2015 Year-End Tax Issues Review

Prepared by Stan Smiley, J.D.
Senior Vice President, Advanced Planning Group
Cetera Financial Group®

Introduction

2015 presents significant income, estate and gift planning considerations and opportunities. In 2015, as a result in part of the American Taxpayer Relief Act of 2012 and the Affordable Health Care Act of 2010, careful review of tax rates, exemptions and deductions is required. This white paper will primarily explore effective tax planning issues and opportunities.

Income Tax Reduction

As a result of the above legislation, an ordinary income tax rate of 39.6 percent, capital gains rate of 20 percent, a net investment income tax of 3.8 percent and an increase in the Medicare tax by .09 percent will apply to some individuals for 2015. As a result of these issues, there is renewed emphasis on finding ways to reduce tax liability for 2015.

Effective income tax planning largely embodies the methodology and timing of income reported, as well as the deductions and credits which are claimed. A fundamental precept involves timing one's income to be taxed at a lower tax rate and claiming deductions in years when they can be offset with higher tax brackets. Where one expects to be in a lower tax bracket in 2016 rather than 2015, deferring receipt of income to 2016 is wise. Yet, if one expects to be in a higher tax bracket in 2016, they may want to accelerate income in 2015 and defer deductions until 2016.

There are three general fundamental guidelines that underlie income tax reduction strategies. Generally, one should (a) recognize income when their tax rate is low, (b) pay deductible expenses when their tax bracket is high, and (c) postpone tax when possible.

Exclusions

It should be remembered that there are numerous items that are excluded from income. Some of these include (a) gifts and inheritances, (b) reimbursements received from employers for business expenses, (c) compensation for injury including workers' compensation, (d) employer-paid health insurance, (e) certain medical savings account withdrawals, and (f) interest on certain municipal bonds and mutual funds that hold such bonds.

Social Security

Some Social Security recipients are taxed on their benefits--either at 50 percent or 85 percent of the actual benefits received depending on one's modified adjusted gross income (MAGI). In 2015, Social Security benefits of joint filers (JF) with MAGI greater than $32,000 are taxed at 50 percent and if over $44,000 at 85 percent. For single filers (SF) these amounts are $25,000 and $34,000 respectively. To avoid taxation of Social Security benefits, it may be possible to defer receipt of other income. A retiree may have a choice of either receiving a lump sum distribution or rolling a retirement benefit to an IRA to avoid current taxation.

Even though investing in municipal bonds generally does not count for income tax purposes, it is still included in determining the taxability of Social Security benefits. If one has a Roth IRA, it should be noted that qualified distributions are tax-free and therefore will not increase the taxability of Social Security benefits.

Additionally in 2015, Social Security benefits will be reduced by one dollar for each two dollars of earnings if you are under age 65 with earnings greater than $15,480.

It should be noted that the Bipartisan Budget Act of 2015 starting in 2016 made certain changes to two different strategies for claiming Social Security benefits for those married each with their own Social Security entitlements.

The first change concerns voluntary suspensions. Previously, an individual who had reached Full Retirement Age (66 years old) could file for benefits and immediately suspend them in order to trigger benefits for a spouse or dependent child while their own retirement benefit continued to accumulate 8% per year Delayed Retirement Credits up to age 70. The new legislation will no longer allow family members to collect on an individual's earnings record while their benefits are suspended. The new law eliminates the "file and suspend" strategy beginning 180 days after enactment, which is expected to be May 1, 2016. Thus, individuals who suspended benefits in the past or do so before that date will be "grandfathered" under the old rules.

The second change concerns the Restricted Application for spousal benefits. Prior to the new law, an individual who was eligible for both a spousal benefit and a retirement benefit based on his or her own work could choose to elect only a spousal benefit at Full Retirement Age. This allowed an individual's own benefit to grow by 8% per year and then he or she could switch to this larger benefit in the future up to age 70. This option is known as a Restricted Application.

The Act phases out this claiming strategy. For individuals born before January 1, 1954, the option to file a Restricted Application for only spousal benefits will remain available. However, people born after January 2, 1954 will be deemed to file for spousal and retirement benefits at the same time and will automatically be paid the higher of the two benefits (if entitled to both). Since the option to file a Restricted Application for only spousal benefits is only available under prior law at Full Retirement Age, and the rules take effect only for people who are currently under age 62, this option is still effectively phased-in over a four-year period . Widows will continue to have the opportunity to restrict an application to only widow or only retirement benefits and later switch to the other benefit.

