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A RETIREMENT PLANNING COMPANY

A PRIMER ON MANAGING YOUR IRA

Keep the IRS out of your lifetime savings

by Glenn Ritt

An interview with Brian Drake, a Cape Cod-based retirement-planning specialist at Drake Saunders & Diwinsky LTD. He can be reached directly at 508-945-5050 or brian@www.retirementmoney.biz

You have built your practice helping baby boomers inadvertently avoid leaving too much of their hard-earned savings to federal and state governments rather than to their heirs. How and why can this happen?

Drake: The first and most important step is to strongly consider converting your 401(k) (or 403b) into an IRA. To a growing degree, the current severe recession is making this decision easier for baby boomers. Many either are losing their jobs entirely, or their companies are discontinuing 401(k) contributions.

Even those people with 401(k)s are too often at the mercy of others deciding where your savings are invested – sometimes with disastrous results. Consider too what it may be costing you to keep your money in an employer-sponsored retirement plan. There's invariably an additional, often hidden, level of administration that you pay for. When you roll the 401(k) or 403B into an IRA, you effectively cut out one layer that wants to take a bite out of your retirement.

Certainly, in most cases, after you leave a company – voluntarily or involuntarily – there is no reason to keep your money in their 401(k) plan, outside of short-term convenience. You have no assurance that the company will remain financially healthy or that it won't be acquired by another firm.

Even if you move on to a new company with its own 401(k) program, please consider the wisdom of taking your current 40l(k) savings and rolling it into a self-directed IRA. Especially if you are a baby boomer and have only another 10 to 15 years before you must begin withdrawing your savings at 70 years of age.

The sooner you can convert to an IRA, the sooner you can take personal control of your investment decisions. You – not someone else – is the owner of your wealth.

Consider too that you will have more options to invest than a company 401(k) provides. That level of choice can be daunting, but if you have a highly qualified advisor, the upside is significant.

An IRA not only puts you in charge of your future wealth, but also let's you or an advisor avoid paying too much in taxes to Uncle Sam – not only while you and your spouse are alive, but even more so upon your deaths.

Without proper planning, your children can be unnecessarily socked with huge taxes on your IRA and especially on your 40l(k). It would be a shame to see your lifetime legacy go to the IRS and Massachusetts treasury.

Why especially on 401(k)s?

Drake: Almost every single 401(k) plan must distribute your entire savings in a lump sum to any beneficiary other than your spouse. This means that your children will end up paying a huge tax bill on their inheritance all at once. Consider the impact on your tax bill if you had to take out hundreds of thousands of dollars from your 401(k) in one year and pay taxes on it all.

Are there other time bombs associated with 401(k) when it comes to inheritances?

Drake: Yes, a very important one that requires most families to seek advice from both a financial expert and a CPA. Put simply, a 401(k) plan actually can supersede your will when it comes to your beneficiaries. Let me give you an example. A widow's son tragically died before she did. The widow knew that her trust specified that her son's 401(k) inheritance would go to his children. She did not think twice or worry about the situation.

But, she should have. The 40l(k) plan listed her three children as contingent beneficiaries equally. With the oldest son dead, only the widow's two remaining children could receive the 401(k) money. That's because 401(k) savings get paid to the plan's listed beneficiaries regardless of what your will or trust may say.

One of the first things I require for my clients is that they take the time to be sure that their beneficiary arrangements will be paid out exactly as they desire.

So, what could this couple have done while both were alive to best protect their own savings and their children's inheritance?

Drake: First, let's go back to the beginning: Convert to a self-directed IRA or Roth IRA.

With an IRA, the children could set up a "stretch" in which they only have to withdraw a minimum amount each year, and pay tax on their distribution only, while continuing to defer the balance. Or, they could take the money out over a 10-year period if that works best. The point is this – IRAs provide more flexibility when it comes to your beneficiaries' options.

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So is the world a better place once someone has converted from a 401(k) to an IRA?

Drake: Better, but there still are many considerations associated with managing your IRA. When you are younger, there is nothing more satisfying than watching your IRA grow every year based on compound interest and good investment advice.

Then, one day you are 59 ½. And suddenly you can see 70 racing toward you when you will be required by law to begin withdrawing your savings every year.

Still, you say to yourself: I will be earning a lot less then, and the tax impact will be minimal.

Maybe.

Have you considered that your withdrawal probably will increase the tax rate on your pension and Social Security? Have you considered that when you reach 70, you may not have retired like your parents did? Maybe, you can't afford to retire. Or more likely, you have decided to start a business and become an entrepreneur, redefining your life.

If so, you need to pay as much attention to tax planning as a baby boomer as you did accumulating wealth when you were in your 40s.

