KANAWHA
CAPITAL MANAGEMENT
First Quarter 2015

This Quarter's Highlights

- Traditional IRAs and Roth IRAs
- Roth Conversions
- Qualified Retirement Plans
- Other Small Business Retirement Plans
- 2015 Important Financial Data

Kanawha Currents

Give Me Shelter While I Save

Making regular contributions to tax-advantaged retirement plans satisfies two important objectives for many investors: 1) Saving money for retirement and 2) sheltering money from Uncle Sam. Trying to navigate through the maze of different retirement savings vehicles can be challenging for those wanting to save for retirement. The focus should be to determine which options give the individual the best opportunity to maximize after-tax wealth over their lifetime.

Individual Retirement Accounts - Traditional IRAs and Roth IRAs:

Traditional IRAs offer individuals with earned income an opportunity to make contributions of up to $5,500 (or $6,500 if age 50 or older) per year. Taxpayers may be eligible for a tax deduction on the amount of their contribution. Deductibility is determined by their Modified Adjusted Gross Income (MAGI) and whether they (or their spouse) are active participants in an employer retirement plan (Figure 1). Advantages of a traditional IRA include a current tax deduction of the amount contributed as well as the deferral of taxes on any current investment income (i.e. capital gains, dividends, and interest). Because of the up-front deduction, the cost of the contribution is offset by your marginal tax bracket times your contribution (i.e. a $5,500 contribution x 25% marginal rate = $1,375 tax savings). Upon obtaining age 59½, distributions may be taken without penalty but are treated as ordinary income for tax purposes. Note that higher earners can still take advantage of the tax-deferred growth of traditional IRAs by electing to make non-deductible contributions.

Taxpayers with earned income can choose to make annual contributions to *Roth IRAs* as long as they satisfy the eligibility requirements of having MAGI below certain thresholds (Figure 1). Contributions to Roth IRAs do not provide the benefit of a current tax deduction, but rather the contributions and any growth within the account can be distributed tax-free at retirement age. By choosing to contribute to a Roth IRA instead of a traditional IRA, one is essentially sacrificing a current tax benefit in exchange for a future tax benefit. The most important factor for determining which IRA is appropriate is the comparison of your current marginal tax bracket to your projected tax rate at retirement. For many younger individuals, there is

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a lot of uncertainty with respect to estimating future tax rates. If one's tax bracket is on the lower end, however, there is little downside risk in choosing a Roth over the traditional IRA. For those nearing retirement age and who expect their income to decrease after retirement, the current tax deduction offered by a traditional IRA (if they are eligible) may be worth more than the future tax benefits of the Roth IRA.

Figure 1:

Traditional IRA Deductibility for Active Participants	Modified Adjusted Gross Income Phaseout Limits
Single	$61,000 to $71,000
Married Filing Jointly	$98,000 to $118,000
Spousal IRA If One Spouse Is Covered By A Plan	$183,000 to $193,000
Married Filing Separately	$0 to $10,000
Roth IRA Eligibility	
Single	$116,000 to $131,000
Married Filing Jointly	$183,000 to $193,000
Married Filing Separately	$0 to $10,000

Unlike traditional IRAs, Roths have the added advantage of not being subject to Required Minimum Distributions (RMDs) at the owner's age of 70½. Consequently, investors can potentially grow and preserve higher amounts of tax-sheltered money in Roths during their later years. Like inherited IRAs, Roths can be stretched over their beneficiaries' lifetimes. Any required minimum distributions from Roths, however, will *not* be subject to income taxes for the beneficiary.

Roth Conversions:

Traditional IRA owners may consider converting all or a portion of their IRAs to Roth IRAs. Income taxes will be due on any amounts converted, unless a portion of the IRA was funded with after-tax contributions. In such cases, the IRA aggregation rule will apply. This prevents IRA owners from being able to convert only those funds or accounts which were made with after-tax contributions. For example, let's assume an individual wants to convert $25,000 of her traditional IRA money. Let's also assume she has two different IRAs totaling $100,000, one of which was funded with $25,000 in after-tax contributions. Instead of being able to isolate the $25,000 in after-tax monies and avoid paying taxes on the conversion, she will have to use the pro-rata rule to determine the taxable amount of the conversion. In this example, 25% of the conversion will not be taxable ($25,000 in after-tax contributions divided by the total IRA balance of $100,000).