Postponing Income

If you will be in a lower tax bracket in 2016, postponing income until next year is one strategy for reducing your 2015 tax liability. A self-employed person can defer billing and effectively shift income to next year. Year-end bonuses could be paid next year by arrangement with an employer as well. Maximizing the allowable contribution to retirement plans (e.g., 401(k), 403(b), IRAs, SEP, SIMPLE and Keogh Plans) is appropriate.

If one is selling property (other than stock or other securities) this year, receipt of the proceeds in installment payments over the next few years can be helpful depending on applicable tax rates. This would avoid having the full amount push one into a higher tax bracket. Interest on T-bills and bank certificates for a term of one year or less will result in income to be reported only at maturity. If funds are invested in interest-bearing accounts and shifted to these investments, interest deferral can be accomplished. Additionally, shifting assets to an annuity will also result in deferral of ultimate income recognition.

Income Acceleration

Anticipated changes in filing status (e.g., marriage) or expectation of a higher income level from employment next year (higher tax bracket) may cause one to seek to accelerate income for 2015. If one is self-employed, they should be sure to do all billing to achieve collection in 2015. For cash basis taxpayers (reporting income and expenses on a regular calendar year), income is not taken into account until it is received. If one has control over a corporation that will pay dividends, they could electively be paid out during 2015. If an employer has given Incentive Stock Options, on exercise (although they are not income taxed) they are a tax preference item, which may result in the paying of Alternative Minimum Tax (AMT). That could increase overall tax liability. This must be fully evaluated before exercise. In certain cases individuals may have received various forms of restricted stock that is subject to forfeiture if the employee is terminated prior to a stated period of time. In this event, if the employee is confident the conditions will be met, they may elect to treat the restricted stock as income when received, instead of at a time when the restrictions are to be lifted. This can be done as an election reported to the IRS under Code Section 83. Unfortunately, once reported, should the forfeiture occur, the individual cannot receive back the tax previously paid.

Deductions

There are many expenses that are appropriate deductions on one's income tax return. These would encompass such items as casualty losses, health insurance premiums, contributions to charity, employment agency fees, home interest deduction, IRA fees, and even safe deposit box fees for investments. There are various personal type items that are specifically not deductible. These would include things like political campaign expenses, attorney's fees in general, commuting expenses, depreciation of property for personal use and insurance on a personal residence as well.

Some deductions may be claimed only to the extent they exceed a certain percentage of Adjusted Gross Income (AGI), 7.5 percent for medical expenses if over age 65 (10 percent if less than age 65) and 10 percent for casualty losses. Then in each case only that further sum in excess of 2 percent of AGI is captured. Therefore, it must be noted that increases in AGI will operate to reduce the value of AGI-based deductions. In 2015 and continuing on a permanent basis, those whose AGI is greater than $309,900 (JF) or $258,250 (SF) will have their itemized deductions phased out. (In 2016 these amounts are $311,300 and $259,400 respectively). In these cases they will be reduced by 3 percent for each dollar above these thresholds up to an 80 percent reduction.

Consideration should also be given to prepaying the January 2016 mortgage payment as well as the first installment of property taxes due in 2016. This can result in greater tax savings for 2015. If one is a statutory employee (as identified on Form W-2), they may be able to claim unreimbursed business expenses as a direct deduction from gross income and avoid the restriction placed on miscellaneous deductions. This classification would include such individuals as full-time insurance salespersons.

In cases where one has not reached the 7.5 percent/10 percent floor for deductibility of medical expenses, consideration should be given for accelerating medical appointments and procedures that would result in payment during 2015. If one claims a parent who resides in a nursing home as a dependent, some or all of the expenses can qualify as a deductible medical expense. Additionally, some or all of the premiums paid for long-term care insurance premiums are deductible medical expenses. The allowable deduction for 2015 is on a sliding scale depending on one's age, from $380 ($390 in 2016) (age 40 or less), $710 ($730 in 2016) (ages 41-50), $1,430 ($1,460 in 2016) (ages 51-60), $3,800 ($3,900 in 2016) (ages 61-70) to $4,750 ($4,870 in 2016) (over age 70).

