



Macke Financial Advisory Group

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As the world moves to a digital platform, the issue of having enough space for document storage has rapidly decreased as the space of the cloud has increased. But for those of us who have saved everything since we first started filing tax returns, how much do we really need to save, and what truly needs to be preserved in scans and PDFs?

As a general rule, tax returns should be held for three years from the date of filing. The same applies for receipts and other corroborating paperwork for the tax return. Paperwork detailing warranties should be held as long as the warranty is in effect, and documents declaring ownership should be maintained for as long as the property or asset is held. As always, situations may vary and this is only a general guideline.

If you have any related questions, please feel free to reach out to our office at anytime and we hope you enjoy this month's edition of the Macke Financial Advisory Group Newsletter!

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Six Potential 401(k) Rollover Pitfalls



You're about to receive a distribution from your 401(k) plan, and you're considering a rollover to a traditional IRA. While these transactions are normally straightforward and trouble free, there are some pitfalls you'll want to avoid.

1. Consider the pros and cons of a rollover.

The first mistake some people make is failing to consider the pros and cons of a rollover to an IRA in the first place. You can leave your money in the 401(k) plan if your balance is over \$5,000. And if you're changing jobs, you may also be able to roll your distribution over to your new employer's 401(k) plan.

- Though IRAs typically offer significantly more investment opportunities and withdrawal flexibility, your 401(k) plan may offer investments that can't be replicated in an IRA (or can't be replicated at an equivalent cost).
- 401(k) plans offer virtually unlimited protection from your creditors under federal law (assuming the plan is covered by ERISA; solo 401(k)s are not), whereas federal law protects your IRAs from creditors only if you declare bankruptcy. Any IRA creditor protection outside of bankruptcy depends on your particular state's law.
- 401(k) plans may allow employee loans.
- And most 401(k) plans don't provide an annuity payout option, while some IRAs do.

2. Not every distribution can be rolled over to an IRA. For example, required minimum distributions can't be rolled over. Neither can hardship withdrawals or certain periodic payments. Do so and you may have an excess contribution to deal with.

3. Use direct rollovers and avoid 60-day rollovers. While it may be tempting to give yourself a free 60-day loan, it's generally a mistake to use 60-day rollovers rather than direct (trustee to trustee) rollovers. If the plan sends the money to you, it's required to withhold 20% of the taxable amount. If you later want to roll the entire amount of the original distribution over to an IRA, you'll need to use other sources to make up the 20% the plan withheld. In addition, there's no need to taunt

the rollover gods by risking inadvertent violation of the 60-day limit.

4. Remember the 10% penalty tax. Taxable distributions you receive from a 401(k) plan before age 59½ are normally subject to a 10% early distribution penalty, but a special rule lets you avoid the tax if you receive your distribution as a result of leaving your job during or after the year you turn age 55 (age 50 for qualified public safety employees). But this special rule doesn't carry over to IRAs. If you roll your distribution over to an IRA, you'll need to wait until age 59½ before you can withdraw those dollars from the IRA without the 10% penalty (unless another exception applies). So if you think you may need to use the funds before age 59½, a rollover to an IRA could be a costly mistake.

5. Learn about net unrealized appreciation (NUA). If your 401(k) plan distribution includes employer stock that's appreciated over the years, rolling that stock over into an IRA could be a serious mistake. Normally, distributions from 401(k) plans are subject to ordinary income taxes. But a special rule applies when you receive a distribution of employer stock from your plan: You pay ordinary income tax only on the cost of the stock at the time it was purchased for you by the plan. Any *appreciation* in the stock generally receives more favorable long-term capital gains treatment, regardless of how long you've owned the stock. (Any additional appreciation after the stock is distributed to you is either long-term or short-term capital gains, depending on your holding period.) These special NUA rules don't apply if you roll the stock over to an IRA.

