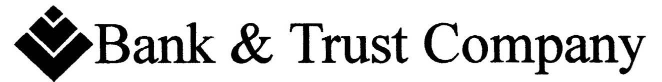
IN THIS ISSUE

Investing
"Impact investing"

Retirement planning
Is conversion to a Roth IRA right for you?
IRAs and FSCs don't mix

Money Matters



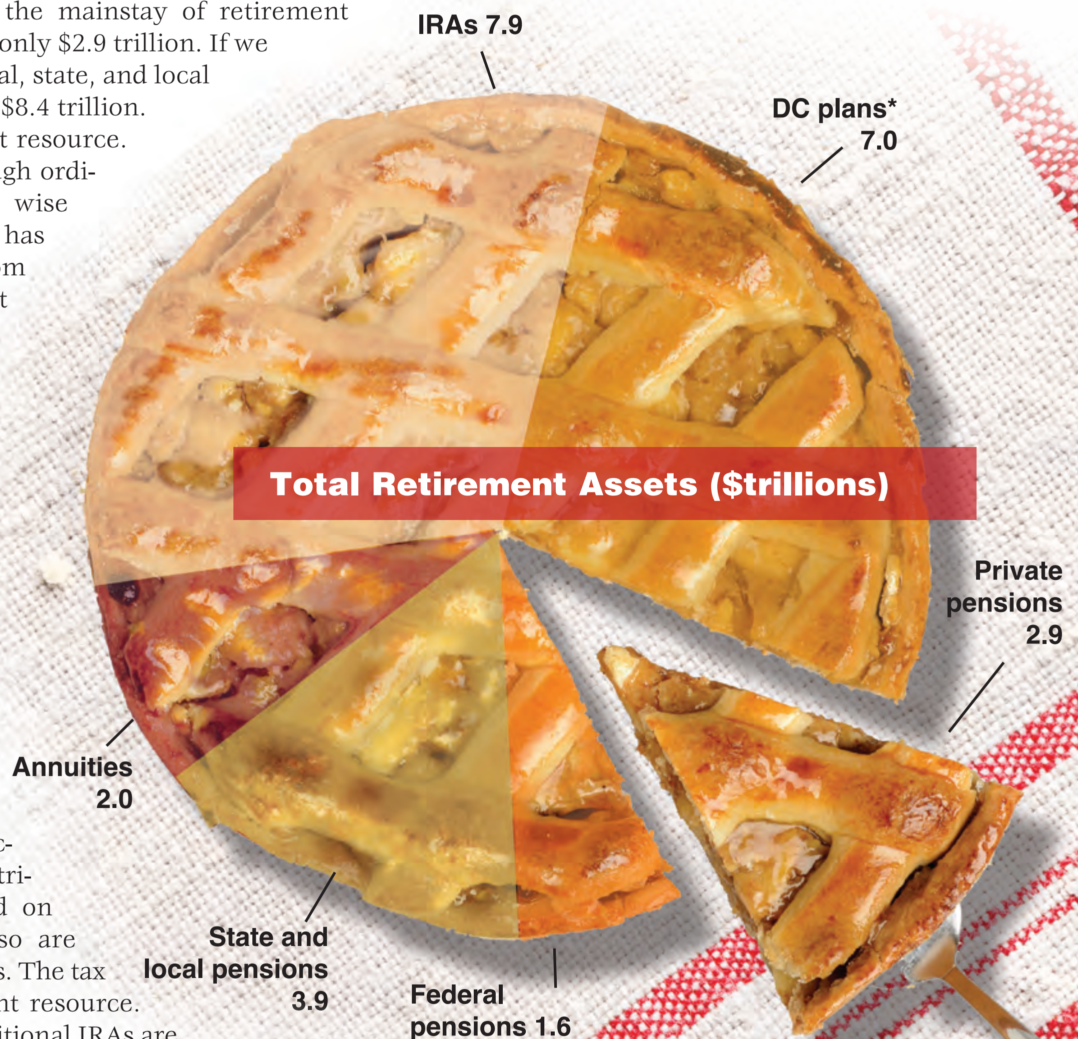
April 2018

Is conversion to a Roth IRA right for you?

