Maximize IRA Assets For You & Your Heirs

Know the rules to rein in required distributions and to create a legacy for your family

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A Presentation in Four Parts

1) Attractions of the Roth
2) IRA and 401(k) RMDs
3) Maximizing an Inherited IRA
4) RMD Calculations by Owner Type

Part 1: Attractions of the Roth

2 Key Advantages of a Roth IRA:

- No Required Minimum Distributions (RMDs) for the original owner of the account
- Money can be withdrawn tax-free

Two Tests to Meet

- Once you've had one Roth IRA for at least five years and are 59½ or older, all withdrawals – including the earnings – are tax free.

- Both tests must be met.

- On the fence about putting a lot of money in a Roth? Consider opening a Roth with a small amount, say $500, to get the five-year clock ticking … in case you later decide to add to your Roth stash. Even if you open your first Roth at age 60, you'd have to wait until age 65 for the earnings to become tax free.

Who Qualifies for a Roth

- Must have earned income to make a Roth contribution and have to be below the income thresholds to be eligible (ineligible at $132,000 for single filers, $194,000 for joint, for 2016; $133,000 for singles and $196,000 for joint for 2017).

- Good news: Anyone can do a Roth conversion – regardless of work status or income level.

- Even if you are taking RMDs, you can do a Roth conversion.

- But you must take the RMD for the year first. You can then convert part or all of the remaining balance.

Partial Conversions

- Roth conversions are taxable events.
- Conversions are taxed at your ordinary income tax rate.
- You don't have to convert all of your traditional IRA. Doing so might spike you into an unnecessarily high tax bracket.
- Smart strategy is to convert an amount that keeps you within your income tax bracket. Say you have $5,000 before you hit the top income threshold of your tax bracket, you'd want to convert just $5,000.

Chance for a Mulligan

- You can change your mind about a Roth conversion until mid October of the following year. “Recharacterizing” the conversion before that deadline, by putting the money back into a traditional IRA, wipes out the conversion tax bill.
- You can do partial recharacterizations, but the math can get messy.
- Smart strategy: Consider splitting a conversion into, say, a stock Roth and a bond Roth. If the stock Roth goes up in value but the bond Roth goes down in value, you can leave the stock Roth alone and just recharacterize the bond Roth.

Early Bird Gets the Worm

- The earlier you put money in a Roth, the more effective it can be because the money will have longer to grow tax-free. A T. Rowe Price analysis showed that a 55-year-old who started doing Roth conversions every year could cut their total taxes paid on retirement accounts by nearly half versus not doing any Roth conversions. Starting at age 60 resulted in a 25% reduction and at 65 about a 10% reduction.
- Starting later can still be advantageous if the Roth will be inherited by a spouse or nonspouse heirs.

Advantages for the Original Owner

- The money can sit and grow tax free.
- Can draw on the Roth IRA for an emergency need, say a roof repair, without jacking up your taxable income for the year.
- Roth withdrawals won't make your Social Security taxable or hike your Medicare premiums.
- Offers tax diversification and flexibility to manage your tax bill.

Advantages for Beneficiaries

- A Roth can be a great legacy tool, which is why it can make sense for even older investors to put money in a Roth. The account passed to young heirs could last for decades beyond your life.
- The inherited account can grow tax free, and withdrawals are income tax free for the heirs.
- A spousal heir can take the Roth as his or her own, so no RMDs would be required in that case.
- Distributions are required for a nonspouse heir, but can be stretched over the heir's lifetime. More on that in a minute.
- Keep in mind that the assets will be income tax free to heirs, but the account's value is counted as part of your taxable estate.

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Part 2: Difference Between IRA and 401(k) RMDs

- There are a couple of differences between RMDs for IRAs and 401(k)s.
- And there's a couple of differences between Roth IRAs and Roth 401(k)s and traditional IRAs and traditional 401(k)s.

Those Still Employed

- If you are still working past age 70 1/2 and don't own 5% or more of the company, you can wait to take RMDs from your current company's 401(k).
- But note: You still have to take RMDs from other 401(k)s you own from previous employers and you still have to take RMDs from your IRAs.
- Smart strategy: Roll other accounts that have RMDs into your current 401(k) to avoid RMDs until you fully retire. Your plan would have to allow the option to do roll-ins.

Together Versus Separate

Another big difference:

- If you hold multiple IRAs, you can calculate the RMD for each account but then take the total RMD out of one or more of those accounts, in any combination.

- If you hold multiple 401(k)s, you will need to calculate the RMD for each 401(k) and you must take each RMD separately from each 401(k).

