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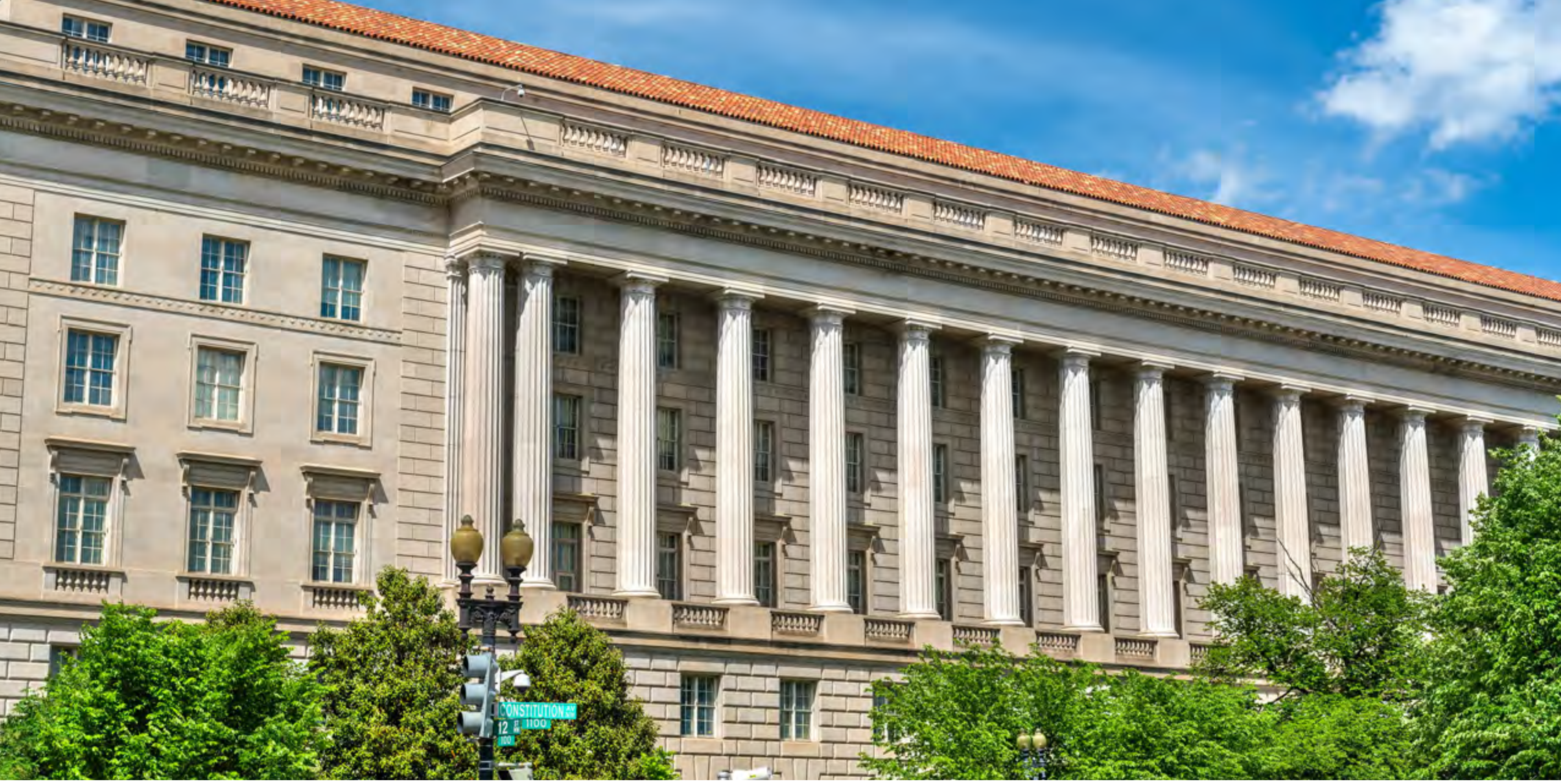


Alternative IRA Investments And The IRS

Michael Kitces, CFP®, MSFS, MTAX, CLU®, ChFC®, RHU®, REBC®, CASL®
Director of Wealth Management

To fulfill their intended purpose in supporting saving for retirement, Congress grants the Individual Retirement Account (IRA) certain tax preferences, from tax-deductible contributions (as in the case of traditional IRAs) to tax-free growth (for a Roth IRA). But to curtail potential tax abuse, the Internal Revenue Code also limits the range of permissible investments in an IRA, and explicitly bans life insurance contracts and collectibles (and under separate rules, S corporations cannot be owned in an IRA, either).

