



# The Wealth Architect

*Helping you build your financial future.*

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Dear Friends,

Welcome to the March 2015 issue of The Wealth Architect. Tomorrow, March 20th, is the first day of spring. For those of us in the Northeast of the United States, spring cannot come soon enough.

As always, this month's issue is filled with pertinent information for increasing your financial literacy. Please feel free to contact us with any questions or concerns you may have.

And don't forget, Armao LLP is your source for cost-effective, professional tax preparation services. April 15th is just weeks away!

Sincerely,  
The Professionals at Armao LLP

## March 2015

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## Converting Your After-Tax 401(k) Dollars to a Roth IRA



Here's the dilemma: You have a traditional 401(k) that contains both after-tax and pre-tax dollars. You'd like to receive a distribution from the plan and convert only the after-tax dollars to a Roth IRA. By rolling over/converting only

the after-tax dollars to a Roth IRA, you hope to avoid paying any income tax on the conversion.

For example, let's say your 401(k) plan distribution is \$10,000, consisting of \$8,000 of pre-tax dollars and \$2,000 of after-tax dollars. Can you simply instruct the trustee to directly roll the \$8,000 of pre-tax dollars to a traditional IRA and the remaining \$2,000 of after-tax dollars to a Roth IRA?

In the past, many trustees allowed you to do just that. But in recent years the IRS had suggested that this result could not be achieved with multiple direct rollovers. Instead, according to the IRS, each rollover would have to carry with it a pro-rata amount of pre-tax and after-tax dollars. The legal basis for this position, however, was not entirely clear.

And while some experts suggested that it might be possible to achieve a tax-free Roth conversion of after-tax dollars using 60-day rollovers, the process was fairly complicated, and it required taxpayers to have sufficient funds outside the plan to make up the 20% mandatory withholding that would apply to the taxable portion of the distribution.

### IRS Notice 2014-54

Thankfully, in Notice 2014-54 (and related proposed regulations), the IRS has backed away from its prior position. The Notice makes it clear that you can split a distribution from your 401(k) plan and directly roll over only the pre-tax dollars to a traditional IRA (with no current tax liability) and only the after-tax dollars to a Roth IRA (with no conversion tax). The IRS guidance, which took effect January 1, 2015, also applies to 403(b) and 457(b) plans. When applying Notice 2014-54, it's important to

understand some basic rules (also outlined in the Notice). First, you have to understand how to calculate the taxable portion of your distribution. This is easy if you receive a total distribution--the nontaxable portion is your after-tax contributions, and the taxable portion is the balance of your account. But if you're receiving less than a total distribution, you have to perform a pro-rata calculation.

This is best understood using an example. Assume your 401(k) account is \$100,000, consisting of \$60,000 (six tenths) of pre-tax dollars and \$40,000 (four tenths) of after-tax dollars. You request a \$40,000 distribution. Of this \$40,000, six tenths, or \$24,000, will be taxable pre-tax dollars, and four tenths, or \$16,000, will be nontaxable after-tax dollars. What this means is that you can't, for example, simply request a distribution of \$40,000 consisting only of your after-tax dollars. The Notice requires that you treat all distributions you receive at the same time as a single distribution when you perform this pro-rata calculation (even if you subsequently roll those distributions into separate IRAs).

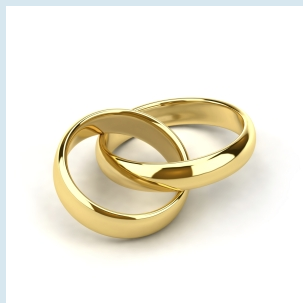
Taking this example a step further, could you now direct the trustee to directly transfer the \$16,000 of after-tax dollars to a Roth IRA (with no conversion tax) and send the remaining \$24,000 to you in a taxable distribution? The answer is no, and this leads to a second basic rule described in the Notice: Any rollovers you make from a 401(k) plan distribution are deemed to come first from your pre-tax dollars, and then, only after these dollars are fully used up, from your after-tax dollars. If you're rolling your distribution over into several different accounts, you get to decide which retirement vehicle receives your pre-tax dollars first.

It's these new rules that allow you to accomplish your goal of rolling over only the after-tax portion of your 401(k) plan distribution into a Roth IRA. Going back to our example, these rules make it clear that you can instruct the 401(k) plan trustee to transfer only your pre-tax dollars--\$24,000--to your traditional IRA, leaving the remaining \$16,000--all after-tax dollars--to be rolled over to your Roth IRA in a tax-free conversion.

#### **Giving love another chance:**

- About 12% of men and women have married twice
- About 3% of each have married three or more times

Source: U.S. Census Bureau, 2011 (data from 2009, most current data available)



*You should consider the counsel of an experienced estate planning professional and your legal and tax advisors before implementing any of these strategies. There are costs and expenses associated with the creation of these legal instruments.*

## **Estate Planning for a Second Marriage**

They say that love is lovelier the second time around. But for many individuals, remarriage later in life can create some unique estate planning issues.

