STIFEL

Retirement Plans Quarterly

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WHY ROTH IRAs MAKE SENSE FOR INVESTORS OF ALL AGES

Many investors today are looking to boost retirement savings, save for a child's education, or even begin the estate planning process. With life expectancy increasing and the uncertainty of how long Social Security and lower tax rates will last, Americans are looking for the best retirement and tax saving strategies. A Roth IRA may be an ideal choice.

In order to contribute to a Roth IRA for the 2018 tax year, individuals must have earned income (or be married to someone with earned income) and have Modified Adjusted Gross Income below $135,000 for single filers and $199,000 for married filing jointly. Even though eligibility to make a Roth IRA contribution has income restraints, there is no age restriction to contribute, making the Roth IRA appealing for all ages.

Why would an individual under the age of 40 contribute to a Roth IRA?

- Provide potential tax- and penalty-free withdrawals on contributions and earnings*
- Save for a car or house
- Pay for educational expenses, including for a spouse or child
- Owe tax in a potentially lower tax bracket now in early earning years versus in 15-30 years when Roth IRA distributions begin
- Hedge against future tax rate hikes
- Supplement 401(k) or other workplace retirement plan

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Why would an individual over the age of 40 contribute to a Roth IRA?

- Provide potential tax- and penalty-free withdrawals on contributions and earnings*
- Leave tax-free assets to beneficiaries
- Contribute as long as the IRA owner or his or her spouse works
- No Required Minimum Distributions at age 70½

Regardless of age, a Roth IRA can be a powerful tool for retirement savings by making after-tax $5,500 ($6,500 if age 50 or older) annual contributions. If the investor makes too much money to contribute directly to a Roth IRA, he or she is still eligible to fund a Roth IRA with a Roth conversion from a traditional, SEP, or SIMPLE IRA, as well as from an employer-sponsored qualified plan.

** Earnings are distributed tax- and penalty-free after five years and age 59½*

THE SIGNIFICANCE OF IRA BENEFICIARY DESIGNATIONS

Many IRA holders are unaware of how the selection of a beneficiary can affect distributions of their IRA assets after their death. Frequently, at the time of the IRA owner's death, it is discovered that the beneficiary designation does not follow the intentions of the IRA owner, which could result in an accelerated payout and taxation.

After an IRA owner dies, inherited IRAs are generally created for the designated beneficiaries in order to receive their portion of the deceased owner's IRA. From these accounts, the beneficiaries receive the inherited assets in the form of Required Minimum Distributions (RMDs). The amount and timing of RMDs will depend upon whether the IRA owner died before or after the Required Beginning Date (RBD) to receive his or her own RMDs. In addition, RMDs will be dependent upon whether the beneficiary is a spouse, a non-spouse, an entity, or a combination thereof. If multiple beneficiaries are named, special rules apply.

Required Beginning Date (RBD)

For Traditional, SEP, and SIMPLE IRA owners, the RBD for the first RMD is April 1 of the year following the year in which an IRA owner turns age 70½. While there are no RMD requirements for Roth IRA owners, after the death of the Roth IRA owner, beneficiaries must generally receive RMDs according to the IRA rules below.

Death Before the RBD

If an IRA owner dies before his or her RBD, in addition to a total distribution, other distribution options are as follows:

Spouse as sole beneficiary

- Five-year rule – No annual RMDs are required, and any amount may be withdrawn by the beneficiary at any time during the five-year period. However, the inherited IRA balance must be totally withdrawn by December 31 of the year containing the fifth anniversary of the IRA owner's death.
- Life expectancy (LE) RMDs – If LE payments are selected, distributions are to begin in the year the decedent would have turned 70½ based over the spouse beneficiary's single LE. The LE factor is recalculated for each year, and distributions are paid at least annually.
- IRA rollover – At any time, a spouse beneficiary may treat the deceased spouse's IRA as his or her own and roll over, or transfer, the IRA into his or her own IRA. RMDs will not be due until the new IRA owner attains age 70½.

Non-spouse beneficiary

- Five-year rule (same rules as previously stated)
- LE RMDs – RMD payments are based on a beneficiary's single LE, and the first RMD must be withdrawn by December 31 of the year following the year of the IRA owner's death. The LE factor is reduced by one for each year until the inherited IRA account is depleted.

Note: There are no rollover options for a non-spouse beneficiary.

Multiple beneficiaries

- If the IRA is not separated into individual beneficiary accounts, RMDs will be based on the single LE of the oldest beneficiary established in the year following the year of the IRA owner's death. If separate beneficiary accounts are established, each beneficiary may choose LE payments and the RMDs will be based on his or her own single LE.

No beneficiary, entity beneficiary, estate beneficiary, or non-qualified trust

- Five-year rule (same rules as previously stated)

Qualified trust (defined later)

- Five-year rule (same rules as previously stated)
- LE payments – RMDs will be based on the LE of the oldest beneficiary identified in the trust. For subsequent RMDs, the LE factor is reduced by one for each year until the inherited IRA account is depleted.

