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NEWSLETTER

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SEE

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INSIDE

The impact of taxes on your retirement savings

Retirement savings have such a huge impact on our future lives, yet most people spend more time planning a vacation than they spend planning for retirement.

They also know more about what the taxes would be for the unlikely chance of hitting the lottery than they know about what the taxes will be on their own IRAs, 401(k)s and Social Security.

According to the results of a new study of 1,000 Americans age 50 or older with annual household incomes between $25,000 and $75,000 by Bankers Life Center for a Secure Retirement, fewer than half understand what taxes will be on:

- Social Security benefits (39 percent of those surveyed)
- Traditional IRA withdrawals (35 percent)
- Roth IRA withdrawal (31 percent)
- 401(k) withdrawals (29 percent)

By not understanding the tax rules that affect their retirement accounts, many Americans may be seriously underestimating the actual amount they will need when they retire.

Many pre-retirees are not aware that if they made pretax contributions to 401(k)s or IRAs, they will be taxed on those contributions and their earnings when they make withdrawals. Of course, in most cases, the income tax rate is likely to be lower after retirement than it was when they were working.

After-tax contributions to IRAs are taxed only on the earnings when withdrawn and not on the withdrawn contributions themselves. Withdrawals from a Roth IRA are 100 percent tax free as long as the taxpayer is at least 59 1/2 years old and has had a Roth for at least five years.

Nearly 60 percent of older Americans surveyed also are not aware that at age 70 1/2 they must begin taking required minimum distributions from their traditional IRAs and 401(k)s or they will incur significant penalties.

And these penalties can be steep. The penalty can equal 50 percent of the difference between the amount that should have been withdrawn and the amount that was withdrawn.

The penalty may be waived if the shortfall in the distribution was due to reasonable cause and reasonable steps are being taken to remedy it.

While it's important to be knowledgeable about penalties that could be imposed, it's also helpful to know that there are exceptions to penalties.

Up to 90 percent of survey respondents did not know they could take early withdrawals from a traditional IRA without penalty if certain exceptions apply. It's a good idea to consult a tax adviser for the specifics, but if taxpayers meet the requirements, early distributions can be penalty-free if they are:

- Paying for health insurance while unemployed
- Using the money to pay college expenses
- Buying a home for the first time
- Paying medical expenses

Only 2 percent were aware of all four exceptions.

In addition to the exceptions listed above, the penalty does not apply if the taxpayer dies or is disabled or if the distributions are made equally over the taxpayer's life expectancy.

See **Taxes and retirement** on the back

By not understanding the tax rules that affect their retirement accounts, many Americans may be seriously underestimating the actual amount they will need when they retire.

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Executive theft larger – and harder to catch

Although internal controls are designed to protect a company against fraudulent schemes by its employees, these controls often prove to be ineffective when senior personnel are involved.

Owners and top executives are able to act out of sight of other employees, who might otherwise become suspicious about unusual conduct. Moreover, senior personnel are usually the very persons responsible for ensuring that the internal control structure functions properly.

As such, in some organizations, they may operate without meaningful oversight except by one another. When the corporate watchdogs act together to defraud the company, it is difficult for those on the inside to detect the fraud or to stop it.

It typically takes 24 months for a crime by a top executive at a company to be detected, while crime by a typical employee is usually found in about 12 months.

Fraud committed by owners or executives takes far longer to detect and is for greater amounts, according to the latest biannual report of the Association of Certified Fraud Examiners (ACFE).

The median amount stolen by executives worldwide was $573,000 in the ACFE's 2012 report, down from the 2010 median amount of $723,000 and 2008 total of $834,000. In the United States, the median amount was $373,000 compared to $4 million in Asia.

Those numbers are more than three times as much as mid-level managers steal and 10 times as much as regular employees steal.

Approximately 18 percent of all on-the-job theft in the United States is committed at the highest levels of the company, while 38 percent of frauds are conducted by mid-level managers and 42 percent by employees.

