - If asset held until death, gain never taxed (stepped up basis)

Tax Deferred Accounts

- Traditional IRAs, 401k plans, 403b plans, 457 plans
- Insurance Annuities
- Strive for highest rate of return with no worrying about current taxes

Tax-free Accounts

- 529 Plans for education expenses (tax-free/tax deferred)
- Roth IRAs
- Tax-free municipal bonds (but avoid “private activity” bonds)
- Strive for highest rate of return with no worrying about taxes - ever

IRAs: Traditional vs. Roth

Traditional IRA

- Contributions and investment gains are <u>tax-deferred</u>
- Withdrawals are <u>taxed</u> at ordinary income tax rates
- RMDs after age 70½
- Withdrawals by beneficiary are <u>taxed</u> at ordinary income tax rates

Roth IRA

- Contributions and investment gains are <u>tax-free</u>
- Withdrawals are <u>tax-free</u>
- <u>No</u> age 70½ RMDs
- Withdrawals by beneficiary are <u>tax-free</u>
- Each dollar in a Roth IRA is more valuable than a dollar in a traditional IRA

Required Minimum Distributions (RMDs)

- IRS requires that you begin taking minimum amounts from your Traditional IRA or 401k at age 70½ (<u>not</u> applicable to Roth IRAs)

- Amount is based on IRS life expectancy tables
  - The older you are, the more you must withdraw
    - Age 70 single life factor is 27.4
      - $500,000 IRA: divide by 27.4 = $18,248 RMD
    - Age 85 single life factor is 14.8
      - $500,000 IRA: divide by 14.8 = $33,784 RMD

- First distribution each year counts as RMD

- Penalty for not taking RMD is severe:
  - Penalty is 50% of RMD amount
  - Plus, RMD amount is subject to regular income tax
  - Top tax & penalty rate is 89.6%
  - Plus, state penalty and taxes !

RMD Alternatives

- Qualified Charitable Distributions (QCD)
- Qualified Longevity Annuity Contracts (QLAC)
- Roth conversions

Qualified Charitable Distributions (QCD)

- December 2015: made "permanent" instead of year-to-year
- If you don't need the full RMD for living expenses
  - Can donate some or all to charity
- Contribution on or after you reach age 70½
  - First distribution in year counts towards your age 70½ RMD
- Funds directly transferred from IRA trustee to charity
- $100,000 annual limit per person
  - Can make multiple QCDs, total not to exceed $100,000
- QCD is <u>not</u> taxable, is <u>not</u> deductible
- Better than being taxable and deductible (doesn't increase AGI)
  - Lower AGI reduces taxes on other income, Soc. Sec, Medicare
  - Reduces phase-outs of deductions, credits, exemptions

Qualified Longevity Annuity Contract (QLAC)

- Delays age 70½ RMDs until as late as age 85 !
- IRS approved QLACs effective July 1, 2014
- Details:
  - Purchase an insurance annuity inside your traditional IRA
  - Maximum QLAC annuity premium: $125M or 25% of IRA
  - RMDs for funds in annuity can be deferred up until age 85
  - QLACs can “guarantee” you a lifetime income
    - Insurance company assumes market risk
    - Insurance company guarantees your income

Roth IRAs

Myths

- You are too old
    - No age limit
    - Tax-free benefits are passed to your surviving spouse, children
- Income limitations
    - Contributions - yes
    - Roth conversions - no
- Must wait 5 years to avoid penalty
    - Contributions can be withdrawn tax-free at anytime
    - Conversions & Earnings: If at least 59-1/2: no penalty
        - There are exceptions to penalty even if under 59-1/2
    - 5 year period begins January 1 of year of contribution/conversion (not date of contribution/conversion)

Conversions

- Move investments from Traditional IRA to Roth IRA
- Amount moved is taxable currently
- Future earnings are tax-free to you and your heirs
- No RMDs

Reasons to Convert to a Roth IRA

1. **No** age 70 ½ RMDs for Roth IRAs
2. If income tax rates rise in the future
3. Reduces taxation of Social Security in future years
4. Reduces Medicare premiums in future years
5. Exposure to AMT reduced in future years
6. Avoids higher income taxes after one spouse dies
   - Married joint tax rates are lower than single rates
   - Pay tax now at lower rate: married joint
7. Time is on the side of Roth IRAs (tax-free compounding of returns)
   - Your lifetime
   - Spouse's lifetime
   - Children's lifetime

