City State Bank Trusts & Investments
Summer 2016 Newsletter

CITY STATE BANK INVEST

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QUARTER 2 UPDATE

RECENT RULING CHANGES

We wanted to explain a recent ruling change that has been in the news, and how it may affect any accounts you maintain with City State Bank Trust & Investments, or elsewhere.

RULE CHANGES

On April 6, 2016, the Department of Labor (DOL) issued a new "conflict of interest" ruling that will affect the financial services industry. The new DOL rules will generally require that all financial professionals who receive compensation for providing advice on retirement accounts be held to a fiduciary standard. This rule takes partial effect in April 2017 and the final requirements do not go into effect until January 2018.

WHAT IS A "FIDUCIUARY" AND WHY DOES IT MATTER?

Simply put, the fiduciary standard means that the advisor must put the client's best interest ahead of his or her own. This short sentence has brokerage, annuity and loaded-mutual fund companies scrambling to change how they handle retirement assets; IRAs and other employee benefits.

HOW WILL (OR WON'T) THIS AFFECT YOUR INVESTMENTS?

For us, concerns from the investment industry about the new rule are laughable. Putting the client's interest first seems to be the most basic of duties that our clients expect from us. As a bank Trust Department, we have always been held to the fiduciary standard of putting our client's interests first. There is no need for us to wait until the deadline, we have been doing this from the very beginning – and that goes not only for retirement assets, but for all assets we manage.

At City State Bank Trust and Investments, we are proud of the investment products that we recommend to our clients. We will continue our independent, un-biased investment selection process and utilizing investment products that never create any hidden revenue to us.

We will be happy to help if you have any questions on this new ruling, or how it may affect other assets you hold. However, in regard to your City State Bank assets, please rest easy, you are already covered.

Thank you for your continued trust, we value it immensely.

~ City State Bank Trust & Investment Committee

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STRATEGIES FOR FIXED-INCOME INVESTORS

A long period of low yields has been challenging for many fixed-income investors, but owning bond investments in a rising interest-rate environment could become even trickier. When interest rates go up, the prices of existing bonds typically fall. Consequently, the Federal Reserve's rate-setting decisions could affect the entire fixed-income market.

Still, bonds are a mainstay for conservative investors who prioritize the preservation of principal over returns, and for retirees in need of a predictable income stream. Although diversification does not guarantee a profit or protect against investment loss, owning a diversified mix of bond types and maturities is one way to manage interest-rate and credit risk in your portfolio.

CONSIDER DURATION

Overall, bonds with shorter maturities are less sensitive to interest-rate fluctuations than long-term bonds. A bond's maturity is the length of time by which the principal and interest are scheduled to be repaid. A bond's duration is a more specific measure of interest-rate sensitivity that takes cash flow (interest payments) into account.

For example, a five-year Treasury bond has a duration of less than five years, reflecting income payments that are received prior to maturity. A five-year corporate bond with a higher yield will have an even shorter duration, making it slightly less sensitive to interest-rate fluctuations. If interest rates increase 1%, a bond's value is generally expected to drop by approximately the bond's duration. Thus, a bond with a five-year duration could lose roughly 5% in value.

BUILD A LADDER

Bond laddering is a buy-and-hold strategy that could also help cushion the potential effects of rising rates. This process puts your money to work systematically, without trying to predict rate changes and time the market.

Buying individual bonds provides some certainty, because investors know how much they will earn if they hold a bond until maturity, unless the issuer defaults. A ladder is a portfolio of bonds with maturities that are spaced out at regular intervals over a certain number of years. When short-term bonds from the low rungs of the ladder mature, the funds are reinvested at the top end of the ladder. As interest rates rise, investors may be able to increase their cash flow by capturing higher yields. A ladder may also help insulate bond portfolios from volatility, because higher yields on new bonds may help offset any paper losses on existing holdings.

Bond ladders may vary in size and structure, and could include different types of bonds depending on an investor's time horizon, risk tolerance, and goals. Individual bonds are typically sold in minimum denominations of $1,000 to $5,000, so creating a bond ladder with a sufficient level of diversification might require a sizable investment.

RISE WITH RATES

Adding a floating-rate component to a bond portfolio may also provide some protection against interest-rate risk. These investments (long offered by U.S. corporations) have interest payments that typically adjust based on prevailing short-term rates.

The U.S. Treasury started issuing floating-rate notes with two-year maturities in January 2014. Investors receive interest payments on a quarterly basis. Rates are tied to the most recent 13-week Treasury bill auction and reset weekly, so investors are paid more as interest rates rise and less as they fall.