Furthermore, because an IRA is intended to be treated as a separate retirement account from the other assets of the IRA owner, the Internal Revenue Code also contains a series of "prohibited transaction" rules intended to prevent the IRA owner from using the account to enrich themselves or their family members (without actually taking a taxable withdrawal).

Fortunately, in the past the IRS has been fairly lax in pursuing and attempting to enforce against IRA prohibited transactions. But with the rise of self-directed IRAs buying real estate over the past decade, and more generally the popularity of using self-directed IRAs for alternative investments—which a recent GAO study estimates is now a $50B marketplace—there is a growing risk that the IRS will increase its enforcement on IRA prohibited transactions. That means it's crucial for IRA owners to take a look at how they're using their IRA, especially for accounts that are not simply invested in traditional publicly traded securities!

Permitted Investments For IRA Accounts

To ensure that retirement accounts are used appropriately for actual saving and long-term investing, though, the tax code places some limits on the types of investments that can be held inside of an IRA. Thus, while most types of traditional (i.e., publicly traded) investments are permissible—like stocks and bonds, or mutual funds—tax code explicitly prohibits IRA assets from being invested into life insurance contracts, and any form of collectibles (including artwork, rugs, antiques, gems, stamps, and coins, but not including certain gold, silver, or platinum coins or bullion).

However, the reality is that there's still a wide space of potential alternative investments that lie between the extremes of permitted traditional stocks and bonds (or funds that hold them), and impermissible life insurance and collectibles (and S corporations). Other types of investments that might be held in an IRA, but aren't traditional publicly traded securities, include limited partnership investments, stock in a small (privately-held) business, or even a direct investment in real estate.

Yet while those investments aren't specifically prohibited from being owned in an IRA, additional complexities arise, because of the limitations that exist between IRA owners and their individual retirement accounts.

The additional complications derive from the fact that an IRA is technically a separate entity from its owner, who will ultimately use and benefit from the money. And as a result, the tax code requires that the assets of the two remain separate, and not be used in a manner where one indirectly enriches the other—also known as a "prohibited transaction."

Tax Consequences And Penalties For A Self-Directed IRA Prohibited Transaction

For those IRA owners (or other disqualified persons) who do engage in a prohibited transaction with an IRA, the tax consequences are severe.

The 'standard' rule is that if a prohibited transaction occurs, there is a penalty tax of 15% of the amount involved in the transaction, imposed on any disqualified person engaged in the prohibited transaction. And if the prohibited transaction isn't promptly unwound/corrected within the current tax year, the penalty tax is increased to 100%(!) of the transaction amount.

In the case of IRAs, the consequences of a prohibited transaction are slightly different, but similarly harsh. When an IRA engages in a prohibited transaction, the entire account is disqualified, which means it loses its tax-deferred status, and is treated as though it was fully liquidated in a taxable distribution at the beginning of that year!

Common Prohibited Transactions With Self-Directed IRAs

Fortunately, the reality is that prohibited transactions with IRAs are quite rare, due to the simple fact that the overwhelming majority of IRA assets are invested into traditional publicly traded securities, which doesn't raise prohibited transaction concerns in the first place. However, beyond traditional investments, prohibited transactions can sneak in surprisingly easily, especially when it comes to directly owning real estate in an IRA. For instance, if an IRA owner invests directly into a 'fixer upper', and then does repair work to it (e.g., fixing up the property), a prohibited transaction has occurred, because the IRA owner rendered services to/for an asset of the IRA. (Instead, the IRA itself needs to hire someone else to repair or otherwise provide services to the property. And the IRA itself must pay for those services out of the IRA's own cash, as the IRA owner paying for services on behalf of the IRA asset would again be a prohibited transaction, or at least deemed a contribution.)

Other common prohibited transactions with direct real estate in an IRA involve renting out the real estate to the IRA owner or other members of his/her family (who are also disqualified persons), allowing family to stay for free in the real estate, or hiring family members to work on/in the real estate property. And of course, trying to transfer existing real estate the IRA owner already owns into the IRA would be prohibited (because even an arms' length fair-market-value sale of the real estate from the IRA owner to the IRA is still a prohibited transaction, as the IRA owner is still a disqualified person).

