Briefly Noted

Considerations When Rolling Over a 401(k) to an IRA

A key decision a person must make when leaving a job is what to do with workplace retirement savings. Among the options are rolling over the assets to an individual retirement account (IRA). Financial industry regulator FINRA says there are 10 things workers should consider when deciding if a IRA rollover is the best option.

1. Which Transfer Option Is Best—A departing worker can typically choose among leaving his savings in his employer's plan, transferring the savings to his new employer's plan, rolling the savings over into an IRA, or cashing out the balance. The last option triggers taxes, including a steep penalty for those under the age of 59½.

2. Roth or a Traditional IRA—No taxes are incurred if a Roth 401(k) is rolled over into a Roth IRA, but if a traditional 401(k) is rolled over to a Roth IRA, taxes will be triggered.

3. Indirect Rollover Downsides—An indirect rollover gives you a lump-sum payout, less a temporary 20% withholding. If the lump sum is not reinvested into a new retirement account within 60 days, the payout is treated as a distribution and is taxable.

4. Free and No-Fee Claims—Ads can mislead investors into thinking the IRA account will be free of charges and fees. While it may be free to roll over your savings, annual charges and other account expenses may still be levied.

5. Conflicts of Interest—The person or party suggesting an IRA rollover may benefit financially from the new account being opened. Always ask an adviser or company representative how they will benefit from your IRA rollover.

6. Investment Options and Services—Not all firms provide the same level of service or selection of investment options. Determine what you need before deciding on where, or if, to rollover your retirement savings.

7. Fees and Expenses—Pay close attention to fees, sales loads, commissions, advisory fees, and account or custodial fees. All of these fees lower your realized return and vary by firm.

8. Raise Important Issues With Your Adviser—Ask about potential tax implications, fees, expenses and services provided. Say no if you don't understand what you are being pitched.

9. Your Age and Taxes—You may be able to take penalty-free withdrawals from an employer-sponsored plan between the age of 55 and 59½, whereas you will have to wait until age 59½ to avoid penalties on an IRA withdrawal.

10. Taxes on Company Stock—Special tax rules may apply if your plan holds company stock. Consult a tax professional for guidance.

Source: "The IRA Rollover: 10 Tips to Making a Sound Decision," FINRA.

Sources of Tax-Free Income

Though most income and compensation is subject to federal taxes, not all it is. J.K. Lasser, whose "Your Income Tax" (John Wiley & Sons, 2014) book we use as a reference for our annual tax guide, identified 25 sources of tax-free income. Some are covered in our tax guide. There are, however, also sources that are less obvious or whose tax treatment may be less understood.

Inheritances: The estate of the deceased individual pays the federal estate tax. Heirs are do not pay taxes on the property or assets they inherit, but may be liable for taxes on any capital appreciation that occurs on inherited property that is sold. Inherited IRAs are subject to special tax rules.

Life Insurance Proceeds: Benefits paid following the death of the insured individual are not taxable. J.K. Lasser says no dollar limit on these payments exists.

Disability Payments: If you pay premiums for disability insurance, any compensation you receive for claims filed are tax-free as long as you paid the premiums yourself. If your employer pays the premiums as a benefit, then the payments are taxable. This rule applies specifically to disability insurance and not Social Security.

Insurance Claims: Claims made on a medical or auto policy for personal illness, injury or property damage are tax-free.

The Sale of a House: Married couples filing jointly can exclude up to $500,000 of capital gains from the sale of a house. Certain restrictions apply, particularly a requirement that the sellers not only lived in the house, but also used it as their primary residence for at least two of the five years preceding the date of the sale.

Coupons, Rebates and Frequent Flyer Miles: None of these benefits are taxable, so take advantage of them. J.K. Lasser says the tax code treats coupons and rebates as an adjustment to the purchase price. Frequent flyer miles are not taxable as long as they cannot be redeemed for cash. (Bankrate.com says credit card rewards are also tax-free so long as a transaction is required to earn them.)

