Alternative Income Solutions

Invest, **R**einvest, **A**nnuitize

A Different Way to Think About Your IRA

The decades long transition from defined benefit plans to defined contribution plans has opened a range of options and opportunities for individuals who have accumulated wealth from a lifetime of work. In this paper we offer a different perspective on how to optimize these vehicles to replace income produced from formal employment. Leveraging the power of the IRA to create an independent source of income is but one tenet of an overall portfolio strategy which we describe as "Income Replacement Therapy."

IRA – Some History

The Individual Retirement Account- IRA - was first introduced in 1974. It was intended to be a retirement savings plan for those without a pension.

Over the years, Congress has tried to focus the benefits of IRAs to those under certain income levels. The IRA, however, remains a valuable tool to individuals at all levels of income. The ability to take workplace sponsored programs, such as 401(k)'s and to roll them over into IRA's when you leave a company can provide an effective and flexible tool to manage accumulated assets.

We believe that IRAs provide a powerful tool for retirement savings whether you start investing as a child or if you wait until after you have retired to open your first IRA as a "rollover."

I=INVEST

We believe that the IRA is most effective when used as a vehicle through which to ***invest***. Starting young helps, but ultimately, the effectiveness will be determined by a commitment to maximize contributions to any and every tax deferred vehicle available.

Many have workplace sponsored retirement plans such as 401(k), 403(b), and 457 plans. If you are self-employed, a small-business owner, or the employee of a small business, an SEP or a Simple IRA are alternative

A Brief History of the IRA *

Individual Retirement Accounts (IRAs) were first authorized by the **Employee Retirement Income Security Act of 1974 (ERISA**; P.L. 93-406).

IRAs were originally limited to workers without pension coverage. **The Economic Recovery Act of 1981** (P.L. 97-34) made all workers and spouses eligible for IRAs.

The **Tax Reform Act of 1986** (P.L. 99-514) limited the eligibility for tax-deductible contributions to individuals whose employers do not sponsor plans and to those whose employers sponsor plans but who have earnings below certain thresholds.

The Taxpayer Relief Act of 1997 (P.L. 105-34) allowed for certain penalty-free withdrawals and authorized the Roth IRA, which provides tax-free growth from after-tax contributions.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) significantly affected the contribution limits in these plans in three ways: it
(1) increased the limits,
(2) indexed the limits to inflation, and
(3) allowed for individuals aged 50 and older to make additional "catch-up" contributions.

The Pension Protection Act of 2006 (PPA; P.L. 109-280) made permanent the indexing of contribution limits to inflation, allowed taxpayers to direct the Internal Revenue Service (IRS) to deposit tax refunds directly into an IRA, and temporarily allowed for certain tax-free distributions for charitable contributions (which was later made permanent by P.L. 114-113).2

The Setting Every Community up for Retirement Enhancement Act of 2019 (SECURE Act), enacted as Division of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94), included multiple provisions related to IRAs.

The SECURE Act

- repealed the maximum age at which individuals can contribute to traditional IRAs;
- increased the age at which required minimum distributions (RMDs) from traditional IRAs must begin;
- treated certain nontuition fellowship and stipend payments as compensation for IRA contribution purposes
- treated tax-exempt "difficulty of care" payments to home healthcare providers as compensation for nondeductible IRA contribution limit purposes;
- allowed penalty-free early withdrawals for qualifying birth and adoption purposes; and modified distribution rules for inherited IRAs

* Excerpted from: Congressional Research Service
Traditional and Roth Individual Retirement Accounts (IRAs): A Primer, Updated February 3, 2021

ways to set aside money on a tax-deferred basis for retirement. Each of these can be managed or *Rolled Over* into an IRA, which makes the IRA a powerful tool as a successor plan if eligibility ends for the workplace plans.

Many employer-sponsored plans limit the universe of investment options to those selected by the employer and plan provider. Many of those options are sub-optimal for tax deferred savings plans as the investment earnings will ultimately be taxed as ordinary income upon withdrawal. This can be inefficient as a considerable portion of the earnings could have been earned as capital gains or dividend income which, currently at least, are taxed at lower rates for most investors if held in a taxable account. We have written about this previously in a paper entitled "Asset Location." It is also one of the reasons we prefer income-based investments for tax deferred vehicles; as investment income is generally taxed at higher rates (*top marginal tax rate plus the ACA tax and applicable state tax*) than either long-term capital gains or dividends (currently 15 or 20% depending on income level plus the ACA tax and applicable state tax).

Once you retire and rollover your 401k or other workplace savings plans into your own IRA, you have many more options, including individual stocks, real estate, other real assets, and a broad array of alternative investments. Private funds including hedge funds, private equity, venture capital, and other alternative assets often cannot be accessed directly through a brokerage account. These brokerage platforms are in the business of offering a range of core options to millions of IRA holders. To access private investments, you may open a self-directed IRA. Self-directed IRA firms are in the business of allowing HNW individuals to invest their IRA's in a broad array of self-selected alternatives – this may be a hedge fund, a private equity fund or a private company. For more on these options see our previous white paper, Need Income? Go Private.

