



## Helping You Avoid IRA Distribution Mistakes



Provided to you by

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0D13621

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Member NASD/SIPC  
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# Helping Preserve Your Retirement Assets by Taking Smaller Distributions

You own two pots of money: The money that has already been taxed (let's call it "regular money") and the money that has not been taxed (let's call this "retirement money" such as IRA, 401k, 403b, etc.). When you spend a dollar of regular money, the cost to you is exactly \$1. When you spend \$1 of retirement money, the cost to you could be as much as \$1.54<sup>1</sup>(1/.65) because you may have to pay off federal income tax on the amount you withdraw. Therefore, if you want to reduce your taxes, consider not taking more than the required distribution from your retirement money.

Some people think they should never spend their principal, but this can be a mistake if you want to save taxes. It could be better to spend some of your regular assets first, so that you can take advantage of the tax-deferral benefits associated with IRAs and qualified retirement plans. You could be better off financially from an income tax standpoint. Your lifetime tax bill can be less or you will at least defer taxes for many years.

Consider the following hypothetical example that assumes you have a taxable regular money account and a tax-deferred retirement account with a \$100,000 balance each. Let's assume the money in each account earns a return of 6% per year. Let's further assume that annual distributions of \$6,000 per year are being taken for a 20-year period. Under one scenario, the \$6,000 will be taken first from the taxable money and the other scenario considers what would happen if the money was taken first from the qualified money. Under this example, you would have \$150,000 more at the end of 20 years by spending your regular money first. The upside is that you could potentially hold onto more money while you are alive.

Of course, the down side is that your beneficiaries will eventually have to pay income taxes on the money when you are gone. As the information provided by this example is hypothetical, actual results will vary depending upon the performance of your investments.<sup>2</sup>

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<sup>1</sup> Federal income tax rates range between 10% to 35% under the 2007 federal tax code, and are based upon the taxpayer's level of annual income. State income taxes could also apply, which vary from state to state. Please note that federal and state tax laws are subject to frequent changes.

<sup>2</sup> The fact that the beneficiaries are going to pay income taxes at a later date could be an advantage if they are in a lower tax bracket. As previously explained, estate taxes could also apply if the decedent's estate exceeds \$2 million (2007–2008), \$3.5 million (2009), \$1 million (2011).

## Spend Regular Money First

	Today	In 20 Years
<b>Spend Regular Money First</b>		
Regular Money	\$100,000	\$40,916
IRA Money	\$100,000	\$320,713
<b>TOTAL</b>	<b>\$200,000</b>	<b>\$361,629</b>
<b>Spend IRA Money First</b>		
IRA Money	\$100,000	\$0
Regular Money	\$100,000	\$211,247
<b>TOTAL</b>	<b>\$200,000</b>	<b>\$211,247</b>

Assumptions: All money is assumed to earn 6%. This assumed rate is used for tax illustration purposes only and does not reflect any particular investment. Federal income taxes are assumed to be 35% in this example, and your income tax rate could be lower based upon your annual income. This illustration covers a 20-year duration, with distributions of \$6,000 occurring each year. The income taxes on withdrawals are also deducted from the IRA account.

# Two Things That Could Ruin Your Plans to Stretch Your IRA Money

If you have consulted a financial advisor about your IRA, they may have told you about the "stretch" IRA the concept of allowing your beneficiaries to spread out the tax on the portion of your retirement dollars that you leave to them. Continuing from our previous hypothetical table, if your \$100,000 retirement fund happened to grow to \$320,000 and you died before spending any, your heirs would receive the \$320,000. They can spread out the payments from the IRA and a spouse can continue to defer taxation until age 70½ (see IRAS P8ublication 590).

The two things that can impair this tax deferral are the possible actions of your heirs and your IRA custodian.

At your death, your heirs can remove the whole balance in one lump sum and go buy a yacht. Yes, they will pay all of the tax at once and lose years of tax deferral. One way to control this is not to leave your IRA assets outright to heirs, but to leave the assets in an IRA trust. In a trust, you can control how the heir gets paid. See more about trusts in "Avoiding Potential Mistakes in Selecting IRA Beneficiaries through an IRA Trust" later in this booklet).

Also, your custodian may have rules such as "all distributions to heirs must be paid out in five years." If your funds are in a 401k, the plan may also force a fast payout and make the stretch concept impossible to implement for non-spouse beneficiaries.

Please call for a list of important questions you will want to ask your custodian about your account. Now, let's examine in greater detail why the beneficiary forms your IRA custodian uses could cause some problems.

# Why You May Need an IRA Asset Will

Let's say you have two sons, Jack and Tom. You name them as primary beneficiaries for your IRA when you open the account by completing an "IRA Beneficiary Designation Form."

