How Retirees Are Blowing Their Nest Eggs

By Kelly Greene, The Wall Street Journal

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When it comes to IRAs, investors and financial experts alike are making plenty of mistakes. Here's why, and what to watch for.

Dorothy Galvin and Barbara Rubinstein realized their mistake too late.

When their mother left the two sisters an individual retirement account worth $212,000 last year, they were advised by an insurance broker to roll the money into new IRAs to avoid a big tax bite all at once. The IRA custodian cut each sister a check, which they deposited into new accounts.

But at tax time this spring, Ms. Rubinstein's accountant had bad news: To preserve an inherited IRA, you have to keep your hands off the money by doing what's called a trustee-to-trustee transfer into an account specifically designated for inherited funds.

Now, the sisters, who live in Lynbrook, N.Y., have to undo the new IRAs, and pay taxes immediately -- almost $50,000 apiece -- on their whole inheritance. "I don't have any other savings down the road, and I've never married," says Ms. Galvin, 52 years old. "I've lost the potential" for decades of tax-deferred growth, she says, "and I'm not happy about that."

Believe it or not, saving money in an individual retirement account is the easy part. Taking it out -- either from your own IRA or one you're lucky enough to inherit -- without running afoul of the Internal Revenue Service is much tougher.

The federal tax regulations governing IRAs are complicated, with rules that vary for traditional accounts vs. Roth IRAs, and for distributions from your own IRA vs. one you inherit. On top of that, the rules get tweaked from time to time, with some big revisions a few years ago still roiling many IRA owners and inheritors.

As a result, investors and their accountants -- along with the banks, brokerage houses and insurers holding IRAs -- are making plenty of mistakes. No matter who's at fault, individual IRA holders like Ms. Galvin and her sister usually wind up paying the price. The cost can be steep, both in lost opportunities and in big penalties if withdrawals aren't done correctly.

Until recently, few people paid much attention to the rules because IRA balances were relatively modest compared with other retirement savings. But now, three decades after the accounts were created, Americans hold $3.5 trillion in IRAs, and they make up 27% of the $13 trillion U.S. retirement market, according to the Investment Company Institute, a mutual-fund industry group in Washington.

Assets held in IRAs are increasing on average 13% a year, and that growth is expected to accelerate as baby boomers retire and roll over savings from defined-contribution plans. Those same boomers are also starting to inherit hefty accounts from their parents.

"As more and more folks are retiring and companies are downsizing, we're seeing much larger balances in these accounts," says Anthony Luciano, a vice president of retirement products at Fidelity Investments in Boston. "We're getting a lot more questions, because making a mistake with that amount of money is very scary."

And for the first time, the federal government is watching to make sure you take your withdrawals, and pay any resulting tax. Last year, the IRS started requiring the institutions that hold your IRAs to report annually whether you have to make a withdrawal from your account.

To help you avoid IRA angst, here are some of the most common, and costly, mistakes that investors and financial experts alike make with IRAs -- and how to fix them:

Failed Rollovers

There are two times when you might roll assets into a new IRA: When you retire or otherwise leave a job with a defined-contribution plan, like a 401(k), or when you simply move an IRA from one financial institution to another. In either case, you have 60 days to get the money from one tax-deferred account to another, though it can sit in a taxable account while you decide what to do with it.

The problem: It's easy to let the deadline pass you by, which means you would have to pay income tax on the entire amount that year, rather than continue to let your assets grow tax-free until you start making withdrawals. Most of the financial planners, investment-firm executives and accountants interviewed for this story say this is the worst IRA mistake they see.

"There's case after case where somebody sent the paperwork to the bank and said, 'Put this in an IRA,' and they put it in a clerical account instead," says Natalie Choate, a Boston tax attorney. "Probably half of them are provider errors, a lot of them are the people's own errors, and a few of them involve hurricanes and snowstorms."

Here's the good news: So many people were missing the 60-day deadline, and often blaming the investment firm or bank that was supposed to get the money into the IRA for the mistake, that the IRS set up what it calls an "automatic waiver" for the problem a few years ago if you meet several conditions.