Roth Conversions may be worth pursuing if you have the liquidity to pay the taxes now and are likely to be paying relatively higher taxes at the time of distribution, either through increased income or higher legislated tax rates. IRA owners who are not likely to need or spend their RMDs may also be candidates for conversions. They can choose to pay taxes now and, in exchange, avoid mandatory taxable distributions for the remainder of their lifetimes.

Qualified Retirement Plans:

Employer-based qualified retirement plans offer several advantages to employees who participate in such plans. The annual limits of $18,000 ($24,000 if age 50 or older) for *401(k)*, *403(b)* and *457* plan elective deferrals is substantially higher than annual IRA contribution limits. Some plans add profit-sharing contributions and/or employer matching to their employee contributions. Employer matching contributions offer an immediate return on employee salary deferrals. Also, qualified plans are not subject to income limitations, which prevent many higher earners from making annual contributions to IRAs. Lastly, individuals who are age 70½ or older and who are still working are not required to take RMDs from their qualified retirement plan, as they would from their traditional IRA (note this rule does not apply if the individual owns more than 5% of the company sponsoring the plan).

In recent years, employers have begun introducing Roth 401(k)s as an alternative to traditional 401(k) plans. Like Roth IRA contributions, money contributed to Roth 401(k)s is not deducted from current income. Instead, future distributions are tax-free. The same approach used to determine whether a Roth IRA is appropriate should be used in deciding if a Roth 401(k) is more suitable than a traditional 401(k) plan. It should be noted that employer matching contributions to Roth 401(k) plans are generally deposited into separate pre-tax accounts. Also, Roth 401(k)s may be subject to RMDs at the age of 70½. This can be avoided if the account is rolled into a Roth IRA at retirement.

Other Small Business Retirement Plans:

Other retirement plan options with less stringent reporting requirements exist for small businesses and self-employed persons. These include *Simplified Employee Pension (SEP) IRAs, Savings Incentive Match*

Plan for Employees (SIMPLE) IRAs, and *Individual 401(k)s*, among others.

In a SEP IRA, contributions are made by the employer only. There are no annual requirements to make contributions and the employer can contribute up to 25% (20% if self-employed) of compensation or $53,000, whichever is less. Benefits to this plan include a relatively high contribution limit and, for employers, the flexibility of not being forced to make contributions during down years. This may appeal to a small-business owner who may wish to make contributions during profitable years but avoid doing so in difficult years.

A SIMPLE is designed to be funded by both employee and employer contributions. The employee can make annual salary deferrals of up to $12,500 ($15,500 if age 50 or older). The employer can choose from two different *contribution options*. Under the *matching* option, the employer is required to match the employee contribution dollar for dollar up to 3% per year. The employer can choose to match a smaller percentage, but not less than 1%, in two out of five consecutive years. The employer is responsible only for matching contributions for employees who participate. With the *nonelective* option, the employer must contribute 2% of eligible employees' compensation, up to $5,300 (for 2015). Employees do not have to make their own salary deferrals to receive their employer contributions under this option.