As shown below, Jack and Tom each have a son. Jack's son is Bob. Tom's son is Dan. So you put your grandsons names on the line of the beneficiary designation form that says "secondary beneficiaries."

## Don't Let Your Custodian Mess You Up

Primary Beneficiaries: Your Sons	Jack	Tom
Secondary Beneficiaries: Your Grandsons	Bob	Dan

If Jack dies before you do, what happens to Jack's half of your IRA when you pass away? You probably think it goes to his son, Bob.

It could go to Tom, because on your beneficiary designation form, there may be no place to specify how the primary beneficiaries and secondary beneficiaries were related. There may be no place for you to explain your intentions and your desires with respect to those beneficiaries. Those beneficiary designation forms that you filled out with the bank or the securities firm may not be sufficiently detailed to carry out your wishes.

What's the possible solution? Give your IRA custodian your complete instructions on your own form. These forms are known as "Retirement Asset Wills" because they provide a complete set of instructions regarding your retirement assets. You should have such instructions drawn by a knowledgeable attorney. Please call if you would like names of local attorneys knowledgeable in preparing these customized IRA instructions that contain your wishes.

By the way, some retirement plan custodians may refuse to take your custom instructions. If this happens, call for a list of custodians that will accept your instructions. And since retirement assets are transferable from custodian to custodian in most cases, you can move your accounts. The same flexibility often applies to a beneficiary who inherits an IRA and finds that the custodian has a rule to pay out the IRA quickly rather than allow the stretch concept. The beneficiary can just transfer to a more flexible custodian. However, income taxes and penalties will apply if you take a distribution and your entire account is not rolled over within 60 days of the day your money is distributed. For this reason, it is often a good idea to have your account transferred via direct roll-over.

# Free Online Resources

There's no substitute for carefully reading the prospectus of a mutual fund or variable annuity before making a purchase. Regulatory agencies such as FINRA and Securities and Exchange Commission (SEC) offer a variety of free online resources to assist the investing public. Here are a few:

- SEC Mutual Fund Cost Calculator  
[www.sec.gov/investor/tools/mfcc/mfcc-int.htm](http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm)
- SEC Mutual Funds  
[www.sec.gov/answers/mutfund.htm](http://www.sec.gov/answers/mutfund.htm)
- SEC Variable Annuities: What You Should Know  
[www.sec.gov/investor/pubs/varannty.htm](http://www.sec.gov/investor/pubs/varannty.htm)
- FINRA Investment Choices  
[www.finra.org/Investor/Choices/investment\\_choices.asp#invmf](http://www.finra.org/Investor/Choices/investment_choices.asp#invmf)
- FINRA Variable Annuities: Beyond the Hard Sell  
[www.finra.org/Investor/Alerts/alert\\_variable\\_annuities.htm](http://www.finra.org/Investor/Alerts/alert_variable_annuities.htm)
- FINRA Understanding Mutual Fund Classes  
[www.finra.org/Investor/alerts/alert\\_mfclasses.htm](http://www.finra.org/Investor/alerts/alert_mfclasses.htm)
- FINRA Investor Newsletter  
[www.finra.org/Investor/tools/email.asp](http://www.finra.org/Investor/tools/email.asp)

If you do not have Internet access at home you might try visiting your local public library to access the Internet free of charge; alternatively, you can call the representative who has provided you with this booklet for a free print-out of this information.<sup>3</sup>

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<sup>3</sup> Websites provided were last visited on 02/14/06 and are on file at Javelin Marketing, Inc.

# Avoiding Potential Mistakes in Selecting IRA Beneficiaries through an IRA Trust

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 this scenario.

If instead you leave the IRA to your son, he could withdraw the funds immediately and decide to buy a mansion jointly with his spouse. Let's say that the following week, your daughter-in-law files for divorce and gets to keep the mansion in the settlement. You just gave your ex-daughter-in-law a mansion with your IRA money. Although these examples are hypothetical, they illustrate problems that sometimes arise when younger family members are left with substantial retirement assets.

To help avoid the above scenario, you may decide to leave your IRA to your estate. Based upon the tax rules today, a designated beneficiary must usually be a natural person (except for cases with qualified trusts, which will be explained later in this booklet).<sup>4</sup> If you leave these assets to an estate, the IRS will require the account to be distributed over a five-year period, rather than the lifetimes of the respective beneficiaries.

So what do some people do to avoid the scenario above? They may leave their IRA in a qualified trust and appoint a trustee like an accountant, financial advisor, attorney, etc., a person that has common sense and tax knowledge.