Roth Conversion Issues

- Short term incursion of taxes
  - Long term tax savings
- Especially useful if current year is a low income year
- Don’t convert too much in one year
  - Avoid moving into high tax brackets
  - Conversion is usually a multi-year project
- If age 70½+ make RMD before making Roth conversion
  - First distribution each year is considered RMD
- Careful long term planning is essential

Roth IRA Conversion Strategy #1

Start-of-Year Strategy: Convert Annual Cash Need Amount

- Anyone age 59-1/2+ withdrawing from their IRA should consider
- Determine cash needed for year from Traditional IRA
- Convert (transfer) that amount from Traditional IRA to Roth IRA
- Withdraw cash, as needed, during year from Roth IRA
- Income tax on conversion: same as monthly withdrawals
- Tax saving: current year investment earnings are in Roth (tax-free) instead of Traditional (tax-deferred)

Example:

Annual cash need:	$ 84,000
Convert in January:	$ 84,000
Withdraw monthly:	$ 7,000
Total Roth withdrawals:	$ 84,000
Year end Roth balance:	$ 3,241* (future tax-free withdrawal)

* 8% rate of return, withdrawals on first of each month

Roth IRA Conversion Strategy #2

Larger Amount Strategy:

- If you have a low income year (e.g. business loss, catastrophe loss, etc.)

- But, be careful not to convert too much in a year
  - Income tax rates are progressive, avoid high brackets
  - High income can take away deductions

- You have until Oct. 15 of the following year to reverse conversion (recharacterization)

Roth IRA Conversion Strategy #3

IRA split, Multiple conversions, Keep the best performer

Example:

- Traditional IRA value $500,000
- Split out two new traditional IRAs, $50,000 each
- Convert both new IRAs at start of year
- Invest each new IRA differently, but use good strategy for each
- After year end*, see which IRA has best returns
  - #1 = $56,000,   #2 = $51,000
  - Retain #1 as a Roth IRA
  - Recharacterize #2 back to a traditional IRA
- You will be taxed on #1 only, at $50,000 even though now $56,000
- Thus $6,000 will never be taxed

- * You actually have until October 15 of following year to decide !

How About a Do-Over ?

Roth IRA Conversion and Recharacterization

1. Convert Traditional IRA to a Roth IRA
   - All, or a portion

2. Amount converted is taxable

3. Conversion can be reversed (Recharacterization)
   - If you later find that taxes are too much, or
   - Investments have not done well
   - Eliminates taxable event

4. You have until October 15 of following year to do Recharacterization

IRA Rollovers

Rollover Types

- 60 day rollover
- Direct trustee to trustee rollover

Tax Reporting

- Must report on your tax return, even if tax-free
- New IRS rule: <u>One</u> 60 day rollover per year (not per IRA)
  - Second "rollover" is taxable distribution
  - Recommendation: always use direct trustee to trustee rollover method in order to avoid this tax trap

Reverse Mortgages

How they work

- It's a mortgage ! (with a twist)
    - The lender pays you instead of you paying them
- Payments to you build as a lien on your home
- Interest accrues based on the payments you receive
- Repayment of the mortgage is not required <u>until</u> any of these:
    - You die (if both spouses are on RM, until both die)
    - You move out of your home
    - You sell your home
    - You fail to properly maintain your home
    - You fail to pay your property taxes
- You can stay in your home even if the total payments exceed your home's market value.
- Regulated by federal law

Reverse Mortgages

Provide income

- Lump sum, or
- Monthly payments

Income is tax-free and can replace taxable IRA withdrawals

- Reducing taxable income compounds tax savings because this can reduce tax on other income (e.g. Social Security, capital gains)

Roth IRA Conversions enabled

- If RM payments replace IRA withdrawals, enables Roth conversions

Disadvantages

- Initial costs (but usually small)
- Reduces net estate value of home
- But if payments replace IRA withdrawals, no effect on estate
- Both spouses must be on RM or big problem if spouse dies

Annuities

Offered by Insurance Companies

- Everyone is eligible
- No limits on income or total amount invested

Tax Deferral

- Earnings are not taxed until withdrawn (like an IRA)
- No RMDs

Income

- Fixed or variable income options (your choice)
- Income payments can begin immediately or be deferred

Guarantee of Your Principal

- Insurance company can guarantee no investment losses
    - But guarantee is only as good as insurance company