You should begin to minimize future taxes as early as possible and not wait until you are 70.

How bad a future tax picture could a baby boomer couple with moderate wealth face down the road?

Drake: At our company, we work closely with some families that have only $250,000 to $1 million. I use the word "only" because on Cape Cod, many financial advisors choose to work with clients who have a minimum of $500,000 – and more likely $1 million in liquid assets.

There's a reason we are committed to financially comfortable clients. That's because we see how just a $300,000 tax-deferred IRA for a baby boomer couple can grow into a lot more money by the time they are in their 80s. A generation ago, most people would be dead by then. But today, life spans are much longer.

So let's meet Bob and Amy, who have $300,000 in their IRA at 65. They no longer are contributing annually, but based on 7 percent interest, that $300,000 will grow to more than $420,000 by the time they reach 70 and must withdraw about $15,000 a year.

By the time both Bob and Amy die at 88, they will have withdrawn $545,000 from an IRA that was only $300,000 23 years earlier, paying taxes at about a 15 percent rate over the most recent 18 years.

Even then, they are leaving $572,000 to their children.

That is a combined $1.12 million in total distributions that require both careful investment guidance and most importantly strong tax-saving advice.

Remember too that during their lives, the money Bob and Amy were required to withdraw annually from their IRA was added to their $48,000 in pension and Social Security – increasing the tax rate on that money too.

Even with these downsides, you are not suggesting to spurn IRAs and 401(k)s for their tax-deferred power?

Drake: Not at all. I am saying you must manage them with income growth and tax savings simultaneously in mind - if not for you and your spouse, at least for your heirs, because that is where the true time bomb is planted.

Once you have rolled your 401(k) into an IRA, then, what other steps should someone take to protect their savings from unnecessary federal or state taxes now and upon their deaths?

Drake: This is a tricky area. No two people are identical Everyone has a different situation. But I can give you some big picture options to consider. You have four alternatives that could potentially be incorporated:

- Personal tax deductions;
- Business tax deductions;
- Tax credits
- Roth conversions

PERSONAL DEDUCTIONS

These include interest you pay on home loans, medical expenses and charitable contributions. Depending on your circumstances, these types of deductions may be a helpful way for you to offset the taxes on your IRA or 401(k) distributions, either partially or in full. I've seen cases where charitable planning has eliminated tax on IRA distributions. Other people have used the interest on home loans or life insurance to reduce taxes.

BUSINESS DEDUCTIONS

This is an expanding option since so many baby boomers are moving to places like Cape Cod not to retire, but to reinvent themselves and buy or start a business. Even rental homes are a business, and business owners often have several potential deductions. These can be used to offset taxes on qualified plan distributions.

I've known some people to take money out of their IRA and use it towards repairs of their rental real estate as a tax-deductible offset. You name your business, and you probably can fiture a way to use qualified plan distributions to pay for a tax-deductible expense.

TAX CREDITS

These are authorized by section 42 of the tax code and are available primarily for people who invest in low-income housing. On Cape Cod, where the need for affordable housing is so acute, this could be a path that not only protects your wealth, but enhances your legacy. I personally like the idea of investing in low-income housing for seniors on the Cape.

The powerful aspect of tax credits is that you receive a dollar-for-dollar reduction of tax on your return. For example, if you must withdraw $30,000 from your IRA at age 70,

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and you are in a 25 percent tax bracket, this costs you $7,500 in taxes.

If you had a $7,500 tax credit, your net tax owed would be zero. Frankly, it is that simple. But, first, you must plan ahead and make important decisions about where you want to direct your hard-earned savings while they still are tax-deferred.

Keep in mind, that investment in senior housing also has the strong potential to be a smart investment.

ROTH CONVERSION

The benefit of a Roth conversion is that your IRA goes from a taxable account to a tax-free account from that on forward. As a bonus, tax-free distributions from Roth IRAs do not count against your Social Security income for tax purposes.

The downside, of course, is that you must pay income tax on the amount of money you convert in the year you convert. But, if you have suffered losses due to the current recession, or your income has been cut substantially right now, this may be a unique opportunity to convert at least part of your 401(k) rollover or IRA into a Roth because your other income is limited.

If there is overarching advice you would give a baby boomer about his or her savings, what is it?

Drake: One of the toughest situations many of us face every month is getting that 401(k) report from your company or broker. You feel helpless.

But, we do have lots of control, beginning with the decision to convert your savings into a “self-directed” account. At the very least, you should be able to manage your wealth. But, after this big step, begin thinking about taxes. It is not just about accumulating money, but protecting it.

That comes from making wise decision based on your risk tolerance - which usually shrinks as you get closer to 70 – and your desire to bequeath your wealth to your children and not the IRS.

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