Regardless of the type of IRA, the goal remains to ***invest*** as much as possible in any tax deferred plan.

- Traditional IRA's, 401(k)s, and related vehicles provide some degree of tax-deferral upon investment. In the case of a 401(k), the contributions to a traditional plan are not taxed. Once you begin withdrawals, typically post-retirement, all funds withdrawn are taxed as ordinary income.

- Roth IRAs and Roth 401(k)s enable taxable contributions. You can contribute the same dollar amount, but you will need to pay the tax on the contribution when filing for the year of the contribution. Therefore, the effective value of the contribution will be greater. The difference is that all withdrawals in the future, once eligible, will be tax free.

R=REINVEST

The second concept references ***reinvestment*** and the power of compounding. The reinvestment of income, dividends, and gains amplifies the power of the structure. Whether you have a traditional or a

Roth plan - income, dividends, and gains stay in the plan and are not taxed when realized. By consistently reinvesting these cashflows, you can accelerate asset growth. If you were to make the same investment in a taxable account, you would incur a tax liability annually for income, dividends and realized gains even if you fully reinvested the cashflows.

The reinvestment period overlaps with the investment period. If all investment income and gains are reinvested and contributions continue, the asset growth will compound. Even once contributions cease, the reinvestment phase enables significant, tax-deferred growth. An investment that earns 10% per year, if compounded, will double in approximately 7.2 years. If earnings are 7% a year, it will take approximately 10 years to double.

If you reach your desired asset level at age 59 and 1/2 (the age at which you can begin accessing these assets without penalty) and continue ***reinvesting*** for an additional 10 years, you can more than double the amount of capital in your IRA, assuming you earn at least 7% per annum. The longer you reinvest without making withdrawals, the more capital you will have in the account, assuming you are generating positive returns. This is, again, why we advocate for a significant allocation to income producing strategies, which have lower levels of volatility and more predictable earning streams. Equities over time have higher returns but with that comes more volatility. Drawdowns, or periods of negative market performance can require significant outperformance to get back to par. For example, a 20% decline in the market requires a 25% market upturn to get back to where you started. More distressingly, a significant market crash can take years to recover. A 50% market fall will require the market to increase 100% to get back to par. This can take time and can detract from the reinvestment benefits of compounding.

A=ANNUITIZE

At some point individuals may leave the workplace or cease the activities that have generated the bulk of their income. These roles may include formal employment or consulting, sitting on boards, and distribution of deferred compensation to name a few. When that happens, it will be very useful to have an additional source of income. We call this need, ***Annuitization*** *or* "*Income Replacement Therapy.*" Your IRA can and should be one source of replacement income.

If you have been diligent about investing, reinvesting, and managing these assets over your lifetime, the core of your IRA, Roth IRA and/or Rollover should be substantial. If you earn 5% or more per year on these assets, then you should be able to take 10% of the principal value per year over a 20-year period or a smaller percentage over a longer period.

Traditional IRA plans become taxable upon the second spouse's demise at the beneficiaries' top marginal tax rate. Therefore, it can be tax efficient to substantially reduce the balance of a traditional plan as you age. Roth IRA's are taxed at the time of contribution, therefore the tax considerations differ.

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Fixed and Variable Annuities offer a similar benefit – but are extremely expensive. The same goes for Insurance products which at a high level offer the benefit of annuitized income but have opaque fees and sales charges which can mute the benefit.

Leveraging the power of the IRA can offer a less costly and potentially higher returning tool that provides the desired source of income.

CONCLUSION

Throughout our working lives we generate income. We use that income to pay expenses and the remainder is saved and invested. When we retire, we lose the income generated from work but gain a range of options to replace that income and enjoy retirement or pass along wealth to younger generations. The IRA is one of those options and should be optimized to offer a stable, growing source of income in retirement.

Invest - Thoughtful use of retirement savings plans will enable us to build a core of assets that are either tax-deferred (traditional) or non-taxable (Roth).

Reinvest - Focusing on tax-efficiency and investing these assets in stable, low volatility, income generating assets enable the accumulation of a core of capital that can continue to grow through reinvestment of income over time.

Annuitize – After investing and reinvesting over time, when additional income is desired, the IRA can provide a stable and substantial source of income.

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Alternative Income Solutions:

Alternative Income Solutions (AIS) provides high net worth individuals and their financial advisors a source of current income for use in retirement or estate planning. AIS identifies and invests in specialty finance strategies that share three common attributes

- Uncorrelated from public equity and fixed income markets
- Significant cash yield
- Low probability of permanent loss of capital

The team have spent their careers in fixed income and alternative investments. They leverage their networks and experience to identify and diligence a targeted selection of investments that provide stable source of income and are uncorrelated to equity and fixed income markets.

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