The Rising Scrutiny Of IRA Prohibited Transactions

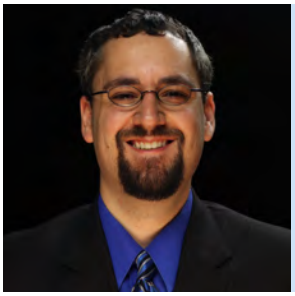
The reality is that the prohibited transaction rules for IRAs have existed as long as IRAs themselves. And for most of their history, they were largely ignored, because they were largely irrelevant. After all, in a world where most IRA custodians were investing in 'traditional' publicly traded investment securities, it was nearly impossible to create a prohibited transaction.

However, with the rise of new 'self-directed IRA custodian' platforms like Pensco, Equity Trust, and Entrust Group, there are more options for investors to pursue 'non-traditional' alternative investments in retirement accounts. Yet the rise of these types of self-directed retirement accounts has caused concern for the IRS. With good reason—there are now nearly half a million accounts with $50B of collective value being invested in 'unconventional' assets in IRAs.

And the lack of consumer education on the issue is concerning, given that avoiding 'mistakes' in an IRA that could cause a prohibited transaction is still the responsibility of the account owner. In fact, the GAO expresses concern that some types of alternative investments are sold into self-directed IRAs in a manner that enriches the salesperson or promoter if the deal closes, but disowns any liability if the investment turns out to be a prohibited transaction! Because in situations where the self-directed IRA provider offers 'checkbook control', it's ultimately still up to the IRA owner to determine that each and every check is compliant with the prohibited transaction rules.

In other words, ignorance is no excuse when it comes to prohibited transactions in IRAs, which means it's time to be more cognizant of the risks of prohibited transactions, and the situations that can trigger them.

If you have questions about the investments in your IRA, speak with your qualified Wealth Manager, and they can guide you through the rules.



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How To Care For Your Aging Parents

Josh Rivers, CFP®
Wealth Manager

Over forty million families are acting as primary caregivers for their aging parents. This generation of adults in their 40's and 50's is called the "sandwich generation" because they are caring for their children and their aging parents at the same time. The number of family care givers will continue to rise as our aging population grows (there will be approximately 84 million people over age 65 by the year 2050). So how do you prepare for the likelihood of caring for your parents?

You must be proactive and have a plan.

Where Will They Live?

Historically both gender and age have played a part in deciding who takes care of your parents when they need to be cared for. Instead of this antiquated way of thinking, siblings should consider who is the best fit in terms of time, location, and finances. Before the family is in crisis mode, you should sit down as a group and talk about who and how you will care for your parents. Ideally you would want to have this discussion when your parents are in their late 60's or early 70's and are still mentally and physically capable. Talk about the financial and geographical issues and who has the time to help. Perhaps as important, find out how your parents feel about their long-term care. For example, do they want to stay in their home, move in with one of the siblings, or go to a facility when the need arises?

Who Will Pay For It?

Caring for aging parents can be very expensive. If your parents have purchased long term care insurance, that can greatly defer the costs of the necessary care; unfortunately, most Americans do not have long term care coverage. If your parents do not have that kind of coverage, you'll need to have an understanding of their finances and what resources are available to pay for their care. Check what assets they have to provide for their care and what each sibling could potentially contribute. Talk to your advisor about your situation —you may be able to claim your parents as dependents if you are paying for more than half of their daily care.

Can Medicaid Help?

If financial resources are scarce from both your siblings and parents, you will want to make sure you understand the benefits Medicaid can provide. Many assume incorrectly that Medicare will pay for long term care. It does not. Medicaid finances 40% of nursing home spending nationwide and is administered by the states; it will cover care at home, in the community, or in a facility. Most Medicaid long term care services assist those who struggle with activities of daily living (e.g., bathing, dressing, using the toilet, eating). While having too much income or assets can disqualify you from receiving benefits, most states will allow you to spend down your excess income on care. Families should look to see what the income and asset limits are for their specific state.

One great web tool for information on state Medicaid rules is **www.familyassets.com**. Also, have a look at **www.agingcare.com** for another great family resource. This website can help you identify local programs that provide information and services for older adults.

Caring for aging parents can be very stressful. Plan ahead by having the discussion with your parents and siblings before a crisis arises. Know what assets are available to care for your parents or if they have long term care insurance which can defray some of the cost. Research Medicaid eligibility and local options for care if assets are scarce. Walking through this with your parents may be hard, but it can also be one of the greatest gifts you can give to the person who cared for you when you needed it the most.

