Financial Intelligence

Peak Asset MANAGEMENT

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Retirement Planning Part 2: The Key Components

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In our second of a two part series, we highlight the overall steps in planning for your retirement. As a potential follow-up to this newsletter, we can provide more information on what we would need to help you develop a retirement plan customized to your specific goals.

Retirement Planning: The Basics

Determine your retirement income needs

It is common to estimate desired annual retirement income as a percentage of your current income or based on expected expenses in retirement. When using percentage of current income you would assume your future retirement income needs will be anywhere from 60 to 90 percent of your current income level. Using percentage of income is simple, but it doesn't factor in specific circumstances related to your situation. In this case estimating your future expenses might be a better way to determine the desired income. One shortfall of this method is that your expenses may change dramatically over time. If you are nearing retirement, the gap between your current expenses and your retirement expenses may be small. If retirement for you is many years away, the gap may be significant, and projecting your future expenses may be more difficult.

For both methods of estimating desired retirement income, factoring in inflation is very important. Based on recent history of price increases, we are currently using a 2.5% inflation factor for general living expenses, a 6% inflation factor for medical expenses, which include Medicare premiums, and a 4.5% inflation factor for possible long-term care expenses.

Once you have estimated your retirement income needs, take stock of your estimated future retirement income and assets that can support your needs. These resources may come from Social Security, pensions, a part-time job, retirement accounts, an inheritance, and other sources.

The Gap: How much will you need to save?

Once you estimate your retirement income needs, you can begin to calculate how much additional savings you will need to make between now and retirement. The following questions can help you assess how your current income and assets play into your projections of future income (e.g. Social Security), savings, and growth of assets.

- At what age do you plan to retire? The younger you retire, the longer your retirement will be, and the more money you'll need to carry you through it.
- What is your life expectancy? The longer you live, the more years of retirement you will have to fund.
- What rate of growth can you expect from your savings now and during retirement? Be conservative when projecting rates of return, especially in today's low interest rate environment.

Build your retirement fund: Save, save, save!

When you know roughly how much money you will need, your next goal is to save that amount. First, you will have to map out

> "Once you have estimated your retirement income needs, take stock of your estimated future retirement income and assets that can support your needs."

a savings plan that works for you. Assume a modest annual rate of return (e.g., 5% or less), and then determine approximately how much you will need to save every year between now and your retirement to reach your goal.

The next step is to put your savings plan into action. It's never too early to get started (ideally, begin saving in your 20s). To the extent possible, you may want to arrange to have certain amounts taken directly from your paycheck and automatically invested in accounts of your choice (e.g., 401(k) plans, payroll deduction savings). This arrangement reduces the risk of impulsive or unwise spending that will threaten your savings plan. If possible, save more than you think you will need to provide a cushion in case unexpected expenses come up, or investment returns turn out less then expected. In general, a person should save at least 15% of their annual gross income for most of their working life to be able to support most retirement goals.

"You need to understand the types of investments that are available, and decide which ones are right for you."

Understand your investment options

You need to understand the types of investments that are available, and decide which ones are right for you. Investment choices and an asset allocation need to be appropriate for your goals, risk tolerance, and time horizon.

Use the right savings tools and know your tax bracket

The following are among the most common retirement savings tools, but others are also available:

Employer-sponsored retirement plans that allow employee deferrals (like 401(k), 403(b), SIMPLE, and 457(b) plans) are powerful savings tools. In most cases, your contributions come out of your salary as pretax contributions (reducing your current taxable income) and any investment earnings are tax deferred until withdrawn.

IRAs, like employer-sponsored retirement plans, feature tax deferral of earnings. If you are eligible, traditional IRAs may enable you to lower your current taxable income through deductible contributions. Withdrawals, however, are taxable as ordinary income (unless you've made nondeductible contributions, in which case a portion of the withdrawals will not be taxable). Roth IRAs don't permit tax-deductible contributions but allow you to make completely tax-free withdrawals if certain rules are followed. Roth IRAs also do not have required minimum distributions when turning 70 ½.