Medicare Part B Premium Surcharge

- "Grandfathered" 2016 Medicare premium: $104.90 (due to no COLA)

- 2016 premium based on 2014 MAGI (AGI plus "tax-exempt" income)

Single Taxpayer:	Married Taxpayer:	Mo. Premium:
MAGI under $85,001	MAGI under $170,001	$ 104.90
$ 85,001- $107,000	$ 170,001-214,000	$ 170.50
$ 107,001- $160,000	$ 214,001-$320,000	$ 243.60
$ 160,001- $214,000	$ 320,001-$428,000	$ 316.70
$ 214,000+	$ 428,000+	$ 389.80

- You can appeal surcharge if "Life Changing Event"
  - Marriage, Divorce, Death of Spouse, Stopping Work
  - Involuntary loss of income (natural disaster, insolvent pension)
  - High income due to sale of property is not a LCE

Medicare Advantage Plans (MAP)
aka Medicare Part C

Alternative to traditional Medicare Parts A & B

- You effectively assign your entitlement to Medicare to a MAP
- Can be an HMO, PPO, or PFFS
- You pay the required Medicare premiums
    - Usually, low or no additional premiums
- Most MAPs cover prescription drugs (similar to Medicare Part D)
- Some cover vision care, dental care, wellness programs
- Many provide free gym memberships (e.g. Silver Sneakers)
- Can switch between traditional Medicare and MAP during annual open enrollment

One Couple's Experience

2014 Chevron Medicare Standard Plan (United Healthcare)

■ Out of pocket medical, drug & vision expenses:	$ 3104
■ Chevron medical plan premiums:	$ 3180
■ Gym membership (one):	$ 420
Total 2014:	$ 6704

2015 (Blue Shield 65 Plus HMO):

■ Out of pocket medical, drug & vision expenses:	$ 842
■ Blue Shield Premiums:	$ 0 a
■ Gym membership:	$ 0 b
Total 2015:	$ 842

a. Medicare pays premiums

b: "Silver Sneakers": numerous free gym choices

Choosing a Medical Plan

- This is a cost vs. service decision
- Are your doctors in the plan's network?
- Is your preferred hospital available in the plan's network?
- Do you have a special prescription? If so, is it covered by the plan?
- If HMO, beware that referrals for specialists are usually required
  - This can delay treatment
  - You can't pick any specialist, only those in network
- Is your spouse under age 65? If so, stay in the Chevron plan because your spouse is not eligible for Medicare
- Chevron plan has coverage when traveling outside USA. Does the Medicare Advantage Plan have this coverage also? (many do).
- If you drop Chevron plan, you can re-enter it next year
  - However, if you die while outside of the Chevron plan, your surviving spouse can <u>never</u> re-enter Chevron plan

Estate Planning

Wills

- Don’t leave (this world) without one !

Trusts

- Revocable and Irrevocable types
- There can be advantages to having these
    - Can better manage who receives your assets
    - Can provide for special needs and situations

Other simple alternatives

- See next slide

Stretch IRAs

- Tax benefits of IRAs can be passed to your heirs

Money isn't everything, but it sure keeps the kids in touch.

Estates: Avoiding Probate

Bank Accounts

- Payable On Death (POD)

Brokerage Accounts, Securities, Real Estate, Motor Vehicles

- New “Transfer Upon Death” (TOD) California law

IRA, 401k, Pension plan, Life Insurance, Annuity

- Beneficiary Designation

Check and update your accounts to avoid probate and funds going to unintended parties!

and

Get an acknowledged copy of your beneficiary designation from your IRA custodian, pension plan, bank, & life insurance company … just in case

Bankruptcy Protection?

IRAs

- Up $1,245,475 for IRAs*
  - Traditional IRA
  - Roth IRA
  - Not inherited IRAs (no protection)

Employer pension plans, 401(k), 403(b), etc.

- Unlimited

* Adjusted for inflation

A fool and his money are soon parted. -- English Proverb

Chevron's Humankind

Matches Your Charitable Contributions

www.chevron.yourcause.com

Chevron will match your charitable contributions $ for $

- Up to $3000 annually
- Minimum contribution for match: $25

Must be a charity that is on Chevron / YourCause' list

Must submit "receipt" when requesting the match

- Contribute and wait until you receive a receipt from the charity

or

- (Herb's trick) Scan a copy of your check before you mail it and use it for your match request

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