The value of each personal and dependency exemption for 2015 is $4,000 ($4,050 in 2016). However, here too in 2015 with MAGI over $309,900 (JF) or $258,250 (SF), the exemption is modified. In 2016 these sums are $311,300 and $259,400 respectively. The exemption is reduced by 2 percent for each $2,500 above these thresholds. The standard deduction for 2015 and 2016 is $12,600 (JF) and $6,300 (SF). For those over age 65 this sum is increased in 2015 and 2016 by $1,250 for joint filers and $1,550 for single filers.

In timing deductions, as a cash basis taxpayer one is entitled to a deduction for 2015 only if a check is prepared and mailed prior to January 1, 2016. Merely giving an entity a note or promise to pay does not suffice. The year of payment is the key.

Home Ownership

In an environment of lowering interest rates on home mortgages, many have sought to refinance home ownership during 2015. Generally, points paid by a buyer to initially acquire a residence are fully deductible in the year of purchase. To the extent in a refinancing process points are paid and excess cash is obtained by the owner solely to make renovations for the property, then a percentage of the points, in a ratio of the amount of the loan to the improvement costs, is immediately deductible. Any points paid by an owner during a refinance (excluding the sum for home improvements), instead of getting a full deduction in the current year must be amortized over the life of the loan. In any subsequent second refinance, the then- outstanding undeducted points become fully deductible. In refinancing, if an owner receives $100,000 or less in cash for themselves, it is generally treated as a home equity loan and all loan interest (apart from any points) is fully annually deductible. The funds can even be used for personal purchases such as automobiles and the like. In circumstances where the excess cash received is greater than $100,000, only the home improvement excess portion is eligible for a home interest deduction.

Interest paid on a primary residence is eligible for a home interest deduction on a mortgage loan of up to a $1,000,000. A vacation home is also eligible for a home interest deduction. If one rents out a vacation or main home fewer than 15 days a year, the rental income is tax-free. In that event, one can only deduct property taxes, mortgage interest and casualty losses. Deduction for maintenance and repairs is not allowed. If, however, the property is rented for greater than 15 days in a year, one must include the rental income, but then these various expenses are deductible. This is true provided the personal use is not greater than the larger of 14 days or 10 percent of the rental period.

Charitable Contributions

Although its value may be reduced due to the phase-out of deductions for high income filers, charitable contributions can still offer great flexibility and opportunity for tax reduction. Here again a mere pledge is not sufficient; the year of actual payment is dispositive. Generally speaking, gifts of appreciated property (like stock) to charity afford great benefits. The charitable deduction is for the full appreciated value for both regular income tax and AMT purposes. Additionally, one can avoid the capital gains that would have been paid if the property were merely sold and only the proceeds were donated. To claim a deduction, cash contributions of any amount must be substantiated with a bank record or written communication from the charity indicating the charity's name, contribution amount and contribution date. If a non-cash contribution in excess of $500 is made, then a completed IRS Form 8283 must be included with the tax return.

If one donates property to a charity, they may even receive a deferred gift annuity in return. For example, in exchange for the gift, the individual may be promised an annuity when they retire. The deduction entitlement is measured by the difference between the value of the gift and value of the annuity being received. Although in the best of circumstances a charitable deduction is limited to no more than 50 percent of one's adjusted gross income--to the extent the value is not used up it can be carried forward for an additional five years.

The provisions under the American Taxpayer Relief Act of 2012--for IRA owners who were older than 70½ (and therefore subject to required minimum distributions) allowing with no tax consequences to gift a maximum $100,000 per year directly from their IRA to certain qualified charities—expired on December 31, 2014. When this was permitted the IRA distribution had to be made directly to the qualifying charity. While no actual deduction is recognized, no income is reported either. Also, this donation could have been used to satisfy the normal required minimum distribution from the IRA without its being taxed. This effectively reduced one's adjusted gross income, which was of great benefit for those who did not itemize. Additionally this may have reduced the potential income tax consequence of Social Security payments received. *It should be noted that many believe this now expired provision may be passed by Congress retroactively to January 1, 2015.*