6. And if you're rolling over Roth 401(k) dollars to a Roth IRA... If your Roth 401(k) distribution isn't qualified (tax-free) because you haven't yet satisfied the five-year holding period, be aware that when you roll those dollars into your Roth IRA, they'll now be subject to the Roth IRA's five-year holding period, no matter how long those dollars were in the 401(k) plan. So, for example, if you establish your first Roth IRA to accept your rollover, you'll have to wait five more years until your distribution from the Roth IRA will be qualified and tax-free.



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When Disaster Strikes: Deducting Casualty Losses



A list of federally declared disaster areas can be found at the Federal Emergency Management Agency (FEMA) website at [fema.gov/disasters](https://www.fema.gov/disasters). Major disaster and emergency declarations in 2015 included areas in 30 states.

Wildfires, tornadoes, storms, landslides, and flooding.... It's almost as if you can't turn on the news without seeing images of a disaster striking somewhere. If you've suffered property loss as the result of these events or other circumstances, you may be able to claim a casualty loss deduction on your federal income tax return.

What's a casualty loss?

A casualty is the destruction, damage, or loss of property caused by an unusual, sudden, or unexpected event. You can experience a casualty loss as the result of something as sweeping as a natural disaster, or as limited in scope as an act of vandalism. You probably don't have a deductible casualty loss, however, if your property is damaged as the result of gradual deterioration (e.g., a long-term termite infestation).

Calculating your loss

The rules for calculating loss can be different for business property, or property that's used to produce income (think rental property). To calculate a casualty loss on personal-use property, like your home, that's been damaged or destroyed, you first need two important pieces of data:

- The decrease in the fair market value (FMV) of the property; that's the difference between the FMV of the property immediately before and after the casualty
- Your adjusted basis in the property before the casualty; your adjusted basis is usually your cost if you bought the property (different rules apply if you inherited the property or received it as a gift), increased for things like permanent improvements and decreased for items such as depreciation

Starting with the lower of the two amounts above, subtract any insurance or other reimbursement that you have received or that you expect to receive. The result is generally the amount of your loss. If you receive insurance payments or other reimbursement that is more than your adjusted basis in the destroyed or damaged property, you may actually have a gain. There are special rules for reporting such gain, postponing the gain, excluding gain on a main home, and purchasing replacement property.

The \$100 and 10% rules

After you determine your casualty loss on personal-use property, you have to reduce the loss by \$100. The \$100 reduction applies per casualty, not per individual item of property. Two or more events that are closely related

may be considered a single casualty. For example, wind and flood damage from the same storm would typically be considered a single casualty event, subject to only one \$100 reduction. If both your home and automobile were damaged by the storm, the damage is also considered part of a single casualty event—you do not have to subtract \$100 for each piece of property.

You must also reduce the total of all your casualty and theft losses on personal property by 10% of your adjusted gross income (AGI) after each loss is reduced by the \$100 rule, above.

If you are married and file a joint return, you are treated as one individual in applying both the \$100 rule and the 10% rule. It does not matter whether you own the property jointly or separately. If you file separately, you are each subject to both rules. If only one spouse owns the property, usually only that spouse can claim the associated loss on a separate return.

Reporting a casualty loss

Generally, you report and deduct the loss in the year in which the casualty occurred. Special rules, however, apply for casualty losses resulting from an event that's declared a federal disaster area by the president.

If you have a casualty loss from a federally declared disaster area, you can choose to report and deduct the loss in the tax year in which the loss occurred, or in the tax year immediately preceding the tax year in which the disaster happened. If you elect to report in the preceding year, the loss is treated as if it occurred in the preceding tax year. Reporting the loss in the preceding year may reduce the tax for that year, producing a refund. You generally have to make a decision to report the loss in the preceding year by the federal income tax return due date (without any extension) for the year in which the disaster actually occurred.

Casualty losses are reported on IRS Form 4684, Casualties and Thefts. Any losses relating to personal-use property are carried over to Form 1040, Schedule A, Itemized Deductions.

Getting help

The rules relating to casualty losses can be complicated. Additional information can be found in the instructions to Form 4684 and in IRS Publication 547, Casualties, Disasters, and Thefts. If you have suffered a casualty loss, though, you should consider discussing your individual circumstances with a tax professional.





