Registered Investment Advisor Firm

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This month's edition deals with issues that have political underpinnings because it addresses a proposed federal budget. I have made every effort to keep this newsletter as apolitical as possible. The fact that we have a divided Congress means that many of the budget proposals may not be enacted, but that aside, these proposals give insight to the desires and wishes of some politicians.

The takeaway for most readers should be an understanding and appreciation for the advice, planning, guidance, products and services that a qualified financial professional can provide to help you in assessing and addressing your financial needs and goals, whether it's with a financial or investment adviser, CPA, estate or tax counselor. Remember these professionals want exactly what you want, to help and advise you, working together to find solutions to the challenges that confront you on your journey to a fulfilling and rewarding retirement.

If you manage your own investment portfolios, you owe it to yourself to stay current on these trends, laws, rules and regulations, because after all – **it's your money** and small inadvertent oversights or mistakes can sometimes have large and lasting ramifications which could adversely affect your retirement plans and goals.

Budget Proposals & Your Retirement Plans

In 2014, the President presented a budget that was not enacted into law, though it did receive extensive scrutiny throughout the media. The President's 2015 budget proposal comes in at $3.9 trillion and seeks to increase entitlement spending while decreasing military spending.

In 2014 there were five (5) specific proposals included in the proposed budget that would have directly affected your retirement plans if enacted.

The current 2015 proposal again contains these same five proposals as well as two additional ones. One of the new proposals seeks to change Social

Security benefits, and all of which if enacted, will affect your retirement plans.

Remember, these are only proposals and almost certainly require Congressional action to implement (except for the proposal that directly affects Social Security).

Essentially the Social Security change becomes possible without Congressional action because once a law is enacted, there are implementing rules and regulations which can become subject to interpretation. These can be changed or amended through changes in the rules and regulations, many times through Executive Orders.

The MyRA instituted by the President through Executive Order was deemed to be created within the confines of existing law related to the Roth IRA, so no Congressional action was required. I make no attempt to address the workings of the MyRA because of its narrow focus and limited practicality.

First Proposal

This proposal which you may recall from debate surrounding the 2014 budget, involves instituting a cap or limits on the amount you would be allowed to have accumulated or saved in *all of your retirement accounts combined*. The cap and the way it's being proposed, is what makes this proposal distinctive.

Instead of proposing that no one can have more than a set dollar amount in their combined retirement accounts, the proposal anchors itself to pension plans and the maximum anyone can receive through that pension plan at $210,000 per year. This number is relevant because it is the basis for the approximately $3 million cap the President proposed in his 2014 budget.

The mechanics behind this number comes from the calculus of how much money would be required for a 62 year old to purchase a private single premium immediate annuity, joint and survivor for the rest of your life, not to exceed $210,000 per year.

Every year the calculations are to be recalculated to determine the maximum allowable dollar amount allowed to be held in all your retirement accounts for that year. Currently, that amount would equate to approximately $3.2 million in all your retirement accounts due to the prevailing low interest rate environment.[1]

When calculating annuity payments, one of the variables the insurance company must consider is current interest rate. When rates are low, like currently, it takes a much larger amount of money to get the same payout than when interest rates are higher.

You might be saying to yourself, "$3.2 million, that's a lot of money, I don't care and I don't have to worry about that figure." Or perhaps you just feel nobody should ever be allowed to have more than that combined total in their retirement accounts.

[1] Net present value for $210K at 4% for 25 years.

However, when interest rates start to rise (remember we're at historic lows), perhaps to where they were just 14 years ago where bank CDs were paying 6%, that means it will take far less money in your retirement accounts to reach that $210,000 cap. If rates were to rise over the next 15 years to 10%, your maximum allowable cap would be reduced to approximately $1.9 million for a 62 year old 15 years from now.

If you think this is counter-intuitive to the mantra to save more towards your retirement - not less, you would be correct. Because the recalculations are proposed to be on a yearly basis, the maximum amount allowable in your accounts will also fluctuate up and down depending on prevailing interest rates. If interest rates rise, even marginally, you could be forced to remove money from your retirement accounts to remain in compliance with the maximum allowable annuitized payout, as you would be deemed to be too wealthy.

Previously I mentioned that many might think they will never amass this amount, but what would happen if you inherit a spousal or non-spousal IRA or 401(k) account? The proposal is silent in these circumstances, but these events could easily result in an aggregate balance exceeding the $3.2 million cap.

It's important to point out that during the Reagan administration, the government in 1982 started taxing Social Security benefits. It passed Congress by positioning the argument that the government was only going to tax single filers who earned $25,000 or more in retirement. If married and earning more than $35,000, you would have to pay taxes on your Social Security benefits (prior to this date, Social Security income was not taxed at all).

The selling point at the time was that less than 1% of Americans fell into these categories, making it politically viable for passage because it affected only a fraction of the American tax payers, "the top 1%."