Source: "25 Ways to Receive Tax-Free Income," J.K. Lasser, February 4, 2014.

Seven Rookie Retiree Mistakes to Avoid

USA Today asked financial experts to list the biggest mistakes people make during their first year of retirement. The newspaper then narrowed down the list to seven key missteps.

1. Not having a financial or a life plan: A large number of people head into retirement without either a financial plan or a lifestyle plan. The latter covers what a new retiree intends to do to bring meaning and fulfillment to his life.

2. Overspending: It's easier to shop more or take more vacations in retirement because there is more time for such activities. Yet, if a new retiree tries to enjoy all of the activities he has been deferring during his working years, he may end reducing his savings more than he should.

3. Claiming Social Security too early: Delaying the age at which benefits are claimed can make a big a difference in lifetime wealth.

4. Being too conservative with investments and not considering inflation: Rising prices will erode a retiree's purchasing power if too conservative of an allocation is followed. USA Today cited John Sweeney of Fidelity suggesting 65-year olds allocate half or more of the portfolios to stocks.

5. Retiring too early: A retiree may never come close to replacing the income he realized during his full-time working years. Jeremy Kisner of Surevest Wealth Management told the newspaper that while 69% of people plan to work after retirement, only 27% actually do.

6. Underestimating life expectancy: Retirees may live much longer than they expect to. Half of all men who reach age 65 will live another 17 years, while women can look forward to an additional 21 years. Longer lifespans extend the period a portfolio has to last.

7. Not having a health care strategy: One of the biggest expenses retirees can expect to face is health care. Having a plan for long-term care can make a big difference protecting one's finances.

Source: "7 Big Mistakes to Avoid in First Year of Retirement," USA Today, December 4, 2013.

Panel Advises Against Mandated Spreads for Small-Cap Stocks

Mandating wider bid-ask spreads for small-cap stocks may unfairly hurt individual investors. This was the opinion issued by the U.S. Securities and Exchange Commission's (SEC) Investor Advisory Committee on January 31, 2014. The SEC has been looking into instituting a pilot program to test the effect of wider bid-ask spreads to improve the liquidity of small-cap stocks. The program would potentially involve mandating spreads of five or 10 cents.

The bid-ask spread is the difference between what buyers are willing to pay (the "bid") and what sellers are willing to accept (the "ask"). Highly liquid stocks trade with bid-ask spreads of a penny. Stocks with lower levels of trading volume tend to have wider spreads. Though low-price and small-cap stocks are most often perceived as having wider spreads, stocks with high share prices can also have wider spreads.

A shift in 2000 to quoting stock prices in penny increments (called decimalization) instead of fractional increments narrowed the spreads. While this has generally resulted in significant cost savings for investors, it has also reduced the revenues realized by market-making firms. This fact is often cited as a reason why efforts need to be made to entice market makers to improve the liquidity of small-cap stocks.

The committee took issue with this stance, citing what they describe as a "chicken and egg" problem. Specifically, committee members questioned whether investor interest in small-cap companies is reduced because there is less information about those stocks available, leading market makers to focus on other sectors. Alternatively, they asked if less market-maker support leads to less information being available. The committee further pointed out that the valuation premium of small-cap companies has increased since decimalization was implemented. At the same time, the committee said no evidence exists showing that market-making firms would provide more research on small-cap stocks if wider spreads were mandated.

Most importantly, the committee raised concerns about the higher transaction costs created by mandating a five- or 10-cent bid-ask spread. They warned, "A government-mandated increase in tick size would subsidize profits for the most sophisticated financial participants at the expense of retail investors."

At press time, it is uncertain as to what the SEC will or won't do in light of the committee's recommendations. Some industry groups are pushing for the implementation of the pilot program, though the SEC could alter it before launch.

Source: "Recommendation of the Market Structure Subcommittee: Decimalization and Tick Sizes," U.S. Securities and Exchange Commission, January 31, 2014.