Individual Retirement Accounts have been with us only since 1974, with the passage of the Employee Retirement Income Security Act (ERISA). What's more, when they began their tax-preferred existence, the IRA contribution limits were quite low, and there were severe restrictions on who could even make a contribution. Notwithstanding the slow start, IRAs have grown to be the largest piece of the retirement savings pie, at some $7.9 trillion, according to the Investment Company Institute. All defined contribution pension plans, such as 401(k) plans, 403(b) plans, and profit sharing plans stand at $7.0 trillion. (See graph below.)

Private pension plans, once the mainstay of retirement financial security, have assets of only $2.9 trillion. If we add in the pension plans of federal, state, and local governments, the total comes to $8.4 trillion.

So, IRAs are a vital retirement resource. They did not get this large through ordinary annual contributions and wise investing. The key growth driver has been rollovers of distributions from employer qualified retirement plans. An estimated 85% of new IRAs each year have rollover contributions. Rollovers may come from 401(k) plans, or they may be lump sum distributions cashing out from traditional pension plans. Employers in recent years have been encouraging retirees to choose lump sums, in part because it shifts longevity and investment risks to the participant, away from the plan sponsor.



Source: ICI 2017 Fact Book
*Defined Contribution plans include 401(k) and 403(b) plans.

Enter the Roth IRA

With a traditional IRA, tax deductions may be available for contributions, and taxes are deferred on investment earnings. Taxes also are deferred for rollover contributions. The tax benefits build a larger retirement resource. However, distributions from traditional IRAs are generally fully subject to ordinary income taxes—

including distributions of capital gains. Still, if one is in a lower tax bracket during retirement, the IRA advantage is magnified.

In 1998 Congress gave us the Roth IRA. With this account, there is no tax advantage upon funding the account. Instead, qualified distributions are fully free from income tax. Taxes on investment earnings are deferred and also may escape taxation entirely.

There are income limits on who may fund a Roth IRA. That helps to account for the fact that Roth IRAs hold less than 10% of the total IRA assets, an estimated $660 billion, compared to $6,695 billion for traditional IRAs.

In contrast to traditional IRAs, which are overwhelmingly opened with rollover contributions, some 74% new Roth IRAs are opened with ordinary annual contributions. (See the table below.)

Roth IRAs have one additional advantage over traditional IRAs. There are no required minimum distributions when reaching age 70½, or any age for that matter. If one does not need the money in the account, it may continue to build up during retirement to become an important resource for one's heirs.

Conversions

Although the income limits bar higher-income taxpayers from making Roth IRA contributions, there is a work-around. A traditional IRA may be converted to a Roth IRA, and there is no longer an income limit on this strategy.

Why the inconsistent treatment? There is a substantial tax cost to the conversion, the entire amount will be taxed at ordinary income tax rates. For the highest bracket taxpayers, this cost may be so prohibitive that Congress felt no limit was needed. A cynic might point out also that the conversion raises tax revenue in the short run, while the cost of forgone taxes on future distributions happens in the long run, outside the budget window used to evaluate the impact of tax changes on revenues.

Example. Taxpayer is in the top tax bracket, 37% for 2018. If he converts a $1 million rollover IRA to a Roth IRA, he will owe an additional $370,000 in federal income taxes. State income taxes will come into play as well, if he lives in a state that imposes income taxes.

New law

Because conversion of a traditional IRA to a Roth IRA is such a big step, Congress gave taxpayers a second look at the decision. The conversion only became final when the tax return was filed reporting the change, which could have been as late as October 15 of the year following the conversion if an extension were requested. Until then, the new Roth IRA could be "recharacterized" as a traditional IRA.