They include: You moved the money to the financial institution setting up the new IRA within the 60 days, and you asked it to put the money into the new IRA, following all of its procedures for doing so. And even though you missed the 60-day window, you still moved the money into the IRA within a year of the first day of that period.

The bad news: A lot of would-be IRA investors don't get the money moved within a year, so they don't qualify for the automatic waiver. Ms. Choate says many people aren't reading their financial statements, which would alert them to the problem. Instead, the first inkling they have that something went wrong comes the following January when they get a 1099 form, a statement from the financial institution showing they took a distribution and owe tax on the money.

There is a fix, however. You can request a "private-letter ruling" from the IRS (by filing an application and paying a $95 fee, plus other fees if you hire an adviser) to get off the hook. Since October 2003, nearly 400 taxpayers have done just that, according to an IRS spokesman.

The rulings have gone investors' way in cases "where there was a real reason beyond their control," such as being hospitalized or called for military duty in Iraq, says Ed Slott, a Rockville Centre, N.Y., tax adviser who specializes in IRAs. But requests are being rejected in which people already had spent the money, demonstrating that they "didn't really have the intent to do a rollover."

Another possible pitfall: If you're already over 70½ years old and taking required distributions from your IRA every year, be sure to make your annual withdrawal before doing a rollover, says Steven G. Lockwood, president of Lockwood Pension Services in New York. "If you're already in pay status, you aren't allowed to roll over that year's minimum distribution."

If you don't know about that rule and move the money anyway, and then take the distribution from the new account, both custodians could wind up reporting your distributions to the IRS -- even though you took only one withdrawal. It's not illegal to take twice as much from your IRA as required, but it means you'd have to pay more in taxes. Untangling the mess requires professional help. "There's no real easy out to it," Mr. Lockwood says. "It's ugly."

Roth Conversion Confusion

If you plan to pass along your IRA to your children and you want them to have it as a Roth, you have to do the conversion -- you can't leave it up to them to do it after you die. Christine Fahlund, senior financial planner at T. Rowe Price Group in Baltimore, says she got a call from middle-aged siblings "in a well-to-do family who wanted to roll the money over and convert it to a Roth.

Their advisers suggested that they do it, and they were psyched about it. I had to tell them, 'Sorry. If your father had done it, you could have a Roth IRA. But you can't do it.' They were so upset. There was bitterness and anger that they could have done this if they'd talked about it."

But it's still easy to make mistakes when you do the conversion in advance. Pat Freeman, of Santa Ana, Calif., persuaded her elderly mother to convert her traditional IRA to a Roth last June, figuring "that her tax rate for the conversion was much lower than mine," she says. "My accountant thought it was a good move but failed to inform me about certain rules," including the need to take her mother's required distribution from her IRA before doing the conversion. Once Ms. Freeman realized the mistake, she took the distribution from the Roth, and did so in the same calendar year, she adds.

Although the IRS could hit her with a 50% penalty, it probably won't, says Mr. Slott, the tax adviser, because she corrected the error quickly and in good faith.

Putting Company Stock in Your IRA

If you have company stock in your 401(k) plan, take a step back before you roll it into an IRA -- or before you make any withdrawal, at any age, of any assets from the plan. A little-known tax break for what's known as "net unrealized appreciation" allows you to pull out some or all of your shares in the company where you work at the same time you roll the rest of your assets into an IRA.

The big advantage: By taking the stock out of your 401(k), any increase in the stock price after you originally acquired the shares would be subject only to long-term capital-gains tax, with a maximum 15% rate, rather than ordinary income tax, up to 35%. You have to pay income tax on the original purchase amount, or "cost basis," when you take it out of your tax-deferred plan. But you wouldn't owe any capital-gains tax until you sell the stock.

"Understanding how to use this and what shares to sell when you need money can have an enormous impact on what's left to your heirs or how long your money lasts you," says Mark Cortazzo, a Parsippany, N.J., financial planner.

