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JIM: When determining what type of retirement plan you should be contributing to and what strategies you should implement when with withdrawing, this is something you definitely don’t want to go alone. You want to work with a team of advisors that can help you make the right decisions. Joining us today to shed a little light on the subject is Attorney Gary Mac Magnuson, who has worked several years at Deloitte & Touche as a benefits attorney and then went onto help consult with advisors in advanced markets and qualified plans. He is a member of the Minneapolis Estate Planning Council, as well as a member of the Society of Financial Service Professionals. Welcome Gary.

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GARY: Thank you Jim. It’s good to be here.

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JIM: The retirement front is always something that’s first and foremost and many of the listeners may have heard us talk about the Department of Labor, looking to get involved in the retirement marketplace a little bit with some regulations that are forthcoming. All the statistics I see are that Americans are still a little bit behind the eight ball when it comes to saving for their retirement, so we thought today we would focus on some of the things that people can do and it never ceases to amaze me. I get together with clients on a regular basis and IRAs have been around for a long time. I don’t know if you remember when IRAs started, Gary?

1:17

GARY: Oh many moons ago. It had to be at least the 1970s or so.

1:22

JIM: Yeah, so IRAs have been around a long time and yet a lot of people are still confused by them. There have been a lot of changes with 401(k)s and 403(b)s and things like that. I know as I meet with clients and talk about the different opportunities there are, many of them are not sure what the benefits are. Of course with 401(k)s and 403(b)s with the employer sponsoring the plan, there are some differences from one plan to the next. They all fall within the same rules but there can be some customization based on what the employer is looking to accomplish for their employees. Let’s get started, Gary. First of all, talk a little bit about for 2016 what are some of the IRA eligibility, deductibility, and dollar limitations for IRAs. The traditional as you mentioned was back in the 1970s. Roth IRAs have been with us since I believe 1998, so talk a little bit about the differences and what it takes for people to be eligible for those.

2:17

GARY: Okay, sure. In order to make a contribution into an IRA, and now we’re talking contributions as opposed to rollovers from plans, in order to make a contribution you have to have what’s called earned income and that’s money coming from a job. If somebody is retired and they’re not working anymore, they don’t have income that’s subject to FICA, social security tax, then they can’t contribute to an IRA. We’ll talk in a second about what’s called spousal IRAs, but that would be the first thing is we need to have earned income, income from a job, income that’s subject to FICA. If somebody doesn’t have a qualified retirement plan, no 401(k), no 403(b), there is no income limit. They could make $1,000,000 a year and they could still contribute to an IRA, whether it’s a traditional or a Roth, but if somebody does have a retirement plan, say they have a 401(k) plan and they’re also contributing to that, then they’re subject to an income limit, so if they’re over the income limit then they can’t make a deductible contribution to an IRA, although they could still make a non-deductible contribution and if they’re under the income limit then they could make a fully deductible contribution, so for tax year 2016, so the current tax year, if somebody is married filing jointly the dollar amounts are $98,000 to $118,000, so if the couple has combined income, a couple with income, adjusted gross income, is below $98,000, then the person who has a 401(k) plan can still make a deductible contribution to an IRA. If they’re over $118,000 combined adjusted gross income, then the person that’s in the 401(k) or 403(b) plan they can’t make a deductible contribution to a Traditional IRA at all and if they’re right in between $98,000 and $118,000 adjusted gross income they could make a partially deductible contribution to an IRA. So far we’ve just been referring to the spouse, if we have a married couple here, the spouse who is in the 401(k) or 403(b) plan. If the other spouse, if we have a stay-at-home spouse, a homemaker with children, who doesn’t have earned income, although she’s working very hard at home, if she doesn’t have earned income we can have what’s called a spousal IRA set up so the spouse who is working can contribute to a spousal IRA with a non-earning spouse and then the income limit is much higher. It’s $184,000 to $194,000, so the spouse who is working and in a 401(k) plan, that’s $98,000 for that person, but for the other spouse that’s not working where we have one spouse that’s in a 401(k) and the other stay-at-home spouse isn’t working, no earned income, then the income limit is much higher. It’s $184,000 to $194,000. As long as their combined income is below $184,000, then the stay-at-home spouse that contribution will be deductible and if they’re over $194,000 then the contribution for that stay-at-home spouse is totally non-deductible, and if they’re right in between the two, $184,000 to $194,000, then it’s partially deductible for that stay-at-home spouse. I know that’s quite of bit of rules and income limits, but that is how it works.

