THE COMPLETE CARDINAL GUIDE TO PLANNING FOR AND LIVING IN RETIREMENT WORKBOOK

NAVIGATING SOCIAL SECURITY,
MEDICARE AND SUPPLEMENTAL INSURANCE,
LONG-TERM CARE, IRA, LIFE INSURANCE,
POST-RETIREMENT INVESTMENT AND INCOME TAXES

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The Complete Cardinal Guide to Planning for and Living in Retirement Workbook

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MODULE 4

IRA (INDIVIDUAL RETIREMENT ACCOUNTS)

KEY QUESTIONS

- What is an IRA?
- How do IRAs work?
- How are a Roth IRA and a traditional IRA different? How are they alike?
- When am I required to start Required Minimum Distributions (RMD)?
- What is the process for making investments into a traditional IRA or Roth IRA?
- How do IRAs figure into my long-term care planning?

*Corresponds to Chapter 5, "Assets: Your IRA, 401(k), and Pension Plan," in **The Complete Cardinal Guide**.*

4.1 The Origin of IRAs

Traditional Individual Retirement Accounts, or IRAs, allow you to save for retirement on a tax-advantaged basis. Traditional IRAs use "pre-tax" funds that can grow while you defer paying taxes on them. Ordinary income taxes are due only when withdrawals are made from a traditional IRA. The IRA was created in 1974 with the passage of the Employee Retirement Income Security Act (ERISA) championed by President Gerald Ford. ERISA was put in place to protect non-government employees by creating standardized vesting schedules for private pension plans like a 401(k) and other employer-sponsored benefits. It also provides individuals and small business owners with access to retirement savings plans like the

Simplified Employee Pension (SEP-IRA) and the Savings Incentive Match Plan for Employers (SIMPLE IRA and SIMPLE 401[k]).

One impetus for ERISA was the bankruptcy of companies, which left employees without access to pensions. A prominent example was the automobile manufacturer Studebaker, which failed and closed in the 1960s. The Employee Retirement Income Security Act does not require private employers to set up expensive and burdensome pension plans; instead it allows for the creation of defined contribution plans that use tax-deferred arrangements and IRAs to help employees invest for retirement. These accounts enable employees to earmark funds for retirement, and allow capital gains and dividend income to compound on a tax-deferred basis until the funds are withdrawn from the account during retirement.

The Roth IRA was created by the Taxpayer Relief Act of 1997 and named for its chief sponsor, Senator William Roth of Delaware. The Roth IRA's principal difference from a traditional IRA is that rather than allowing a tax deduction when the money is deposited into the IRA, the tax benefit is granted when the money is withdrawn during retirement. You pay no income taxes on money coming out of a Roth IRA. Tax-free retirement income is now a reality. It is now also possible to convert traditional IRA money (taxable) to Roth IRA money (tax-free). The bad news is that you must pay all the income taxes due to make the conversion.

Reading Check

How long have traditional IRAs been around? What is the main difference between a traditional IRA and a Roth IRA?

4.2 America's IRA Expert

Ed Slott became "America's IRA expert" by training financial advisors, CPAs, attorneys, insurance agents, and consumers on the ins and outs of planning for and then using an IRA for its intended purpose: living off it in retirement. IRAs enjoy tax preferences or "loopholes" that allow taxes to be postponed, or now even the possibility of tax-free income with the Roth IRA. The Internal Revenue Service is very unforgiving when a taxpayer neglects or remains ignorant of the regulations about transferring or "rolling over" an IRA, taking money out of an IRA or failing to do so, and leaving your IRA to your heirs.

Consumers are focused on the accumulation of the balance in their IRA or 401(k) while they are still working. At retirement, or just before retirement, the focus changes from accumulation to distribution (or living off of it). Now come the decisions about how you plan to distribute your IRA and make it last the rest of your life. Many financial advisors, attorneys, CPAs, and insurance agents who advise retirees on IRA and 401(k) decisions during retirement are not well trained in the IRS rules for handling them. Mistakes are costly and many times cannot be reversed.

In this module, we discuss transfers and rollovers, beneficiary designations, age 70½ required minimum distributions, and Roth conversions, and we issue a warning about stockpiling money in an IRA to leave to your kids.

Reading Check

Why do retirement planning experts take specific training on IRA distributions?

4.3 Transferring Your IRA

Your IRA/401(k)/pension must remain in your name, and your name alone, as long as you are alive. Your money and securities must be held by a custodian (like a bank or stock brokerage) who makes sure all the IRS rules and reporting requirements are followed exactly. You may choose another custodian or your plan might require you to move the money and securities to another custodian. This is referred to as a rollover or transfer. There is a way for you to take a check for the balance (possibly after income taxes are withheld). You then have 60 days to get it redeposited into a new IRA or face income taxes on the whole amount. New IRS rules are in place limiting the frequency of this "60-day exemption," making it even more complicated.

Our advice is: "Don't take the risk. Have the money transfer directly to the new custodian without it ever coming into your direct possession." Some employers or retirement plans will tell you that they have to make the check out to you when leaving their plan. The check can be made out to XZY IRA CUSTODIAN COMPANY for the benefit of MARY SMITH. This will satisfy your employer and the IRS. If it takes an example to convince you, see Rebecca's story in chapter 5 of ***The Complete Cardinal Guide***.

