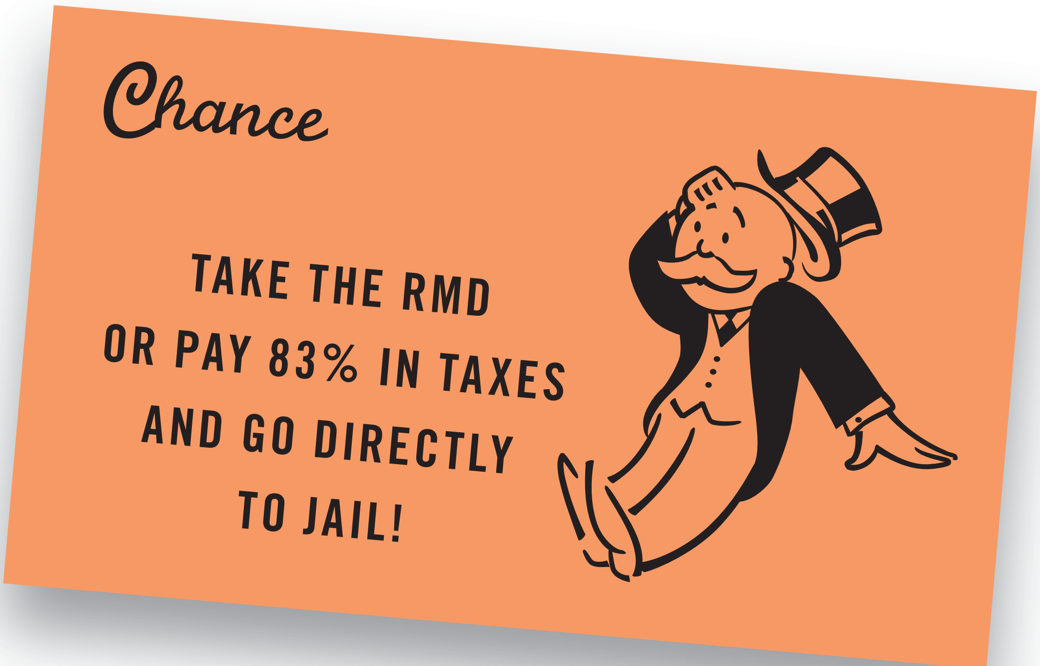
The Most Costly Mistake Your IRA Clients Must Avoid



BY DAVID F. ROYER

The most costly mistake made by individual retirement account (IRA) owners and their beneficiaries involves the Required Minimum Distribution (RMD). The first RMD must be taken by April 1 the year after the IRA owner turns age 70½. This is called the Required Beginning Date. Future required distributions are based on the account value as of Dec. 31 of the prior year and must be taken by Dec. 31 of the current year.

Extreme penalties are charged if the IRA owner fails to take the full RMD by the deadline. In addition to paying income tax, the owner is charged an excise tax of 50 percent of the missed RMD! This could create a tax burden of more than 80 percent on missed RMDs.

Example:

Let's assume that the IRA owner is 79, the account balance was $500,000 at the end of the prior year and the owner is in a 33 percent income-tax bracket. The RMD at age 79 is 5.13 percent of $500,000, or $25,650. The Dec. 31 deadline to take the current year's distribution has passed and the IRA owner failed to withdraw the required amount. This creates a big payday for the Internal Revenue Service. The IRA owner will still need to pay income tax on the missed distribution when it is finally taken and he or she will also owe an additional 50 percent excise tax. Let's do the math…

The $25,650 missed distribution minus $8,465.50 income tax (33 percent), minus $12,825 excise tax (half of the missed distribution) means that $21,290.50 goes to the IRS. The IRA owner is left with only $4,359.50 of the $25,650 required distribution. The IRS took 83 percent of the missed distribution and the IRA owner was left with a mere 17 percent. Any time an RMD is missed the IRS becomes the IRA owner's senior partner!