Death On or After the RBD

If an IRA owner dies on or after his or her RBD, in addition to a total distribution, other distribution options are as follows:

Spouse as sole beneficiary

- Continue LE payments – For the year of the IRA owner's death, the RMD is based on the decedent's LE. For subsequent years, RMDs are based on the longer of the single LE of the spouse beneficiary and recalculated each year thereafter, or the single LE of the deceased IRA owner established in the year of death, reduced by one for each year thereafter.
- IRA rollover – After the RMD for the year of death of the deceased spouse is satisfied, a surviving spouse beneficiary may transfer or roll the balance of the IRA into his or her own IRA. Once complete, distributions will be based on the age of the new IRA owner. If the surviving spouse has not yet reached the RBD, RMDs may be discontinued until that time.

Non-spouse beneficiary and multiple beneficiaries

- Continue LE payments – After the RMD for the year of death of the deceased owner is satisfied, remaining RMDs must begin by December 31 of the year following the year of the IRA owner's death and based on:

1. The single LE of the oldest primary beneficiary, if separate inherited beneficiary accounts are not established.
2. The single LE of each beneficiary, if separate inherited beneficiary accounts are established by December 31 of the year after death.

Estate, non-qualified trust or entities

- LE payments – The RMDs will be calculated using the remaining single LE of the deceased IRA owner, established in the year of death.

Qualified trust (defined later)

- LE payments – After the RMD is distributed in the year of the IRA owner's death, subsequent RMDs will be based on the LE of the oldest beneficiary identified in the trust. For subsequent RMDs, the LE factor is reduced by one for each year until the inherited IRA account is depleted.

Qualified Trust

In order for a trust to be considered qualified for the purpose of determining life expectancy, it must:

1. Be valid under state law
2. Be irrevocable upon the death of the IRA owner
3. Have identifiable beneficiaries named (a charity has no life expectancy and could alter the ability to establish LE RMDs)
4. Provide qualifying documentation or a copy of the trust document to the custodian

Non-Qualified Trust

If the trust does not meet these requirements, the IRA will be treated as if no beneficiary is named, which could affect the ability to stretch RMDs over a certain period.

Conclusion

Post-mortem distributions and estate planning for IRAs can be extremely complicated, and it's highly recommended that IRA owners consult with a qualified attorney, tax advisor, and investment professional prior to making important beneficiary designation decisions.

PROTECTING RETIREMENT ACCOUNTS FROM CREDITORS

Retirement accounts remain among many people's most valuable asset for saving for their future. The protection provided to these accounts will depend on the type of account, the state of residence, and whether the assets are inherited.

Certain employer-sponsored plans, such as 401(k)s, are covered by the Employee Retirement Income Security Act (ERISA). In bankruptcy, ERISA plans are completely protected from creditors. However, they are subject to IRS levies and possible reassignments due to divorce. Plans not covered by ERISA, such as IRAs, have only limited federal protection. Under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), federal law protects up to roughly $1 million in an IRA that's been contributed to directly, and protects the entire account balance if the money was rolled over into an IRA from an employer's plan. In addition, Simplified Employee Pension (SEP) and Savings Incentive Match Plan for Employee (SIMPLE) IRAs are totally protected under BAPCPA.

For anything short of bankruptcy, individual state law will determine whether IRAs (including Roth, SEP, and SIMPLE IRAs) are shielded from creditors' claims. Some states exempt 100% of the assets, while other states vary widely on the amount that is covered. Some states exempt only what is "reasonably necessary" to support the owner and his or her dependents.

In the case when an individual has terminated employment, rolling over assets from a qualified plan into an IRA has estate planning benefits. However, if the individual is not filing for bankruptcy protection and lives or is moving to a state where IRAs are not protected from creditors, the individual may be better off leaving the assets in the company plan. So, an individual should contact an attorney familiar with the creditor protection laws of the state where he or she plans to live.

For individuals who might be returning to work after a period of unemployment and who previously rolled their retirement plan assets into an IRA after leaving a former employer, their new employer's plan may allow rollovers of assets held in IRAs directly into the plan. A rollover may be a wise choice to regain creditor protection. This strategy may also be attractive to people who are starting their own business.

Inherited IRAs Not Protected

Unlike IRAs for owners, it's important to note that an IRA inherited by a beneficiary after the death of the owner is not subject to the same federal protection. In a 2014 U.S. Supreme Court decision (Case No. 13-299), a married couple who filed a Chapter 7 bankruptcy petition identified an inherited IRA as exempt under the bankrupt estate. They argued that an inherited IRA is still technically a retirement fund because that's the way it was originally established.

Relying on the "plain language of §522(b)(3)(C)," the court concluded that "inherited IRAs represent an opportunity for current consumption, not a fund of retirement savings."