Within the boundaries of your wishes and IRS-required minimum distributions, the trustee can be empowered to decide who among your beneficiaries will get the IRA and how much they get. The trustee can then be empowered to decide how quickly this money gets distributed over and above the annual minimum amount of required IRS distributions. You can even give very detailed instructions. For example, if the money is to be used for education you 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 you can go on and on with such instructions. Please note that the trust must satisfy the rules set forth in the treasury regulations to qualify as an IRA beneficiary, and it is important to consult with an experienced attorney prior to setting up such a trust.<sup>5</sup>

So if you would like to have restrictions or limitations on how your retirement plan eventually gets used and distributed, you should leave it to a trust rather than directly to a person. Because if you leave it to a person, it's their decision how to use it as they desire. You can call the representative who has provided you with this booklet for referral information regarding experienced attorneys in your area.<sup>6</sup>

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<sup>4</sup> Treasury Reg. § 1.401 revised 4/1/06

<sup>5</sup> See Prop. Reg. § 1.401(a)(9)-4, A-5(a), A-6 (2006) for further guidance on establishing a qualified trust.

<sup>6</sup> The cost of establishing an IRA trust or IRA asset will vary by location and attorney and may be significant.

## If You Have Charitable Desires...

If you want to leave even \$1 to charity, you may want to do it from your IRA money. You can specify one or more charities to receive portions of your IRA, and your other heirs could thank you for doing it.

When you leave your heirs a dollar of IRA funds, they could pay up to 35 cents tax and have 65 cents left to spend.<sup>7</sup> If your estate is over \$2 million, you may also be required to pay estate taxes on some of this money. However, when you leave them a dollar of non-retirement money, the income tax they pay could be reduced and sometimes eliminated as a result of the basis increase they will typically receive on the transferred asset (assuming the transfer is made after death). Furthermore, the estate tax burden can also be minimized and even eliminated in some cases with credit-shelter trusts, irrevocable life insurance trusts, and other estate planning strategies. Therefore, your surviving family could be better off if they received their inheritance from non-qualified resources.

On the other hand, qualified charities do not pay any income taxes on death bequests that come from IRAs and qualified retirement money.<sup>8</sup> Also, your estate will receive an estate tax deduction for the amount of the charitable gift, which helps to reduce the overall tax. Therefore, if your estate plan includes charitable gifts, it is often a good idea to satisfy these gifts with qualified money.

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<sup>7</sup> Federal income tax rates range between 10% to 35% under 2007 federal tax code and are based upon the taxpayer's level of annual income. State income taxes could also apply, which vary from state to state. Please note that federal and state tax laws are subject to frequent changes.

<sup>8</sup> Certain restrictions may apply to the amount of the deduction, based upon the status of the charity and the annual income of the donor. See your tax advisor for further details regarding charitable donations.

# Which Investments Should You Consider for Your Retirement Accounts?

## *Investment Options*

*Stocks?*

*CDs?*

*Real Estate?*

*Municipal Bonds?*

*Treasury Bonds?*

*Mutual Funds?*

In your efforts to achieve a balanced portfolio, it will often make better sense for tax-planning reasons to purchase certain assets with your IRA or qualified retirement plan money and to purchase other assets with funds outside of these plans. This article will explore some of these considerations.

For example, many of you already know that no federal, state, or local income taxes are incurred on the income received from municipal bonds. Also, income from federal treasury bonds is typically exempt from state and local taxes. If the income from these investments is already being received tax-free outside your retirement plan, does it make sense from a tax-planning position to hold these investments in a tax-deferred account?<sup>9</sup> It may not, in many cases. In fact, holding these investments in your qualified account could result in a situation where your earnings will be subjected to taxes in the future.

If we assume that it's reasonable for a certain investor to balance his or her portfolio with some equity investments, then a purchase through an IRA or qualified plan could help this investor to achieve some tax-deferred growth on any income received. Although a gain on the sale of these investments would normally be subject to federal income taxes, these taxes can be deferred when the investments are bought and sold inside a qualified retirement account. Outside the plan, any earnings and growth are subject to immediate taxes. Inside the plan, these taxes can be deferred for many years (usually until distributions are taken at retirement).

The point of this is that it makes sense to consider income taxes when deciding what assets should be purchased with qualified and non-qualified resources. Please keep in mind that municipal bonds held outside of a qualified plan can be subject to the Alternative Minimum Tax. These bonds are usually exempt from state and local taxes, though discount bonds may be subject to capital gains tax. These bonds are also backed by the issuing state or local government. On the other hand, equity investments such as stock and mutual funds involve market risk, which includes the possible loss of your principal investment. How you chose to allocate your investment funds is a serious decision, based upon these and other suitability considerations specific to your financial situation.

Please call if you would like more information on this.

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<sup>9</sup> Of course, assets held inside a qualified retirement plan are protected assets under ERISA and federal bankruptcy law. Creditor protection is just one of a number of additional issues that should be considered when planning for retirement.

