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Cooper Advisory Newsletter

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401(k) Withdrawals: Beware the Penalty Tax

You've probably heard that if you withdraw taxable amounts from your 401(k) or 403(b) plan before age 59½, you may be socked with a 10% early distribution penalty tax on top of the federal income taxes you'll be required to pay. But did you know that the Internal Revenue Code contains quite a few exceptions that allow you to take penalty-free withdrawals before age 59½?

Sometimes age 59½ is really age 55...or age 50

If you've reached age 55, you can take penalty-free withdrawals from your 401(k) plan after leaving your job if your employment ends during or after the year you reach age 55. This is one of the most important exceptions to the penalty tax.

And if you're a qualified public safety employee, this exception applies after you've reached age 50. You're a qualified public safety employee if you provided police protection, firefighting services, or emergency medical services for a state or municipality, and you separated from service in or after the year you attained age 50.

Be careful though. This exception applies only after you leave employment with the employer that sponsored the plan making the distribution. For example, if you worked for Employer A and quit at age 45, then took a job with Employer B and quit at age 55, only distributions from Employer B's plan would be eligible for this exception. You'll have to wait until age 59½ to take penalty-free withdrawals from Employer A's plan, unless another exception applies.

Think periodic, not lump sums

Another important exception to the penalty tax applies to "substantially equal periodic payments," or SEPPs. This exception also applies only after you've stopped working for the employer that sponsored the plan. To take advantage of this exception, you must withdraw funds from your plan at least annually based on one of three rather complicated IRS-approved distribution methods.

Regardless of which method you choose, you generally can't change or alter the payments for five years or until you reach age 59½, whichever occurs later. If you do modify the payments (for example, by taking amounts smaller or larger than required distributions or none at all), you'll again wind up having to pay the 10% penalty tax on the taxable portion of all your pre-age 59½ SEPP distributions (unless another exception applies).

And more exceptions...

Distributions described below generally won't be subject to the penalty tax even if you're under age 59½ at the time of the payment.

- Distributions from your plan up to the amount of your unreimbursed medical expenses for the year that exceed 10% of your adjusted gross income for that year (You don't have to itemize deductions to use this exception, and the distributions don't have to actually be used to pay those medical expenses.)
- Distributions made as a result of your qualifying disability (This means you must be unable to engage in any "substantial gainful activity" by reason of a "medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.")
- Certain distributions to qualified military reservists called to active duty
- Distributions made pursuant to a qualified domestic relations order (QDRO)
- Distributions made to your beneficiary after your death, regardless of your beneficiary's age

Keep in mind that the penalty tax applies only to taxable distributions, so tax-free rollovers of retirement assets are not subject to the penalty. Also note that the exceptions applicable to IRAs are similar to, but not identical to, the rules that apply to employer plans.

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Buying a Fuel-Efficient Vehicle

Fuel-efficient vehicles are designed to help reduce pollution emissions and fossil fuel dependence, which can limit the effects of climate change. These factors make fuel-efficient vehicles appealing to drivers looking to be more green. But there are pros and cons to consider before buying an electric or hybrid car.

You're searching for a new car and interested in fuel-efficient vehicles. On the surface, they sound like a good idea: You may save money by making fewer trips to the gas station, and you'll help protect the environment. However, there are pros and cons to owning and driving a fuel-efficient vehicle, particularly when it comes to your finances.

Know your options

Many different vehicles fall into the fuel-efficient category. There are electric vehicles (EVs), which run solely on electricity. One or more electric motors are powered by rechargeable battery packs. Some EVs have built-in chargers, whereas others must be plugged into external chargers. EVs produce zero emissions and run quietly.

Another kind of fuel-efficient vehicle is the traditional hybrid, which exists in two forms: parallel and series. Parallel hybrids have a small internal combustion engine as well as batteries that power an electric motor. The vehicle's transmission and wheels can be powered by both the engine and electric motor. Series hybrids use an on-board generator to produce electricity which, in turn, charges batteries or powers the electric motor. The vehicle is never directly powered by the gasoline engine.

Plug-in hybrids are very similar to traditional hybrids, but plug-ins rely on a different primary energy source. The battery-powered electric motor functions as the main source of power. When the battery reaches a certain level, the internal engine's power kicks in and the vehicle uses gasoline to extend its range. The battery is recharged by plugging the vehicle into an external charger, hence the name.

In addition to EVs and hybrids, vehicles that run on alternative fuel are also considered fuel-efficient. Alternative fuels include diesel, bio-diesel, ethanol, compressed natural gas, and hydrogen fuel cells.

