On Course Financial Planning

Facing the Future with Optimism and Courage

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Vectors

geo@oncoursefp.com

425-861-9997

A Tax Primer for Retirees

In 1789, Benjamin Franklin famously said: *"Our new Constitution is now established and has an appearance that promises permanency; but in this world, nothing can be said to be certain, except death and taxes."* New retirees discover that the tax man still comes knocking, often at a different door -

1. **Estimated quarterly tax payments may be required**

Tax planning is an important component of retirement income planning. If you have never been self-employed, you are accustomed to having federal, state (if your state has an income tax), and payroll taxes withheld from each paycheck. When you retire, unless you decide to have taxes withheld from your pension, Social Security benefit and IRA withdrawals, you will have to make quarterly, estimated tax payments to avoid paying a penalty for under withholding.

2. **A portion of your Social Security benefit may be taxed**

From its inception in 1935 through 1983, Social Security benefits were not taxed. This changed in 1984 and today, if the sum of your adjusted gross income + nontaxable interest + half of your Social Security benefit is between $25,000 and $34,000 (between $32,000 and $44,000 if filing a joint return), you may have to pay income tax on up to 50% of your benefit. If the sum is more than $34,000 ($44,000 for a joint return), up to 85% of your benefit will be included in your taxable income. These limits are not inflation indexed. To add insult to injury, 13 states also tax Social Security benefits.

3. **Required Minimum Distributions are taxable**

Required minimum distributions (RMDs) are minimum amounts that must be withdrawn annually from defined contribution retirement plans (SEP IRAs, Simple IRAs, 401(k)s, 403(b)s, 457(b)s, profit sharing plans) and IRA accounts starting in the year you reach age 70½. The first payment can be delayed until April 1st of the following year, but this will necessitate taking another RMD withdrawal before December 31st of that year. RMDs are not required for Roth IRAs.

Many retirees have multiple IRA accounts or retirement accounts from several former employers. The RMD for each IRA can be calculated and the total RMD can be taken from any one, or combination of, IRAs that you own. However, the RMD for each former employer's defined contribution retirement plan must be withdrawn from that plan. This complication can be avoided by rolling assets from former employer retirement plans into your IRA. You don't have to take an RMD from a company plan if you are still working for the company after age 70½, unless you own more than 5% of the company.

Your RMD does not have to be withdrawn from an IRA in cash. If you don't plan on spending all the RMD, you can transfer assets from your IRA "in kind" to a brokerage account or trust account. The asset is not sold but the dollar value of the transfer counts towards your RMD.

If you expect to have RMDs that will push you into a higher tax bracket, investigate the option of making a Qualified Charitable Distribution (QCD) to a charity or other nonprofit organization. A QCD allows you to annually distribute up to $100,000 from your IRA to a qualified charity once you turn age 70½. For married couples, each spouse can make a separate QCD. The donated amount will not be included in your taxable income in the year of the donation. QCDs allow taxpayers who do not itemize deductions to receive a tax benefit from their charitable contributions. An unnecessary complication with RMDs and QCDs is that any retirement plan withdrawal during the year in which you turn 70½ counts toward your first RMD. But you can make a QCD only after you are 70½.

4. **Mishandling post-tax 401(k) contributions**

While most contributions to 401(k) plans are tax-deductible and taxable as ordinary income when withdrawn, some 401(k) plans allow employees to make non-deductible, after-tax contributions to their 401(k) as well. In 2014 the IRS issued a notice that allows taxpayers, upon retirement, to roll over 401(k) after-tax funds into a Roth IRA. This benefit will allow them to take advantage of the tax-free appreciation of the post-tax money.

5. **The hidden cost of selling your primary residence**

Few retirees understand the tax ramifications of selling a home, which can trigger an unexpected tax liability if the home has appreciated significantly in value. If you've lived in your primary residence for at least 24 out of the past 60 months prior to selling, you can exempt up to $250,000 of any gain from taxes if you are single and up to $500,000 if you are married. If you are widowed, you may still qualify for the $500,000 exemption if you sell your home within two years of the death of your spouse and haven't remarried. Some other restrictions apply, consult a tax professional for further clarification.