Using annuities administered by insurance companies is an ideal way to eliminate making this costly mistake for four reasons:

1. Annuity providers are keenly aware of the many IRS dates and deadlines that can easily be missed, causing costly additional taxes and penalties.

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2. Annuity companies have been making lifetime distributions to annuity owners and their beneficiaries for well over 200 years, and many annuity companies have developed state-of-the-art beneficiary documents that are designed to automatically calculate and distribute the RMDs to both IRA owners and their beneficiaries. Some of these beneficiary documents will allow the owner to predetermine the date that the annual distribution will be made to ensure that the required distributions will never be missed.

3. Annuity advisors typically conduct annual reviews for their annuity clients. If there has been a triggering event such as the death of the IRA owner or the owner reaching age 70½, requiring a distribution to be made, the well-trained advisor will be in the position to make sure distributions are made on a timely basis.

4. Annuities are guaranteed to never lose value. Keep in mind that RMDs are calculated based on the account value as of Dec. 31 of the prior year. Let's assume that the IRA account value as of Dec. 31 is $500,000 and the IRA owner is 79. As I pointed out earlier, the RMD will be 5.13 percent of the account value, or $25,650. If the year was 2008, when we saw the biggest market crash since the 1930s, and the account value dropped by 40 percent, the remaining value would be only $300,000. The RMD would still be based on the Dec. 31 value of $500,000. This is exactly why under the Worker, Retiree, and Employer Recovery Act of 2008 the RMDs were suspended for 2009. Those who have their IRAs in guaranteed annuities will not need to rely on government intervention to save the day.

A beneficiary can also make the mistake of failing to take an RMD from an inherited IRA.

Spousal beneficiaries must decide if they will become the owner of the inherited IRA or remain a beneficiary. Making this choice will determine when distributions are required. If an inheriting spouse chooses to become the owner, distributions can be delayed until the original IRA owner would have reached age 70½. If an inheriting spouse chooses to remain a beneficiary, he or she must begin taking distributions based on his or her life expectancy, beginning by Dec. 31 of the year following the year of the IRA owner's death.

Extreme penalties are charged if the IRA owner fails to take the full RMD by the deadline. ... [It] could create a tax burden of more than 80 percent on missed RMDs.

Nonspousal beneficiaries, often the children and grandchildren, do not have the option of becoming the owners of inherited IRAs. They must remain beneficiaries for the IRAs to continue to have tax-deferred status. If the owner has not taken his or her RMD during the year of death, the beneficiary will need to take a taxable distribution equal to the RMD that the owner would have taken if still living. If the IRA owner did take the distribution for the year prior to death, the nonspousal beneficiary's first RMD will be based on the beneficiary's life expectancy and must be taken by Dec. 31 of the year following the year of the IRA owner's death. If this deadline is missed, the beneficiary may get a big and untimely surprise in the form of a 1099.

The annuity advisor's annual review again can save beneficiaries from missing required distributions that would result in additional taxes and penalties.

Many nonspousal beneficiaries aren't aware of their right to take only the required distributions and keep the majority of the inherited IRA in tax-deferred status. Taking only the required distribution allows the beneficiaries to continue to earn interest on money that would otherwise be paid to the IRS prematurely.

With all the important dates and deadlines to remember, it is no wonder that failing to take an RMD is the No.1 mistake made by IRA owners and their beneficiaries. Lack of consumer awareness can result in rapid distribution and often immediate taxation. A well-trained IRA advisor can be the consumer's first line of defense.

Proper planning and having a formal IRA distribution plan can ensure that your clients will never become the IRS's junior partner when it's time to take some of their hard-earned money out of their IRAs. Annuity carriers can provide the documentation to get the job done and the guarantees your clients deserve. INN

***David F. Royer** has trained thousands of financial advisors in the discipline of qualified retirement plan accumulation and distribution. David's many articles on qualified plan distribution have been published in leading national financial periodicals. For additional information about IRA distribution planning, visit www.KeystotheIRAKingdom.com.*