Weigh the advantages against the disadvantages

One of the biggest factors in deciding whether to buy a fuel-efficient vehicle is cost. Generally, fuel-efficient vehicles come with a higher purchase price that can be off-putting when comparing them to standard vehicles. And if your fuel-efficient car is equipped with an expensive battery, you must be prepared to pay even more when the battery eventually needs to be replaced.

Other drawbacks include scarcity of public chargers, limited driving range, and fewer model options to choose from (as opposed to traditional vehicles).

On the other hand, driving a green vehicle could add some green to your wallet. Many EVs and hybrids qualify for a federal income tax credit. Depending on your vehicle's battery capacity, you could earn a credit ranging from $2,500 up to $7,500. However, certain restrictions do apply. For more information, see IRS Form 8936, Qualified Plug-in Electric Drive Motor Vehicle Credit.

Your auto insurance provider may also offer discounts if you drive an EV or hybrid. It's worth checking to see whether you will save on insurance by driving a fuel-efficient vehicle.

Chances are good that a fuel-efficient vehicle will save you money at the gas station. Fuel-efficient vehicles typically have superior fuel economy, which means you'll likely be taking fewer trips to refuel your car. Over time, the savings from reduced gas station stops could be significant.

Decide what suits your lifestyle

Financial considerations aside, think about what kind of car best fits your needs. To help decide, ask yourself these questions:

- Can you afford a more expensive fuel-efficient vehicle, or does it make more sense to buy a conventional vehicle?
- How much driving do you do in a typical week?
- Do you want an EV or a hybrid? Or do you want to consider an alternative fuel option?
- If you choose an EV or plug-in, are you able to charge it at home? If you frequently drive longer distances, will you be able to recharge it easily on the road?
- When will you need to replace the battery in your vehicle? How expensive will it be?
- What kind of gas mileage should you expect to get from an EV or hybrid?
- Are there any reliability or safety issues associated with EVs or hybrids?

If you don't drive your vehicle on a consistent basis, you might consider sticking with a conventional vehicle. For example, after just one week of not driving an EV or hybrid vehicle, the battery could be affected and may not function properly.

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Why a Life Insurance Claim May Be Denied

As with most financial decisions, there are expenses associated with the purchase of life insurance. Policies commonly have mortality and expense charges. In addition, if a policy is surrendered prematurely, there may be surrender charges and income tax implications.

Any guarantees associated with payment of death benefits are based on the claims-paying ability and financial strength of the insurer.

Life insurance can be an important financial tool for you and your family. For example, life insurance can help replace earnings that would cease upon your death. It can provide a legacy for your children or grandchildren, and can even be used to make a charitable gift after your death.

However, the fact that you've purchased life insurance doesn't guarantee that the death benefit will be paid when it's needed most — after you've died. There are several reasons insurance companies may attempt to deny, or at least delay, paying a claim for the death benefit. Here are some possible circumstances when a death-benefit claim may be contested by the insurer.

Misstatements on the application

A clause that's commonly found in life insurance contracts is the incontestability clause. A life insurance claim may be denied if the insurer finds that the applicant made misstatements on the policy application and death occurs within two years of the policy's start date. If the applicant makes statements intended to defraud the insurer, there is essentially no time limit, and the claim can be denied no matter how long the policy has been in force. That's why it is very important to provide accurate information on the policy application and not withhold information or facts that are requested by the insurer.

A good example of a policy being contested involved actor Heath Ledger, who died within seven months of purchasing a $10 million life insurance policy for the benefit of his daughter. The medical examiner ruled that the cause of death was due to an accidental drug overdose. Subsequently, the insurer denied the claim on two grounds: The death was the result of an intentional drug overdose and amounted to suicide, and the insured did not disclose on the insurance application (as requested) that he was a user of illegal drugs, which is a material misrepresentation. The policy beneficiary sued the insurer, and the case was eventually settled for an undisclosed amount believed to be much less than the policy death benefit.

Suicide clause

Most life insurance policies contain a suicide clause, which generally states that no death benefit will be paid if the insured's death results from suicide within two years from the inception of the policy. Often, policy owners inadvertently restart the two-year suicide clause when they replace existing life insurance with a new policy.

Even in the unfortunate circumstance that death by suicide occurs within two years from the policy's inception, the beneficiaries may still be able to receive at least a portion of the death benefit, depending on the circumstances. For example, whether death is intentional (suicide) or by accident is not always easily determined.

Policy lapse

A life insurance policy may not be in force because the coverage has lapsed. Policies may lapse for several reasons, including nonpayment of the premium and expiration of a stated term. Insurers generally send written notifications when a premium payment is past due, when the policy is about to lapse, and when a policy has actually expired. Sometimes the policy owner may inadvertently or intentionally neglect to make premium payments. In any case, the insurance beneficiary may not realize that the policy has lapsed until after the death of the insured.

