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# Financial Insight Quarterly

## Your Source for Financial Well-Being

### Playing Catch-Up with Your 401(k) or IRA



A recent survey of baby boomers (ages 53 to 69) found that just 24% were confident they would have enough money to last throughout retirement. Forty-five percent had no retirement savings at all, and of those who did

have savings, 42% had saved less than \$100,000.<sup>1</sup>

Your own savings may be on more solid ground, but regardless of your current balance, it's smart to keep it growing. If you're 50 or older, you could benefit by making catch-up contributions to tax-advantaged retirement accounts. You might be surprised by how much your nest egg could grow late in your working career.

#### Contribution limits

The federal contribution limit in 2016 and 2017 for all IRAs combined is \$5,500, plus a \$1,000 catch-up contribution for those 50 and older, for a total of \$6,500. An extra \$1,000 might not seem like much, but it could make a big difference by the time you're ready to retire (see table). You have until the April 18, 2017, tax filing deadline to make IRA contributions for 2016. The sooner you contribute, the more time the funds will have to pursue potential growth.

The deferral limit in 2016 and 2017 for employer-sponsored retirement plans such as 401(k), 403(b), and most 457(b) plans is \$18,000, plus a \$6,000 catch-up contribution for workers 50 and older, for a total of \$24,000. However, some employer-sponsored plans may have maximums that are lower than the federal contribution limit. Unlike the case with IRAs, contributions to employer-sponsored plans must be made by the end of the calendar year, so be sure to adjust your contributions early enough in the year to take full advantage of the catch-up opportunity.

The following table shows the amount that a 50-year-old might accrue by age 65 or 70, based on making maximum annual contributions (at current rates) to an IRA or a 401(k) plan:

Potential Savings a 50-Year-Old Could Accumulate		Without Catch-Up	With Catch-Up
IRA	By Age 65	\$128,018	\$151,294
	By Age 70	\$202,321	\$239,106
401(k)	By Age 65	\$418,697	\$558,623
	By Age 70	\$662,141	\$882,854

*Example assumes a 6% average annual return. This hypothetical example of mathematical compounding is used for illustrative purposes only and does not represent any specific investment. It assumes contributions are made at end of the calendar year. Rates of return vary over time, particularly for long-term investments. Fees and expenses are not considered and would reduce the performance shown if they were included. Actual results will vary.*

#### Special 403(b) and 457(b) plan rules

403(b) and 457(b) plans can (but aren't required to) provide their own special catch-up opportunities. The 403(b) special rule, available to participants with at least 15 years of service, may permit an additional \$3,000 annual deferral for up to five years (certain additional limits apply). A participant can use this special rule and the age 50 catch-up rule in the same year. Therefore, a participant eligible for both could contribute up to \$27,000 to his or her 403(b) plan account (the \$18,000 regular deferral limit, plus the \$3,000 special catch-up, plus the \$6,000 age 50 catch-up).

The 457(b) plan special rule allows participants who have not deferred the maximum amount in prior years to contribute up to twice the normal deferral limit (that is, up to \$36,000 in 2016 and 2017) in the three years prior to reaching the plan's normal retirement age. (However, these additional catch-up contributions can't exceed the total of the prior years' unused deferrals.) 457(b) participants who elect to use this special catch-up rule cannot also use the age 50 catch-up rule in the same year.

<sup>1</sup> "Boomer Expectations for Retirement 2016," Insured Retirement Institute.

#### 1st Quarter 2017

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## Tax Tips for the Self-Employed



**Self-employed individuals make up 10.1% of the total U.S. workforce.**

**Source: U.S. Bureau of Labor Statistics, March 2016**

Being self-employed has many advantages — the opportunity to be your own boss and come and go as you please, for example. However, it also comes with unique challenges, especially when it comes to how to handle taxes. Whether you're running your own business or thinking about starting one, you'll want to be aware of the specific tax rules and opportunities that apply to you.

### Understand the self-employment tax

When you worked for an employer, payroll taxes to fund Social Security and Medicare were split between you and your employer. Now you must pay a self-employment tax equal to the combined amount that an employee and employer would pay. You must pay this tax if you had net earnings of \$400 or more from self-employment.

The self-employment tax rate on net earnings (up to \$127,200 in 2017) is 15.3%, with 12.4% going toward Social Security and 2.9% allotted to Medicare. Any amount over the earnings threshold is generally subject only to the Medicare payroll tax. However, self-employment and wage income above \$200,000 is generally subject to a 0.9% additional Medicare tax. (For married individuals filing jointly, the 0.9% additional tax applies to combined self-employment and wage income over \$250,000. For married individuals filing separately, the threshold is \$125,000.)

If you file Form 1040, Schedule C, as a sole proprietor, independent contractor, or statutory employee, the net income listed on your Schedule C (or Schedule C-EZ) is self-employment income and must be included on Schedule SE, which is filed with your Form 1040. Schedule SE is used both to calculate self-employment tax and to report the amount of tax owed. You can deduct one-half of the self-employment tax paid (but not any portion of the Medicare surtax) when you compute the self-employment tax on Schedule SE.