Retirement Issues

In 2015 and 2016 the maximum contribution to a traditional or Roth IRA is $5,500 (with an extra $1,000 available for persons over age 50). Although those with earned income can always have a traditional IRA contribution, it may not always be deductible. For 2015 if one is also an active participant in an employer's retirement plan and their MAGI exceeds certain sums, no deduction is allowed. For married filing jointly (MF) in 2015 and 2016 the limit is over $118,000 and for single individuals (SF) it is $71,000. If the MAGI is over $98,000 and $61,000 respectively, only a partial deduction is permitted. Below these sums, full deductibility may be available. Contributions can be made up to April 15, 2016 for 2015 taxes. Roth IRA contributions also have MAGI phase-out limitations: for married filing jointly, that is $183,000 to $193,000 ($184,000 to $194,000 in 2016); and for single filers it is $116,000 to $131,000 ($117,000 to $132,000 in 2016). Even if one is a participant in an employer's retirement plan, they may have a Roth IRA if they meet the above MAGI criteria.

For 2015 and 2016 the maximum elective deferral to 401(k), 403(b), salary reduction SEPs and 457 retirement plans for 2015 is $18,000 plus $6,000 for those over age 50. For 2015 and 2016, the contribution limit for a SIMPLE plan is $12,500 plus $3,000 for those over age 50. For a SEP, the maximum effective contribution for 2015 and 2016 is the lesser of 25 percent of compensation or $53,000. For a self-employed individual, the limit is further limited since only net self-employment income is taken into account. The deadline for a SEP contribution is the tax filing date with extensions. For defined contribution plans, the 2015 and 2016 limit on annual additions is $53,000 or 100 percent of compensation, whichever is less. Only $265,000 of compensation may be considered. In 2015, Keogh plans and solo 401(k) plans (for self-employed individuals) must be established by the end of 2015, although they can be funded up to the due date of the 2015 tax return. For 2015 and 2016, the maximum limit for the annual benefit under a defined benefit plan is $210,000.

Many individuals may have converted traditional IRA accounts to a Roth IRA earlier in 2015 with the expectation of paying tax on the amount distributed from the traditional IRA. Conversions with clients may result in perhaps a rethinking of whether the Roth conversion is still desired. Appropriate analysis could be made to determine whether the new Roth account should be recharacterized to undo or reverse the initial transaction thereby negating the taxable event for the original conversion. This recharacterization can be accomplished up to as late as October 15, 2016 for a 2015 conversion.

Retirement income received after December 31, 1995 cannot be taxed by the state where an individual formerly resided at the time it was created for tax deferral. This includes most IRAs, SEPs and other retirement plans. Individuals who are nearing retirement may consider seeking to relocate to states where there are low or even no income taxes. In doing so, their former state of residence will be precluded from taxing retirement benefits merely deferred while the individual lived there. Only the new state of residence can tax the retirement income benefits once they are ultimately paid out.

Business Issues
A business owner may be able to deduct a significant cost of depreciable personal property placed in service during 2015. This special deduction is commonly referred to as an Internal Revenue Code Section 179 deduction. This section of expense deduction is not an item of AMT preference or adjustment. Section 179 treatment allows a one-time expense deduction rather than the use of the normal depreciation schedules. There is a maximum deductibility of $25,000 with a $200,000 investment limit for 2015. In lieu of Section 179, if depreciation is used, bonus deprecation may be available.

Kiddie Tax
For 2015, the kiddie tax involves those children less than 19 years old with unearned income above $2,100. In that event, the children are taxed for their unearned income at their parents' tax rates. Additionally, the kiddie tax also involves those children between 19 and 23 who are fulltime students; do not file a joint tax return and whose earned income does not exceed one-half of their support.

To minimize the kiddie tax impact, changes to a child's portfolio might be considered. Shifting into long-range vehicles such as growth stocks or even U.S. Savings Bonds may be utilized, thereby reducing current earnings. Use of municipal bonds may also be an option. It should be noted that unlike custodial accounts, investments in 529 Plans are not subject to the kiddie tax.

Tax Credits and Adjustments
Tax credits are available for a wide range of purposes. These would include such items as child and dependent care, elderly and permanent disability, adoption tax credit, foreign tax credit, earned income credit, Hope Scholarship Credit and the Lifetime Learning Credit. Since credits directly offset tax due obligations, these and the other available credits should be carefully scrutinized. In the case of employment with two or more employers during the year, one may have paid more individual Social Security tax (OASDI) beyond the maximum 2015 and 2016 compensation base of $118,500. This could result in a further tax credit for the excess contributions the employee has made. Of course the Medicare rate of 1.45 percent for employees would still be applicable. For those with MAGI more than $250,000 (JF) or $200,000 (SF), an additional 0.9 percent would apply.