Why might someone want to back out of the conversion decision months later? One reason might be that the conversion lifted the taxpayer into a higher tax bracket than expected, so the tax cost was larger than anticipated. Another possibility is that the investments in the Roth IRA did very poorly, so that the taxpayer would be paying taxes on income that might never be realized.

In any event, this flexibility was removed by the Tax Cuts and Jobs Act of 2017. As of the first of this year, a decision to convert a traditional IRA to a Roth IRA is irrevocable. The IRS has clarified that this new rule does not apply to conversions made in 2017. Those taxpayers still have until October 15, 2018, to change their minds.

Interestingly, the Joint Committee on Taxation scored this tax change as increasing revenue by some $500 million over the next ten years. The most likely effect of eliminating flexibility will be to slow the rate of conversions to Roth IRAs, which will *reduce* federal revenue, not increase it.

What is best for you?

Conversion of a traditional IRA to a Roth IRA is a major life decision, definitely worth paying for professional advice before undertaking. The decision must be put into the context of the taxpayer's total resources and wealth management objectives. Two observations:

- The tax consequences of a conversion may be softened by doing partial conversions over time. It's not an all-or-nothing decision. The conversion might be handled at 20% per year for five years, for example. Or a larger share might be converted in a year when one's income is low, putting the transaction in a lower tax bracket.
- For greater tax efficiency, the taxes should not come from the IRA. In the case of the $1 million conversion at a 37% tax rate, if the tax payments come from the account, the Roth IRA will start with only $630,000. Better to use other savings to pay the taxes, so that the Roth IRA will have the full $1 million for creating a tax-free stream of income.

We can be of service

Helping retirees manage their retirement income is among our core services. We manage investment portfolios as well as large IRAs and Roth IRAs. Looking for lifetime financial security? Call upon our professionals soon for a consultation. ☐

New Roth IRAs Often Are Opened with Contributions;

New Traditional IRAs Often Are Opened with Rollovers

Percentage of new IRAs opened in 2014 by type of IRA

	Roth IRAs	Traditional IRAs
Contribution only	74%	11%
Conversion only	9%	0%
Rollover only	12%	85%
Combination of activities	5%	3%

Components may not add to 100 percent because of rounding.
Source: ICI 2017 Factbook

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“Impact investing”

Looking beyond risks, returns, and balance sheets

The idea that investments may have a moral dimension is not new and may be traced to the 1700s. The Quakers forbade their members to participate in the slave trade, for example. John Wesley, one of the founders of Methodism, advised avoiding investment in companies with practices that injured employee health.

In the 1990s, the idea of “socially responsible investing” took shape. The initial idea was to use negative screening to avoid companies that traded in “sin” or “vice,” such as tobacco companies, gun manufacturers, casinos, and liquor companies. Some people added oil companies to the proscribed category.

Although screening out disfavored firms may have made investors feel virtuous, it didn’t affect the fortunes of those firms in a material way. In fact, the “vice stocks” generally outperformed the market as a whole, because those companies tend to be rather profitable, paying generous dividends to their shareholders.

A less constricting version of socially responsible investing has emerged in recent years, one that employs positive screens or themes as well as exclusions. Three categories of factors are involved: environmental, social, and governance (ESG). An environmental focus may look at carbon emissions, water stress, renewable energy, or pollution. Social factors might be diversity, inclusion, labor, employee welfare, or data security. Governance issues might touch upon independent directors, audit standards, women in leadership, and executive compensation.

Companies may be scored for their ESG performance. They may self-report, or data may be gathered by third parties who then sell the data. These scores may be combined with traditional financial analysis tools in determining which companies are likely to have the desired impact while still providing strong returns to shareholders.

Some have argued that companies with higher ESG scores are less likely to be disrupted by environmental problems, labor relations woes, or governance scandals, and as such may provide superior risk-adjusted returns. The jury is still out on that question. Still, the popularity of the “impact investing” approach was demonstrated by Paul Sullivan in *How to Invest With a Conscience (and Still Make Money)* [*New York Times*, March 16, 2018]. His case studies show the range of concerns that investors have today.

What about trust investing?