If you're anything like the typical person contemplating a second (or third) marriage, you are older, have children, have accumulated property, and have been enjoying a standard of living you would like to maintain. Entering into a new marriage can raise many, perhaps conflicting, concerns such as:

- How can you protect assets you already own?
- How can you provide for children from a previous marriage?
- How do you share assets acquired or inherited after the marriage equally or fairly?
- How do you ensure your prospective spouse's future financial security?
- How can you avoid family disharmony?

### **Put your financial cards on the table**

Money is a major cause of stress in any marriage, but it can be especially so in a second one. You and your future spouse should discuss and agree on all important financial issues and formulate plans that, hopefully, you both can live with. Full disclosure is important, especially if you are considering a prenuptial or postnuptial agreement.

### **Protect your assets with a prenuptial or postnuptial agreement**

You're probably well aware that life is not a stroll down the primrose path, so while the suggestion of a prenup or postnup may not fan the flames of romance, you should know that this contract is important if you're bringing assets into the marriage. Why? By law, a surviving spouse has the right to take an "elective share" of the deceased spouse's estate, regardless of what is in the will. An elective share is typically one-third or one-half of the elective estate. An elective estate can include almost all the decedent's property, even property with beneficiary designations and property held in trust. If your surviving spouse takes his or her elective share, this may result in the unintentional disinheritance of your children or other heirs.

The only way to supersede elective share laws is with a prenup or postnup, in which both parties can waive their rights to the elective share. This way, you can minimize the chance that state law will interfere with your intended estate plans.

### **Revise your will and other estate planning documents**

Remarriage does not revoke a will (although state law can trump a will, as we have just discussed). It is vital, therefore, that you draft a new will in light of your new circumstances. While you're at it, review and update other estate planning documents, such as your durable power of attorney, advance medical directives (for example, a living will or health-care proxy), trusts, and beneficiary designations (for life insurance and retirement plans, for example).

### **Providing for your children from a previous marriage**

A big concern in many second marriages is providing for the new spouse without disenfranchising children from a prior marriage. Having your assets pass into a qualified terminable interest property (QTIP) trust can be part of the solution. With a QTIP trust, all trust income is used to support the surviving spouse while the principal is preserved for the children. And there's a bonus: Assets passing to a valid QTIP trust qualify for the marital deduction, helping to minimize potential estate taxes at your death.

### **Dealing with wealth disparity**

In second marriages, it's not uncommon for one spouse to be wealthier than the other. If federal estate taxes are a concern, equalizing your estates so that you and your spouse can take advantage of both of your basic exclusion amounts (\$5,430,000 in 2015) may be in order. Without equalization, you may lose valuable tax savings if the less wealthy spouse dies first. This may be less of a concern now that the applicable exclusion amount is portable. Portability allows a surviving spouse to use the unused applicable exclusion amount of a predeceased spouse. You might also consider state death taxes.

### **Apportioning estate taxes**

If you and your spouse have children from a previous marriage, you may want to plan for the payment of estate taxes in such a way that each child will bear the burden equally.

### **Conclusion**

Each couple entering into a second marriage has unique concerns and goals. It's important to deal with your issues squarely, and create a plan that will optimize dispositions, help minimize taxes, and avoid unintended results, family disharmony, or even litigation.



*In 1993, Congress officially approved the use of SNTs to maximize the use of all available resources, both private and governmental, to provide more fully for the needs of the disabled.*

*For tax years beginning after December 31, 2014, states can establish and operate ABLÉ programs, allowing the establishment of ABLÉ accounts, which are intended to help pay for the qualified disability expenses of eligible individuals. These accounts won't replace SNTs but may be used as part of an overall strategy.*

## Special Needs Trusts

A special needs trust\* (SNT), sometimes referred to as a supplemental needs trust, is a trust that is established to benefit a disabled person or a person who has special needs, while still allowing that person to qualify for and receive government health-care benefits.

\*There are costs and expenses associated with the creation of a trust.

### Background

Some government programs aimed at assisting the disabled, such as Medicaid and Supplemental Social Security Income (SSI), are needs-based. That means if the disabled individual has access to more than a specified level of resources (generally \$2,000), he or she will not be eligible to receive such benefits. In 1993, Congress officially approved the use of SNTs to maximize the use of all available resources, both private and governmental, to provide more fully for the needs of the disabled.

For persons of limited means, government programs may constitute the primary, if not the only, source of funding for their current and future needs. However, government assistance may also be available to families who have resources available to meet their loved one's basic needs. These families may be fortunate enough to be able to use their personal resources to provide for non-basic needs as well. With an SNT, the disabled person is able to first tap into any government benefits to which he or she is entitled, and then can spend personal resources as a secondary source for additional support and comfort.

### Types of SNTs

There are three types of SNTs: a self-settled or first-party SNT, a pooled SNT, and a third-party SNT.