Difference Between Roth and Traditional Accounts

- Traditional IRAs and traditional 401(k)s have required minimum distributions when the owner reaches age 70 1/2. (Unless you're still working, which lets you delay only current 401(k) RMDs.)

- Roth IRAs do not have RMDs for the owner.

- But Roth 401(k)s do have required minimum distributions starting at age 70 1/2. Avoid that by rolling the money into a Roth IRA.

Part 3: Maximizing an Inherited IRA

- An inherited IRA can be an amazing tool for the next generation to build wealth. But whether you are the heir or you are the owner who wants his/her heirs to maximize the account, there are a number of rules you need to know.
- Some of the rules have deadlines.
- Key point: For heirs to maximize the IRA, they need to be named as beneficiaries on the IRA. Be sure the beneficiary form is filled out and updated as needed.
- The beneficiary form trumps the will.

Spouses Have More Freedom

- There are huge differences between being a spousal heir and a nonspousal heir. Spouses get a lot of flexibility.
- A spouse at any time can choose to take the deceased spouse's account as her own. If she's under 70 1/2, that means she won't have to take any required minimum distributions from that account until she hits that age. If it's a Roth account, she won't ever have to take RMDs if she claims it as her own.
- A younger spouse might want to stay as a beneficiary until she hits age 59 1/2. As a beneficiary, she can tap an inherited IRA free of the 10% early-withdrawal penalty. Once she hits age 59 1/2, that penalty goes away and she can then make the IRA her own—putting off required distributions until age 70 1/2.
- That younger widow doesn't have to take RMDs as a beneficiary until or unless her deceased spouse has/had hit age 70 1/2.

Nonspousal Heirs Must Retitle the Account

- For any nonspouse heir, such as an adult child or grandchild, who's named as the beneficiary of an IRA, the account cannot be rolled into his or her own IRA.
- Instead, that heir must retitle the account into his or her own name along with the decedent's name, clearly identifying who's who. For example, the account could be retitled to "Mary Smith (deceased October 20, 2016) for the benefit of Joe Smith."
- An heir should name successor beneficiaries.

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Stretching the IRA

- To “stretch” the benefits of the tax shelter over an heir’s lifetime, the heir must take annual withdrawals based on his or her life expectancy.
- Must start RMDs by the end of the year following the year the original owner died. Those distributions are taxable from an inherited traditional IRA, but tax free from an inherited Roth IRA.
- The younger the heir, the smaller the RMDs.
- Heirs can always take out more each year above the RMD.

Split an IRA – Why?

- With multiple IRA beneficiaries, it can pay off for those heirs to divide the IRA after the owner's death.
- Remain together on the inherited IRA, and the life expectancy of the oldest beneficiary must be used to calculate RMDs.
- Splitting the IRA is particularly important if there is a large age difference between heirs.
- Say a 60-year-old son and a 22-year-old granddaughter are named heirs to a traditional IRA. Separating the accounts would set the 22-year-old's first RMD at 1.6% of the account balance, compared with a 4% withdrawal required by the 60-year-old. That means more of her money can stay in the account to grow tax-deferred.

Split an IRA – Deadline

- The IRA must be split by December 31 of the year after the year the owner died.
- After splitting, each heir can then devise a personal investment strategy and name his or her own beneficiaries.

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Pay Out a Nonperson's Share

- If you are named an heir along with a charity or other nonperson entity, pay off that share no later than September 30 of the year following the owner's death if you want to stretch the IRA.

- Otherwise, you lose the chance to stretch the IRA over your own lifetime because all assets must be disbursed within five years of the owner's death if the owner died before age 70½ . If the owner died after that age, you'd have to take annual withdrawals based on the deceased's remaining life expectancy, as set out in IRS tables.

Turn It Down

- If you think the IRA could be better maximized by the next beneficiary in line, you can disinherit your interest in the IRA.
- For example, a daughter may be the primary beneficiary but decides she wants her children, who were named as contingent beneficiaries, to inherit the IRA. They could stretch distributions out longer and perhaps pay tax on the money in a lower bracket. The daughter can "disclaim" the IRA and it will pass to the contingent beneficiaries.

Turn It Down -- Deadline

- The heir disclaiming must typically do so within nine months of the original owner's death, and the heir cannot have taken control of the assets before deciding to disclaim the inheritance.
- If you decide you don't want the IRA, you can't simply pick someone to take your inheritance. Instead, follow the path on the beneficiary form to see where the money will go before making the irrevocable decision to disclaim the money.

Part 4: RMD Calculations Vary by Account Owner Type

- Key point: Calculations for required minimum distributions are not the same for all IRA owners.
- The RMD calculation is different for an original owner and for beneficiaries, and for different types of beneficiaries.