Earn Too Much for a Roth IRA? Try the Back Door!



If you have taxable compensation, you can contribute up to \$5,500 to an IRA in 2016, or \$6,500 if you'll be 50 or older by the end of the year. You can't contribute to a traditional IRA for the year you turn 70½, or thereafter.

To be eligible for tax-free qualified distributions from a Roth IRA, you must satisfy a five-year holding period and, in addition, one of the following must apply: you have reached age 59½ by the time of the withdrawal, the withdrawal is made because of disability, or the withdrawal is made to pay first-time homebuyer expenses (\$10,000 lifetime limit from all IRAs).

It's not clear how long the back door is going to remain open. There have been suggestions that this is a loophole that should be legislatively closed.

Background

Roth IRAs, created in 1997 as part of the Taxpayer Relief Act, represented an entirely new savings opportunity--the ability to make after-tax contributions that could, if certain conditions were met, grow entirely free of federal income taxes. These new savings vehicles were essentially the inverse of traditional IRAs, where you could make deductible contributions but distributions would be fully taxable. The law also allowed taxpayers to "convert" traditional IRAs to Roth IRAs by paying income taxes on the amount converted in the year of conversion.

Unfortunately, the law contained two provisions that limited the ability of high-income taxpayers to participate in the Roth revolution. First, the annual contributions an individual could make to a Roth IRA were reduced or eliminated if his or her income exceeded certain levels. Second, individuals with incomes of \$100,000 or more, or whose tax filing status was married filing separately, were prohibited from converting a traditional IRA to a Roth IRA.

In 2005, however, Congress passed the Tax Increase Prevention and Reconciliation Act (TIPRA), which repealed the second barrier, allowing anyone to convert a traditional IRA to a Roth IRA--starting in 2010--regardless of income level or marital status. But TIPRA did not repeal the provision that limited the ability to make annual Roth contributions based on income. The current limits are set forth in the chart below:

Phaseout ranges for determining ability to fund a Roth IRA in 2016*

Single/head of household	\$117,000-\$132,000
Married filing jointly	\$184,000-\$194,000
Married filing separately	\$0-\$10,000

***Applies to modified adjusted gross income (MAGI)**

Through the back door...

Repeal of the provisions limiting conversions created an obvious opportunity for high-income taxpayers who wanted to make annual Roth contributions but couldn't because of the income limits. Those taxpayers (who would also run afoul of similar income limits that prohibited them from making deductible contributions to traditional IRAs) could simply make

nondeductible contributions to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA--a "back door" Roth IRA.

The IRS is always at the front door...

For taxpayers who have no other traditional IRAs, establishment of the back-door Roth IRA is essentially tax free. Income tax is payable on the earnings, if any, that the traditional IRA generates until the Roth conversion is complete. However, assuming the contribution and conversion are done in tandem, the tax impact should be nominal. (The 10% penalty tax for distributions prior to age 59½ generally doesn't apply to taxable conversions.)

But if a taxpayer owns other traditional IRAs at the time of conversion, the tax calculation is a bit more complicated because of the so-called "IRA aggregation rule." When calculating the tax impact of a distribution (including a conversion) from any traditional IRA, all traditional and SEP/SIMPLE IRAs a taxpayer owns (other than inherited IRAs) must be aggregated and treated as a single IRA.

For example, assume Jillian creates a back-door Roth IRA in 2016 by making a \$5,500 contribution to a traditional IRA and then converting that IRA to a Roth IRA. She also has another traditional IRA that contains deductible contributions and earnings worth \$20,000. Her total traditional IRA balance prior to the conversion is therefore \$25,500 (\$20,000 taxable and \$5,500 nontaxable).

She has a distribution (conversion) of \$5,500: 78.4% of that distribution (\$20,000/\$25,500) is considered taxable (\$4,313.73), and 21.6% of that distribution (\$5,500/\$25,500) is considered nontaxable (\$1,186.27).