Knowing your tax bracket both now and in the future is also key in making proper savings and withdrawal decisions. Besides finding ways to reduce your taxes in high income tax years, unique opportunities may exist if you expect a tax year with lower income. For example, you may benefit by converting IRAs to Roth IRAs, or by realizing capital gains on taxable investments and paying $0 federal taxes on those gains. For your review, we have attached a "Key Numbers 2016" reference guide that highlights tax brackets and potential maximum retirement plan/IRA contributions. If you are uncertain about the opportunities to reduce your future taxes, let us review your tax return and discuss possible strategies that could make a big difference in meeting your retirement goals. Later in this article we provide a detailed example of possible strategies and tax saving opportunities that we might look for, depending on each client situation.

Make up any income shortfall

If you're lucky, your expected income sources will be more than enough to fund even a lengthy retirement. But what if it looks like you will come up short? Don't panic--there are probably steps that you can take to bridge the gap. A retirement plan can help you figure out the best ways to do that, but here are a few suggestions:

- Try to cut current expenses so you will have more money to save for retirement
- Shift your assets to investments that have the potential to substantially outpace inflation (but keep in mind that investments that offer higher potential returns may involve greater risk of loss)
- Lower your expectations for retirement so you won't need as much money.
- Work part-time during retirement for extra income
- Consider delaying your retirement for a few years (or longer)

Monitor and update your planning

The success of any retirement planning depends on your ability to see where you stand on a regular basis, and possibly make changes to ensure your success. Your goals, future expenses, financial resources, and available tax saving strategies will change, and it is important to know how all these variables affect your overall plan. Please know that we are here to help you with the retirement planning process and to provide recommendations that can help you reach your overall financial goals.

A Tax Planning Scenario

The following scenario does not represent an actual client, and all assumptions regarding situational finances, investment returns, tax laws, and potential tax savings are subject to change. The scenario is provided only to show the potential benefits of retirement and tax planning, and will not reflect your actual situation.

Client Assumptions:

John and Sally Smith are married, living in Colorado. John and Sally are following a retirement plan based on the assumption that John will live to 90 and Sally to 94. John will take his Social Security benefit at age 70, and Sally will take a spousal benefit starting at age 62. Starting In 2019, the additional income from Social Security and required IRA distributions will likely put them well into the 25% marginal tax bracket.

2014 Tax year Assumptions:

The Smiths received a large deferred compensation in 2014 while they also received self-employment income. Without any tax planning, the Smiths would have taxable income of over $211,000, and have federal taxes of $46,329 and Colorado taxes of $10,234. They would be in the upper range of the 28% federal marginal tax bracket.
To save taxes for 2014 and boost their retirement savings, the Smiths did the following:

1. As a self-employed individual, John opened up a solo 401k and contributed $26,482, which consisted of employee and employer contributions. They were ineligible to contribute additional funds to IRAs based on Modified Adjusted Gross Income. The solo 401k allowed larger contributions than other qualified plans for self-employed individuals such as a SEP IRA or SIMPLE IRA.

2. John and Sally would like to always contribute at least $2,000/year to charity even in retirement years, so they opened up a Donor Advised Fund (DAF), and contributed a mutual fund out of their taxable account worth $13,500. Even though this fund had an unrealized gain of $6,000, no taxes are ever due, and the Smiths could include the full value on their schedule A for tax deduction purposes. The Smiths will use the DAF to make donations to the charities of their choice in future years, especially during those years when they are likely to be the 0% to 15% marginal tax bracket.

3. The net effect of these two strategies is a 2014 federal tax savings of <u>$12,326</u> ($46,329-$34,003) and a state tax savings of <u>$1,780</u> ($10,234-$8,454) for a total of <u>$14,106</u> in tax savings. If you assume that the $6,000 unrealized gain of the investment given to charity would have instead been sold to fund living expenses in a 25% marginal tax bracket year, then this saves another <u>$1,178</u>, based on the 15% federal capital gains tax rate and 4.63% CO state tax rate. The potential total tax savings for the strategies implemented in 2014 could be $14,106 + $1,178 = <u>$15,284</u>.

2015 Tax year Assumptions:

In 2015, their federal taxable income was expected to drop dramatically, before climbing back up when collecting full Social Security and required IRA withdrawals in 2019. This would not justify any 401k or traditional IRA contributions for further deductions as federal income taxes due in 2015 would be $0. They would still pay Self Employment taxes (for Social Security and Medicare), which cannot be reduced. They would be using their Donor Advised fund to contribute to charity, as normal cash contributions would provide little if any federal tax benefit. Even though their taxable income was expected to be very low, their Adjusted Gross income was expected to be high enough that any health insurance subsidy through the Affordable Care Act would be minimal.