"You have a one-time opportunity to do this," he warns. You're no longer eligible once you take any distributions at all from your company retirement plan, including required distributions from your company plan after age 70½.

Harvey Cohen, a 62-year-old retired engineer from Pfizer Inc. in Wayne, N.J., heard about the strategy from Mr. Cortazzo at a monthly dinner with co-workers just before he retired in December 2000. Mr. Cohen took out a "seven-figure sum" and used the stock to fund a charitable trust. "It worked like a charm," he says.

Mr. Cohen's advice: "One of the most important things is to make sure whoever is doing the transferring really understands what you're doing. If the company doesn't do the transfer right, it could be a problem." In his case, he sold off his shares that had a higher cost basis before starting the process to make sure they weren't included in the transfer.

Also make sure that both parts of the transaction -- the withdrawal of the stock and the rollover of any remaining assets into an IRA -- are completed in the same year. Otherwise, the IRS could deny the tax break.

One other note: Mr. Cortazzo advises using the company stock first to fund your retirement needs or make charitable donations. Upon your death, most stock that your heirs inherit gets what's called a stepped-up basis, which means they wouldn't owe capital-gains tax. But employer stock that already has gotten the favorable treatment described above does not receive the same bump in value.

Taking Too Little or Too Much

It's possible to take regular payments from your IRA and avoid paying the 10% penalty for withdrawals taken before you turn 59½ years old, the magic age for getting access to your retirement money. But it's also easy to make mistakes with those payments, by taking out too little or too much, that could cost you thousands of dollars in retroactive penalties and interest. (They are called 72(t) payments for the section of the tax code that governs them.)

The big rules: You have to take what the IRS calls a series of substantially equal periodic payments, on a schedule. And you must continue taking them for at least five years or until you turn 59½, whichever period is longer. So, if you start taking withdrawals at age 50, you're on the hook for 9½ years; if you start at age 57, you'd have to take the withdrawals until you turned 62. And you should work with a financial adviser, accountant, or IRA custodian familiar with 72(t) payments to set up your plan.

But once you get the payments established, it's easy to forget the rules' rigidity after a few years, says Ellie Deskin, a Troy, Mich., financial planner. She rescued one client just months shy of turning 59½, who had been taking payments since age 52, after she received a letter from the insurer that held his IRA saying it was "in receipt of the request for additional payment" and would mail the check. It turned out that his daughter was expecting twins, and he wanted the money to buy nursery furniture.

"It would have cost him $10,000" -- a 10% penalty on all his seven years of payments so far, plus interest, she says. "You call and ask [the IRA custodian], 'Can I take the money out?' They'll tell you, 'Yes, you can,' but that doesn't mean there won't be huge tax ramifications."

You can also get into trouble for taking out too little money after setting up scheduled withdrawals, though you're allowed to change the way you take payments one time. After the stock-market downturn, the IRS ruled in 2002 that you could switch from higher payments to lower ones calculated using your life expectancy (the same way you would calculate minimum withdrawals after age 70½). The idea was to keep retirees from using up their retirement accounts too quickly.

But the fix is of limited use, Ms. Deskin says. The minimum distributions often are so much smaller than the original withdrawals that "it doesn't help the person who needs income."

Missing the Low-Tax Window

There's one mistake that you could make by not taking money out of your IRA -- particularly if the bulk of your nest egg is tied up in such an account, as is often the case for doctors and other self-employed professionals.

You probably think you're doing the right thing by leaving your IRA money untouched until age 70½, when you have to start making withdrawals. After all, that allows you to take full advantage of the tax-free growth your financial advisers have touted for years, right?

Perhaps not. "Their mistake is in thinking because they don't need the money, they should, by default, never take a distribution from the IRA," says Jerry Yeager, a financial planner in Warsaw, Ind.