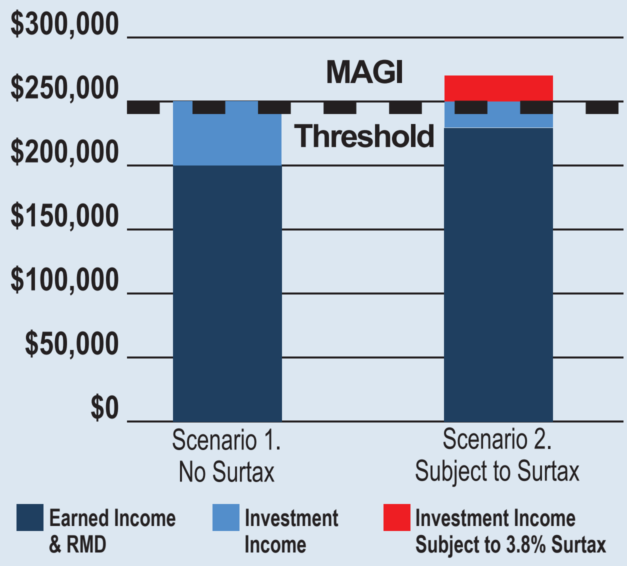
An Individual 401(k) is a relatively new retirement plan available to self-employed business owners with no employees other than a spouse. Like traditional 401(k) plans, individuals may make annual salary deferrals of up to $18,000 ($24,000 if age 50 or older). You may also make profit-sharing contributions of up to 20% of your self-employment income, up to a maximum of $53,000. Annual contributions from both salary deferrals and profit-sharing cannot exceed $53,000 ($59,000 if age 50 or older). An IRS Form 5500 must be filed annually once assets exceed $250,000.

Conclusion:

There are a myriad of different tax-advantaged accounts available to those wishing to save for retirement. While we have touched on some of the more popular vehicles, there are several other types of defined contribution and defined benefit plans that you may have access to as an employee or wish to implement for your closely held business. Trying to determine which retirement plans and IRAs will yield the greatest after-tax benefits, given personal circumstances, can be a difficult task. What might be the right strategy for one saver may not be an appropriate solution for another. While it is prudent to understand the various rules associated with the different accounts to maximize wealth, individuals should often remind themselves of the most important wealth creation rule of all, paying yourself first. After all, no retirement plan rule can benefit an investor unless he or she is able to save money.

Distributions from Retirement Accounts and the Net Investment Income Surtax:

The Medicare surtax of 3.8% on Net Investment Income went into effect in 2013 for those individuals with MAGI exceeding $200,000 ($250,000 for joint filers). The law explicitly excludes taxable distributions from retirement accounts such as IRAs and 401(k)s as well as Roth Conversions. The reality, however, is that distributions from such accounts may indirectly cause taxpayers to be impacted by the surtax. For example, assume John and Jane Doe have $200,000 of earned income and $50,000 of investment income. In this case, none of their investment income would be subject to the surtax since their MAGI falls just below the $250,000 threshold (Scenario 1). Now let's assume they were forced to withdraw $25,000 from John's IRA due to a required minimum distribution. Even though the distribution itself is not subject to the surtax, the distribution is included in their AGI and pushes $25,000 of their investment income above the threshold (Scenario 2). Therefore, this $25,000 is now subject to the surtax of 3.8%, resulting in an incremental tax cost of $950.



This is intended to be for informational purposes only and should not be interpreted as advice. Consult your trust and estate attorney as well as tax professional for advice regarding your specific circumstances.

2015 Important Financial Data

2015 Tax Rate Schedule	
Taxable Income	Marginal Rate
Single	
$0 to $9,225	10%
$9,226 to $37,450	15%
$37,451 to $90,750	25%
$90,751 to $189,300	28%
$189,301 to $411,500	33%
$411,501 to $413,200	35%
$413,201 +	39.6%
Married Filing Jointly & Surviving Spouse	
$0 to $18,450	10%
$18,451 to $74,900	15%
$74,901 to $151,200	25%
$151,201 to $230,450	28%
$230,451 to $411,500	33%
$411,501 to $464,850	35%
$464,851 +	39.6%
Head of Household	
$0 to $13,150	10%
$13,151 to $50,200	15%
$50,201 to $129,600	25%
$129,601 to $209,850	28%
$209,851 to $411,500	33%
$411,501 + $439,000	35%
$439,001 +	39.6%
Married Filing Separately	
$0 to $9,225	10%
$9,226 to $37,450	15%
$37,451 to $75,600	25%
$75,601 to $115,225	28%
$115,226 to $205,750	33%
$205,751 to $232,425	35%
$232,426 +	39.6%
Estates and Trusts	
$0 to $2,500	15%
$2,501 to $5,900	25%
$5,901 to $9,050	28%
$9,051 to $12,300	33%
$12,301 +	39.6%