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Alice In Financeland

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Partner
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My client, Alice, came in for her semi-annual review meeting recently and said (as many clients do), "I don't like paying taxes."

Good news: You only pay taxes when you've made money. But that does not mean you should not try to minimize your taxes as much as possible. In Alice's case, she was transitioning into retirement from a long career in the tech industry, and the retirement transition planning would cover a wide range of issues. We had already figured out that she had enough money. Over time we would need to deal with how to do the actual retirement transition, the timing of claiming Social Security benefits, analyzing pension options, and how to replace her paycheck and sustain her retirement spending. And we'd do all of this while balancing her desire to help her two daughters now and leave a legacy for them when she was gone.

In that day's meeting, however, we focused on the exciting world of the tax efficient liquidation of her investment portfolio. (As she said, "I don't like paying taxes.") Our primary focus was on coordinating the liquidation of the retirement accounts (e.g., IRAs, 401ks, and Roth IRAs) and her taxable brokerage account.

The rule of thumb is that taxable investment accounts should be liquidated first allowing tax-deferred accounts to continue to grow. It makes sense, since otherwise you would be drawing on the IRA first, forcing you to pay income taxes earlier than you otherwise would. Then you would start drawing on your brokerage account, but that would not have grown as quickly because of the annual drag of taxation on interest, dividends, and capital gains. If the retiree draws from the brokerage account first, then they are not paying any additional taxes early, so the portfolio can maintain spending for a lot longer.

You only pay taxes when you've made money. But that does *not* mean you should not try to minimize your taxes as much as possible.

Rules of thumb often provide simple, easy to follow methods that generally work. They do *not*, however, necessarily offer the most effective approach. It is one thing to delay paying taxes, but it is quite another to simply pay less in taxes (near and dear to Alice's heart). By taking the blended approach of drawing from the IRA when you are in lower tax brackets, coordinated with the draws from the brokerage account to avoid adding too much income and ending up in a higher tax bracket, the portfolio can last even longer.

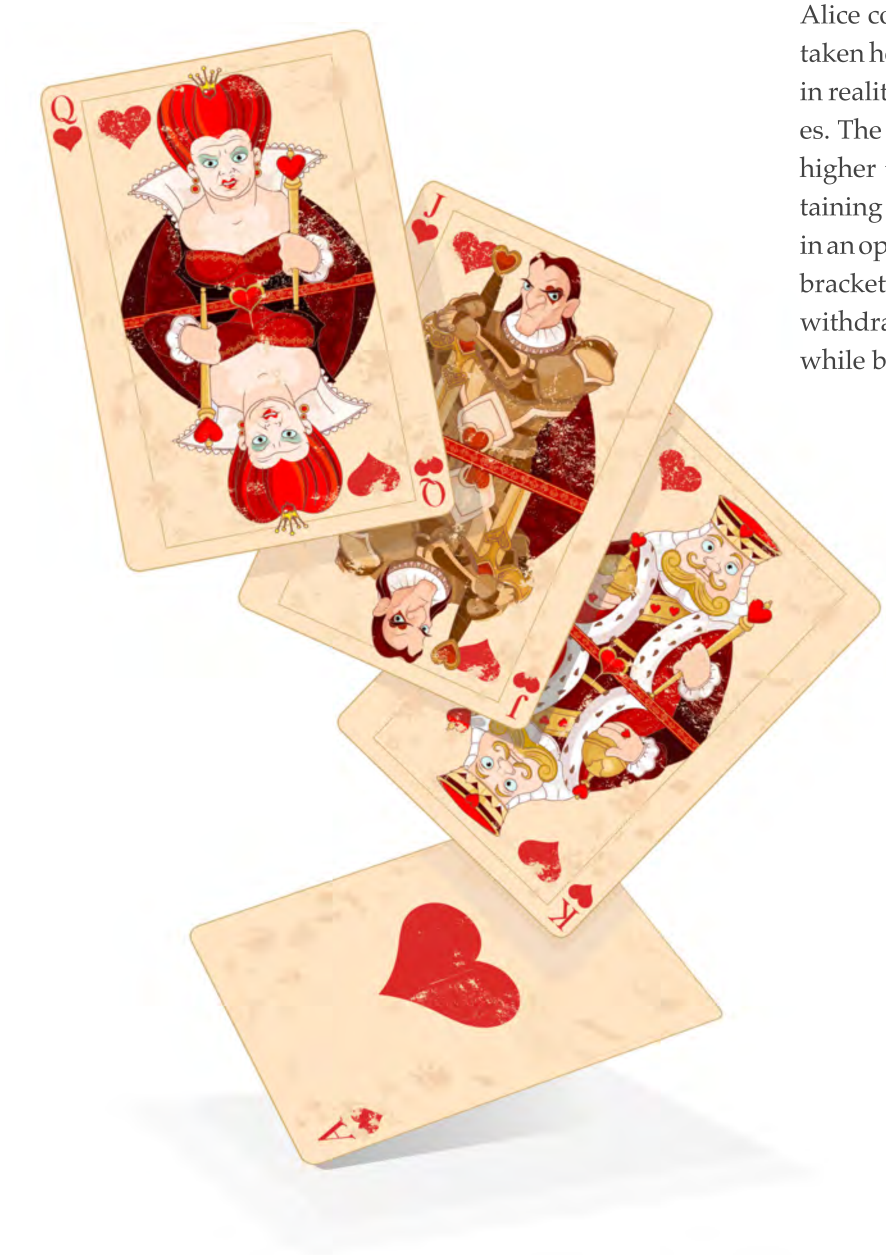
In addition, when many people with large IRAs turn age 70.5, they are forced to draw from them, suddenly moving them into a higher tax bracket. By reducing the IRA amount at earlier ages, you potentially lower the tax bracket you will be in at age 70.5 and beyond.

