

A Consideration for Retirement Planning
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When people approach their retirement years, they're frequently bombarded with competing recommendations: Buy an annuity vs. don't buy an annuity. Invest here. Invest there. Save, don't invest. And so forth. Far too often, these suggestions are offered by "financial advisors" who are, in fact, little more than sales persons for a particular line of products. So what's the truth?

No company, product or industry is right for everyone and
No company, product or industry is right for anyone's every dollar.

Beyond that, everything depends on individual circumstances, but there are some guidelines.

1. Everyone wants three things from every financial account: Growth, Safety, and Liquidity. And to maximize two of those three, a third must be traded off – if at least by a bit. This means there are three pairings by objective: Growth plus Liquidity. Safety plus Growth. Liquidity plus Safety. Genuine diversification is better accomplished by a focus on these objective pairings; not products.
2. Income taxes matter and particularly when taxable income causes increased tax liability on Social Security. Accordingly, financial account considerations should include how taxable they are to you and then how taxable they are to your heirs.
3. Financial accounts can be categorized as belonging to one of three "buckets"
 - A. Qualified (pre-tax dollar) accounts – IRA, 401(k), 403(b), 457. etc. – which must be liquidated starting at age 70½ according to a table of Required Minimum Distributions (RMDs).
 - B. Non-qualified, meaning Non-IRA (401(k), or similar). These are accounts that are funded with after-tax dollars and have no IRS restrictions or mandates on withdrawals.
 - C. Roth IRA Money. These are accounts funded with after-tax dollars and are permitted to grow and be received tax-free (if taken after 59½ and held at least 5 years).

How each bucket is taxed to you and then to your heirs is different. An understanding of those differences sets the stage for what category of account or investment is ideally suitable.

	IRA	Non-IRA	Roth IRA
YOU	100% Taxed as Ordinary Income RMD mandated	Annuity: Gains Taxed as ordinary income	Non-Annuity: Gains Taxed LTCG
HEIRS	100% Taxed as Ordinary Income RMD mandated	Annuity: Gains Taxed as ordinary income RDM mandated	0 Tax RMD mandated

IRA Money is always taxed as Ordinary Income, whether to you or your heirs. There is no step-up in basis at death, no Long-Term Capital Gain (LTCG) and you cannot deduct losses if there is a market correction. The money must be withdrawn by the owner starting at the Required Beginning Age (usually 70½) and must be withdrawn by heirs (other than a spouse younger than 70½) starting the year after death, regardless of how young that beneficiary is. It doesn't matter if the IRA is in an Annuity or not.

Non-IRA Money when held in an Annuity has no distribution requirement to the account owner or spouse, but does have a liquidation mandate when inherited by a non-spouse. Gains are tax-deferred until taken but then are taxed as Ordinary Income to the account owner or any beneficiary, whether or not a spouse. Market losses cannot be deducted.

Non-IRA Money NOT held in an Annuity has no distribution requirement to anyone. Dividends, Interest and Short-term Gains are reported as taxable events in the year generated, whether taken or not, including reinvested. Long-term growth (366 days or more) is not taxed until taken and then is taxed at the more favorable Long-Term Capital Gain rate. When inherited, Non-IRA/Non-Annuity money receives a step-up in basis, meaning the "after-tax" principal portion is equal to the entire account value as of the date of death. "Realized" market losses (meaning when the account is liquidated) are tax-deductible as capital losses, either as short-term or long-term depending on the time held.

Roth IRA Money is tax-exempt to both the owner and beneficiaries. It doesn't matter if the money is held in an Annuity or not. There is no distribution requirement to the Roth owner or owner's spouse (if they're a beneficiary after death). However, non-spouse beneficiaries must liquidate the Roth according to the same schedule as a Traditional IRA; the only difference is the funds are not taxed. But, from that point onward, those liquidated Roth IRA funds become Non-IRA and all future growth is taxable as Non-IRA money.

From this, we can deduce the following:

1. **IRA Money** should be used as regular income (a check every month) and, if possible, not regarded as the first source of discretionary use funds. In other words, if you need and want a monthly paycheck, use the IRA first (after 70½ you gotta anyway). Beyond income, avoid using the IRA Bucket for big ticket items such as vacations, big-ticket expenses (new roof, etc.) or other occasional needs. Doing so not only can drive up your tax rate, but also can increase the tax load on Social Security – and those purchases cost more. If, for example, the total increased tax load that results from a lump-sum withdrawal is 25%, you just (effectively) increased the cost of what you are purchasing by 25%. Put another way, suppose you need a new roof that will cost \$10,000. Taking IRA money to pay for it effectively means your new roof just cost \$12,500.

Of the Growth, Safety, and Liquidity variables, Liquidity is the least important. No matter what the account source, Required Minimum Distributions (RMDs) are always paid out and if you're retired (and not working) you can't add to the account. Therefore, the need to maximize Liquidity is not part of the equation. Conversely, the proper pairing is Growth plus Safety. An IRA in a Required Distribution schedule cannot be exposed to negative markets. The way in which RMDs are calculated makes even a single market down-turn disastrous to maintaining principal. Similarly, the schedule of RMDs starts off relatively low (3.65% or 3.77% depending on the month of your birth) and gets progressively larger each subsequent year. From age 70 through age 90, the schedule of RMDs will

reduce the account by an average of 5.7% per year meaning failure to average 5.7% per year growth will result in erosion of principal. Thus, the most ideal pairing for IRA money is Growth plus Safety.