6:02

JIM: Now again if we have a spouse that is not a stay-at-home spouse but just working and has some income but not a 401(k), they’re still under the same rules, or if they have income and don’t have a 401(k), do you throw out those income limitations and they can fully deduct it?

6:19

GARY: They can scroll up the income limits and they can fully deduct it if they don’t have any plan at work.

6:23

JIM: Another thing to consider; I’m in Wisconsin; IRAs are protected up to $1,000,000. I know some states are unlimited and this is why you really want to work closely with an advisor. I see a lot of people that have the misconception based on the old rules because it used to be a spousal IRA the limit was $250 in contributions and now they’ve really opened it up. The government is really encouraging people to really start saving for their future, people are still misunderstanding what these rules are because it’s a lot more available, Gary’s going over all those numbers, it gets really confusing, bottom line is just go to your advisor and find out what you’re eligible to do. Don’t make the mistake of missing the opportunity. We talked about earlier the Roth contributions. Gary, you said that if someone does not have a 401(k) they can contribute to a Roth regardless of income, or did I misunderstand that.

7:17

GARY: It’s the other way around, so for a Roth IRA there’s no connection with a qualified retirement plan whatsoever, so all that matters for a Roth is the income limit, so for a married couple as long as their combined income is below $184,000 then they can both contribute to Roth IRAs.

7:36

JIM: There’s a phase out with that as well, right, $184,000 up to what?

7:41

GARY: Up to $194,000, right.

7:43

JIM: Okay, and then real quickly what’s the phase out for say a single payer?

7:47

GARY: For a single then it’s a little bit less, so for a Roth, well actually quite a bit less, it’s $117,000 to $132,000.

7:56

JIM: Okay, and what about for the traditional?

7:58

GARY: The traditional it’s even less yet; it’s $61,000 to $71,000 is the phase out for a single person to continue to a Traditional IRA, so if they’re in a qualified retirement plan and they’re below $61,000, then they can still make a deductible IRA contribution, but if they’re over $71,000 and they’re single and they have a plan at work where they’re an active participant and they’re over $71,000 then their contribution to a Traditional IRA is not deductible.

8:28

JIM: Obviously your individual circumstances are really going to dictate this. We have a lot of people that don’t really look at this and they’re plugging all this money away, it’s all deductible, all deductible, all deductible, well someday we have to pay the tax and the benefit of the Roth is it’s all tax-free as long as you fall within the rules; you take the money out when you’re supposed to, the principal is accessible to you basically at any time for any reason and it can grow tax-free as long as you make a qualified distribution without penalty and that’s like first-time home purchase, making it to 59 1/2, disability, death. There’s many different ways to access that money tax-free and a lot of people are under the impression if they made too much money and they found out years ago that they couldn’t contribute, they just decided they could never contribute, and since 2010 we had a change in the rules as far as Roth conversions. It used to be if you made over $100,000 of income you could not do a Roth conversion, well now it doesn’t matter what your income levels are. You mentioned those limitations, but really you can get around that by making a non-deductible IRA contribution and turning around and converting it, right?

9:34

GARY: That is correct but we have to be careful here. If somebody had some deductible pre-tax IRA contributions those get added into the mix and the IRS looks at it as this is just one big IRA. Both the after-tax and the pre-tax contributions are all added together and when we go to convert it’s pro rata, so a portion of whatever we convert is the after-tax non-taxable portion and a portion is pre-taxed, the taxable, so that’s the risk when we try to do what’s called this back door Roth contribution. By doing a conversion of an after-tax traditional amount, the risk here is that we might also have some pre-tax IRAs and if we do that then when we go to convert it’s not fully non-taxable we’re going to be caught and we’re going to pay some income tax if we have some pre-tax IRAs out there.

10:24

JIM: Personally with a lot of clients, we implemented some strategies to do some Roth conversions and try to minimize the tax bite so I could get myself to the point where every year I make my IRA contributions and then the next day turn around and convert them and I’ve been doing that since 2010, so it is something that you still can get there. Also, for people that might not be able to afford to do the taxes of conversions, remember if the money is not in an IRA you’ll never be able to convert it, so I see a lot of people saying well why even put into a non-deductible IRA, I can’t afford to pay the tax, and if I can’t get the deduction why even bother contributing? Again, what I say to those folks is you still have tax deferral, you’ve got the freedom to move from one investment to another as long as it stays within the IRA and still not pay tax, and who knows maybe down the road there’s some opportunity that allows you to do a conversion and some of those opportunities might be you lose your job, you go on unemployment, all the sudden your tax bracket is lower, that might be an opportunity to convert, so don’t make the mistake that a lot of people do and think that the only time you go to your advisor is when you have money to invest. You may have opportunities to really optimize your retirement and take advantage of these Roth IRAs when bad things happen. Unfortunately, that happens to all of us from time to time but let’s see how we might be able to take advantage of that and create an opportunity. Gary, we’re going to take a short break. When we come back let’s talk a little bit about qualified retirement plans.