This coordinated strategy still means that you are depleting a tax-deferred asset, so an even better option might be to convert IRA dollars when you are in a low tax bracket to a Roth IRA. This couples the potentially lower tax brackets pre and post age 70.5 with tax-free growth on the new Roth IRA dollars.

Since Alice was a good saver who lived within her means, she was happily retiring early at age 60. This gave her at least 10 years to control her tax brackets and implement these strategies. But it is important to note that this is an annual process of managing tax brackets.

First of all, what tax bracket is "low" is dependent on one's overall wealth and income. For some, they can target always trying to just fill up the current 12% bracket and try to avoid ever being in the 22% bracket. With Alice's good fortune of having one of the few remaining private pensions, she would always be in at least the 22% bracket, so avoiding the 24% (and certainly the 32%) brackets becomes ideal.

In addition, taking more income in a given year can have consequences on other income—especially in the lowest tax brackets where otherwise non-taxable long-term capital gains can suddenly become taxable at 15%; or Social Security that would not have been taxed suddenly is. Alternatively, years with very high medical costs or business losses could create opportunities in very low tax brackets. It is *critical* to truly understand the tax rate on the dollars you convert or draw from the IRA to properly implement these strategies.



Alice could have followed the rule of thumb and just taken her income from her brokerage account first, but in reality you can actually be *too* good at deferring taxes. The IRA can grow so large that it pushes you into higher tax brackets. Instead, she is focused on maintaining the tax advantages of her retirement accounts in an optimal approach of filling her lowest possible tax brackets early on, balancing taxable brokerage account withdrawals with annual partial Roth conversions, while being mindful of ancillary tax impacts.

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In the second quarter volatility waned and performance decoupled as divergent backdrops created variances in returns for assets classes and markets across the globe. The winning trades for the second quarter were in the U.S. energy sector, U.S. small companies, and a select group of technology and consumer discretionary stocks. Energy thrived on a rising oil price, small companies on avoiding international earnings exposure, and technology / discretionary on the back of their perceived growth and safety prospects. While U.S. stocks rebounded throughout the quarter, international markets declined, and emerging market stocks were severely punished on the back of a soggier global growth backdrop combined with higher U.S. rates and a stronger dollar. Commodities were a mixed bag, with the energy complex posting big positive returns resulting from favorable supply fundamentals, while the metals and agriculture sectors appeared to succumb to a stronger dollar and other micro fundamental concerns. In fixed income, bonds were volatile but range bound, and very short-term maturities saw moderate returns on the back of continued tightening by the Federal Reserve.

Looking forward investors are challenged with deciding whether these divergent trends will persist, or whether markets are set to recouple as policy burdens build across the globe.