Investment Issues
Of significant impact for many and continuing in 2015 and 2016 is the additional 3.8 percent surtax on Net Investment Income (NII). The 3.8 percent NII tax applies to individuals on the lesser of NII or the MAGI exceeding certain statutory threshold amounts. The threshold amounts for individuals are $250,000 (JF) and $200,000 (SF). These amounts are not adjusted for inflation.

Estates and trusts are also subject to the NII tax if they have undistributed net investment income and also have adjusted gross income greater than the dollar amount at which the highest tax bracket for an estate or trust begins. For reference, this figure is $12,300 for 2015 ($12,400 in 2016). Certain trusts, such as grantor trusts and tax-exempt trusts like charitable trusts and qualified retirement plan trusts are not subject to the NII tax.

Net investment income includes: interest, dividends, and capital gains from the sale of stocks, bonds, mutual funds, and investment real estate, as well as capital gain distributions from mutual funds. Gains from the sale of a principal residence will only be subject to the tax on NII to the extent the gain exceeds the special IRC Section 121 exclusion amount ($500,000 for JF and $250,000 for SF). It also includes rental and royalty income, nonqualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities.

Social Security benefits, tax-exempt interest, self-employment income, alimony, and distributions from most qualified plans and IRAs are not considered net investment income subject to the 3.8 percent.

To arrive at net investment income, the income described above is reduced by deductions properly allocable to the income, such as deductions for investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in net investment income.

It must be noted that the NII tax is subject to estimated tax rules, but is not required to be withheld from wages. Nonresident aliens are not subject to the tax on NII.

If a capital asset were held for more than 12 months (long-term), the gain on any sale usually would be taxed at a maximum rate of 15 percent (0 percent if one is in the 10 percent or 15 percent bracket). However for those in the 39.6 percent tax bracket with taxable income more than $464,850 (JF) ($466,950 in 2016) or $413,200 (SF) ($415,050 in 2016) they are subject to a 20 percent capital gains rate. Gains from collectibles such as stamps and coins are taxed at a 28 percent capital gains rate. The holding period begins on the day after the property is acquired. Additionally, the date the asset is disposed of is also part of the holding period. This means that for publicly-traded securities the holding period begins the day after the trade date or purchase and ends on the trade date when the securities are sold. Settlement date is not relevant for tax purposes.

For capital assets held less than 12 months, disposition is deemed to be a short-term gain or loss. Short-term capital losses are applied first against short-term gains, and if there is still a balance, they are to be applied against the net long-term gain/loss one has. After netting against the long-term losses, to the extent one still has a short-term gain, the balance would be treated as ordinary income and taxed accordingly. This could be taxed as high as 39.6 percent in 2015. To the extent one has a long-term loss which is not netted against a long-term gain; the balance can be offset against $3,000 of ordinary income in a year. In that case, if not fully used up, the balance can be carried forward to subsequent tax years.

The capital gains rate (0 percent, 15 percent or 20 percent) above will also apply to dividends received from a domestic corporation or qualified foreign corporation. Corporate stock dividends passed through to investors by a mutual fund are also eligible. A holding period applies to stock purchased close to the ex-dividend date (the date following the record date). The stock must be held for 61 days during the 121-day period beginning 60 days before the ex-dividend date.

Typically, when an individual inherits property from a decedent, they can be eligible to have any gain from an ultimate sale deemed a long-term capital gain (Code section 1223(11)). Despite perhaps a lesser actual holding period, the one who inherits is to be deemed to have held the asset for greater than one year.

Based upon the capital gains rules above, if one has already realized a capital loss for 2015 that exceeded their current capital gains for the year plus $3,000, it may be advantageous to sell capital gain property for a gain. If one has prior 2015 excess gains over losses, realizing further capital losses may offset or eliminate that capital gain.

One must be cognizant of loss denial under the wash sale rule (IRC 1091(e)). Under that rule, one cannot take a loss deduction for a loss on a security sale if within a period of 30 days before or after the sale date the same or a substantially similar security was acquired.

