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The 401(k) protection plan

An estimated $6.7 trillion is currently held in 401(k) plans. That resource will play an enormous role in the retirement security of millions of Americans over the coming years. *Accumulating* money in a 401(k) is one thing—arrange for salary reductions to fund the plan, evaluate investment choices for the money, check on progress periodically and make adjustments as needed.

Distribution of 401(k) money is another thing entirely—one that raises a host of new and, for most people, unfamiliar issues. Care must be taken to preserve that retirement resource. Here are some of the most important considerations.

To roll or not to roll

Everyone who receives a lump sum distribution from an employer's qualified retirement plan has this tax choice:

- Defer all federal income tax on the payout by rolling it over into an Individual Retirement Account.
- Declare the distribution as immediate income; pay income tax and, possibly, penalty tax; then invest the balance outside an IRA.

For those who are under age 59½, the 10% premature distribution penalty will be incentive enough, in most cases, to defer taxation.

The direct approach

The safe and sure way to avoid income and penalty tax on a lump sum distribution is to set up an IRA Rollover and have your entire lump sum moved directly—trustee to trustee—from your company retirement plan to your IRA.

The fallback alternative is to take possession of the lump sum, then deposit it into the IRA within 60 days.

However, the second choice includes a tax trap. By law you will receive only 80% of any lump sum distribution—the other 20% goes directly to the IRS as withholding tax. Then to achieve a full rollover of your lump sum distribution, you

Required Minimum Distributions

Age	Distribution years	Percentage equivalent	Age	Distribution years	Percentage equivalent
70	27.4	3.6%	86	14.1	7.1%
71	26.5	3.8%	87	13.4	7.5%
72	25.6	3.9%	88	12.7	7.9%
73	24.7	4.0%	89	12.0	8.3%
74	23.8	4.2%	90	11.4	8.8%
75	22.9	4.4%	91	10.8	9.3%
76	22.0	4.5%	92	10.2	9.8%
77	21.2	4.7%	93	9.6	10.4%
78	20.3	4.9%	94	9.1	11.0%
79	19.5	5.1%	95	8.6	11.6%
80	18.7	5.3%	96	8.1	12.3%
81	17.9	5.6%	97	7.6	13.2%
82	17.1	5.8%	98	7.1	14.1%
83	16.3	6.1%	99	6.7	14.9%
84	15.5	6.5%	100	6.3	15.9%
85	14.8	6.8%			

Source: IRS Publication 590; M.A. Co.

would have to come up with an amount from your other savings equal to the withholding, which is difficult for most taxpayers. And if you don't come up with the money, the amount sent to the IRS will be taxable income.

Investments

Your IRA investments need to be evaluated in the context of your entire portfolio, both taxable and tax-deferred elements. Although taxes are deferred in the IRA until withdrawal, all payouts are taxed as ordinary income. When stocks are held in taxable accounts, there is the potential for a favorable tax rate on long-term gains and qualified dividends.

Before factoring in all the tax nuances, focus on what's really important: your investment goals.

How much of your IRA do you hope to leave untouched for as long as possible? How much, if any, do you plan to withdraw in the next three to five years? Will you need to make withdrawals even sooner?

Once you answer these questions, you'll have a good idea of how much you can put into stocks for the long term, how much into short-to-intermediate bonds, and how much into money market funds.

Distributions

From age 59½ to 70½ funds may be withdrawn from the IRA Rollover without tax penalty; only income tax will be due. A program of regular withdrawals from the IRA Rollover must begin once you reach age 70½. The amount of the "required minimum distribution," as it is called by the IRS, is determined under IRS tables. Failure to receive a required minimum distribution from an IRA triggers a draconian 50% penalty tax on that amount.

See "Required Minimum Distributions" for the factors used to calculate how much must come out of an IRA each year. The sidebar below, "How large are IRA payouts?", provides an illustration for various rates of return.

Estate planning

If the wealth that you roll over into an IRA represents a substantial portion of your estate, new, heavy-duty estate planning may be needed. Amounts remaining in an IRA at death are subject to federal estate taxes and, in some states, state inheritance or estate taxes as well. Married couples often rely on marital trusts or QTIP trusts for the surviving spouse. (QTIP stands for Qualified Terminable Interest Property.) The services of an experienced estate planner will be needed to coordinate the terms of the IRA Rollover with any trusts designed for favorable federal estate tax treatment.