Estate and Gift Tax	
Annual gift tax exclusion	$14,000
Estate and gift tax exclusion	$5,430,000
Maximum estate tax rate	40%

Capital Gains Tax Rates	
Short-term (held 1 year or less)	Same as ordinary income
Long-term (held > 1 year):	
If income falls in 10% or 15% brackets	0%
If income falls in 25%,28%,33%, or 35% brackets	15%
If income falls in 39.6% bracket	20%
Unrecaptured gains on Section 1250 property	25%
Collectibles	28%

Qualified Dividend Income Tax Rates	
If income falls in 10% and 15% brackets	0%
If income falls in 25%,28%,33%, and 35% brackets	15%
If income falls in 39.6% bracket	20%

Income Tax Deductions and Exemptions	
Standard Deduction	
Single	$6,300
Married filing jointly	$12,600
Head of household	$9,250
Over age 65 or blind additional standard deduction	
Married or surviving spouse	$1,250
Single or not a surviving spouse	$1,550
Itemized deduction may be reduced by 3% of every dollar that exceeds certain AGI thresholds	
Personal exemption	$4,000
Personal exemption may be reduced by 2% for every $2,500 that exceeds certain AGI thresholds	

Retirement Plan Contribution Limits	
401(k), 403(b), 457 plans elective deferrals	$18,000
Catch-up contributions for 50 and older	$6,000
Defined contribution plans	$53,000
Defined benefit plans	$210,000
SIMPLE plans elective deferrals	$12,500
Catch-up contributions for 50 and older	$3,000
Traditional and Roth IRA	$5,500
Catch-up contributions for 50 and older	$1,000
Traditional IRA deductibility for active participants	Phaseout Limits:
Single	$61,000 to $71,000
Joint	$98,000 to $118,000
Spousal IRA if one spouse is covered by a plan	$183,000 to $193,000
Married filing separately	$0 to $10,000
Roth IRA income phaseout	
Single	$116,000 to $131,000
Joint	$183,000 to $193,000
Married filing separately	$0 to $10,000

New Medicare Surtaxes
0.9% on wages that exceed $200,000 (single filers) or $250,000 (joint filers)
3.8% on net investment income that falls above MAGI of $200,000 (single filers) or $250,000 (joint filers)

Medicare			
Part A Hospitalization			
First 60 days inpatient deductible		$1,260 for each benefit period	
Days 61 - 90		$315 per day, for each benefit period	
Days 91 +		$630 per day, up to 60 days over lifetime, then full amount per day	
Part B Premium			
MAGI Single (for *2013*)	MAGI Joint (for *2013*)	Part B Monthly Premium	Part D Addition to Premium
$85,000 or less	$170,000 or less	$104.90	$0
$85,001 to $107,000	$170,001 to $214,000	$146.90	$12.30
$107,001 to $160,000	$214,001 to $320,000	$209.80	$31.80
$160,001 to $214,000	$320,001 to $428,000	$272.70	$51.30
$214,001 +	$428,001 +	$335.70	$70.80
Part B Deductible	$147		
Coinsurance	20% of Medicare-approved amount for most services		

Long Term Care Insurance: Potential Deductibility of Premiums for Qualified Policies (medical expenses are subject to % of AGI thresholds)	
Age	Amount of premium that may be treated as "medical care'
40 or less	$380
41 to 50	$710
51 to 60	$1,430
61 to 70	$3,800
71 +	$4,750

Source: www.irs.gov, IRS Rev. Proc. 2014-61, IR-2014-99, Centers for Medicare & Medicaid Services.
The data contained on this sheet is for informational purposes only and should not be interpreted as tax or investment advice.
Consult your tax professional for specific advice about your personal situation.