Note: These tax calculations can be complicated. Fortunately, the IRS has provided a worksheet (Form 8606) for calculating the taxable portion of a conversion.

There's also a side door...

Let's assume Jillian in the example above isn't thrilled about having to pay any income tax on the Roth conversion. Is there anything she can do about it?

One strategy to reduce or eliminate the conversion tax is to transfer the taxable amount in the traditional IRAs (\$20,000 in our example) to an employer qualified plan like a 401(k) prior to establishing the back-door Roth IRA, leaving the traditional IRAs holding only after-tax dollars. Many 401(k) plans accept incoming rollovers. Check with your plan administrator.

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How can I manage the net investment income tax?

If you are subject to the 3.8% net investment income tax, there are strategies that may help you manage that tax. The tax is applied to the lesser of

your net investment income or the amount by which your modified adjusted gross income (MAGI) exceeds the applicable income tax threshold. MAGI is basically adjusted gross income plus any associated foreign earned income exclusion. Any strategy you consider should be directed at the appropriate target.

If your net investment income is greater than your MAGI over the threshold, then your focus should be aimed at reducing your MAGI. Conversely, if your MAGI over the threshold is greater than your net investment income, you should try to reduce your net investment income.

Here are a few strategies that may help you manage the net investment income tax:

- Before selling appreciated securities, consider whether you can offset the gain with capital losses. Likewise, if you have any capital loss carryforwards, you should review your portfolio for capital gain opportunities to make use of the capital losses.

- Consider gifts of appreciated securities to tax-qualified charities.
- If passive income is from a business, offset passive income with passive losses. If you don't have passive losses, you may be able to convert the passive income to non-passive income (not subject to the tax) by becoming more active in the business.
- You may be able to reduce your MAGI by increasing contributions to a traditional IRA, 401(k), or 403(b).
- Consider investments that may have growth potential but typically do not generate dividends.
- Generally, any gains in tax-deferred annuities and cash value life insurance are not reportable as income unless withdrawn, which may help reduce both your MAGI and your net investment income.

While any of these alternatives may help reduce your net investment income or your MAGI, they may also affect your financial planning. So before implementing strategies to reduce or eliminate exposure to the net investment income tax, consult with a tax professional to help with your specific situation.



What is compound interest?

When Benjamin Franklin died in 1790, he left the equivalent of \$4,400 each to the cities of Boston and Philadelphia in his will, under the condition that

the money be loaned and invested. He stipulated that the cities would have access to a portion of the funds after 100 years and receive the remaining funds after 200 years. When the cities received their balances after 200 years, the combined bequest had grown to \$6.5 million. How did such a small initial sum grow to such a large amount? Through the power of compound interest. (Source: Benjamin Franklin Institute of Technology, Codicil to Benjamin Franklin's Will)

There are two basic types of interest: simple and compound. The main difference between the two is that simple interest generates interest only on the initial principal amount, while compound interest generates interest based on both the initial principal amount and all accumulated interest. Here's an example of how each works.

Say you put \$10,000 in an account that earns 2% simple interest per year. In the first year you would generate \$200 and end up with a total of

\$10,200. In year two, you'd earn another \$200, bringing your total to \$10,400.

If you put that same \$10,000 in an account that earns 2% compound interest per year, in the first year you would generate \$200 and end up with a total of \$10,200. At the end of the second year, however, interest builds on the interest from the previous year, and now you earn money on the amount in your account rather than the initial principal alone. Therefore, the interest earned in that second year is \$204, bringing your total to \$10,404.

While the interest may not seem like much at first, it can add up over time, especially when you invest an additional amount each month. For example, if you invest that \$10,000 in an account that generates 2% compound interest per year, and then invest an additional \$400 per month, your initial investment would grow to \$214,943.55 after 30 years. In another 10 years, you would have \$315,141.32. With compound interest, time is your friend, so the earlier you can start saving, the better.

Note: This hypothetical example of mathematical compounding is for illustrative purposes only and does not represent any specific investment. Actual results may vary.



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