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# The Specialist

ANSWERS TO TOUGH QUESTIONS ABOUT TAXES AND INVESTING

26 Cherry Street • Milford, CT 06460
http://fnlonline.com • info@fnlonline.com
(203) 878-8194

## Tax-Friendly Retirement Plans for the Self-Employed

By Ed Slott, CPA

The percentage of workers who are self-employed rises with age and increases markedly after age 65. In fact, 45.5% of workers ages 65 to 69, and almost 60% of those ages 70 to 74, are self-employed.[1] Some older self-employed individuals are traditional small-business owners, while others are independent contractors — often working for their former employers.

At any age, self-employment offers a challenge and an opportunity when it comes to saving for retirement. The challenge is that you are on your own, with no matching employer contributions. The opportunity is that you may be able to save more in a tax-advantaged account than you typically could as an employee.

At any age, self-employment offers a challenge and an opportunity when it comes to saving for retirement.

Anyone with earned income can set up an IRA, but contribution limits are low — $6,000 in 2021 ($7,000 if you are 50 or older). Thus, one of these two options may be better for self-employed individuals to save for retirement.

**Solo 401(k)** — appropriate for a sole proprietor or partnership with no employees other than a spouse or spouses. You can contribute salary deferrals up to the $19,500 annual maximum in 2021 ($26,000 if you're 50 or older). As the employer, you can also contribute an additional 25% of your compensation if your business is incorporated or 20% of your net earnings if you are self-employed.* Total contributions, not counting catch-ups, are capped at $58,000 in 2021. A spouse who earns income from the business can also participate, potentially doubling the savings for a married couple. Employee deferrals can be traditional (pre tax or tax deductible) or Roth (after tax), but employer contributions are always traditional and generally tax deductible for the business.

**SEP IRA** (Simplified Employee Pension) — appropriate for a sole proprietor, partnership, or small business with lower-paid employees. You may contribute up to 25% of your compensation if the business is incorporated or 20% of your net earnings if you are self-employed, up to the $58,000 annual maximum in 2021.* If you have employees, you are required to contribute the same percentage of your employees' salaries to SEP IRAs in their names; however, the dollar amounts would be different for different salary levels. A SEP IRA is easy to set up, and you do not have to contribute each year. This is a traditional IRA, so contributions for yourself and any employees are usually tax deductible as a business expense.

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*If you have any questions about the topics in this newsletter or about your financial future, call us. We are available to help.*

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# Sharing Your Money Values Can Be Part of Your Legacy

When it's time to prepare the next generation for a financial legacy, you might want to bring your family members together to talk about money. But sitting down together isn't easy, because money is a complicated and emotionally charged topic. Rather than risk conflict, your family may prefer to avoid talking about it altogether.

If your family isn't quite ready to have a formal conversation, you can still lay the groundwork for the future by identifying and sharing your money values — the principles that guide your financial decisions.

## Define Your Own Values

What does money mean to you? Does it signify personal accomplishment? The ability to provide for your family? The chance to make a difference in the world? Is being a wise steward of your money important to you, or would you rather enjoy it now? Taking time to think about your values may help you discover the lessons you might want to pass along to future generations.

## Respect Perspectives

The unspoken assumption that others share your financial priorities runs through many money-centered conversations. But no two people have the same money values (even relatives). To one person, money might symbolize independence; to another, money equals security. Generational differences and life experiences may especially influence money values. Invite your family members to share their views and financial priorities whenever you have the opportunity.

## See Yourself as a Role Model

Your actions can have a big impact on those around you. You're a financial role model for your children or grandchildren, and they notice how you spend your time and your money.

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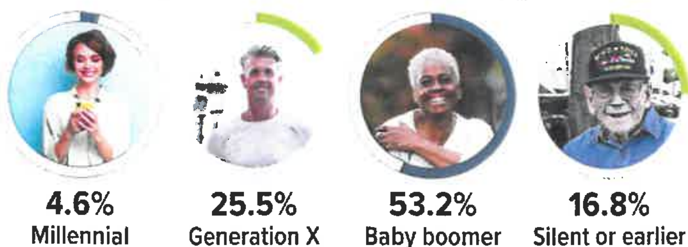
## The Great Wealth Transfer

Seventy percent of U.S. household wealth is held by older generations. Although younger people may be far behind today, they stand to inherit much of this wealth in the coming decades, while also accumulating wealth through their own efforts.