Unfortunately, these income levels were never indexed to inflation, so they remain the benchmarks of today. This means that over the past 32 years, wages or income measured at $35,000 (married filing jointly) encompasses a very large number of people in retirement.[2]

The current proposal is again using the argument that the proposed cap will "only affect about 1% of Americans." If interest rates rise or hyper-inflation returns, $3.2 million could become a much smaller number.

Second Proposal

This proposal seeks to create a maximum retirement account contribution limiting the deduction to 28%. This means that if you're in the 15% tax bracket and contribute $1,000 to your deductible IRA, you would get a $150 tax deduction. As your marginal tax bracket moves up, the deduction moves up as well. However, if you're in the 30% tax bracket and can still make a

[2] Over 50% of Americans pay tax on their SS benefits.

deductible contribution, your allowable deduction would be capped at 28%.

While your income may prevent deductibility of an IRA contribution, it may not for a 401(k). The impetus behind the proposal derives from an argument of "fairness" where it is argued that higher income earners benefit disproportionately by receiving higher tax deductions.

The tax changes passed in 2012 already reduces the amount of itemized deductions you can earn. For single filers, that phase-out begins a little north of $150,000.

Third Proposal

This proposal seeks to eliminate the use of a "stretch IRA." A stretch IRA involves a non-spouse inheriting an IRA where under current law, the beneficiary can either close (withdraw) that IRA within five years taking it all out and pay the taxes owed, or "stretch" the withdrawals based on an IRS actuarial table of life expectancy.

This proposal is created in an effort to accelerate the collection of taxes meaning the account would have to be liquidated within five years in all instances.

Fourth Proposal

This proposal seeks to allow a non-spouse beneficiary to conduct a 60 day rollover of an inherited IRA. As a reminder, these proposals were carried forward from the previous proposed budget and were never enacted, however this proposal makes sense.

Currently, if you as a non-spouse inherit an IRA which is held at a custodian or company you either don't like or want to change, you can conduct a transfer or direct rollover. But if you liquidate the account and receive a check with the intent to redeposit it to another IRA account, you are prohibited from conducting this transaction. When you realize your mistake, you can't redeposit it back with the previous custodian, it will be deemed to have been a full distribution with all taxes owed.

Fifth Proposal

This proposal deals with "auto-enrolled IRAs" or "payroll deducted IRAs." An employer can open an IRA for their employee and automatically deduct from their pay, a contribution to this retirement account.

These already currently exist but most may be unfamiliar with them because they are not frequently used because they are record intensive and have costs or fees the employer must pay. The advent of the 401(k) has in many respects replaced their use.

The proposal seeks to make it mandatory to implement "auto-enrolled IRAs" or "payroll deducted IRAs" for any business that: 1) does not offer a retirement plan; 2) that is more than two years old: and 3) has more than 10 employees. The proposal does not (currently) mandate any employer matching contribution, but the employee contribution must be 3% unless the employee opts out.

By making employees opt-out instead of opting-in, it makes it harder for the employee to do very little or nothing toward saving for their retirement. As previously mentioned, the proposal is not currently requiring the employer to match any contribution which could have a detrimental effect on small businesses that typically roll their money back into the businesses.

Sixth Proposal

In this proposal, the President is proposing to "harmonize" the traditional IRA Required Minimum Distributions (RMD) with the Roth IRA.

Most readers probably realize that under current rules, RMD does not apply to Roth IRAs – currently there is no legal obligation to make a withdrawal from the Roth IRA if the account owner does not wish to, regardless of their age. Traditional IRAs require RMD when the account owners reaches the age of 70 ½.

You may not think this is not a revenue generator for the government because currently Roth IRAs grow and distributions from them are all income tax free. However, if these two are "harmonized" vis-à-vis RMD rules, should you forget or miss a RMD withdrawal, you will be subject to a 50% penalty of the amount that was subject to the RMD.

Seventh Proposal

To set the frame of reference and tone of this proposal I have included the actual language of the proposal:[3]

- **"In addition, the Budget proposes to eliminate aggressive Social Security claiming strategies, which allow upper-income beneficiaries to manipulate the timing of collection of Social Security benefits in order to maximize delayed retirement credits."**

There is no clarification or definition defining "upper income" or "aggressive" in the Budget Proposal.

Under current law there are a multitude of claiming strategies and options legally available to Social Security recipients which can result in increased lifetime benefits.

Generally speaking, for every year you delay claiming your Social Security beyond Full Retirement Age (FRA)[4], you can earn an additional 8% per year added to your monthly benefit until you reach the age of 70. Another way to look at it is you receive 32% more by waiting from a FRA of 66 to age 70.

Financial planners routinely consider Social Security claiming strategies when

[3] Page 150 of the President's 2015 Budget Proposal

[4] For most readers that age will be either 66 or 67

planning for retirement to project and protect asset longevity, spousal and survivor benefits just to name a few.

Changes to the ability to assess various claiming strategies could adversely impact millions of plans already in place.

Because this law, along with its implementing rules and regulations are already in place, it may not require Congressional action to implement this particular proposal and change.

If you would like more information or a personalized report detailing your optimal Social Security claiming strategies, please contact me to discuss your options.

Davis Investment Group

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

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