11:52

BREAK

12:51

JIM: Welcome back as we continue to meet with Gary Mac Magnuson. Gary is a consultant in advanced markets and qualified plans, advisor to an independent broker/dealer. He’s also an attorney. He’s got a lot of years of experience, written a lot of articles, and he helps advisors understand some of the more intricate details, especially when it comes to retirement accounts and I’ve known Gary for many years and I’ve relied on him as a resource many of times when I have a question. Gary, before the break we were talking about the benefits of an IRA, Individual Retirement Account, Roth or Traditional. Now let’s talk about the employer plans. What type of employer plans are available as an employer that you might offer your employees, and if I’m an employee and we have one of these plans, how do we take advantage of them?

13:38

GARY: Good question. Basically if you’re an employer it generally comes down to three types of plans. You’re looking at a SEP, a Simplified Employee Pension, plan; a SEP, a SIMPLE, or a 401(k). The basic difference is between the SEP and the SIMPLE, the SEP is made up of all employer contributions, so just money coming in from the employer into the SEP. No employee dollars are permitted. If you go with a SIMPLE plan, the SIMPLE plan is made up mostly of employee dollars, so it’s salary reduction out of their paychecks, the employer is required to make a contribution, either a matching or a non-matching contribution, but most of the money in the SIMPLE is coming from the employee, so those are the basic differences; SEP coming from the employer, SIMPLE coming from the employee. The 401(k) is very similar to the SIMPLE plan. Most of the money in the 401(k) is coming from the employee. There are no employer contributions that are required in a 401(k) but a lot of times in the small plans, what’s called the discrimination case, is going to be flunked if we don’t have some employer contributions going in. There’s something called the Safe Harbor plan in a 401(k) that’s very similar to a SIMPLE plan and if the employer makes those required contributions for a Safe Harbor, then we don’t have the discrimination testing in the 401(k). What I mean by discrimination testing, these plans have tax code to them, they have tax benefits, because the basic idea here is that the government is encouraging people to save for their retirement, so their basic tax benefit here is money goes into these plans, whether it’s a SEP, SIMPLE, or 401(k), it goes in pre-taxed, so no income tax is paid when that money goes in, income tax is going to be paid later when the money comes out, but typically hopefully that’s going to be many years later. In the meantime, you get what’s called the tax deferred power of compounding, so that’s like the eighth wonder of the world and the reason that’s so powerful is all the money that we would have paid in income tax we haven’t paid. All that money stays in the account and it compounds on a tax deferred basis. Over a period of 20 or 30 years that is extremely powerful. That allows somebody to build up a really nice nest egg for retirement, so that’s the basic tax code is that money goes in pre-taxed, no income taxes paid on it, federal or state, there are a few states that pay taxes, but the big tax is federal. That money goes in pre-taxed and builds up, so that’s on the employee side, and also for the employer SEP dollars go in pre-taxed. On the other side of the equation the employer gets a deduction, so even though no income tax is paid up front, the employers allow the deduction and that’s extraordinary in the Internal Revenue Code. Ordinarily the way that this works, the employer doesn’t get a deduction, or actually income tax, there’s a symmetry in the tax code; you get a deduction, offsetting deduction, when you pay income taxes. Here you’re given this extraordinary tax treatment, able to defer tax, pre-tax, plus you get a deduction, so it’s a great tax treatment, but the price for that is there’s something called discrimination rules. What these discrimination rules are all about is the highly compensated people, and that’s a technically defined term as to who exactly is a highly compensated person, were only allowed to have so much if it weren’t for the plan for a highly compensated person as compared to the non-highly compensated person. Again, a technically defined term and we take the averages of those two groups, the highly compensated versus the non-highly compensated, and if they’re too far apart, too disparate those two averages, then we flunked the discrimination test. If we flunk the discrimination test something has to happen. Either we have to distribute out the excess through the highly compensated, they’re going to be taxed on that excess and they generally don’t like that, or the employer is going to have to contribute additional money to the plan. That’s what happens if we flunk the discrimination test. In the 401(k) area we have something called a Safe Harbor so that requires an employer contribution, either a 4% match or 4% non-match and if the employer is ready, willing and able to make one of those contributions, usually it’s the match, then there is no discrimination test, which allows the highly compensated to contribute as much as they want in a 401(k) or 403(b) or 457 plan, that’s going to be $18,000 per year for someone under age 50, and then an additional $6000 per year for somebody 50 or over for a total of $24,000. If you put that money in each year, you’re going to have yourself a tidy sum after 30 years. It works very nicely. If we have a Safe Harbor 401(k), and many, many 401(k) plans these days are a Safe Harbor 401(k), the employer stands ready to make the 4% match or 3% non-match then the highly compensated can put in their maximum, so that’s the Safe Harbor 401(k) and I know I’ve given you a lot of material there. The Safe Harbor 401(k) is actually very similar to the SIMPLE. With the SIMPLE the employer doesn’t have choices the way they do in the 401(k) plan. The Safe Harbor isn’t mandatory in a 401(k). You can choose not to have a Safe Harbor but then you’re subject to the discrimination testing. In the SIMPLE plan there isn’t that choice as to whether to have the “Safe Harbor” or not. If the employer chooses the SIMPLE plan then the choice is either a 3% matching contribution from the employer, and that’s 3% of compensation and I’ll give you an example in a second, or a 2% non-match. In a SIMPLE plan the way that this works, just throwing out these percentages and what do these percentages mean, well in a SIMPLE plan the employee can contribute up to $12,500, so now that’s less than the 401(k). A 401(k) is $18,000 for someone under age 50. The SIMPLE plan is up to $12,500 for someone under age 50. Typically the employer is going to do the 3% match in the SIMPLE. If the employer elects to do the 3% match, his 3% times the employee’s compensation, so if the employee puts in, let’s just say they put in $5000, they could put in up to $12,500, but they don’t have that much money, they’re going to put in $5000 for the year. Let’s say the employee, just so we have some round numbers here, let’s say the employee is making $100,000. The employee put in $5000, he’s making $100,000. The employer if he chooses a 3% match, has to match 3% to $100,000, so that’s $3000, so the employee puts in $5000, the employer has to match 3% of $100,000, so that’s $3000. The employee puts in $5000, the employer is on the hook to match $3000 of that $5000 and that’s how the SIMPLE plan works. It’s relatively inflexible but it’s very simple and very affordable. The employee has control over that account. It’s in an IRA account, unlike the 401(k) where it’s in an employer plan and the employee doesn’t have direct control over that account other than to choose the investments. In the SIMPLE IRA, the employee controls that and he could actually move that to a different location if they wanted to.