If your tax bracket drops after you stop earning a regular paycheck, and you expect your tax rate to increase again when you start taking mandatory IRA withdrawals, it may be a good time to take some money out of your IRA. That way, you pay lower taxes on your IRA money than you would by postponing those withdrawals, says Twila Slesnick, an accountant in Dublin, Calif.

To figure out how much to take out, you would subtract your income for the year from the ceiling of your current tax bracket, and then withdraw as much as you could from your IRA without bumping yourself into a higher bracket.

For example, a retired, married couple with $50,000 in income would be in the 15% tax bracket, which has a ceiling of $59,400 in income. They could withdraw $9,400 from their IRA before bumping their tax rate for additional income to 25%.

Taking your money out of an IRA now to save on taxes down the road doesn't mean you should run out and spend it, of course. Mr. Slott says withdrawing the assets earlier than required makes sense only "if you have a use for it, like life insurance, or a real-estate investment, where you could leverage it even further." Another option: Since you've paid taxes on the withdrawal, you could roll it into a Roth IRA, an account in which you can invest after-tax money in exchange for tax-free growth.

Losing Out on the Stretch

Inherited IRAs don't work like regular IRAs. So don't assume that any of the rules governing the IRAs you own would apply to any that you inherit.

For example, if you inherit an IRA from anyone other than your husband or wife, you cannot, under any circumstance, roll it into your own IRA. You also can't withdraw the assets from an inherited account and then deposit them into a new IRA. And you can't consolidate IRAs you inherit from different people into one account.

But traditional IRAs and Roths that you inherit have one important thing in common with the ones you hold yourself: You can stretch out the withdrawals across your lifetime, rather than taking them as a lump sum. That gives you a chance to postpone the tax bite and lengthen the time that tax-free earnings can accrue, possibly increasing your inheritance by thousands of dollars.

Unfortunately, few heirs realize that's even an option. Until 2001, when the IRS proposed new IRA rules that became final the following year, most people -- including all types of financial advisers -- assumed that you had to cash out an inherited IRA within five years of the owner's death. That's because the government had made that option the default, Mr. Slott explains. But the new rules make it easier to stretch those withdrawals across your life expectancy.

Even if you successfully get the money into your own account, it's important to recognize the unique way you must withdraw it. With your own IRA, you have to start taking minimum withdrawals by April 1 of the year after you turn 70½, and you determine the minimum amount each year by looking up your life expectancy in the appropriate table and then dividing your year-end account balance by that number. (The tables, which changed three years ago, are at www.irs.gov in Publication 590. Make sure any adviser you consult is using the current numbers.)

But with an inherited IRA, you first need to retitle the IRA so it's clear that the owner died and you are the beneficiary. After doing that, you would look up your life expectancy one time. Each year, you simply subtract a year from your initial life expectancy to figure out how much to withdraw. Sound complicated? Most investment firms will calculate required distributions from your own account for you, and a few are starting to do the math in inherited IRAs as well, says Martin Riehl, principal of Vanguard Group's retirement resource center. "I think you'll see more of that over time," he says.

And if you inherit an IRA along with other heirs, typically your siblings, you can split up the account, allowing each heir to spread withdrawals across his or her own life expectancy. Otherwise, you get stuck using the life expectancy of the oldest heir.

Watch out: Some IRA inheritors are finding they must hold the hands of the institutions that maintain their accounts. After Carol Kenzel's father died in 2001, she split his IRA among her siblings. But when she and her sister visit the respective banks holding their inherited IRAs each year, the bank staffs are as unfamiliar with such accounts as most consumers.

"After I explain all the rules to them, they call their help desk," says Ms. Kenzel, 50, who lives in Elk Grove Village, Ill. "I finally get the check, and they advise me they are not responsible if I'm penalized for an early withdrawal" -- even though she is actually taking a distribution required by federal law.

Naming No Beneficiary, or the Wrong One

When it comes to your IRA, your will is irrelevant. The way an IRA gets passed along to your heirs is governed by the beneficiary form you are supposed to fill out when you open the account. It's a good idea to review those forms regularly and keep your own copy in an easy-access spot, says Mr. Slott, because banks and brokerage firms can lose track of the paperwork over time. And make sure you fill out a beneficiary form when you inherit an IRA as well.