#### *Self-settled or first-party SNT*

A self-settled or first-party SNT is created for the sole benefit of a disabled person who is under age 65. The trust must be established by the disabled person's parent, grandparent, or guardian, or by the court, but it cannot be created by the disabled person. However, the disabled person can fund the trust. For example, the disabled person could fund the trust with money that has been inherited or received in settlement of a lawsuit, or as a result of a divorce.

As previously stated, in order to qualify for Medicaid or SSI, the person who is enrolling

must have a limited amount of income and resources. Generally, Medicaid and SSI will look back 60 months to see if assets have been transferred to someone else in order to qualify for benefits, and if so, a penalty is imposed. The penalty will be that the person who is enrolling won't be able to receive benefits for a certain amount of time. Transferring assets to an SNT, however, does not trigger these look-back provisions.

The other benefit of this SNT, of course, is that assets in the trust will not be countable as resources for eligibility purposes.

One disadvantage, however, is that upon the disabled individual's death, any money or assets remaining in the trust must be used to reimburse the government for Medicaid benefits extended to the individual during his or her lifetime.

#### *Pooled SNT*

A pooled SNT is a trust that is managed by a nonprofit organization. Funds are pooled for investment purposes, but separate subaccounts are maintained for each disabled beneficiary. A pooled SNT works in the same way as a self-settled or first-party SNT. However, with a pooled SNT, the disabled individual can create the account for himself or herself.

Furthermore, any funds remaining in the account upon the individual's death can be used to pay back Medicaid, or they can remain in the pooled SNT to help others in the pool, depending on state law.

#### *Third-party SNT*

A third-party SNT is a trust created by a disabled person's parent or other third party, but this type of SNT has no payback requirement. The person establishing the trust must not have a duty to support the disabled child, so the child must be age 21 or older, depending on state law. There is no requirement that the disabled person be under the age of 65. However, transfers to a third-party SNT may or may not trigger the Medicaid or SSI penalty period. Again, it depends on state law.

### Conclusion

An SNT requires careful drafting and administration to avoid disqualification for government benefits. Be sure to consult a specialist.



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### Do I need to purchase flood insurance even if I don't live in a high-risk area for floods?

It depends. Powerful storms, inadequate drainage, melting snow, and hurricanes can all cause serious flooding

damage, even if you don't live in a high-risk flood area. According to the National Flood Insurance Program (NFIP), approximately 20% of all flood insurance claims come from areas that are at low to moderate risk for floods.

(Source: National Flood Insurance Program, October 2014) Since standard homeowners insurance generally does not cover damage directly caused by flooding, you may want to consider purchasing flood insurance if you live in an area of the country that is prone to severe weather systems that could result in flood damage to your home.

If you do plan on purchasing flood insurance, it is important to note that you can't simply buy flood insurance as an endorsement to your current homeowners policy. Instead, if you are eligible, you can purchase a separate flood insurance policy through an insurance company that participates in the NFIP.

A flood insurance policy provides flood protection for both your home and its contents. You can purchase up to \$250,000 of coverage for the building itself and up to \$100,000 of coverage for the contents. If the value of your home exceeds the amount available through the federal program, you may be able to buy excess flood insurance through a private insurer. Excess flood insurance covers amounts above the \$250,000 federal limit and, unlike NFIP coverage, may cover your home for its full replacement cost.

Keep in mind that even though flood insurance offers some degree of protection for flood-related basement damage, it doesn't cover all types of damage. It also doesn't cover events such as seepage or failure of a sump pump, and damage caused by sewer backups unless it is directly related to a flood. For more information on flood insurance, visit

[www.floodsmart.gov](http://www.floodsmart.gov).



### Will I have to pay a penalty tax if I withdraw money from my IRA for a down payment on a house?

Whether you may be subject to a penalty tax depends on a number of factors, such as your age at the time of the

withdrawal, how quickly you use the funds, and whether the person acquiring the home is a first-time homebuyer.

Distributions from an IRA before you reach the age of 59½ are generally considered premature distributions (or early withdrawals) by the IRS. To discourage withdrawals taken before retirement age, these premature distributions are subject to the usual federal (and possibly state) income taxes in the year received, and the taxable portion may be subject to a 10% federal tax penalty under Internal Revenue Code Section 72(t) (and possibly a state penalty tax). This 10% tax is referred to as the "premature distribution tax."

Fortunately, not all distributions before age 59½ are subject to this penalty. The IRS does allow some exceptions, including one for the payment of first-time homebuyer expenses.

In order for your withdrawal to qualify for this exception, the funds must be used within 120 days to pay the costs of acquiring the principal residence of a first-time home buyer. A first-time homebuyer (you or your spouse, or the child, grandchild, or ancestor of either you or your spouse) is one who neither owned nor had an ownership interest in another principal residence during the two-year period ending on the day the new home is acquired.

Keep in mind that if you qualify for this exception, it is subject to a \$10,000 lifetime limit.