NOTE: Bonds redeemed prior to maturity could be worth more or less than their original cost, and investments seeking to achieve higher yields also involve a higher degree of risk. Interest payments are taxed as ordinary income. Treasury bond interest is subject to federal income tax but exempt from state and local income taxes. than their original cost. Investments that seek a higher return tend to involve greater risk. Rebalancing may result in commission costs, as well as taxes if you sell investments for a profit.

QUIZ:
WHICH BIRTHDAYS ARE FINANCIAL MILESTONES?

When it comes to your finances, some birthdays are more important than others. Take this quiz to see if you can identify the ages that might trigger financial changes.

QUESTIONS

1. Eligibility for Medicare coverage begins at what age?
   a. 62 b. 65 c. 66

2. A child can stay on a parent's health insurance plan until what age?
   a. 18 b. 21 c. 26

3. At this age individuals who are making contributions to a traditional or Roth IRA or an employer-sponsored retirement plan can begin making "catch-up" contributions.
   a. 50 b. 55 c. 60 d. 66

4. This age is most often associated with drops in auto insurance premiums.
   a. 18 b. 25 c. 40 d. 50

5. Individuals who have contributed enough to Social Security to qualify for retirement benefits become eligible to begin collecting reduced benefits starting at what age?
   a. 62 b. 65 c. 66 d. 70

6. To obtain a credit card, applicants under this age must demonstrate an independent ability to make account payments or have a cosigner.
   a. 16 b. 18 c. 21

Answers can be found on the next page.

EARN TOO MUCH FOR A ROTH IRA? TRY THE BACK DOOR!

BACKGROUND: Roth IRAs, created in 1997 as part of the Taxpayer Relief Act, represented an entirely new savings opportunity – the ability to make after-tax contributions that could, if certain conditions were met, grow entirely free of federal income taxes. These new savings vehicles were essentially the inverse of traditional IRAs, where you could make deductible contributions but distributions would be fully taxable. The law also allowed taxpayers to "convert" traditional IRAs to Roth IRAs by paying income taxes on the amount converted in the year of conversion.

Unfortunately, the law contained two provisions that limited the ability of high-income taxpayers to participate in the Roth revolution. First, the annual contributions an individual could make to a Roth IRA were reduced or eliminated if his or her income exceeded certain levels. Second, individuals with incomes of $100,000 or more, or whose tax filing status was married filing separately, were prohibited from converting a traditional IRA to a Roth IRA.

In 2005, however, Congress passed the Tax Increase Prevention and Reconciliation Act (TIPRA), which repealed the second barrier, allowing anyone to convert a traditional IRA to a Roth IRA, starting in 2010, regardless of income level or marital status. But TIPRA did not repeal the provision that limited the ability to make annual Roth contributions based on income. The current limits are set forth in the chart below:

Phaseout ranges for determining ability to fund a Roth IRA in 2016*	
Single/head of household	$117,000-$132,000
Married filing jointly	$184,000-$194,000
Married filing separately	$0-$10,000
*Applies to modified adjusted gross income (MAGI)	

Through the back door...

Repeal of the provisions limiting conversions created an obvious opportunity for high-income taxpayers who wanted to make annual Roth contributions but couldn't because of the income limits. Those taxpayers (who would also run afoul of similar income limits that prohibited them from making deductible contributions to traditional IRAs) could simply make nondeductible contributions to a traditional IRA and then immediately convert that traditional IRA to a Roth IRA – a "back door" Roth IRA.

The IRS is always at the front door...

IRAs, establishment of the back-door Roth IRA is essentially tax free. Income tax is payable on the earnings, if any, that the traditional IRA generates until the Roth conversion is complete. However, assuming the contribution and conversion are done in tandem, the tax impact should be nominal. (The 10% penalty tax for distributions prior to age 59½ generally doesn't apply to taxable conversions.) But if a taxpayer owns other traditional IRAs at the time of conversion, the tax calculation is a bit more complicated because of the so-called "IRA aggregation rule." When calculating the tax impact of a distribution (including a conversion) from any traditional IRA, all traditional and SEP/SIMPLE IRAs a taxpayer owns (other than inherited IRAs) must be aggregated and treated as a single IRA.

For example, assume Jillian creates a back-door Roth IRA in 2016 by making a $5,500 contribution to a traditional IRA and then converting that IRA to a Roth IRA. She also has another traditional IRA that contains deductible contributions and earnings worth $20,000. Her total traditional IRA balance prior to the conversion is therefore $25,500 ($20,000 taxable and $5,500 nontaxable).

She has a distribution (conversion) of $5,500: 78.4% of that distribution ($20,000/$25,500) is considered taxable ($4,313.73), and 21.6% of that distribution ($5,500/$25,500) is considered nontaxable ($1,186.27).