Individual investors are free to invest as they please. What about the trustees of a trust? Could they go in the “impact investing” direction? That question was explored recently by Casey Clark and Andy Kirkpatrick in *Impact Investing Under the Uniform Prudent Investor Act* [*Probate & Property*, March/April 2018].

The Uniform Prudent Investor Act, adopted by 46 states to date, provides the legal framework within which trustees operate. Rather than focus on particular investment choices, this law looks to the performance of a portfolio as a whole, taking the approach of modern portfolio theory. Diversification and asset allocation take precedence.

Official comments explaining the Uniform Act suggest that “social investing” may violate the duty of loyalty that the trustee owes to the trust beneficiaries. Below market returns for the beneficiaries are not an acceptable price to pay for meeting other social goals. However, at the time those comments were written, socially responsible investing was less sophisticated than it has become today. The emphasis then was on the negative screens; today it is on the positive. A number of studies have argued that impact investing does not appear to depress returns. Incorporating the ESG factors should not, by itself, impair the diversification of trust investments.

The authors conclude that, depending upon how broadly or narrowly the terms of the investment aspects of a trust have been drafted, impact investing may be a permissible strategy. For new trusts, they recommend adding impact investing provisions, provided that is what the trust creator wants. Older irrevocable trusts may be “decanted” into new trusts to provide this investment flexibility.

Would you like to know more?

The primary duty of every trustee is to fulfill the vision of the trustor, typically to provide family financial security. That leaves quite a bit of wiggle room when it comes to choosing trust investments and managing the assets for the long term. If you have questions about how trusts may benefit you and your family, or about how trust assets are invested, please bring them to us. Put our expertise to work for you! ☐

IRAs and FSCs don't mix

In 1977 Mazzei obtained a patent for an injector that mixes chemicals with water, and he started a business selling injectors in 1978. The business prospered. In 1984 he began selling injectors overseas through foreign distributors.

Mazzei was a member of the Western Growers Association (WGA). Sometime in the 1990s, WGA began a program for its members that combined interests in a foreign sales corporation (FSC) with an IRA. In 1998 the Mazzei family signed up. Mazzei, his wife, and his daughter each funded a Roth IRA with $2,000. An FSC was formed to handle Mazzei's foreign sales, and each Roth IRA purchased a one-third interest in the FSC. The family accountant looked over the arrangement and declared it to be legitimate.

Each year the FSC collected payments for foreign sales, paid appropriate U.S. taxes, and distributed the balance as dividends to the Roth IRAs. Over a five-year period, more than $500,000 was sent to the three Roth IRAs as dividend payments. Quite a return on that initial investment!

Apparently, the IRS thought so as well. The Service went after the Mazzeis for excess contributions to their Roth IRAs, arguing that the FSC was merely a conduit for their contributions, not a bona fide investment. The Tax Court concurs, using a substance over form analysis. The Roth IRAs were exposed to no risk, and they had no upside potential from the investment. The company controlled by the Mazzeis had complete discretion in directing payments to the FSC. Accordingly, the payments to the Roth IRAs were not dividends but contributions by the owners, far in excess of what is allowable. The only solace for the taxpayers was that penalties were abated because they relied upon professional advice in implementing their plan.

A vigorous dissent points out that the Tax Court recently was reversed by the Sixth Circuit Court of Appeals in a nearly identical case. The dissent suggests that the majority is acting like Caligula, who posted tax laws in fine print and so high that the Romans could not read them, because the majority is substituting judge-made law for the clear language of the tax code.

The majority answered that the other case involved a Domestic International Sales Corporation, not an FSC. Moreover, the Mazzei case is not appealable to the Sixth Circuit, but to the Ninth, which is not bound by the decisions in other circuits.

Whether the family will appeal the decision is currently unknown. They might yet prevail. But the old adage may apply here: When it sounds too good to be true, it isn't true. ☐

Who's the boss?
And the *next* boss?

Keeping a family business in the family takes sound planning. We can help.

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