Jim Williams

Super-Size My IRA equals Bad Tax Planning?

IRA accounts and tax-deferred retirement in general are an integral part of the retirement planning toolbox. They provide incentives for saving and disincentives for taking the money out early. Most of these accounts provide some protection from creditors and in certain instances can be quite impactful in planned giving.

I recently reviewed a professional outline for a presentation about tax deferred accounts that shows the dollar difference between growing the same amounts in a taxable account and in a tax deferred account. The clear and unambiguous statement was that because tax deferred account was a significantly greater dollar amount than the after tax alternative, it was therefore the better deal. That is an incomplete picture. In all but the rarest of cases, the benefit of the tax deferred account is not the entire dollar difference between the two. When looking at a balance in a tax-deferred account, we ought to always picture the tax lien attached to the account. That is, the account is only partly yours. Part of it “belongs” to the Treasury. The size of the portion that belongs to the Treasury depends on your personal tax rate when you withdraw the funds. If the tax lien is greater than the dollar difference between the two illustrations, the tax deferral is a detriment.

It is not always well understood that the tax-deferral benefits of retirement accounts are entirely dependent on the change in tax rates between when the money created a deduction going in, and when the money is taxed coming out. So, if the tax rates stay the same between the contribution and distribution phases, the tax benefit of the deferral is zero. Let me say that another way. The only way tax deferral in a qualified retirement account or IRA yields a benefit is if the owner’s tax rate is less upon withdrawal than it was in contribution. (Note: for the record, that a Roth account generally works just the opposite, and has other benefits and attributes.)

There is now a proposal to limit retirement accounts to about $3.4 million. My first reaction to this bit of news was quite negative. But then I started thinking about it and I realized that this is just a way of helping us do better financial planning. Yes, really. Read on.

The elements seem to be that the proposal would:

- Limit retirement plan account accumulations to “the amount necessary to fund a retirement income of $205,000”,
- The $205,000 amount would be indexed for inflation,
- The calculation depends heavily on the prevailing interest rates underlying the market for annuities
    - The current low interest rates make the cap calculate out to about $3.4MM
    - Higher interest rates (where else can they go?) will reduce the cap significantly
- It is unclear from the proposal how the cap would be implemented or enforced.

It has been widely reported that Presidential Candidate Mitt Romney, has or had an IRA with $100 million. That fact has frequently been connected with the notion of limiting how much can be in an IRA. Let’s take a look.

Remember, the tax deferral game is beneficial only when the tax rate arbitrage works the right way. That is, if the tax rate for the account holder is higher when the money goes in and lower when it comes out, the tax deferral is a good deal. If the rates go the other way, it’s a loser. If tax rates stay the same, it is a push. For a very large IRA, the required minimum distribution (RMD), starting at age 70½ will push the owner into the top bracket and either eliminate the tax deferral benefit or even turn it to a detriment. Using the standard tables, the RMD for age 71 is 3.77% of the balance at the beginning of the year. So the age 71 RMD on the $100 million account would be $3.77 million, way into the top rates. It seems like that would be great for the government.

Now at a more pedestrian asset level, for married taxpayers, the top rate starts at $225,000. $225,000 is 3.77% of about $5.9 million. So any married person (or couple) with combined IRAs more than about $6 million will probably be suffering a negative arbitrage and will certainly be receiving very little benefit from deferral. The proposed cap is even better planning. The $3.4 million cap amount, at age 71 will produce a RMD of about $113,000. For a married IRA holder, that number alone will leave most of the income in the 28% bracket.

This leads me to believe that the people proposing the $3.4MM cap on retirement accounts want to make sure that IRA owners don't pay taxes at rates higher than about the 28% level. This will encourage savers to grow their assets outside the IRA rather than inside.

For the final irony, consider that retirement accounts convert capital gains into ordinary income. The assets that Governor Romney put in his IRA were surely capital assets that appreciated and would have gotten capital gains treatment had they not been in an IRA. Those assets now will be taxed at the ordinary income rates. The top Capital Gains rate is now 20% plus state. The top marginal rate for ordinary income is now 39.6% plus state. That differential is 19.6%. On $100 million, the IRA owner is out (and the Treasury will benefit) almost $20 million in taxes.

I think that limiting the size of IRA accounts, however it is done, and for whatever reasons, is bad public policy and bad tax policy. I also think that accumulating huge gains in an IRA account is most likely bad tax planning.

Ownership change

Over the past 5 years, Matt Elliott has made himself integral to the operation of this firm and integral to the relationships we have with our clients. This month Matt became a part owner in the firm. Welcome aboard Matt.

We appreciate your referrals

The table below shows the returns through March 31, 2013 for selected investment asset classes. In most cases, the results below are appropriate benchmarks for the related mutual funds in your investment portfolio.

Asset Class	Data Series	YTD	3 Yrs.	5 Yrs.
Ultrashort Bonds	BofA Merrill Lynch Three-Month US Treasury Bill Index	0.02	0.11	0.34
Short Term Municipal Bonds	Barclays Capital Municipal Bond Index 3 Years	0.56	2.46	3.33
Short Term Government Bonds	Barclays Capital Treasury Bond Index 1-5 Years	0.16	2.40	2.63
Short Term Corporate Bonds	BofA Merrill Lynch 1-5 Year US Corporate and Government Index	0.30	2.92	3.33
Short Term Global Bonds	Citigroup World Government Bond Index 1-3 Years (hedged)	0.22	1.26	2.03
Intermediate Term Municipal Bonds	Barclays Capital Municipal Bond Index 7 Years	0.46	6.01	6.01
Intermediate Government Bonds	Barclays Capital US Government Bond Index Intermediate	0.14	3.91	3.70
Intermediate Corporate Bonds	Barclays Capital Credit Bond Index Intermediate	0.47	6.41	6.54
Intermediate Global Bonds	Citigroup World Government Bond Index 1-5 Years (hedged)	0.24	1.96	2.66
US Marketwide Core 1 & 2	Russell 3000 Index	11.07	12.97	6.32
US Marketwide Vector	Russell 2500 Index	12.85	14.59	9.02
US Large Cap Market	S&P 500 Index	10.61	12.67	5.81
US Large Cap Value	Russell 1000 Value Index	12.31	12.74	4.85
US Small Cap Market	S&P Small Cap 600 Index	11.81	15.18	9.19
US Small Cap Value	Russell 2000 Value Index	11.63	12.12	7.29
Real Estate Investment Trusts	Dow Jones US Select REIT Index	7.04	16.94	6.07
International Marketwide Core & Vector International Large Cap Market	MSCI World ex USA Index (net div.)	4.70	4.78	-0.75
International Large Cap Value	MSCI World ex USA Value Index (net div.)	3.13	3.57	-1.16
International Small Cap Market International Small Cap Value	MSCI World ex USA Small Cap Index (net div.)	7.24	7.80	2.05
Emerging Markets	MSCI Emerging Markets Index (net div.)	-1.62	3.27	1.09

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