### Make estimated tax payments on time

When you're self-employed, you'll need to make quarterly estimated tax payments (using IRS Form 1040-ES) to cover your federal tax liability. You may have to make state estimated tax payments as well.

Estimated tax payments are generally due each year on the 15th of April, June, September, and January. If you fail to make estimated tax payments on time, you may be subject to penalties, interest, and a large tax bill at the end of the tax year. For more information, see IRS Publication 505, Tax Withholding and Estimated Tax.

### Invest in a retirement plan

If you are self-employed, it is up to you and you alone to save sufficient funds for retirement. Investing in a retirement plan can help you save for retirement and also provide numerous tax benefits.

A number of retirement plans are suited for self-employed individuals:

- SEP IRA plan
- SIMPLE IRA plan
- SIMPLE 401(k) plan
- "Individual" 401(k) plan

The type of retirement plan you choose will depend on your business and specific circumstances. Explore your options and be sure to consider the complexity of each plan. In addition, if you have employees, you may have to provide retirement benefits for them as well. For more information, consult a tax professional or see IRS Publication 560, Retirement Plans for Small Businesses.

### Take advantage of business deductions

If you have your own business, you can deduct some of the costs of starting the business, as well as the current operating costs of running that business. To be deductible, business expenses must be both ordinary (common and accepted in your field of business) and necessary (appropriate and helpful for your business).

Since business deductions will lower your taxable income, you should take advantage of any deductions to which you are entitled. You may be able to deduct a variety of business expenses, such as start-up costs, home office expenses, and office equipment.

### Deduct health-care expenses

If you qualify, you may be able to benefit from the self-employed health insurance deduction, which would enable you to deduct up to 100% of the cost of health insurance that you provide for yourself, your spouse, your dependents, and employees.

In addition, if you are enrolled in a high-deductible health plan, you may be able to establish and contribute to a health savings account (HSA), which is a tax-advantaged account into which you can set aside funds to pay qualified medical expenses. Contributions made to an HSA account are generally tax deductible. (Depending upon the state, HSA contributions may or may not be subject to state taxes.)

## Grandparents Can Help Bridge the College Cost Gap



**Assets in 529 plans reached \$266.2 billion, spread over 12.7 million accounts, as of the second quarter of 2016.**

**Source: College Savings Plans Network, 529 Report: An Exclusive Mid-Year Review of 529 Plan Activity, September 2016**

**Note:** Investors should consider the investment objectives, risks, charges, and expenses associated with 529 plans before investing, along with each plan's specific investment options, underlying investments, and investment company. More information can be found in the plan's official disclosure statements and prospectus, which should be read carefully before investing. As with any investment, there are generally fees and expenses associated with participation in a 529 plan. There is also the risk that your underlying investments may lose money or not perform well enough to cover college costs as anticipated. Finally, be aware that your ability to take advantage of any 529 plan state tax benefits may be contingent on your enrollment in your own state's 529 plan.

For many families, a college education is a significant financial burden that is increasingly hard to meet with savings, current income, and a manageable amount of loans. For some, the ace in the hole might be grandparents, whose added funds can help bridge the gap. If you're a grandparent who would like to help fund your grandchild's college education, here are some strategies.

### 529 college savings plan

A 529 college savings plan is one of the best vehicles for multigenerational college funding. 529 plans are offered by states and managed by financial institutions. Grandparents can open a 529 account on their own — either with their own state's plan or another state's plan — and name their grandchild as beneficiary (one grandchild per account), or they can contribute to an existing 529 account that has already been established for that grandchild (for example, by a parent).

Once a 529 account is open, grandparents can contribute as much or as little as they want, subject to the individual plan's lifetime limits, which are typically \$300,000 and up. Grandparents can set up automatic monthly contributions or they can gift a larger lump sum — a scenario where 529 plans really shine.

Contributions to a 529 plan accumulate tax deferred (which means no taxes are due on any earnings made along the way), and earnings are completely tax-free at the federal level (and typically at the state level) if account funds are used to pay the beneficiary's qualified education expenses. (However, the earnings portion of any withdrawal used for a non-education purpose is subject to income tax and a 10% penalty.)

Under rules unique to 529 plans, individuals can make a lump-sum gift of up to \$70,000 (\$140,000 for joint gifts by a married couple) and avoid federal gift tax by making a special election on their tax return to treat the gift as if it were made in equal installments over a five-year period. After five years, another lump-sum gift can be made using the same technique. This strategy offers two advantages: The money is considered removed from the grandparents' estate (unless a grandparent were to die during the five-year period, in which case a portion of the gift would be recaptured), but grandparents still retain control over their contribution and can withdraw part or all of it for an unexpected financial need (the earnings portion of such a withdrawal would be subject to income tax and a 10% penalty, though).

What happens at college time if a grandchild gets a scholarship? Grandparents can

seamlessly change the beneficiary of the 529 account to another grandchild, or they can make a penalty-free withdrawal from the account up to the amount of the scholarship (though they would still owe income tax on the earnings portion of this withdrawal).