The sale may trigger the 3.8% tax on investment income. It's a complex calculation that can ensnare retirees who have investment income and an adjusted gross income above $200,000 ($250,000 for married filers). Consult a tax professional for further clarification.

6. **A stealth tax on affluent retirees**

Affluent retirees will become familiar with the Income Related Monthly Adjustment Amount on Medicare premiums, better known as IRMAA income premium surcharges. The surcharges – stealth taxes disguised as higher Medicare part B and part D premiums – date back to the Medicare Modernization Act of 2003. Medicare beneficiaries with income that exceeds certain levels must pay a higher share of their Medicare insurance cost. The IRMAA kicks in for single filers with a "Modified Adjusted Gross Income" (adjusted gross income plus tax-exempt interest income) above $85,000 and above $170,000 for joint filers. From there, the IRMAA surcharges move up through four brackets and can increase the annual Part B premium from a minimum of $642 to a maximum of $3,535 per person. Retirees who pay IRMAA surcharges are not protected by the "hold harmless" provision that prevents Medicare part B premium increases from exceeding the annual cost-of-living increase in your Social Security benefit. Medicare recipients most likely to pay IRMAA surcharges are those who continue to work past age 65 and those with a taxable capital gain in the sale of a home. Affluent seniors may also receive a surprise if their RMD increases their income above the IRMAA threshold. Qualified Charitable Distributions can limit the RMD driven IRMAA surcharge because the charitable gifts do not appear as income on your tax return. Each year's IRMAA calculation is based on income reported on your federal tax return two years prior. If your income has declined due to a "life-changing" circumstance and the income from two years ago no longer reflects your economic status, you can file an appeal using form SSA-44 from the Social Security Administration.

7. **The tax benefit of the net unrealized appreciation of company stock inside your 401(k)**

Upon retirement, most employees roll their 401(k) assets into an IRA. But this may not be the right decision for employees who own appreciated company stock in their 401(k). There's a special rule for "net unrealized appreciation" (NUA) that allows a retiree to take advantage of the lower capital gains tax rates when selling shares of their employer's stock after they retire. To take advantage of the NUA tax rule, you must roll all the funds in your 401(k), except the company stock, into an IRA, which won't be taxed until you start taking withdrawals. The company stock is deposited into a taxable brokerage account and you will pay income tax on what you paid for the stock (not its current market value). When shares are subsequently sold, the net unrealized appreciation (sales price minus your cost) will be taxed at the long-term capital gains tax rate, which should yield a significant tax savings.

Where Have All the Stocks Gone?

A common, "worrisome", note about the domestic stock market that has been making the rounds recently is that the number of publicly listed domestic stocks has fallen by about 50% over the past 20 years. In 1996, there were more than 7,000 publicly listed US companies. By the end of 2016, this number had fallen to 3,800. The unspoken assumption is that there must be something wrong when the stock market loses almost half of its publicly listed companies. However, the adage that "figures don't lie but liars figure" may be playing a part in this negative assumption.

The first mistake would be to assume that the number of stocks in 1996 represents an average historical number. In fact, just the opposite is true – the number of stocks in 1996 was an historical anomaly. The economic boom in the late 1990s led to the tech bubble and a multitude of initial public offerings (IPOs) of small companies. In 1996, there were 677 IPOs – the largest annual number in the last 40 years – and the number of publicly listed stocks was also the highest in the past 40 years.

Most of the stocks that disappeared between 1996 and 2016 were the smallest "microcap" companies, many of which disappeared when the dot.com bubble burst. Few mutual funds invested in these companies because of regulatory constraints on the percentage of ownership that one fund may have in any publicly traded company. Microcap stocks aren't included in most stock market indexes because most are illiquid and rarely trade. Twenty years ago, more than 4,000 microcap stocks were too small to be included in the Russell 2000 small company stock index. Today, that number is less than 1,000 stocks. As a group, microcap stocks have historically represented less than 2% of the market capitalization of the domestic stock market.

A proper analysis of the domestic stock market must not be limited to the number of stocks available to investors. It must include the total value of all publicly traded stocks. The IPO regulatory burden and the cost of going public have risen in the past two decades. Consequently, many small and microcap companies have chosen to be acquired by larger public companies – about 500 each year according to a Vanguard study – rather than going public in an IPO. Today, the market capitalization of the domestic stock market is about three times greater than it was in 1996.