NOTE: These tax calculations can be complicated. Fortunately, the IRS has provided a worksheet (Form 8606) for calculating the taxable portion of a conversion.

There's also a side door...

Let's assume Jillian in the example above isn't thrilled about having to pay any income tax on the Roth conversion. Is there anything she can do about it?

One strategy to reduce or eliminate the conversion tax is to transfer the taxable amount in the traditional IRAs ($20,000 in our example) to an employer qualified plan like a 401(k) prior to establishing the back-door Roth IRA, leaving the traditional IRAs holding only after-tax dollars. Many 401(k) plans accept incoming rollovers. Check with your plan administrator.

BIRTHDAY MILESTONES QUIZ ANSWERS:

1. b. 65. Medicare eligibility begins at age 65, although people with certain conditions or disabilities may be able to enroll at a younger age. You'll be automatically enrolled in Medicare when you turn 65 if you're already receiving Social Security benefits, or you can sign up on your own if you meet eligibility requirements.
2. c. 26. Under the Affordable Care Act, a child may retain his or her status as a dependent on a parent's health insurance plan until age 26. If your child is covered by your employer-based plan, coverage will typically end during the month of your child's 26th birthday. Check with the plan or your employer to find out exactly when coverage ends.
3. a. 50. If you're 50 or older, you may be able to make contributions to your IRA or employer-sponsored retirement plan above the normal contribution limit. These "catch-up" contributions are designed to help you make up a retirement savings shortfall by bumping up the amount you can save in the years leading up to retirement. If you participate in an employer-sponsored retirement plan, check plan rules – not all plans allow catch-up contributions.
4. b. 25. By age 25, drivers generally see their premiums decrease because, statistically, drivers younger than this age have higher accident rates. Gaining experience and maintaining a clean driving record should lead to lower premiums over time. However, there's no age when auto insurance rates automatically drop because rates are based on many factors, including type of vehicle and claims history, and vary by state and insurer; each individual's situation is unique.
5. a. 62. You can begin receiving Social Security retirement benefits as early as age 62. However, your benefits will be reduced by as much as 30% below what you would have received if you had waited until your full retirement age (66 to 67, depending on your year of birth).
6. c. 21. As a result of the Credit Card Act of 2009, credit card companies cannot issue cards to those under age 21 unless they can show proof that they can repay the debt themselves or unless someone age 21 or older with the ability to make payments cosigns the credit card agreement.

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ROLLOVER.

Good Investment.

Benefits of rolling over your old 401k to City State Bank Trust & Investments:

- Greater investment flexibility
- Manage more of your retirement funds in one place
- Keep your retirement savings tax advantaged
- Ongoing investment management of your portfolio
- Access to comprehensive financial planning

Not changing careers but want to take advantage of the above benefits? We can help you roll over your existing IRA accounts.

Call City State Bank Trust & Investments today to get started.

Not FDIC insured. Not deposits or other obligations of bank and are not guaranteed by bank. Are subject to investment risk, including possible loss of principal.

SHOULD I DELAY TAKING MY FIRST RMD?

Your first RMD from a traditional IRA and an employer retirement plan must be taken for the calendar year in which you turn 70½. However, if you're still working, you can delay RMDs from your current employer's plan until the year you retire (but only if allowed by the plan and you are not a 5% owner). In general, you must take your RMDs no later than December 31 of each calendar year to avoid a serious tax penalty equal to 50% of the amount you failed to withdraw. However, a special rule applies to your first RMD. You have the option of delaying your first distribution until April 1 of the following calendar year. You might delay taking your first distribution if you expect to be in a lower income tax bracket in the following year, perhaps because you're no longer working or will have less income from other sources. However, if you wait until the following year to take your first distribution, your second distribution must be made on or by December 31 of that same year.

Receiving your first and second RMDs in the same year may not be in your best interest. Since this "double" distribution will increase your taxable income for the year, it will probably cause you to pay more in federal and state income taxes. It could even push you into a higher federal income tax bracket for the year. In addition, the increased income may result in the loss of certain tax exemptions and deductions that might otherwise be available to you. Obviously, the decision to delay your first required distribution can be important. Your tax professional can help you decide whether delaying the RMD makes sense for your personal tax situation.

IMPORTANT DISCLOSURES

City State Bank, or Broadridge Investor Communication Solutions, Inc. do not provide tax, or legal advice. The information presented here is not specific to any individual's personal circumstances.

To the extent that this material concerns tax matters, it is not intended or written to be used, and cannot be used, by a taxpayer for the purpose of avoiding penalties that may be imposed by law. Each taxpayer should seek independent advice from a tax professional based on his or her individual circumstances.

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