21:22

JIM: As you’re going through all that, Gary, I know it’s probably got some people’s heads spinning a little bit with all those numbers and percentages, and bottom line with any of this stuff, you really want to talk to your advisor and I hear all the misconceptions, I hear people think well geez I can’t afford to put $5000 away in my retirement account so then I can’t do it, or I can’t put away 3% or whatever the case is. These are maximums that will be matched and it’s like getting free money, so the example you gave, if I put $5000 in and my employer puts $3000 in, that’s like getting an instant 60% return on my money. I’ve had clients in situations where the couple, maybe one spouse had a 401(k) and there was a 5% match at the 401(k) and the other spouse has a SIMPLE plan at their work and there’s only a 3% match, so they only put money into the 5% match plan and they were actually putting in more than 5% and not getting a match there and then not putting anything into the wife’s account where they could have got a 3% match, so this is where it’s really important to have an advisor that looks at some of these options that you might have and make sure you’re taking advantage of them and not leaving money on the table that can help you towards your retirement. It’s really important that you understand how your benefits work. I meet with people all the time. They don’t realize they can still contribute to IRAs. They don’t understand how the matches work. They’re not taking full advantage of them and that’s all money that’s going to help you in retirement and as an employer offering those benefits, one of the big advantages of paying that benefit, and it’s also a benefit to an employee, whatever the employer pays, as you mentioned is pre-taxed, but it’s also pre-FICA. The 7.65% that the employer pays, the 7.65% that the employee pays, anything that the employer puts in is not subject to that FICA tax and it’s not subject to FICA tax when you take it out as well, so it’s really a way to really compound money when you get it away from some of these taxes. Gary, let’s move onto one other issue. There’s a new tax rule right now and this effects people that are over 70 1/2. They have required minimum distributions and I know a lot of people make contributions to their church or their favorite charities and a lot of them once they’re in retirement the mortgage interest is gone, the kids are gone, they don’t have a lot of itemized deductions and the money they give to the church they’re not getting a deduction, but now they have an option that was just made permanent.