Finally, a word about financial aid. Under current federal financial aid rules, a grandparent-owned 529 account is not counted as a parent or student asset, but *withdrawals* from a grandparent-owned 529 account are counted as student income in the following academic year, which can decrease the grandchild's eligibility for financial aid in that year by up to 50%. By contrast, parent-owned 529 accounts are counted as parent assets up front, but withdrawals are not counted as student income — a more favorable treatment.

### Outright cash gifts

Another option for grandparents is to make an outright gift of cash or securities to their grandchild or his or her parent. To help reduce any potential gift tax implications, grandparents should keep their gift under the annual federal gift tax exclusion amount — \$14,000 for individual gifts or \$28,000 for joint gifts. Otherwise, a larger gift may be subject to federal gift tax and, for a gift made to a grandchild, federal generation-skipping transfer tax, which is a tax on gifts made to a person who is more than one generation below you.

An outright cash gift to a grandchild or a grandchild's parent will be considered an asset for financial aid purposes. Under the federal aid formula, students must contribute 20% of their assets each year toward college costs, and parents must contribute 5.6% of their assets.

### Pay tuition directly to the college

For grandparents who are considering making an outright cash gift, another option is to bypass grandchildren and pay the college directly. Under federal law, tuition payments made directly to a college aren't considered taxable gifts, no matter how large the payment. This rule is beneficial considering that tuition at many private colleges is now over \$40,000 per year. Only tuition qualifies for this federal gift tax exclusion; room and board aren't eligible.

Aside from the benefit of being able to make larger tax-free gifts, paying tuition directly to the college ensures that your money will be used for education purposes. However, a direct tuition payment might prompt a college to reduce any potential grant award in your grandchild's financial aid package, so make sure to ask the college about the financial aid impact of your gift.

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## What's the difference between a direct and indirect rollover?

If you're eligible to receive a taxable distribution from an employer-sponsored retirement plan [like a 401(k)],

you can avoid current taxation by instructing your employer to roll the distribution directly over to another employer plan or IRA. With a direct rollover, you never actually receive the funds.

You can also avoid current taxation by actually receiving the distribution from the plan and then rolling it over to another employer plan or IRA within 60 days following receipt. This is called a "60-day" or "indirect" rollover.

But if you choose to receive the funds rather than making a direct rollover, your plan is required to withhold 20% of the taxable portion of your distribution (you'll get credit for the amount withheld when you file your federal tax return). This is true even if you intend to make a 60-day rollover. You can still roll over the entire amount of your distribution, but you'll need to make up the 20% that was withheld using other assets.

For example, if your taxable distribution from the plan is \$10,000, the plan will withhold

\$2,000 and you'll receive a check for \$8,000. You can still roll \$10,000 over to an IRA or another employer plan, but you'll need to come up with that \$2,000 from your other funds.

Similarly, if you're eligible to receive a taxable distribution from an IRA, you can avoid current taxation by either transferring the funds directly to another IRA or to an employer plan that accepts rollovers (sometimes called a "trustee-to-trustee transfer"), or by taking the distribution and making a 60-day indirect rollover (20% withholding doesn't apply to IRA distributions).

Under recently revised IRS rules, you can make only one tax-free, 60-day, rollover from any IRA you own (traditional or Roth) to any other IRA you own in any 12-month period. However, this limit does not apply to direct rollovers or trustee-to-trustee transfers.

Because of the 20% withholding rule, the one-rollover-per-year rule, and the possibility of missing the 60-day deadline, in almost all cases you're better off making a direct rollover to move your retirement plan funds from one account to another.



## What do you need to know about chip-card technology?

When you're checking out items at the store, should you insert your card into the payment terminal? These days, as the use of chip-card technology grows, the answer to that question is less clear. The computer chip now embedded in debit and credit cards uses EMV (Europay, MasterCard, and Visa) technology, which is meant to reduce fraud at physical retail stores (as opposed to online shops). But because businesses aren't required to upgrade their terminals, it's confusing to figure out what to do at the register. Here are answers to some questions you might have about chip cards.

**How does it work?** Magnetic strip cards contain information within the strip, so it's easy for a thief to "capture" that information and use it to accrue charges without the cardholder's knowledge. By contrast, the chip card generates a unique, specific code for each transaction that cannot be reused.

**Why does it take longer to check out?** The unique code generated by the chip for each transaction is sent to the bank by the payment terminal. The bank matches the code to an

identical one-time code and sends it back as verification for the transaction. As a result, it takes a few seconds longer to check out using a chip card because it takes time for the information to be transmitted.

**Why aren't some terminals working yet?** You might notice that terminals in some stores are equipped with a chip-card reader, but you're told you can't use it. These terminals are awaiting chip-card certification, which can take several months to process. Until their terminals are certified, retailers are responsible for any fraudulent charges.

**How much longer will I have to carry a physical card?** The answer to this question isn't clear. However, it's important to note that terminals with upgraded chip-card technology are also equipped with technology that can accept wireless near-field communication. This allows data to be exchanged between two different devices (e.g., a cell phone and a terminal) that are a short distance away. This means that one day, instead of swiping or inserting a card at the checkout, you might just be tapping the terminal to make payments.