2015 Tax Planning is now reversed from 2014, in that the Smiths want to move future federal taxable income to 2015, such that this income could be taxed at a low 0% to 15% level, compared to a possible 15% to 25% level in 2019 and beyond.

1. The Smiths can now sell investments in their taxable account that have unrealized long term capital gains, since these gains would be taxed at a 0% federal rate, as long as they are in the 15% or lower marginal tax bracket. Selling these investments later when in the 25% marginal tax bracket would result in a federal capital gains tax rate of

15%. Once sold, these same investments could be bought back if desired, resetting the cost basis to the new purchase price. By taking an extra $29,286 of gains out now versus in future high tax years, the Smiths could save approximately $4,243 in federal taxes ($29,286 * 15%).

2. John decides to take a $24,000 distribution from his traditional IRA, of which some money is withheld for federal and state tax purposes, such that they don't have to pay estimated taxes. Since the Smiths had sufficient self-employment income, both John and Sally were able to contribute the maximum $6,500 each to individual Roth IRAs. John could have rolled over the entire $24,000 to a Roth IRA, however, they elected to take the distribution and partially fund Roth IRAs.

3. Since John is 65 or older, he gets the maximum Colorado "Pension/Annuity" deduction of $24,000, which saves him 4.63 cents on the dollar or $1,111. Starting in year 2019, his social security will use the full $24,000 deduction, and any standard IRA withdrawal will not qualify for a state tax deduction. Although 2016 strategy is not included here, Sally, who is between the ages of 55 and 65, will have available a $20,000 CO deduction. Converting $20,000 from her IRA to a ROTH IRA could also save 4.63 cents on the dollar or $926.

4. The combined strategy above results in taxable income of $59,465 federal and $35,668 state. This results in taxes (not including self-employment taxes which are fixed) of $1,879 federal and $1,651 state. Even though we increased federal taxable income from $6,134 to $59,465, the increased federal tax was only $1,879. The effective federal tax rate is 3.16% ($1,879/$59,465). If John had instead waited to take out the $24,000 IRA distribution when well in the 25% marginal tax bracket, then these withdrawals could result in $6,000 of taxes. If you compare this to a net effective tax rate of 3.15% * $24,000 = $758, then this could result in a tax savings of $5,242.

5. The total tax savings for this 2015 strategy could be $4,243 + $1,111 + $5,242 = $10,596

Summary:

1. Based on potential income and taxes, the Smiths may have the same opportunity to implement the 2015 strategies in years 2016 through 2018. If the same assumptions hold true, then the Smiths could have a combined 2014-2018 total tax savings of $15,284 + ($10,596 * 4) = $57,668.

2. The Smiths also have a unique opportunity in years 2015 through 2018 to build up funds in Roth IRAs, which they did not have access to in past years. With Roth IRAs, all withdrawals, including investment gains, are tax free. Current law does not require minimum distributions once one turns 70 ½, and any inherited Roth IRA passes tax free as well. These are wonderful savings vehicles that would be a great supplement to their other retirement assets. By now having a tax free account in the mix, the Smiths can more strategically plan their withdrawals, such that further taxes could be saved in years 2019 and beyond.

