Many Advisors Wrong About IRA Distributions

Over 4,000 people reach the age of mandatory IRA distributions every day. Some have $100,000 to $1 million+ in their plans. Do you ignore this market?

When IRS "simplified" the IRA distribution rules in January 2001, many advisors mistakenly believed that there was no longer an opportunity to gain IRA assets through IRA distribution planning services. The new rules have in fact not made planning simpler, they have simply replaced one set of planning opportunities with another. In this article, you will learn the expensive mistakes that many IRA owners encounter and how you can use superior knowledge to attract IRA and qualified plan assets.

Mistake #1

Every IRA owner can name a beneficiary and "stretch" the IRA for maximum tax deferral over the next generation.

Informed IRA owners believe that the following will occur with any retirement assets they do not consume. Say they leave $500,000 of retirement assets. They believe junior will make small withdrawals each year (required by IRS) and at 6%, the account with a 42-year-old beneficiary, will generate $2.5 million during junior's lifetime (distributions plus ending balance at life expectancy). This sounds great but it may never happen.

There are at least 2 ways that the stretch IRA can fail. The first way is because of a custodian with rules that do not permit lifetime payments. This is particularly common in qualified plans where the rule may be that "all distributions to beneficiaries are to be completed within 5 years." Since no one ever reads that fine print for their qualified plan, they have no idea that a fast distribution will be forced to non-spouse beneficiaries.

The other problem is the beneficiary. Just because mom and dad have the good sense to understand tax deferral does not mean that junior will comply with this wisdom. The minute junior finds our that he can close the IRA, take all the money and buy a Ferrari and Lamborghini at the same time, he does so, pays a fortune in taxes and blows the money to have fun.

The way to control this is to have your clients leave their retirement assets in an IRA trust. In a trust, mom and dad can control how the heir gets paid.

Mistake #2

I am leaving my IRA to my wife. I only have one son and he can do with the IRA what he wants when we are both gone. My situation is simple.When most people select beneficiaries for their

IRAs, they select their spouse or their children. As simple as this seems, it can create problems. Consider these two scenarios.

When a plan owner leaves an IRA account to the spouse, it inflates the spousal assets. And when the spouse later dies with an estate exceeding $1 million (the estate exemptions limit in 2003), they pay estate tax. By leaving the IRA to the spouse, the deceased spouse has created unnecessary estate taxes by making the survivor's estate larger.

So instead, they leave the IRA to the son. But as indicated before, this leaves the son total control over the asset. He may withdraw the funds immediately and decide to buy a mansion jointly with his spouse (who was despised by mom and dad). To complete your client's misery, let's say that the following week, the daughter-in-law files for divorce and gets to keep the mansion in the settlement. Mom and dad just gave the despicable daughter-in-law a mansion with their IRA money. Even in death they have money problems.

To avoid the above two scenarios, they decide to leave the IRA to the "estate." Many attorneys advise that you never leave a retirement plan to your estate. Because at death, the IRS requires the account to be rapidly distributed rather than enjoy the potential stretch over the lifetimes of beneficiaries. Additionally, the IRA will now be a probate asset and subject to claims of creditors. So what do rich people do to avoid the three gloomy scenarios above? They leave their IRA in a trust and appoint a trustee like an accountant, financial advisor, attorney, etc., a person that has good common sense and tax knowledge. Within the boundaries of mom's and dad's wishes and IRS-required minimum distributions, the trustee will determine who among the beneficiaries will get the IRA and how much they get. The trustee will determine how quickly this money gets distributed over and above the annual minimum amount of required IRS distributions. Mom and dad can even give very detailed instructions. For example, they could dictate no distributions for purchases of homes with the despicable spouse. Or if the money is to be used for education they may stipulate that up to $15,000 a year can be distributed, or to start a business up to $25,000 can be distributed, and they can go on and on with such instructions.

