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A Few Things You Should Know About IRAs

From humble beginnings, IRAs are now holding assets in the trillions of dollars. With large cohorts of Americans reaching retirement age, here are a few essentials to remember about these accounts.

Background

In 1974 Congress passed the **E**mployee **R**etirement **I**ncome **S**ecurity **A**ct. **ERISA** established legal standards for employee benefits plans (Pension Plans, 401(k), 403(b)) and introduced tax-deductible **I**ndividual **R**etirement **A**ccounts in order to induce Americans to save for retirement. Subject to income limitation, most annual **IRA** contributions are made on a pre-tax basis and are currently limited to $5,500 annually if you are less than 50 and $6,500 if you are older. Additionally, the earnings on your IRA assets grow tax-free until you start making withdrawals, generally during your retirement years. At that point, the IRS starts collecting the taxes that were, up until then, tax-deferred. Note that in 1997 Congress made it possible for Americans to fund **Roth IRAs**. Contributions on these IRAs are made on an after-tax basis and can grow tax-free until they are liquidated. Roth IRAs are not the subject of this note although I will mention their characteristics in the course of my commentary, when appropriate.

Bankruptcy Protection

Under most circumstances the first $1 million in a traditional IRA is fully exempt from the potential claims of creditors. The amount over the exemption is subject to state law. There have been recent cases where the bankruptcy protection of the IRA has been challenged. If you find yourself in a situation where you need absolute certainty, consult a qualified lawyer in your state of residence.

IRA Roll-Overs

If you change job or retire and decide to take control of your 401(k) assets (or other qualified retirement plans) you may have heard that you can roll them over into your IRA. This is without tax consequences as long as there are no more than 60 days between the time your ex-employer liquidates the assets on your 401(k) and the time you deposit the proceeds on your IRA.

Note that, if you are happy with your ex-employer investment choices and are allowed to keep your account with them, there is no reason to liquidate the assets and transfer them to your IRA. This is because 401(k) and other plan administrators, under ERISA, are held to the highest standard of care when dealing with your retirement assets. This is called the **Fiduciary Standard**. The fiduciary standard of care requires that a financial adviser act solely in the client's best interest when offering personalized financial advice. While caring for your retirement assets they must insure that your assets are invested and managed efficiently. As fiduciaries, plan administrators are legally bound to put your interest ahead of theirs.

Most IRA custodians' representatives are not legally subject to such a high standard of care. All they need to do is to insure that the assets that your IRA is invested in meet the **Suitability Standard**. This is a lower standard of care whereby they must ensure that their securities recommendations are suitable and appropriate for you. As a consequence, once your assets are on your IRA, they no longer automatically benefit from the oversight of a fiduciary. This is in part why the brokerage industry is very keen on IRA roll-overs, and why you should be circumspect when presented with them.

The Obama Administration is currently attempting to remedy this situation through new regulation that would compel the brokerage industry and its representatives to adhere to fiduciary standards when

managing IRA assets. Let's hope they succeed. Until then my advice is to not roll your 401(k) or other qualified plan assets into your IRA, unless: 1) the current investment choices offered by your ex-employer are lacking and, 2) you are competent to manage these assets yourself or, 3) the financial advisor who will oversee them within your IRA follows the fiduciary standard of care. If you are note sure whether they follow this standard of care, ask them. If there is any equivocation it is probably a no…

Early withdrawal penalties

Most of you know this but just in case! IRA owners will pay a penalty of 10% on any amount withdrawn from their IRA if they withdraw before the age of 59 ½. For the traditional IRA owner this amount will be collected in addition to the income taxes that will be levied on the withdrawal. There are a few emergency situations that may allow for the penalty to be waived. For simplicity, your should assume that your IRA is a pile of money that you should not plan to use until you reach 59 ½ years of age, at the earliest.

What happens to my IRA after I am 59 ½?

When you reach the age of 59 ½ you can withdraw assets from the IRA without incurring the 10% penalty. You will have to pay the federal and state income taxes on those withdrawals if your assets are in a traditional IRA. The IRS claims then the taxes that have been deferred on both your contribution and the earnings on those contributions. No such taxes are payable in a Roth IRA since contributions have been made on an after-tax basis. Nevertheless, you will have to pay taxes on the amount of your withdrawal due to potential investment gains.

If you do not need to withdraw assets from your IRA past the age 59 ½ (because you have other sources of income) you may decide to do nothing and let the asset grow tax-free. You can do so until the age of 70 ½. During that period of your life, you can continue to make contributions to the account as long as you generate what the IRS calls "earned income"(in most instances that means being employed). In the case of a Roth IRA, you may contribute to the account past the age of 70 ½.

What happens after the age of 70 ½?

In a traditional IRA, you must start taking Required Minimum Distributions (RMDs). There is no avoiding this. The IRS wants to collect the taxes that have been deferred and this is when this process starts. The annual withdrawals are based on the account owner's life expectancy. The IRS has standard tables such as the one below.

Uniform Lifetime Table			
Age of Account Owner	Divisor	Age of Account Owner	Divisor
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

If you own a $1 million IRA and are now 72, you will need to withdraw a minimum of $39,062 ($1 million/25.6) in the year that follows and pay income tax on that amount. If you do not withdraw the RMD, you will have to pay 50% of the amount you should have withdrawn and did not. In this example, if you

withdraw $20,000 when the IRS tells you the minimum is $39,062, you will end up paying a penalty of $9,531 (50% of [$39,062-$20,000]). This is hefty! For more detailed calculations on these RMD, please go to https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/UniformLifetimeTable.pdf or to any other large brokerage company website.

Naming Beneficiaries

This is absolutely crucial for IRAs, qualified plans and generally for any assets you own. If you do not, upon your death your assets have to go through the probate process. This is the process that the state of your residence follows to determine who should inherit your assets in the absence of guidance from you. It is long and costly. For the sake of your heirs, you want to avoid it.

The failure to name beneficiaries has tax consequences. Here is one concerning IRAs: if you die before taking any RMDs from your IRA and without naming a beneficiary, your account will have to be liquidated, by whoever inherits it, within a maximum of five years. Since your legitimate heir may be a younger spouse or a child or grandchild of yours, the failure to name them as beneficiary will force them to liquidate the account faster than they might have been able to. In most cases they should be able to use standardized tables reflective of their own life expectancy to withdraw from the account and stretch it in the future, presumably beyond five years.

Concluding remarks

The regulation applied to IRAs can be rather convoluted given the variety of personal situations it is intended to address. The various points made earlier are only some of the most relevant I could think of. Before taking any initiative concerning your retirement assets, please inform yourself of their consequences and seek professional advice when in doubt.

While we are all unique and each situation may require specific advice, below are a few IRA-related recommendations that apply to all: 1) Make sure to name beneficiaries and review your elections regularly since circumstances change over time, 2) Do not withdraw before 59 ½, 3) Starting with the age of 59 ½ start planning your IRA withdrawal strategy by talking it over with a competent financial adviser. 4) Do not roll over your 401 (k) into your IRA unless you are a competent investor, are forced to do so by your ex-employer or have fiduciary advice at your disposal.

Please feel free to call me with any questions. I wish you all a happy and peaceful year-end holiday season.

Jeff de Valdivia, CFA, CFP® is founder of Fleurus Investment Advisory, LLC - a registered investment advisor. Details on his firm can be found at www.fleurus-ia.com.