In the case of a security which was given as a gift to an individual, one generally receives the donor's original basis (or adjusted basis for any gift tax paid). However, where the recipient ultimately sells the security at a loss, their basis is the fair market value on the date of the gift.

An oftentimes overlooked point is that if one has purchased a zero-coupon bond and it is not held in a tax deferred account (e.g., IRA), then the accrued interest must be reported annually even though repayment is being deferred to a later year.

Alternative Minimum Tax (AMT)

Alternative Minimum Tax (AMT) is a separate and distinct tax regime. This requires many to calculate taxes based upon both a regular income tax and AMT basis. In that event, they are obligated to pay the tax that is the greater of the two. AMT credits can be used in subsequent years to offset some of the future tax burden. Obviously, specifics should be best addressed with the client's tax professional. There are some in Congress who want to abolish AMT in total, but to date no permanent solution has occurred. An individual is subject to AMT if the tentative AMT determination exceeds the regular tax liability. Tentative AMT for joint filers for 2015 is measured by (a) 26 percent of the first $185,400 in excess of the exemption amount plus (b) 28 percent of the remaining AMT income. Although previously AMT has historically not been adjusted for inflation, starting in 2013 Congress has enacted a permanent exemption. In 2015, the amount of the AMT exemption is $83,400 ($83,800 in 2016) for MF and $53,600 ($53,900 in 2016) for SF.

It must be recognized that many high-income individuals may be trapped by AMT even though not engaged in business activities that generate AMT preference items or adjustments. This is because Schedule A deductions for items such as state and local taxes, property taxes and various miscellaneous deductions, and personal exemptions are not allowed. These must be added back to the taxable income to determine AMT income. Additionally, interest paid as home equity debt may also not be deductible.

Planning for the Future – Specifics

There are some immediate specifics that should not be overlooked at this time in planning. Based upon Congress' action last year, there is now a new "roadmap" available concerning expectation of future tax rates. Considerations concerning the use of Roth conversions might be revisited. A Roth conversion will assure that no minimum Required Minimum Distribution is mandated at age 70½.This would avoid potential Social Security benefits from themselves being further taxed. Additionally, the 3.8 percent surtax on NII might cause a renewed interest in evaluating municipal bond holdings. Use of more tax-sensitive mutual funds might be explored as well. In evaluating the income tax issues, estate and gift tax considerations should be considered as well. For 2015 the Federal Estate Tax exclusion is $5,430,000 ($5,450,000 in 2016) per individual (with increases for inflation in the future) and any unused portion is portable for the surviving spouse's use. The lifetime gift exemption has been raised to this same estate tax exempt amount. This might greatly aid in gifting a significantly valued business to the next generation without incurring an immediate gift tax. This gift would also reduce the future income consequences for the donor. The annual gift tax exclusion is $14,000 per recipient in 2015 and 2016.

Not to be overlooked is the significance of the U.S. Supreme Court ruling in the 2013 *Windsor* case involving same-sex marriage. Consistent with that opinion and later IRS pronouncements, for Federal purposes same-sex couples who are married in any U.S. state are entitled to all benefits available to all other married couples. This means that when previously unable to file joint income tax returns, they may now, within the statute of limitations, amend their tax returns. Even Estate Tax returns wherein the marital deduction heretofore was not available should be reviewed. For financial planning purposes, same-sex married couples may want to reevaluate all their beneficiary designations, including the impact to their retirement plans. Additionally, this year's U.S. Supreme Court ruling in the *Obergefell* case now mandates 50 state recognition of same-sex marriage for all individual state tax and regulatory issues.

Naturally, one cannot be certain what future tax changes Congress could make, but it is most important to use the known current regime at this time to develop tax savings strategies for clients with the client's tax professionals.

Conclusion

The above is presented as an educational overview of some of the salient tax issues involved with overall and year-end tax planning. Certainly, it is not meant to be an exhaustive explanation of this broad and technical area. Obviously, registered representatives should not be rendering tax advice to clients. Such advice should be left to the client's tax professionals. This review should afford greater familiarity with some of the tax issues to better assist clients in their financial planning in the current environment.

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For more information, please contact:
Cetera Financial Group®
200 North Sepulveda Blvd., Suite 1200
El Segundo, CA 90245
866.489.3100
www.cetera.com

Prepared by Stan Smiley, J.D.
Senior Vice President, Advanced Planning Group
Cetera Financial Group®