Reading Check

When moving IRA/401(k) money into a new IRA, move the money from ______________ to ______________.

4.4 IRA Beneficiary Forms

Beneficiary forms must be updated regularly. Your beneficiaries will need to pay income tax on this inheritance (unless the IRA is a Roth). With the right advice and proper account titling, they can stretch the income taxes over their lifetime.

A spouse beneficiary is treated more favorably than a non-spouse beneficiary. A spouse can leave the IRA titled in the original holder's name or retitle the IRA in their own name. A non-spouse beneficiary must retitle the IRA—"Mary Smith, Deceased, IRA FBO Jack Smith"—or cash it out and pay the taxes.

For a good example of the complications involved in effectively using an inherited IRA, see Sybil and Jackson's story in chapter 5 of ***The Complete Cardinal Guide***.

Reading Check

Who should you name as the beneficiary of your IRA? Is it OK to forget the use of the beneficiary designation in your IRA and just name them in your will?

4.5 Required Minimum Distributions (RMD)

The US federal tax code gives a significant tax break to people who set aside money in an IRA or other retirement plan. This is to encourage savings for retirement. You can withdraw money as early as age 59½, but you must start withdrawing money by age 70½; this rule is called Required Minimum Distributions, or RMD. Ordinary income tax is due on any money coming out of the IRA unless it is a Roth IRA.

To calculate your RMD, find your IRA balance as of December 31 in the prior year. Calculate your age as of that same date in the current year and find your IRS life expectancy from the table below. Add up all your traditional IRA balances and multiply the total by the percentage that corresponds with your age. You can distribute the money any time during the year and you can withdraw from any IRA you choose. Roth IRAs have no minimum distribution requirements.

Fig 4.1

AGE OF IRA OWNER OR PLAN PARTICIPANT	LIFE EXPECTANCY (IN YEARS)	AGE OF IRA OWNER OR PLAN PARTICIPANT	LIFE EXPECTANCY (IN YEARS)
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115+	1.9

AGE OF IRA OWNER OR PLAN PARTICIPANT	RMD AS A % OF ACCOUNT BALANCE	AGE OF IRA OWNER OR PLAN PARTICIPANT	RMD AS A % OF ACCOUNT BALANCE
70	3.65%	93	10.42%
71	3.78%	94	10.99%
72	3.91%	95	11.63%
73	4.05%	96	12.35%
74	4.21%	97	13.16%
75	4.37%	98	14.09%
76	4.55%	99	14.93%
77	4.72%	100	15.88%
78	4.93%	101	16.95%
79	5.13%	102	18.19%
80	5.35%	103	19.24%
81	5.59%	104	20.41%
82	5.85%	105	22.23%
83	6.14%	106	23.81%
84	6.46%	107	25.65%
85	6.76%	108	27.03%
86	7.10%	109	29.42%
87	7.47%	110	32.26%
88	7.88%	111	34.49%
89	8.34%	112	38.47
90	8.78%	113	41.67
91	9.26%	114	47.62
92	9.81%	115+	52.64

A different table can be used if your spouse is more than 10 years younger than you.

Reading Check

After what age must you begin withdrawing money from your traditional IRA?

4.6 Life Insurance and RMD

You can use all or part of the net taxable distributions from an IRA to pay the annual premiums for a life insurance policy. The death benefit on the life insurance policy can equal the balance of the IRA. Life insurance proceeds at your death will be paid to your heirs income tax-free.

Fig. 4.2

IRA Annuity Distributed over 10 Years
Age 70 • Female • $100,000

Taxable IRA Distributions for 10 Years	$11,903
Life Insurance Policy Paid Up for Life	$141,967

$141,967 or more paid to beneficiaries tax-free at death

Another way to leave tax-free money to your heirs is with a Roth IRA. In contrast to a traditional IRA, contributions to a Roth IRA are not tax-deductible. Instead, withdrawals are tax-free and there are no required minimum distributions during your lifetime.

A Roth conversion strategy involves paying the income taxes due on the traditional IRA and then changing it into a Roth. It makes the most sense if you can pay the taxes from other funds and place the entire traditional IRA into a new Roth IRA.

Reading Check

What is the reason IRA funds are not as favorable to heirs as other savings and investments?

4.7 Long-Term Care and IRAs

If you must pay the bill for home health care, assisted living, or nursing home care yourself, we suggest drawing down your IRA balance first before going into other funds. Long-term care expenses are deductible as a medical expense, so you can offset a good bit of the tax liability from the IRA distributions. If you die before spending all your IRA money on long-term care, your heirs will receive money on which the taxes have already been paid.

IRA PLANNER

List all IRA, 401(k), 403(b), 457, and any other accounts:

ACCOUNT	BENEFICIARY(S)

Spouse:

ACCOUNT	BENEFICIARY(S)

I am eligible for a pension from:...

Spouse is eligible for a pension from:...

My plan for Required Minimum Distributions after the age of 70½ is:

....