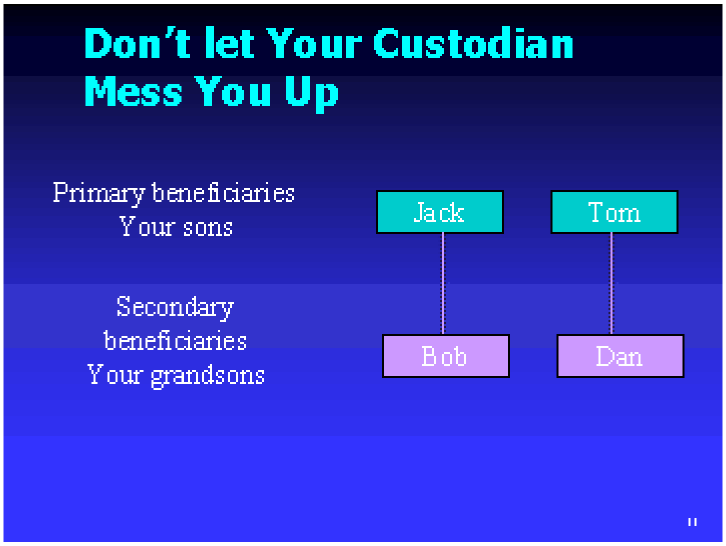
Your clients don't realize that the above problems can arise and they also don't know the solution. Use this knowledge to be the valuable advisor in yet one more instance.

Mistake #3

The IRA owners has checked with the custodian and yes, they do allow lifetime distributions to non-spouse beneficiaries. Additionally, their two unmarried sons understand tax deferral and there is no need for a trust. Everything is okay.

Many plan owners don't consider what happens if their beneficiary pre-deceases them.

Let's say your client has two sons, Jack and Tom. Your client names them as primary beneficiaries for the IRA by completing an "IRA Beneficiary Designation Form" at the bank or securities firm.



As shown above, Jack and Tom each have a son. Jack's son is Bob. Tom's son is Dan. So your client writes the grandson's names on the line of the beneficiary designation form that says "secondary beneficiaries."

If Jack dies before his parents who own the plan assets, they probably think Jack's share goes to his son, Bob. Wrong.

It goes to Tom, because on the beneficiary designation form, there is no place to specify how the primary beneficiaries and secondary beneficiaries are related. There is no place for you to explain your intentions or write "per stirpes" to clarify intentions with respect to those beneficiaries. Those beneficiary designation forms with the bank or the securities firm are not sufficiently detailed to carry out the probable wishes of your clients.

At minimum, your client should replace those forms with their own forms, called an "IRA Asset Will." This can be inexpensively prepared by any attorney. And if the custodian won't accept it, move your client's account to another custodian.

Mistake #4

Failing to use IRA funds for charitable intent

If your clients wants to leave even $1 to charity, do it from the IRA money. Clients can specify one or more charities to receive portions of the IRA and the heirs will thank you. When taxpayers leave heirs a dollar of IRA funds, the heirs will pay, for example, 35 cents to tax and have 65 cents left to spend. If the estate is over $1 million, heirs will also pay estate tax on this money and may have only 30 cents left from each dollar. However, when mom and dad leave heirs a dollar that is non-retirement money, heirs can spend it with no income tax. Therefore, heirs would much rather have "regular" money and not retirement money.

Mistake #5

Failure to realize that a bear market can help their retirement account.

Most people have heard of the Roth IRA but few seniors have converted their regular IRAs. And that's understandable, as the tax on the conversion becomes immediately due. However, now may be the time to give this option your clients' full attention.

The one good aspect of a bear stock market is that when the IRA balance is down, the owner can convert to a Roth IRA, pay tax on a reduced value, and future distributions are tax free.
(For the first 5 years after conversion they may withdraw principal tax free, but earning withdrawals would be subject to tax. If under age 59½, all withdrawals are also subject to penalty). Not everyone can take advantage of the Roth conversion, as the adjusted gross income must be under $100,000. This may be an opportunity for you to help clients "engineer" when they receive income. For example, those people with a business or income in their control may be able to defer income, drop their income for one year, and make the Roth conversion. This conversion is best for people who prefer to have growth-oriented investments in their IRA and plan to take advantage of much of their balance during their lifetime.

There are additional benefits since distributions from a Roth IRA are tax free (unlike the minimum distributions from a regular IRA). Some clients may even pay less tax on your social security. Income because of the tax free nature of Roth distributions. Since the tax on social security income is calculated on total income (minus distributions from a Roth IRA), some clients may experience additional tax savings from a Roth conversion.

Additionally, for those who are married, it is common that the household income remains the same when one spouse dies. This often pushes the single spouse into a higher tax bracket (because single people are taxed more heavily than married people on the same income). By having a Roth IRA, the tax-free distributions can help a surviving spouse minimize their tax bracket. Would the Roth IRA benefit your clients? During a depressed market is the time to give this a hard look.

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