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Federal/State Tax Planner

State: Colorado — Date: 04-26-2016

Prepared for **John and Sally Smith** — Prepared by Peak Asset Management, LLC

	Without plan 2014 (MFJ) Fed	State	ACTUAL(post plan) 2014 (MFJ) Fed	State	Without plan 2015 (MFJ) Fed	State	ACTUAL (post plan) 2015 (MFJ) Fed	State	Without 2015-2018 plans 2019 (MFJ) Fed	State
INCOME										
Wages	197,102	197,102	197,102	197,102	20	20	20	20	20	20
Taxable Interest	57	57	57	57	26	26	26	26	26	26
Dividends	6,760	6,760	6,760	6,760	2,548	2,548	2,548	2,548	800	800
State Tax Refunds	0	0	0	0	501	0	501	0	0	0
Alimony Received	0	0	0	0	0	0	0	0	0	0
Schedule C or F	35,306	35,306	35,306	35,306	37,426	37,426	37,426	37,426	8,250	8,250
Capital Gain	10,901	10,901	10,901	10,901	9,834	9,834	38,120	38,120	1,000	1,000
4797 Ordinary Gain/Loss	0	0	0	0	0	0	0	0	0	0
IRA/Pension/Lump Sum Dist.	0	0	0	0	0	0	24,000	0	83,260	83,260
Schedule E (Non-Passive)	0	0	0	0	0	0	0	0	0	0
Passive Activities	0	0	0	0	0	0	0	0	0	0
Taxable Social Security	0	0	0	0	0	0	0	0	45,502	45,502
Unemployment Compensation	0	0	0	0	0	0	0	0	0	0
Other Income or Losses	0	0	0	0	0	0	0	0	0	0
TOTAL INCOME	**250,126**	**250,126**	**250,126**	**250,126**	**50,355**	**49,854**	**102,641**	**78,140**	**138,858**	**138,858**
ADJUSTMENTS TO INCOME										
Taxpayer IRA	0	0	0	0	0	0	0	0	0	0
Spouse IRA	0	0	0	0	0	0	0	0	0	0
Taxpayer Keogh/Sep	0	0	26,482	26,482	0	0	0	0	0	0
Spouse Keogh/Sep	0	0	0	0	0	0	0	0	0	0
Self Employed Health Ins.	2,133	2,133	2,133	2,133	13,978	13,978	13,978	13,978	4,978	4,978
Ded. for Self-Employment Tax	777	777	777	777	2,644	2,644	2,644	2,644	583	583
Early Withdrawal Penalty	0	0	0	0	0	0	0	0	0	0
Alimony Paid	0	0	0	0	0	0	0	0	0	0
Moving Expenses	0	0	0	0	0	0	0	0	0	0
Educational Interest	0	0	0	0	0	0	0	0	0	0
Qualified Higher Education	0	0	0	0	0	0	0	0	0	0
Other Adjustments	0	0	0	0	0	0	0	0	0	0
State Adjustments to Fed AGI	N/A	0	N/A	0	N/A	0	N/A	0	N/A	35,508
TOTAL ADJUSTMENTS	**2,910**	**2,910**	**29,392**	**29,392**	**16,622**	**16,622**	**16,622**	**16,622**	**5,561**	**41,069**
ADJUSTED GROSS INCOME	**247,216**	**247,216**	**220,734**	**220,734**	**33,733**	**33,232**	**86,019**	**61,518**	**133,297**	**97,789**
ITEMIZED DEDUCTIONS										
Total Medical Expenses	0	0	0	0	0	0	0	0	0	0
Taxes	11,941	2,663	11,941	2,663	4,917	2,517	4,917	2,517	4,986	2,586
Interest	0	0	0	0	0	0	0	0	0	0
Charitable Contributions	2,500	2,500	13,942	13,942	449	449	449	449	1,000	1,000
Casualty and Theft	0	0	0	0	0	0	0	0	0	0
Misc. Ded. Subj to 2% of AGI	9,165	9,165	9,694	9,694	10,233	10,233	9,188	9,188	11,934	11,934
Gambling Losses	0	0	0	0	0	0	0	0	0	0
Other Misc. Deductions	0	0	0	0	0	0	0	0	0	0
High Income Reduction	0	0	0	0	0	0	0	0	0	0
State Adj. to Fed Item. Ded.	N/A	0	N/A	0	N/A	0	N/A	0	N/A	0
TOTAL ITEMIZED DEDUCTIONS	**23,606**	**14,328**	**35,577**	**26,299**	**15,599**	**13,199**	**14,554**	**12,154**	**17,920**	**15,520**
STANDARD DEDUCTION	**13,600**	**13,600**	**13,600**	**13,600**	**13,850**	**13,850**	**13,850**	**13,850**	**15,150**	**15,150**