Keep us in the loop

If you will be retiring in the next few years, and if a lump sum distribution is part of that picture, it's not too soon to start rehearsing your tax strategy and reviewing your investment choices. We'll be pleased to offer our assistance with these important retirement planning issues.

We look forward to meeting with you for a more detailed discussion. ☐

How large are IRA payouts?

Required minimum distributions from an IRA won't exhaust the account before the owner lives beyond age 100, even if the account has poor investment return. Accounts that enjoy even modest returns will keep getting larger in the early years of minimum distributions. This table shows the projected size of a required minimum distribution from a $1 million IRA at various ages, for various rates of return. It also shows total distributions and the balance remaining at age 100, if only required minimum distributions are taken each year. If a 6% annual rate of return can be achieved, the account balance won't dip below $1 million until age 92.

Age	2% return	4% return	6% return	8% return
70	$36,496	$36,496	$36,496	$36,496
80	$42,255	$51,750	$63,124	$76,700
90	$42,859	$64,606	$96,587	$143,259
100	$28,394	$53,269	$98,650	$180,439
Total payments through age 100	$1,233,056	$1,624,697	$2,387,026	$3,434,869
Remaining balance at age 100	$154,067	$295,750	$560,139	$1,047,272

Source: M.A. Co.

Rates of return are for illustration only and do not represent any particular investment.

Triple record

On August 11, all three major U.S. stock market indices set record highs, something that hadn't happened since December 31, 1999. In the late 20th century, triple highs were not so rare—it happened 148 times from 1983 through 1999.

That date—December 31, 1999—may send shivers down the spine of long-time investors. That was the date for the Y2K doomsday, when the country's computers were going to have trouble with their calendars turning over the new century. In the event, there was no catastrophe for the computers—but there was for investors! Within three months the "Internet bubble" burst, and stock prices began to plummet. Over the next 18 months, the DJIA dropped 27%; the S&P 500 fell 43%; and the NASDAQ collapsed by nearly 80%. The sheer magnitude of the NASDAQ decline is what accounts for the long dry spell for triple records.

Could it happen again?

The price of stocks tells us little about whether they are fairly valued. Investors generally look to the price/earnings ratio to get a handle on that. Nobel Prize-winning economist Robert Shiller developed the Cyclically Adjusted Price/Earnings Ratio to gauge whether the market as a whole is overvalued or undervalued. He uses the current value of the S&P 500 divided by average earnings over 10 years, adjusted for inflation. Data for the period since 1955 are in the graph at right.

On the one hand, the CAPE ratio is nowhere near the stratospheric levels found before the dot-com crash. On the other hand, it is approaching the levels seen just before the 2008 financial crisis. The long-term average for the CAPE is 16, and at mid-August it stood at 27.1.

What is sustaining these high prices, if not strong corporate earnings? The second line on the graph below shows the long-term interest rates, which have been at unprecedentedly low levels. It would appear that investors are choosing to stay with stocks because the alternatives in bonds are not appealing enough.

Few observers believe that the economy is poised for recession, even though this recovery is getting long in the tooth. On the other hand, with valuations this high there isn't a whole lot of upside potential left for stock investors.

The pension angle

The Wall Street Journal reports that, historically, when the CAPE ratio reaches the current levels, the average annual stock market return over the next ten years averages about 4%. Some investors might find that satisfactory. But pension funds usually build far higher expected returns into their calculations of future obligations, typically in the range of 7% to 8%. When one considers that, since 1926, the compounded total return of the S&P 500 has been 10.1%, an assumption of an 8% annual return may seem reasonable, even conservative. In an era of very low bond rates, it is rather optimistic.

Say the portfolio is 40% bonds and 60% stocks, which is not unusual. A basket of government and corporate bonds might yield 2% today. The 60% equity portion portfolio will need a return of 10.3% to bring the whole portfolio up to a 7% return, or 12% to get to 8%. That is a tall order indeed, based upon today's stock valuations. ☐

The CAPE ratio and long-term interest rates

Source: http://www.econ.yale.edu/~shiller/data.htm

That is *not* IRS on the phone

How do con men succeed in fooling smart people? They use fear or anger in the target to interfere with the logic centers of the brain. Some psychologists refer to this as “amygdala hijacking,” an attack that utilizes the most primitive part of the brain.