You may see a box on the forms to check for a "per stirpes" designation. That means the assets would go to your beneficiary's children if he or she dies before inheriting your IRA.

If you name no beneficiary, or you name your estate, your heirs lose the ability to stretch their withdrawals over their lifetimes, which means they would also lose out on the potential for decades of tax-free growth of your assets. In some cases, naming the estate as the beneficiary could even prevent your spouse from being able to roll the plan into his or her own IRA, adds Ms. Slesnick, the accountant.

Take extra care with your beneficiary form if you're in a complicated family situation. Maryann Bolles, a 67-year-old retiree in Buffalo, N.Y., set up a trust in her will that left her money to her second husband. But upon his death, it would go to her two children from her first marriage. "I just wanted to assure my children that if I died before my husband, they were going to get their fair share of things," she says.

Only one problem: Most of her assets are in her IRA, and she designated her estate as her IRA beneficiary. That means "everyone would get the money, but they wouldn't have the opportunity to keep it as an IRA," says Richard Schroeder, a financial planner who advised her to rewrite her IRA beneficiary form.

He suggested having her estate-planning lawyer rewrite the beneficiary language to "specifically set up the same situation that the trust sets up," Mr. Schroeder says. "The trustee can give the distributions to the husband if he's alive, and if he's not, to the kids."

Leaving Your IRA to a Trust

Naming a trust as a beneficiary can create problems, too, even though many people are advised by estate planners to do so, contends Mr. Slott. It can make sense if your heir is a minor child (because minors can't make tax elections), has a disability or needs help managing IRA distributions, or if you're trying to shelter assets in a divorce.

Otherwise, using a trust to inherit an IRA poses two big risks. First, it could wind up paying higher taxes than your heirs would, because trust tax rates are higher than most individuals' rates. (The 35% tax rate kicks in on a trust when income exceeds $9,750, compared with $326,450 for individuals.)

Second, the IRS could decide that the trust doesn't qualify as a "look-through" or "see-through" trust, meaning your heirs wouldn't qualify to take stretched-out withdrawals -- even though you may have set up the trust in the first place to make sure they did just that. Trusts that fail to qualify typically include beneficiaries who aren't people, such as the estate, a charity or another trust. Since those entities don't have life expectancies, stretched-out withdrawals would not be allowed for any of the beneficiaries involved.

If you have reason to use a trust but are wary of the cost or fear it might not meet the test for stretched withdrawals, a possible fix is a "trusteed IRA," a combination of a trust and IRA in which the "trustee can have more active responsibility, withholding payments from the beneficiary or making payments to a disabled beneficiary," Ms. Choate says.

Overlooking the Estate-Tax Break

When you inherit an IRA on which federal estate tax has been paid, you're entitled to a little-known tax break called the Income in Respect of a Decedent, or IRD, deduction. It often gets overlooked because the accountant or attorney who prepares the estate's tax return doesn't break out the amount of tax caused by the IRA; the accountant or financial planner working with the heir doesn't ask for it; and the heir doesn't know it exists.

Gerry Mandel, a Santa Cruz, Calif., magazine editor, and her two sisters inherited an IRA in 2002 from their mother. Four months ago, financial planner Rich Winer asked one of the sisters if they had taken the deduction, and they had not. "Both my accountant and the accountant that my sisters used missed it," Ms. Mandel says. "On my return this year, it was over $7,000 as a deduction" -- enough to cover the tax she owed on her $17,000 withdrawal from the inherited IRA. Now, she and her sisters are amending their 2002 and 2003 returns.

"Before my parents died, I always did my own taxes, and I feel like I understand every line of this return. But I didn't know about the IRD deduction," Ms. Mandel says. When she walked into her annual meeting with her accountant in March, "the first thing she said was, 'You are eligible for this deduction, and I'm really sorry I didn't catch it.' "