U.S. Tug of War & Rising Global Pressures

Currently major U.S. stock indexes appear to be trapped in a trading range defined by the January 26th high and the February 8th low, while international indexes have recently slipped to new lows on the year. The U.S. has been a relative source of market strength this year and continues to enjoy the residual fruits of the prior tax cuts that are flowing through the economy. But outside the U.S., the overall message of the markets seems to be that a variety of forces are percolating that may act to keep a ceiling on equity valuations for the time being. The combination of cooling global growth, monetary tightening, an increasing risk of a trade policy error, and a challenging seasonal backdrop all appear to be conspiring to prevent stocks from making new highs in the short-term. This has created an environment akin to a tug of war in the U.S., but risks seem to be building and may keep world markets under pressure over the next quarter or so.

2018 Surprise: Less Synchronized Growth

One of the surprises of 2018 has been the downshift in the synchronized global growth story. The simultaneous expansion in global economic growth and earnings was a major driver that helped propel global stock prices higher in 2017. Coming into 2018, that story looked promising to continue, but instead the global economy has run into a soft patch. The U.S. economy got off to a sluggish start in the first quarter, but most signs pointed to a strong acceleration in the second quarter. However, most global economies have experienced recent setbacks, and there doesn't appear to be any catalysts on the horizon to give them a fresh boost in the near term.

China is the second largest economy in the world and has been slowing, but policymakers there have been taking it in stride, so it's probably too early to expect a 2015/2016 style fiscal intervention that would pump up growth again. European and Japanese growth rates have also been weaker, with recent headwinds caused by their leverage to overall global growth rates, escalating trade tensions, and the upcoming tapering of bond purchases by European monetary authorities.

While the developed world seems soggy, it's the emerging economies that are coming under considerable pressure. The combination of rising U.S. interest rates and an unexpected rebound in the U.S. dollar has led to a tightening of financial conditions and exposed underlying weakness in some of the more fragile developing economies. Stock prices have come under fire, and the currency markets are experiencing some notable volatility, which may be a warning signal that some of the weak links in developing markets are starting to crack. The bottom line is that global growth looks weaker than it did coming into the year, and despite the U.S. doing its best to pull the rest of the world along, it may not be able to do so without some sort of positive catalyst coming to the fore.

U.S. Fundamentals Currently Strong

In a world where global growth has softened, the U.S. continues to look fundamentally solid, and we agree with consensus expectations for a material second quarter bounce back in GDP growth after a somewhat tepid first quarter performance. Presently, both consumer and business confidence is high, the labor markets are robust, leading indicators are still pointing up, and fiscal stimulus is still exerting upward pressure on the U.S. economy. Overall, the odds of a recession still seem very low over coming quarters in the absence of a major shock from something like a spike in oil prices or a full-blown trade war. Earnings have also been rising in tandem with the economy, and small business confidence has remained elevated, providing a solid backdrop that should give businesses the wherewithal to invest more and help keep the expansion going. Though the U.S. is likely in the late phase of the expansion, so far the economy has reaped the fruits of a healthy labor market and higher incomes, along with inflationary pressures that have been developing at a slow enough pace to keep the positives outweighing the negatives.

Risks To U.S. Rising

When it comes to the economy, stocks are currently caught in a bit of a pickle. One risk is that the U.S. is beginning to overheat as late cycle tax cuts collide with a tight labor market where demand appears to be outstripping supply. The risk is that eventually the tightness in the labor market will stoke a material rise in wages. Higher wages are good for consumers' wallets, but if they accelerate too fast they become an inflationary input that crimps corporate earnings and puts pressure on interest rates. From this perspective, good economic news can actually be bad news for financial assets like stocks and bonds. So far wages have been rising very slowly, which has allowed the Federal Reserve to move methodically in raising rates, but if this dynamic changes it would likely be a game changer that lures the Fed into a more aggressive approach that eventually chokes off growth.

Another more deflationary risk is that the U.S. may be headed towards an economic disappointment in coming quarters due to several factors that appear to be materializing at the same time. The Fed is tightening monetary policy at the same time the world appears to be slowing, and financial conditions are starting to tighten in the U.S. due to the mix of higher rates, a stronger dollar, and increasing oil prices. The tax cuts should continue to give the economy upward inertia for a few more quarters, but the boost will gradually fade, leaving the economy to deal with several headwinds that may start to dampen the recent forward momentum. The risks outlined above are also being compounded by the all-important wildcard coming out of Washington in the form of trade policy.