Final Notes

Even though some clarity is presented for the treatment of IRAs in bankruptcy, it is an over-statement to say it protects IRAs from all claims and attachments by creditors. Remember, the IRS still has the right to levy IRAs. And, some states allow creditors to attach IRAs in domestic relations court cases regarding unpaid child support, or in cases of civic judgment. If an individual owns traditional and/or Roth IRA assets and is planning to file for bankruptcy, it's imperative that he or she check with a tax advisor or attorney for details and ask about segregating contributory amounts from qualified plan rollover amounts.

This information is not intended to give legal or tax advice and is for educational purposes only. It is recommended that individuals seek the aid of a competent tax advisor or tax attorney to assist with tax advice and bankruptcy guidance.

QUALIFIED DOMESTIC RELATIONS ORDERS (QDROs)

In general, ERISA and the Internal Revenue Code do not allow a plan participant to assign or alienate his or her interest in a retirement plan to another person. These "anti-assignment and alienation" rules are meant to assure that benefits will be available to participants in their retirement years. A limited exception to these rules is provided through qualified domestic relations orders (QDROs).

Every retirement plan is required to establish written procedures for determining whether domestic relations orders (DROs) are qualified and for administering distributions under QDROs. The plan administrator (generally the employer maintaining the plan) is required to make the determination within a reasonable period of time and to promptly notify the participant and each alternate payee when a determination is made. Plan administrators can get assistance from certain retirement plan recordkeepers in obtaining a sample QDRO, determining whether a DRO is a QDRO, communicating the order's status to all parties, and, if qualified, its approval to the alternate payee.

A DRO is a judgment, decree, or order (including the approval of a property settlement) that is made pursuant to state domestic relations law (including community property law) and that relates to the provision of child support, alimony payments, or marital property rights for the benefit of a spouse, former spouse, child, or other dependent of a participant.

A QDRO creates or recognizes the existence of an "alternate payee's" (a spouse, former spouse, child, or other dependent of a participant) right to receive all or a portion of a participant's benefits under a retirement plan. If an alternate payee is a minor or is legally incompetent, the QDRO can require payment to someone with legal responsibility, such as a guardian.

QDROs must contain the following information:

- The name and last known mailing address of the participant and each alternate payee;
- The name of each plan to which the order applies;
- The dollar amount or percentage (or the method of determining the amount or percentage) of the benefit to be paid to the alternate payee; and
- The number of payments or time period to which the order applies.

A QDRO can pertain to retirement benefits under more than one plan of the same or different employers as long as each plan and the assignment of benefit under each plan are clearly specified.

A QDRO cannot provide that benefits will be paid to an alternate payee before the participant's "earliest retirement age," unless the plan permits payments at an earlier date. Generally, a QDRO policy will accompany a plan document to address how QDROs should be handled for a plan.

An alternate payee will generally be considered a beneficiary under the plan for purposes of ERISA and therefore, upon written request, be entitled to receive copies of a variety of plan documents. When benefit payments to the alternate payee begin, he or she will be treated as a "beneficiary receiving benefits under the plan" and automatically receive the summary plan description, summaries of material plan changes, and the plan's summary annual report.

According to the U.S. Bureau of Labor Statistics, 70% of civilian workers have access to retirement and medical care benefits as of March 2017. Therefore, understanding QDROs can be important in separation, divorce, and other domestic relations proceedings.

For more information on QDROs, see the Employee Benefits Security Administration's (EBSA) booklet on line at https://www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/publications/qdros.pdf.

QUALIFIED PLAN DISTRIBUTIONS PENALTY FREE

It is well known that an employee may take a distribution from a retirement plan at age 59½ and avoid the 10% early withdrawal penalty tax. Not so well known are the provisions of the penalty exception at age 55.

If an ex-employee receives a distribution from a Qualified Retirement Plan (QRP) after separation from service, and separation occurs during or after the year in which the employee attains age 55, the 10% penalty does not apply. So, a 54 year-old taking a distribution is not subject to the penalty if she separated from service in the calendar year she turned 55. On the other hand, a 55 year old taking a distribution cannot escape the 10% penalty if she separated from service at age 53.

Although the 10% penalty is waived, 20% federal tax withholding is required for direct payments to participants. Also, note that if the assets from a QRP are rolled into an IRA, the age 55 penalty exception is no longer available.

The age 55 exception can be easily misunderstood given the varying time periods by which participants separate service and when their distributions are taken from the plan.

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5 Reasons to consider a Roth IRA

1

Tax-free growth potential; tax-free withdrawals when certain conditions are met

2

No required minimum distributions

3

Hedge against future tax hikes

4

Withdraw contributions at any time and any age, tax free

5

Tax flexibility in retirement; an additional source of tax-free income

Contact your Stifel Advisor today and see if a Roth IRA is right for you.

Stifel does not provide tax advice. You should consult with your tax advisor regarding your particular situation.