2. **Non-IRA Money** is more favorable for inheritance than for personal discretionary use – but with a caveat. Because Non-IRA money held in a Non-Annuity is inherited with a step-up in basis, the gains are available income tax-free. Conversely, when Non-IRA money is held in an Annuity, there is no step-up so the gains are taxed as Ordinary Income plus the Annuity **MUST** be liquidated. Thus from an income tax perspective, inherited Non-IRA money held in Annuities is not as attractive as Non-Annuities. Insofar as accessing Non-IRA funds from Non-Annuity accounts is concerned, Long-Term Capital Gains are taxed at a more favorable rate but are still taxed. Conversely, gains whether short-term or long-term in an Annuity are taxed as ordinary income and mandatorily are Last In First Out (LIFO) meaning the taxable growth must be taken before the non-taxable principal. Thus taking money from an annuity for big ticket purchases can expose you to higher income taxes than if taken from a Non-Annuity.

From a Growth, Safety, and Liquidity perspective, the most suitable pairing is a bit less obvious. However, having unrestricted inbound liquidity (meaning making unlimited deposits) is an advantage. Consider the following. In retirement (you're not working), you cannot contribute to an IRA or a Roth IRA. Therefore, you can only add to a Non-IRA account. If you need all the income you generate from Social Security, Pensions, Required Distributions, etc. then this is not so important, but what if you generate more income than you need? Having a place to invest (put) that money is important. Therefore Liquidity becomes an important variable. But with Liquidity as a component, that leaves two pairings: Liquidity with Safety and Liquidity with Growth.

Liquidity with Safety – Professional Financial Planners recommend that a minimum amount of money be kept in the bank or money market accounts as cash or cash-equivalents. The recommended amount varies but is roughly between 3 and 10 months of monthly bills. This becomes the first source of short-term liquidity to cover unexpected needs, particularly big ticket expenses.

Liquidity with Growth – Once adequate short-term liquidity is secured, growing money is generally desirable. However, because there is no mandate to withdraw in any given year and the money is not being used for Required Income, then being completely risk-adverse may not be necessary.

3. **Roth IRA** – After securing short-term liquidity, Roth IRA money is ideally suited as a primary source of discretionary funds because it is never taxed, regardless of long-term or short-term exposure. Therefore (for example) purchasing a new \$10,000 roof with Roth money means the roof only cost \$10,000. It has no impact on your income tax including no impact on how much of your Social Security is taxed. Moreover, you have no government mandate to withdraw Roth IRA money at any age. This makes Roth IRA money ideal for YOU as a discretionary source. However, upon inheritance, while it's not taxable as income, there is a liquidation requirement by the same schedule as an inherited IRA. And while it is not taxable to them, from the moment the money is distributed, any growth that occurs afterward is subject to income tax, either as Long-term Gains (if by growth over more than a year) or as Ordinary Income (as Dividends, Interest or other Short-term reportable gains). Therefore, inheriting a Roth IRA vs. inheriting Non-IRA is minimally different to your heirs.

Accordingly, Roth money is most attractive as a discretionary source for YOU. This makes a Growth and Liquidity pairing more attractive.

Three Pairings, Three Industries: The financial services world consists of three industries: Securities, Insurance, and Banking. Each industry fundamentally specializes in one pairing.

Securities (stocks, bonds, mutual funds, exchange traded funds, etc.) pair Growth and Liquidity, trading off complete Safety. It's important to note that investing in Securities does not mean taking high risk. There are plenty of investment possibilities that offer relatively low risk without sacrificing reasonable growth potential. Thus, the notion that there is a direct correlation between growth and risk is false. This is why genuine financial professionals are more focused on Risk-adjusted Return (average return in relation to relative risk) than raw return. However, while it's entirely possible to reduce risk exposure without reducing return potential, it is also true that investing in Securities cannot eliminate all risk of loss. This is why every Security Investment carries (or should carry) the disclaimer "May lose value."

Insurance (specifically Uncapped Fixed Index Annuities) pairs Safety plus Growth. However, not all Annuities function in this capacity. Only Fixed Annuities truly offer Safety. Variable Annuities can reduce market risk exposure but do not eliminate it; they're Securities (see above). Many Fixed Annuities do not offer enough growth potential to warrant a "Growth" criterion – including Fixed Index Annuities that impose severe limitations on growth – especially those with caps of less than 5%.

Bank (and Credit Union) accounts pair Safety plus Liquidity provided they are not time-deposits. Note that because CDs are time deposits, you cannot prematurely withdraw penalty-free or add until maturity. Therefore, CDs do not really qualify for the Liquidity criteria. However, non-time bank deposits are the most liquid sources of money available. Because of ATMs, bank liquidity becomes greater than any account held by an institution that does not offer 24/7 access. Accordingly, the Bank is where a retiree should maintain a ready source of first cash money for short-term needs – even ahead of a Roth IRA.

SUMMARY:

Conclusion #1: IRA money is well suited for Uncapped Fixed Index Annuities. Ideal pairing: Growth plus Safety.

Conclusion #2: Non-IRA Money destined for short-term discretionary and emergency need is best suited for a Bank or Credit Union. Ideal pairing: Liquidity plus Safety.

Conclusion #3: Non-IRA Money intended for long-term accumulation and inheritance is ideally suited for Securities Investments, subject to individual risk analysis. Ideal pairing: Growth plus Liquidity.

Conclusion #4: Roth IRA Money is ideally suited for long-term discretionary use by the account owner and is appropriately positioned in Securities Investments, subject to individual risk analysis. Ideal pairing: Growth plus Liquidity.

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