**Percentage of U.S. household wealth, by generation**




Source: Federal Reserve, 2020 (Q2 2020 data)

Look for ways to share your values and your financial knowledge. For example, if you want to teach children to make careful financial decisions, help them shop for an item they want by comparing features, quality, and price. If you want teenagers to prioritize saving for the future, try matching what they save for a car or for college. Teaching financial responsibility starts early, and modeling it is a lifelong effort.

## Practice Thoughtful Giving

How you give is another expression of your money values, but if a family member is the recipient, your generosity may be misconstrued. For example, your adult son or daughter might be embarrassed to accept your help or worried that a monetary gift may come with strings attached. Or you may have a family member who often asks for (or needs) more financial support than another, which could lead to family conflicts.

Defining your giving parameters in advance will make it easier to set priorities, explain why you are making certain decisions, and manage expectations. For example, are you willing and able to:

- Help fund a college education?
- Provide seed money for a small business?
- Help with a down payment on a home?
- Pay for medical expenses?
- Contribute to an account for a family member with special needs?
- Offer nonfinancial help such as child care or transportation?

There are no right or wrong answers as long as your decisions align with your financial values, and you are sure that your gift will benefit both you and your family member. Maintaining consistent boundaries that define what help you are willing and able to provide is key. Gifts that are not freely given may become financial or emotional obligations that disrupt family relationships.

## Reveal Your Experiences with Money

Being more transparent about your own financial hopes and dreams, and your financial concerns or struggles, may help other family members eventually open up about their own.

Share how money makes you feel — for example, the satisfaction you felt when you bought your first home or the pleasure of giving to someone in need. If you have been financially secure for a long time, your children may not realize how difficult it was for you, or for previous generations, to build wealth over time. Your hard-earned wisdom may help the next generation understand your values and serve as the foundation for a shared legacy.

# The Two Roth Five-Year Rules

If you own a Roth IRA or are interested in opening one, you may have heard of the "five-year rule." In fact, there are two separate five-year holding periods that might apply to Roth distributions. The first determines whether a withdrawal of *earnings* will be tax-free, and the second determines whether a withdrawal of *converted principal* will be penalty-free.

## Withdrawal of Earnings

You can withdraw contributions to a Roth IRA at any time without tax liabilities or penalties, because contributions are made with after-tax dollars. However, to qualify for a tax-free and penalty-free withdrawal of earnings, the distribution must take place after age 59½ (with some exceptions) and meet the Roth earnings five-year rule.*

The five-year holding period for earnings begins on January 1 of the tax year for which you made your first contribution (regular or rollover) to any Roth IRA you own. For example, if your first Roth IRA contribution was designated for tax year 2021 (even if made in early 2022), your five-year holding period began on January 1, 2021, and will end on December 31, 2025. You have only one five-year holding period for determining whether distributions from any Roth IRA you own are qualified tax-free distributions. (Inherited Roth IRAs are subject to different rules.)

## Converted Principal

When you convert assets in a traditional IRA or traditional employer plan to a Roth IRA, the amount you convert (except for any after-tax contributions) is subject to income tax in the year of the conversion. You may withdraw these assets tax-free at any time, but if you withdraw any portion of the converted amount within five years, you may have to pay the 10% early-distribution penalty on those funds, unless you've reached age 59½ or qualify for an exception.*

This five-year holding period starts on January 1 of the year you convert assets to a Roth IRA. If you have more than one conversion, each will have its own separate five-year holding period for this purpose.

Funds rolled from a Roth 401(k) to a Roth IRA are not subject to the holding period for converted principal. However, such funds must meet the five-year holding period for tax-free and penalty-free withdrawals of earnings, regardless of how long the funds were held in the Roth 401(k).

These guidelines may be helpful, but Roth distribution rules are complex. Be sure to consult your tax professional before taking any specific action that might have tax consequences.

*Exceptions to the age 59½ rule for a tax-free withdrawal of earnings include death, disability, and up to $10,000 (lifetime cap) for a first-time home purchase. Additional exceptions apply to the 10% early-withdrawal penalty on earnings or converted amounts.

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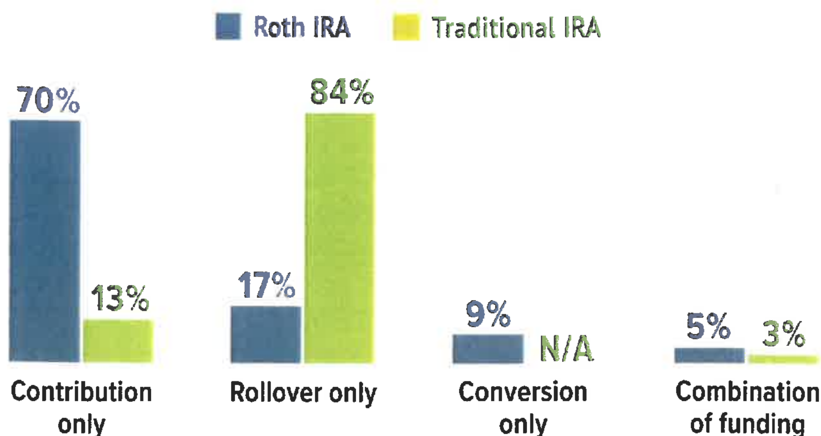
## Opening New IRAs

While traditional IRAs are often opened with rollovers from employer plans, Roth IRAs are typically opened with direct contributions.