Penalty for Missing an RMD

- No matter what kind of owner you are, missing an RMD subjects you to a penalty of 50% of the shortfall.
- By not using the proper RMD calculation, you're at risk of taking out too little and getting hit with a hefty penalty.
- To make sure you take out the right amount, it's important to know what calculation fits your account owner type.
- Tip: This penalty is often waived, if you ask and have a good excuse.

Original Owner RMD

- When an owner turns 70 1/2, he must start RMDs.
- The first must be taken by April 1 of the year following the year he hit 70 1/2.
- All subsequent RMDs must be taken by December 31 of each tax year.
- If you do delay the first RMD until April 1, you'll have to take two RMDs that year because the second one must be taken by December 31.

+ Owner's Calculation

- Take the account balance on December 31 of the previous tax year and divide that by a factor from IRS Table III, called the Uniform Lifetime Table (find it in Publication 590-B).
- That factor is based on your remaining life expectancy.
- If the owner has a spouse who's more than ten years younger, there is a different table you can use to take out a smaller RMD to account for the younger spouse's longer life expectancy.

Spousal Beneficiary RMD

- A spouse can either claim the IRA as her own or remain a named beneficiary of the inherited IRA for as long as she wants.

- If she claims the money as her own, she won't start RMDs until she turns 70 1/2 and she'll use Table III like any owner would. (If the account is a Roth IRA, she won't take RMDs at all.)

- But a widow who stays a named beneficiary won't take RMDs until her late husband would have turned 70 1/2. Then, she must take distributions based on her life expectancy, using Table I.

Spousal Beneficiaries

- A widow who stays a beneficiary gets a better deal than nonspouse beneficiaries. Each year, the widow can recalculate life expectancy, which results in smaller distributions.
- Note, though: RMDs are still lower as an owner. Say the widow is age 75 and the deceased spouse's IRA value is $500,000. If she keeps it as an inherited IRA, she uses a factor of 13.4. If she takes the money as her own, the factor is 22.9 and she will take out about $15,500 less than the widow with the inherited IRA.
- Key point: Once a younger widow is past age 59 1/2, a widow likely would want to just take the account as her own.

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Cases When a Spouse Stays a Beneficiary

A few things to know if a spouse stays a beneficiary:

- An older widower past age 70 1/2 can wait until the younger deceased spouse would have reached age 70 1/2 before he has to take distributions.
- If a late spouse already started distributions, the survivor could use either her own life expectancy or her spouse's. Choosing the longer of the two life expectancies would mean smaller distributions.
- Big negative for heirs: If a widow keeps the account as an inherited IRA and then dies after starting RMDs, the next beneficiaries will have to take RMDs based on the life expectancy the widow was using. Younger beneficiaries will have lost the chance to stretch the IRA. (Note: If the widow keeps it as an inherited IRA and dies before her deceased spouse would've turned 70 1/2, beneficiaries can stretch the distributions over their own lifetimes.)
- If the widow had made the money her own, the beneficiaries can use their own life expectancies to stretch the distributions over their own lifetimes.

Nonspousal Beneficiary RMD

- Nonspouse heirs must start RMDs the year after the original owner dies.
- At that time, he consults Table I for his first RMD, using the factor based on his age at that time.
- Table I is based on single life expectancy and results in bigger RMDs than Table III.
- For each subsequent year's distribution, the nonspouse heir subtracts one from that factor.

Nonspousal Beneficiary RMD

Here's how it works:

- If the nonspouse heir is 55 at his first RMD, he will use a factor of 29.6 from Table I. For his second RMD, he uses 28.6, instead of the table's factor of 28.7 for age 56.
- By the time he reaches age 75, he will use a factor of 9.6 instead of the table's 13.4. At age 75 in 2016, his RMD will be $52,083, about $15,000 more than if he were a spousal heir who remains a beneficiary.
- Key point: Nonspouse heirs who mistakenly take RMDs as if they were an owner or a spousal beneficiary will take out too little. They'll owe the 50% penalty on the shortfall.

Calculation Comparisons

- Assuming a 72-year-old is required to take a distribution for 2017 from a traditional IRA with a 2016 year-end balance of $500,000. The balance is divided by the life expectancy factor.

	Factor	RMD
Owner (using Table III)	25.6	$19,531
Owner (Table II with 55-year-old spouse)	30.8	16,234
Spouse Beneficiary of Inherited IRA (Table I)	15.5	32,258
Nonspouse Beneficiary (Table 1; Heir at age 60)	13.2	37,879

- Note: With the age of the person withdrawing being the same, the nonspouse beneficiary is required to take the largest RMD; spouse beneficiary, second largest (and larger than as the owner); the owner; and the owner with a younger spouse, who has the smallest RMD.

Questions?