The type of fraud most often perpetrated by upper management is corruption, which includes conflicts of interest, economic extortion, bribery and illegal gratuities (53 percent), followed by billing fraud and expense reimbursement fraud.

It typically takes 24 months for a crime by a top executive at a company to be detected, while crime by a typical employee is usually found in about 12 months.

The reason: Perpetrators with higher levels of authority are typically in a better position to override controls or conceal their misconduct. There may also be a reluctance on the part of employees and anti-fraud personnel to lodge complaints about or to investigate those with higher levels of authority.

For very small companies, it is difficult to construct an effective internal control structure because management consists of a very small group of people, or even a single person.

If management is the problem, there is no one for an employee who discovers or suspects fraud to go to other than the authorities. This decision may carry some risk. Having at least one director or investor who is not involved in management gives a suspicious employee somewhere to go.

Employee tips and management reviews are the primary detection methods for most employee fraud. But at the executive level, a strong internal audit function may be the best guard against employee thefts. According to the ACFE report, 14 percent of all fraud is detected by internal audit.

An internal auditor, or even an external auditor, who comes in periodically to review all company transactions, provides a mechanism by which fraud can be detected and reported. For the audit function to be effective, procedures must be established so the auditor has access to documentation relating to all transactions. In addition, there must be procedures for safeguarding those documents from alteration or destruction.

Preservation of the documents in electronic read-only form is perhaps the most effective method, particularly with a system that keeps a record of when the document is created and when any attempts at modification were made.

Creating the internal audit function and assuring preservation of and access to key information is only part of the job. It is equally important to assure that the auditor has someone to report to, either within the organization or outside.

When there is a non-management director on the board, or where an effective audit committee exists, the auditor must have the authority to report any suspected irregularities directly to that person or committee.

If there are no independent directors, the internal auditor should still have the authority to report to an outside investor or oversight committee if necessary.

While some companies will prefer to hire their own internal auditor, a CPA can be engaged to act as the "external" internal auditor. Independence rules will generally require that the CPA who performs the external audit not also be the organization's financial statement auditor.

Approximately 18 percent of all on-the-job theft in the United States is committed at the highest levels of the company, while 38 percent of frauds are conducted by mid-level managers and 42 percent by employees.

Every accountant who audits financial statements knows that detecting a collusive fraud is difficult at best.

The creation of an internal or external audit function to oversee a company's financial record keeping and transactions as they are occurring can be a vital step in assuring that the system of internal controls is not frustrated or rendered ineffective from within. ■

One in three business sales end because of price gap

Nearly one in three sales of a business enterprise fell through during the past year, most because of a valuation gap in pricing, according to a new study.

And the price gap for those transactions that didn't close was most often between 21-30 percent, the 2014 Capital Markets Report of Pepperdine University found in surveys with 141 investment bankers.

The primary reasons deals terminated were:

- ✤ Valuation gap in pricing (26 percent)
- ✤ Unreasonable seller or buyer demand (20 percent)
- ✤ Economic uncertainty (12 percent)
- ✤ Insufficient cash flow (11 percent)
- ✤ Lack of capital to finance (11 percent)
- ✤ No market for business (10 percent)
- ✤ Seller misrepresentations (4 percent)

Surveys with 40 brokers found similar results, though more brokers saw deals end because of buyers or sellers who made unreasonable demands.

Of transactions that were closed by investment bankers during the past 12 months, most were in manufacturing. The least number was in construction and engineering.

Most sales took between eight months and a year to close, but about one sale in four was able to close in six months or less.

The types of businesses that had most successfully completed sales were:

- ✤ Manufacturing (20 percent)
- ✤ Business services (17 percent)
- ✤ Consumer goods and services (12 percent)
- ✤ Financial services and real estate (10 percent)
- ✤ Information technology (9 percent)
- ✤ Healthcare and biotech (8 percent)
- ✤ Wholesale and distribution (7 percent)
- ✤ Basic materials and energy (6 percent)
- ✤ Media and entertainment (4 percent)
- ✤ Construction and engineering (4 percent)

Investment bankers said there is an imbalance between companies worthy of financing and capital available.