The number of domestic small company stocks may have declined, but over the last 20 years the number of global equities has increased by almost 10,000. The Vanguard Total International Stock Index Fund (VGTSX) holds 6,200 foreign stocks in its portfolio. The shrinking number of publicly traded domestic stocks does not mean that the public market has become less investable or more concentrated to the detriment of investors. Globally, there are still plenty of smaller companies going public, offering investors the opportunity to take part in early-stage growth companies.

In the News

The widow of Roy M. Speer, cofounder of the Home Shopping Network, sued Morgan Stanley Wealth Management, Mr. Speer's former advisor, Ami Forte, and the branch manager, Terry McCoy, for excessive trading, unauthorized use of discretion and abuse of fiduciary duty. Mrs. Speer claimed that in the five years prior to his death in 2012, when Mr. Speer suffered from "significant diminished capacity", his advisor and others at the firm made approximately 12,000 unauthorized trades generating $40 million in commissions. This averages out to $32,000 in commissions every day. Demonstrating that fact can be stranger than fiction, *Barron's* named Ms. Forte Florida's top financial advisor in 2013.

The Financial Industry Regulatory Authority (FINRA) is a private corporation that acts as a self-regulatory organization governing stock brokers and brokerage firms. FINRA establishes conduct rules by which its members must abide. In March 2016 a FINRA arbitration panel awarded $34 million to Mr. Speer's widow and estate. The panel ruled that Mr. Speer's broker and branch manager at Morgan Stanley were jointly liable for unauthorized trading, breach of fiduciary duty, constructive fraud, negligence, negligent supervision and unjust enrichment. The arbitrators also found that Morgan Stanley violated a Florida law prohibiting the exploitation of vulnerable adults. Ms. Forte was fired by Morgan Stanley a few days after the $34 million arbitration award was announced. Last month, FINRA barred Terry McCoy, her former branch manager, from working in a supervisory capacity and fined him $75,000 for failing to supervise Ms. Forte.

A paper published in 2016 by researchers at the University of Minnesota and the University of Chicago found that 44% of brokers who lost their jobs for misconduct were hired by another firm within a year. According to an article in *Investment News*, Ms. Forte has joined broker-dealer Pinnacle Investments as an advisor and chief business development officer for its expansion into Florida. "*We are thrilled to have a top industry advisor like Ami join our team,*" Ryan York, CEO of Pinnacle, said in a prepared statement. *"Having previously worked at several global firms, she brings additional high-level experience that will contribute to our growth strategy by providing sound, knowledgeable and tailored financial advice to clients in the Tampa area..."* No mention by Mr. York that FINRA is recommending new disciplinary action against Ms. Forte for excessive trading in discretionary accounts, unsuitable investment recommendations and violation of FINRA Rule 2010 - *"a member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."* I can't make this stuff up.

According to an article in the *Wall Street Journal*, more than 360,000 Americans with overdue tax debts will be denied new or renewed passports until they settle their tax debt. In response to a new law passed in 2015, the Internal Revenue Service is sending the names of taxpayers who owe more than $51,000 in overdue tax debt to the State Department, which has already denied passports to some debtors.

The California Public Employees' Retirement System (CalPERS) is the largest public pension fund in the country. It manages pensions for more than 1.6 million California public employees, retirees, and their families. It is currently implementing a plan that lowers its expected annualized return from 7.5% to 7.0% due to lower return expectations. This will increase CalPERS' unfunded pension liability; necessitating higher contributions from the state, cities, towns and school systems that CalPERS serves. The legislative representative to the League of California Cities has urged the CalPERS Investment Committee to think "out of the box" to find a way to exceed its 7.0% investment return projection. In other words, "Think Harder You Guys!" Thinking good thoughts might enhance your mood but when it comes to investing, CalPERS is no different from any other investor. Its return will be the return of the markets, in proportion to its portfolio allocation, minus its expenses. Wishing it wasn't so or trying harder won't change anything. There's going to be lots of financial uncertainty in the years ahead for many California state employees who are counting on a "guaranteed", under-funded pension.