# How Lower Stock Values May Lower Your IRA Distribution Taxes and Increase Your Income

One thing you can consider to save on federal income taxes during your retirement is to convert your qualified tax money into a Roth account. By doing this, you could shield any appreciation on these assets from federal income taxes. Additionally, distributions from these assets will come to you free of income taxes as well. This, of course, assumes that the holding period rules are satisfied (age 59½ and the five-year holding period).

Unlike the traditional IRAs, the owner of a Roth is not required to take distributions at age 70½. Also, any distributions you do take from Roth accounts are **not counted** for purposes of figuring income taxes on Social Security benefits. This provides Roth owners with another tax benefit that cannot be achieved from a traditional IRA.

Although an income tax must be paid if you convert your retirement money to a Roth, the potential for future tax savings could make this a good strategy. For instance, let's consider an example where a taxpayer converts \$300,000 of traditional IRA money into a Roth IRA. Let's further assume that the Roth money is invested in a diversified portfolio of investments. If we assume over the long-term that the investments grew at 10% for 15 years, the accumulated value of this portfolio would be \$1.2 million. Although the portfolio grew by \$900,000, no income tax is paid in the future. Although your beneficiaries are required to take minimum distributions based upon their life expectancies, any future appreciation in the account will come to them free of income taxes. **Please remember that investments in traditional and Roth IRAs are subject to various levels of market risk, depending on the type of investments held in the accounts. Therefore, you should never assume that your IRA investments will perform in the same way as was explained in this example. Your results will likely vary from this example.**

There is a requirement to be eligible for a Roth conversion. To do a conversion, you cannot have Modified Adjusted Gross Income that exceeds \$100,000 per year. This amount includes your income from all sources and your Social Security. Although the Roth distributions will not affect the taxation of your Social Security, some of your Social Security income will be counted to determine if you're eligible for a Roth conversion. Thus, this option may not be available to taxpayers in higher tax brackets.

Please call if you would like more information about Roth IRAs.

# **For Those of You Who Are Holding Your Employer's Stock Inside Your Qualified Retirement Plan...**

Some people reading this might be holding employer stock in their retirement plan. If this stock has appreciated significantly, it might be worth your while to take a lump-sum distribution of this stock. Yes—this is one case where a lump-sum distribution could actually make more sense.

If you take a lump-sum distribution of the employer stock from your plan, you are only required to pay ordinary income taxes on the value of the stock when you obtained it through your plan. The appreciation on this stock will be taxed at the lower capital gains rates, which are currently 5% or 15%, depending upon your annual income. Tax experts commonly refer to this unrealized gain as net unrealized appreciation (NUA). Additionally, any appreciation that occurs after the distribution date will receive the favorable capital gains rates if the stock is held for an additional 12 months.

Now had you simply left the stock in your plan, the appreciation would have eventually been subject to income taxes at your ordinary income tax rates when you start taking retirement distributions. On the other hand, the net unrealized appreciation strategy can help you reduce income taxes by taking advantage of the lower capital gains rates that are now in place today.

As is the case with most complex tax planning strategies, there are rules that must be followed to get the tax benefits. First, this strategy only applies to qualified employer stock. For NUA purposes, this means the stock of your employer. So, if you worked for IBM, the NUA tax break only applies to IBM stock. Also, the employee must elect a lump sum, in-kind distribution from the plan, and this distribution must also occur within one calendar year.

Please note that tax laws are subject to frequent changes and you should consult with a qualified tax professional before making any final decision. Please call if you have any questions regarding this particular strategy.

# About Greg McMullen



Greg McMullen has been providing financial planning services for individuals, families, small businesses and seniors in the San Diego County area for several years. As a Certified Senior Advisor, Greg has the additional expertise and professional responsibility to assist his senior clients in areas of social, health, and financial matters.

Specializing in the financial planning industry, Greg is able to properly assist clients to preserve their capital, maintain proper growth so as to not outlive assets, and to properly distribute assets with minimizing taxes. His goal is to implement the best financial plan for his clients.

Greg is a very active participant in his local parish in the Carmel Valley area. He shares his time, talent, and treasure with fellow parishioners whether in financial matters or in social services. Thus, Mr. McMullen's motto is paraphrased from the Book of Jeremiah 29:11—Building God's kingdom through financial freedom.

# About McMullen Financial & Insurance Services

- **Financial Planning**– Includes utilizing various insurance and investment products to provide and implement the best financial plan to preserve, grow, and distribute assets. –
- **Insurance Planning**–Includes comparing various insurances to provide the most cost effective plan to protect assets, especially life, health, disability, long term care, and annuity. –
- **Wealth Strategies**–Includes utilizing various products and types of accounts to protect assets, provide consistent and adequate growth, and minimizing taxes. –
- **web site address**– [www.mcmullenfis.com](http://www.mcmullenfis.com) –

**Phone today with questions or to see if we can help you.  
There is no charge for an initial meeting.**

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First Published 12/10/02

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Distribution of this booklet is valid only through March 15, 2008