Source: Investment Company Institute, 2020 (data on new IRAs opened in 2016)

# Is the Medicare Donut Hole Really Closed?

You may have heard that the coverage gap for Medicare Part D prescription drug coverage — commonly known as the donut hole — closed in 2020. While it's true that recent changes should reduce costs for many beneficiaries, the coverage gap still exists, and costs for some prescriptions may increase in the gap.

Here's an overview of the four stages of Medicare Part D prescription drug coverage and how prices can vary in the coverage gap. Note that this does not apply to prescription drug coverage offered through Medicare Advantage (Part C) plans.

**Stage 1 — Deductible.** Most Part D plans have an annual deductible that cannot exceed $445 in 2021. You pay the full negotiated price for your prescriptions until you meet the deductible.

**Stage 2 — Coverage.** After you meet the deductible, your plan covers part of the cost of your prescriptions. With the standard Medicare model, you would pay 25% of the cost and the plan would pay 75%. However, few plans follow the standard model. Most have varying copays or coinsurance for drugs at different "tiers" — for example, progressively higher copays for generics, preferred brand-name drugs, non-preferred brand-name drugs, and very high-cost drugs. This coverage continues until spending by you and your plan reaches the initial coverage limit ($4,130 in 2021, including the deductible).

**Stage 3 — Coverage gap.** When you exceed the initial coverage limit, you enter the coverage gap (donut hole). In this stage, you pay 25% of the negotiated retail price for all prescriptions. For generic drugs, your plan pays the other 75%; for brand-name drugs, the drug company pays 70% and your plan pays 5%.

If your plan follows the standard Medicare model in which you pay 25% of the cost of all prescriptions, you would see no difference in the coverage gap, so the donut hole would be effectively closed. However, because most plans have different copays or coinsurance for different types of drugs, the 25% of retail price that you pay in the coverage gap may be higher or lower than what you pay during the coverage stage. It could be substantially higher for very high-cost drugs. The good news is that you remain in the coverage gap only until you reach the out-of-pocket spending limit, which is $6,550 in 2021. This includes your out-of-pocket expenses (deductible, copays, and coinsurance) and the 70% paid on your behalf by drug companies; it does not include payments by your plan.

**Stage 4 — Catastrophic coverage.** After you reach the out-of-pocket spending limit, you pay a relatively small amount per prescription for the rest of the year: the greater of 5% of the plan's negotiated retail price or a flat fee ($3.70 for generics, $9.20 for all other drugs in 2021).

For additional information on Medicare Part D drug coverage, see *medicare.gov/drug-coverage-part-d*.

**Ed Slott** is a professional speaker and the creator of several public television specials, including "Retire Safe & Secure! with Ed Slott." He is the author of *The Retirement Savings Time Bomb...And How to Defuse It* and many other books about IRA planning.

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## Tax-Friendly Retirement Plans for the Self-Employed

*(Continued from page 1)*

In addition to any employer contributions, you and your employees can generally make individual contributions to the SEP IRA (or a different IRA), subject to IRA annual contribution limits. The SEP IRA belongs to the individual, so it may remain open for further individual contributions if your business closes or an employee leaves your employment.

A solo 401(k) must be set up and salary deferrals formally elected by the end of the tax year. You generally have until your tax filing deadline (including extensions) to deposit contributions to a solo 401(k) and to set up and make contributions to a SEP IRA.

*Traditional retirement plan distributions are taxed as ordinary income. Withdrawals prior to age 59½ may be subject to a 10% federal income tax penalty, with some exceptions. You can withdraw Roth contributions at any time, but for a tax-free and penalty-free withdrawal of earnings, the account must meet the five-year holding period and withdrawals must occur after age 59½, with some exceptions. Early withdrawals from Roth 401(k) accounts must be prorated between contributions and earnings.*

*For this purpose, net earnings is net business income minus deductible self-employment tax.

1) National Bureau of Economic Research, 2020 (data includes full-time, part-time, and second jobs)