There is a shortage of capital for companies that have less than $10 million in EBITDA (earnings before interest, taxes, depreciation and amortization), they said. For companies with more than $10 million in EBITDA, there is a surplus, the survey found.

This year, one-third of investment bankers and brokers expect to close six deals or more, and two-thirds expect to close between one and five deals. ■

Most sales took between eight months and a year to close, but about one sale in four was able to close in six months or less.

Seven steps to help improve succession planning

Finding a successor to take over a business is an underestimated challenge, according to a recent study on succession planning by Stanford University's Graduate School of Business.

While most businesses know that having a succession plan is important, few are doing enough to prepare.

The study found that companies tend to plan for succession to "reduce risk" rather than to "find the best successor." Succession plans are not typically connected with coaching and internal development programs, which puts many organizations at risk of having unstable future leadership.

To prepare the leaders of tomorrow, Stanford professor David Larcker and Scott Saslow, founder of The Institute of Executive Development, recommend the following:

1. Map skills required of executive positions and benchmark executives to these skills. Evaluate executives on their abilities to assume larger roles in the organization. Where deficiencies exist, plans should be put in place to rectify them, such as job rotation or development activities.

2. Cast a wide net. Evaluate talent for skills that will be needed in the future, not the past or present. Compare internal executives to the external market for talent.

3. Be comprehensive and continuous. Succession preparations should be continuous, not episodic, and should be conducted throughout the organization, not just in the CEO's office. Succession is much riskier after a departure.

4. Assign ownership and roles. An independent chairman or experienced outsider should be given responsibility for the succession process. Board members and executives should be assigned specific roles and held accountable. Not assigning accountability is one of the main reasons succession plans fail.

5. Connect succession with coaching and internal talent development. Map succession to a pipeline of internal executive talent. Identify deficiencies in internal talent, and design development plans to overcome these.

6. Assign coaches and mentors. Outside coaches, as well as mentors from the board, can give executives new perspective and the opportunity to grow outside the organization's normal chain of command.

7. Get strategic assistance when necessary. Study the practices of other organizations, and integrate the ones best suited for your organization. ■

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Taxes and retirement *continued from front*

As to Social Security, benefits were not subject to tax before 1984. But since then, Social Security payments can be taxed based on the amount of the taxpayer's non-Social Security income.

More than half (54 percent) have never received any professional retirement guidance, and the same percentage do their own taxes without any external advice or guidance.

The higher the non-Social Security income, the greater the portion of Social Security benefits that can be taxed.

Social Security benefits are totally nontaxable if the sum of one-half of a person's Social Security benefits plus all other gross income plus all tax-exempt interest income is below the following threshold amount:

- $32,000 for married couples filing jointly
- $25,000 for unmarried individuals and married couples filing separately, who did not live together at any time during the year
- $0 for married couples filing separately, who lived together at any time during the year

Above those thresholds, a portion of their Social Security benefits is included in their taxable income.

At the highest income levels, if taxpayers are in the 39.6 percent marginal tax bracket, the tax effect of including 85 percent of Social Security benefits in taxable income effectively causes them to repay about one-third of their benefits to the federal government.

The survey also found that few Americans approaching retirement are aware of tax deductions that potentially might help them during retirement:

- In some cases, taxpayers may claim their parents living outside the home as dependents for tax purposes.
- A higher standard deduction begins at age 65.
- Blindness is a cause for a higher standard deduction.

Many of the middle-income Americans surveyed were unaware of the tax issues involved in retirement because they don't seek tax or retirement guidance.

More than half (54 percent) have never received any professional retirement guidance, and the same percentage do their own taxes without any external advice or guidance. ■

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