An insurer may deny payment of the death benefit when death occurs outside the policy coverage term. Term life insurance provides death benefit coverage for a stated number of years, usually from one to 25 years, depending on the policy purchased. This type of insurance is also common through employer-provided plans. In any case, if the insured's death occurs after the policy term has expired, the claim for insurance proceeds will be denied.

What can you do?

Nothing can be more emotionally trying than having a life insurance claim denied while dealing with the loss of a loved one. Here are some tips that may help get the death benefit paid.

Whether you fill out the life insurance application or it is completed by a life insurance agent, be sure you review each section of the application and answer each question honestly. Do not withhold or falsify information.

Pay the premiums on time. Indicate an alternative address for mailing the premium notices and also name another individual to receive notices of premium lapses. If you move or change financial institutions and don't notify the insurer, you may forget about the premium payments and the policy could lapse without your knowledge.

If you have group life insurance, verify that it is still in force at least once each year. Also, review your policy with an insurance professional. You may not realize that your life insurance will end on a certain date.

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Will I owe income taxes when I sell my home?

In general, when you sell your home, any amount you receive over your cost basis (what you paid for the home, plus capital improvements, plus the costs of selling the home) is subject to capital gains taxes. However, if you owned and used the home as your principal residence for a total of two out of the five years before the sale (the two years do not have to be consecutive), you may be able to exclude from federal income tax up to $250,000 (up to $500,000 if you're married and file a joint return) of the capital gain when you sell your home. You can use this exclusion only once every two years, and the exclusion does not apply to vacation homes and pure investment properties.

For example, Mr. and Mrs. Jones bought a home 20 years ago for $80,000. They've used it as their principal residence ever since. This year, they sell the house for $765,000, realizing a capital gain of $613,000 ($765,000 selling price minus a $42,000 broker's fee, minus the original $80,000 purchase price, minus $30,000 worth of capital improvements they've made over the years). The Joneses, who file jointly and are in the 28% marginal tax bracket, can exclude $500,000 of capital gain realized on the sale of their home. Thus, their tax on the sale is only $16,950 ($613,000 gain minus the $500,000 exemption, multiplied by the 15% long-term capital gains tax rate).

What if you don't meet the two-out-of-five-years requirement? Or you used the capital gain exclusion within the past two years for a different principal residence? You may still qualify for a partial exemption, assuming that your home sale was due to a change in place of employment, health reasons, or certain other unforeseen circumstances.

Special rules may apply in the following cases:

- You sell vacant land adjacent to your residence
- Your residence is owned by a trust
- Your residence contained a home office or was otherwise used for business purposes
- You rented part of your residence to tenants
- You owned your residence jointly with an unmarried taxpayer
- You sell your residence within two years of your spouse's death
- You're a member of the uniformed services

Do I need to file a gift tax return?

If you transfer money or property to anyone in any year without receiving something of at least equal value in return, you may need to file a federal gift tax return (Form 709) by the April tax filing deadline. If you live in one of the few states that also impose a gift tax, you may need to file a separate gift tax return with your state as well.

Not all gifts, however, are treated the same. Some gifts aren't taxable and generally don't require a gift tax return. These exceptions include:

- Gifts to your spouse that qualify for the marital deduction
- Gifts to charities that qualify for the charitable deduction (Filing is not required as long as you transfer your entire interest in the property to qualifying charities. However, if you are required to file a return to report gifts to noncharitable beneficiaries, all charitable gifts must be reported as well.)
- Qualified amounts paid on someone else's behalf directly to an educational institution for tuition or to a provider for medical care
- Annual exclusion gifts totaling $14,000 or less for the year to any one individual (However, you must file a return to split gifts with your spouse if you want all gifts made by either spouse during the year treated as made one-half by each spouse — enabling you and your spouse to effectively use each other's annual exclusion.)

If your gift isn't exempt from taxation, you'll need to file a gift tax return. But that doesn't mean you have to pay gift tax. Generally, each taxpayer is allowed to make taxable gifts totaling $5,490,000 (in 2017, up from $5,450,000 in 2016) over his or her lifetime before paying any gift tax. Filing the gift tax return helps the IRS keep a running tab on the taxable gifts you have made and the amount of the lifetime exclusion you have used.

If you made a gift of property that's hard to value (e.g., real estate), you may want to report the gift, even if you're not required to do so, in order to establish the gift's taxable value. If you do, the IRS generally has only three years to challenge the gift's value. If you don't report the gift, the IRS can dispute the value of your gift at any time in the future.