Elephant in the Room: Trade Policy Risk

Last quarter we wrote that the most significant risk to equities was a potential trade-related policy misstep coming out of Washington. We've been monitoring this risk closely for the last quarter and have not been encouraged by the tone coming out of the White House. The optimists on trade frictions still believe that President Trump is either posturing for the best possible revised agreement, or that he will only push things so far if financial markets begin to riot, since he hasn't been shy about using stock market gains as a barometer for success. We are not so sure if either choice will have a positive impact. The idea that the U.S. has been disadvantaged in our trade relationships seems to be a core belief of this administration, and as a result, they appear determined to pursue significant changes to long-standing trade agreements.

There are a multitude of reasons to believe the risk of a trade war is growing. First and foremost is the fact that the president and his team believe that making material changes to trade is the right thing to do, and that a trade war will be easy to win because we have such a significant trade deficit. This may be a miscalculation in the eyes of many economists, but the administration seems to staunchly believe in the premise, which is important when trying to discount future decision making. The president has assembled a team around him that will be tough on trade, and this is one area of policy that he has unilateral authority to change without the approval of Congress. To make matters thornier, the president's approval ratings have been rising recently, so he will likely believe his recent actions on trade to be winning support going into the mid-term elections this fall. Why change strategy when things appear to be working?

The current math on trade frictions may seem harmless at first blush, but a closer look at the numbers shows that this protectionist behavior could be a material headwind to the global economy. While some estimates of the first $250 billion in tariffs on China may only cost the U.S. less than half of a percentage point in GDP growth, the real trouble will likely be felt in the secondary effects of tariffs on supply chains across the globe. This is because many goods exported through China are made in other Asian countries and sold to China before making their way to the U.S. The result is that a material reduction in Chinese exports turns into a problem for not only China, but also those countries that start the chain of production. One eye popping stat from research firm Cornerstone Macro shows that

China plus other key Asian supply chain countries make up approximately 20% of global growth. The administration seems very focused on changing the trade relationship with China, and if they keep pushing then a large chunk of global GDP could be at risk.

Outside of China, the White House seems ready to pick a fight with any country, including some of our allies like Canada and the European Union. Recently, auto tariffs seem to be under serious consideration, and there is a non-trivial risk to pulling the plug on the North American Free Trade Agreement and possibly even our membership in the World Trade Organization. The bottom line is that trade risks are escalating and will likely weigh on markets globally until there is enough political or market pressure to get the U.S., China, and other countries to pull back from these ill-advised policies. This may eventually happen, but right now it seems like it may take some pain before policymakers reverse course, particularly from the U.S. side.

Building Some Defense

We are beginning to lower portfolio volatility profiles due to what appears to be a poor risk/reward scenario that may be developing over the next quarter or so. We will be de-risking in an incremental fashion and looking to use upside volatility as an opportunity to get more defensive on the rise. From a high level, portfolios will generally own less in equities, with less international and cyclical exposure than in recent quarters. In U.S. and international sectors, we plan to rotate into more defensive sectors of the equity market that should be less volatile than the overall market, should volatility begin to rise. In fixed income we are also building back into high-quality treasury bonds as a defense against the faltering of global growth and the risk of a trade war causing a deflationary shock. We continue to hold some gold as a hedge as well, but prefer to own a variety of hedges in case the dollar keeps rising and continues to weigh on the precious metal. We'll also continue to own more cash-like securities than the benchmark. In an environment where short-term rates are rising and there are seemingly risks to any asset class, cash just might be king for a little while.

Conclusion

As we start the third quarter, we believe there are a variety of risks building in markets that have tilted the risk/reward balance into a place where global equity volatility may be poised to increase in coming quarters. We don't currently see the signs of an increased risk of a recession in the U.S., which should limit potential downside (though the trade frictions in progress could potentially turn into a game changer if policymakers continue to turn up the heat and trade frictions turn into a full-blown trade war).

While we are pulling back towards neutral volatility levels on a tactical basis, we are also keeping an open mind for what develops from here. If volatility forces policymakers into a better place while the evidence stays firm, it may provide an opportunity to increase exposure at better prices. On the other hand, if evidence deteriorates or policy keeps getting worse, it might compel us to start defending more aggressively against the possibility of a cyclical bear market. The last few years have been great for growing investor wealth, but we may be drawing closer to a time where we need to focus on preserving principal. This is a time to be more cautious, but also to remain flexible to react to what unfolds over coming quarters.

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