For example, as you answer the phone, you notice that caller ID indicates the area code is 202 (Washington, D.C.), and the caller is the Internal Revenue Service. That’s enough to get the pulse racing for most people. The caller identifies himself as an IRS agent and gives a “badge number.” He correctly provides your Social Security Number and date of birth to confirm your identity. Therefore, he seems legitimate.

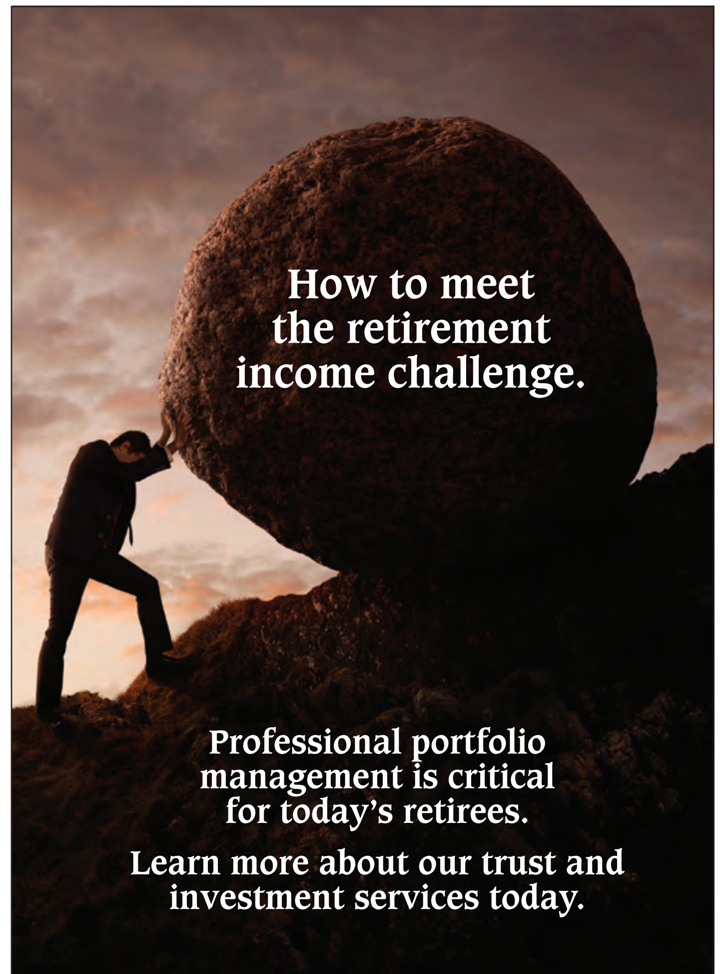
The caller then says you owe hundreds, perhaps thousands of dollars in unpaid taxes. He may threaten arrest, deportation, or property seizure if tax is not paid immediately. Sometimes he may warn that law enforcement officers are already en route to make an arrest. If you panic at this point, logic may go out the window.

You probably have heard that the IRS never initiates contact with a taxpayer by telephone or e-mail, only by paper mail, but in your panic this fact is easily forgotten.

If you ask the caller what you can do, you will get an improbable answer. You will be instructed to purchase iTunes gift cards in sufficient quantity to pay off the tax debt! After the cards are purchased, you pay the caller by providing the redemption codes that are included on each card. The caller launders the payoff by transferring the balances to an iTunes account, which then may be sold for pennies on the dollar.

You might not believe it, but this scheme is really happening today. *Tax Notes* reports that 70% to 90% of the IRS tax scams now use iTunes gift cards for payments. The publication quotes an anonymous official as saying, “As crazy as that sounds, [scammers are] doing it at a very high and successful rate.” And it’s not just IRS scams, but all manner of financial frauds that use iTunes gift cards as currency, according to the National Consumers League.

Reminder: The first contact that a taxpayer receives from the IRS is always by paper mail. The practice of a few local IRS campuses to use telephone contact to set up audits was stopped last May after complaints from tax professionals. If you get an unsolicited call from someone claiming to be from the IRS, just hang up. Don’t rely on your caller ID for verification; that system is easily spoofed. ☐



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