TOTAL DEDUCTIONS	**23,606**	**14,328**	**35,577**	**26,299**	**15,599**	**13,850**	**14,554**	**13,850**	**17,920**	**15,520**
TAX COMPUTATIONS										
Adjusted Gross Income	247,216	247,216	220,734	220,734	33,733	33,232	86,019	61,518	133,297	97,789
Total Deductions	23,606	14,328	35,577	26,299	15,599	13,850	14,554	13,850	17,920	15,520
Exemptions	11,850	11,850	11,850	11,850	12,000	12,000	12,000	12,000	8,800	8,800
TAXABLE INCOME	**211,760**	**221,038**	**173,307**	**182,585**	**6,134**	**7,382**	**59,465**	**35,668**	**106,577**	**73,469**
Tax From Tax Tables/Schedules	44,548	10,234	33,781	8,454	0	342	2,066	1,651	17,272	3,402
State Exemption Credits	N/A	0	N/A	0	N/A	0	N/A	0	N/A	0
Tax	44,548	10,234	33,781	8,454	0	342	2,066	1,651	17,272	3,402
Tax on Lump Sum Dist.	0	0	0	0	0	0	0	0	0	0
Alternative Minimum Tax	1,781	0	222	0	0	0	0	0	0	0
Excess Prem. Tax Cred. Repay.	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
TAX BEFORE CREDITS	**46,329**	**10,234**	**34,003**	**8,454**	**0**	**342**	**2,066**	**1,651**	**17,272**	**3,402**
CREDITS (NONREFUNDABLE)										
Dependent Care Credit	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Child Tax Credit *	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Educational Credits *	0	N/A	0	N/A	0	N/A	178	N/A	69	N/A
Elective Deferral/IRA Credit *	0	N/A	0	N/A	0	N/A	0	N/A	0	N/A
Other Nonrefundable Credits	0	0	0	0	0	0	9	0	9	0
TOTAL CREDITS	**0**	**0**	**0**	**0**	**0**	**0**	**187**	**0**	**78**	**0**
TAX AFTER CREDITS	**46,329**	**10,234**	**34,003**	**8,454**	**0**	**342**	**1,879**	**1,651**	**17,194**	**3,402**
OTHER TAXES										
Self-Employment Tax	1,553	N/A	1,553	N/A	5,288	N/A	5,288	N/A	1,166	N/A
Tax on IRA/Qualified Plan Dist.	0	0	0	0	0	0	0	0	0	0
Other Taxes	0	0	0	0	9	0	9	0	9	0
TOTAL OTHER TAXES	**1,553**	**0**	**1,553**	**0**	**5,297**	**0**	**5,297**	**0**	**1,175**	**0**
TOTAL TAX	**47,882**	**10,234**	**35,556**	**8,454**	**5,297**	**342**	**7,176**	**1,651**	**18,369**	**3,402**
PAYMENTS/REFUNDABLE CREDITS										
Inc. Tax Withheld from Wages	48,815	8,955	48,815	8,955	0	0	0	0	0	0
Estimated Tax Payments	0	0	0	0	6,000	2,400	0	0	1,168	0
Earned Income Credit	0	N/A	0	N/A	0	0	0	0	0	0
Excess Soc. Sec./ Local Tax	0	0	0	0	0	42	0	42	0	42
Other Taxes Paid In	0	0	0	0	0	0	6,000	2,400	16,000	2,400
Refundable Credits **	0	0	0	0	0	0	0	0	0	0
TOTAL PAYMENTS	**48,815**	**8,955**	**48,815**	**8,955**	**6,000**	**2,442**	**6,000**	**2,442**	**17,168**	**2,442**
BALANCE DUE OR REFUND (-)	**-933**	**1,279**	**-13,259**	**-501**	**-703**	**-2,100**	**1,176**	**-791**	**1,201**	**960**
Tax Bracket / Effective Marginal *** Tax Rate on Ordinary Income	**28 / 32.5**	**4.63 / 4.7**	**28 / 32.5**	**4.63 / 4.7**	**0 / 0**	**4.63 / 4.6**	**15 / 15**	**4.63 / 4.7**	**25 / 26.4**	**4.63 / 4.7**

* May be limited by AGI and/or AMT.

** See separate worksheet for detailed breakdown.

*** Effective marginal tax rate on next $1000 of ordinary income, taking into account phase-outs, AMT, etc.

File Description: Plan Summary - (4/7/2016)