23:45

GARY: That’s what we call the charitable rollover. Technically they call that the qualified charitable distribution and that allows money to go direct from the person’s IRA account and have the check written directly to charity, not made out to the person, but the check is actually made out to the charity, that qualifies as an exclusion from gross income so it’s not subject to income tax, plus and this is only available to folks over age 70 1/2, it satisfies the RMD, the required minimum distribution, rules. Because people once they get to be 70 1/2 there is a required amount that has to come out each year and if they have enough other income and they give to charity anyway, this is an excellent way to make the most of their money and to avoid income tax on the money coming out of that account.

24:35

JIM: I’ll just give you a quick example, Gary. A new client had come in and they had RMDs. They didn’t have a lot of money in their retirement accounts but they were required to take out roughly $1300 out of their IRA. They were giving away $100 a month to their local church and I said look, we could either just take the $100 you’re doing right now, give it directly to your church from your IRA and they were in a 10% bracket so that saved them $120. I said or maybe with that tax savings we’d give your church an extra $100, we’ll do the $1300, we’ll save $130 because they weren’t able to itemize and they’re only in a 10% bracket. At first they thought wow that seems like a lot of rigmarole to go through. I said no it’s really easy. All we have to do is fill out a piece of paper and have you sign it and now we’ll satisfy your RMDs, you won’t pay any tax on it, your church will get a little bit more money and you’ll get a little bit more money if we want to do it that way, or you just have some extra money and keep it the same with the church. They decided to give their church a little bit of that extra money they were saving in taxes and everybody was happy.

25:38

GARY: Yeah, great strategy. This allows it to be totally excluded from gross income so it doesn’t flow through down to the adjusted gross income and the bottom line on the front page of your 1040, and so that reduces the amount of income, potentially can, that’s going to be subject to income tax, or I should say social security income that could be subject to income tax. By keeping that AGI number more since it’s going to be excluded from gross income, the IRA amount is going to charity, excluded from income it doesn’t increase the AGI number on your 1040, which could have the effect of keeping social security from being subject to income tax.

26:20

JIM: One other thing that I’ve talked to my clients about as well is let’s say you’re used to paying that tax, well now we’ve lowered their income. If we took another $1300 in that example and I converted it to a Roth IRA, now that’s not a lot of money, okay I’ve taken $1300, I’ve converted it to a Roth, they’re at about the same point that they were with taxes because we’re not paying taxes on the money we were forced to take out and then we turn around and they gave it to charity and they didn’t get a deduction for that because they defaulted to the itemized deduction. If I just took that extra $1300 and let’s say they live 20 years in retirement without even a dime of growth or interest, that’s $26,000 now that they could pass tax-free to their kids. One of the benefits of a Roth IRA is you are not forced to take money out. You could allow it to grow tax-free and pass tax-free to your family. Well Gary this was fantastic. I think the moral of the story is don’t go this alone, don’t make decisions alone. There are so many opportunities. There are also some trap doors when it comes to retirement plans, like if you quit your job and have a 401(k) to rollover, a lot of people look at that as like severance pay and they end up paying taxes and penalties on it. You want to make sure that you optimize these accounts and you keep more of that money for yourself to help you when you’re in retirement and today we only scratched the surface. Gary, are there any final thoughts that you would give anybody or any words of advice you would give anybody regarding their retirement accounts?

27:45

GARY: Someone had asked me the other day talking about the Roth conversion whether it’s possible to reach inside of your Traditional IRA and just select those particular stocks or bonds that they want to convert to a Roth, or do they have to convert pro rate from everything in the account. The answer is yes they can cherry pick, so I could just select my IBM Stock. Let’s just say that the stock had recently gone down in value and I believed it was going to go back up, I could convert just that IBM Stock and convert that to a Roth and now when it goes back up in value everything inside of that Roth IRA is all going to be tax-free.

28:26

JIM: That’s a great point. Gary thanks for being our guest again. I really appreciate you joining us and I look forward to having you back on again in the future.

28:34

GARY: Great, thank you Jim. This has been fun.

28:35

JIM: Thanks for joining us this week and tune in again next week as we explore another phase of the Real Wealth process, and remember if anything you heard in today’s show you’d like to get more information about, contact your Real Wealth Advisor. Also, if you feel that any of this information would be helpful to a friend or family member just click the forward to a friend button.