The Mallard Flyer

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IRA Rollover ABC's

Paul S. Baumbach

In the last newsletter, my article compared and contrasted choices you have with your employer retirement plan (401k, 403b, 457, TSA, …), once you have retired from that job: leaving it there, taking a lump sum, or rolling it over to an IRA. I described the advantages of rolling it over. These benefits begin with the ability to **stretch** out the income tax deferral over many, many more years, and also include greater flexibility for beneficiary designations, increased investment selections, and the ability to convert some/all of the money to a Roth IRA (although you will be able to convert company retirement plan money into a Roth beginning in 2008). In this article I offer some suggestions for avoiding mistakes when making a rollover.

Stretch Concept—The goal is to keep as much value in the IRA, sheltered from income taxes, for as long as possible. Often heirs are pressured by custodians to withdraw the entire IRA value within five years of the IRA owner's death. While this makes for a very comfortable five years, the IRA owner would probably have preferred to **stretch the benefit** over a much longer time period, providing help to their heirs throughout their lives, not just for the five years after the IRA owner's death.

Resources—As with the prior article, I am using Ed Slott's book *The Retirement Savings Time Bomb…And How to Defuse It*. A second resource that I use is Natalie Choate's book *Life and Death Planning for Retirement Benefits*. I have heard both authors speak at conferences, and I consider them both to be wonderful authorities.

Custodian Checklist—You may think that all IRAs and IRA custodians (where you are rolling the money into) are alike. Actually they differ greatly, and it is worth finding this out early. Slott recommends you ensure that your IRA custodian supports features required to maximize IRA stretches. Custodians should permit your beneficiary, upon inheriting a portion of your IRA, to name their

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Mallard Announcements

Pam Baumbach—CPA!

Mallard is very proud that Pam has successfully reinstated her CPA certification with the State of Delaware. Pam passed the CPA exam in 1986, having earned her Bachelors Degree in Accounting from the University of Delaware in 1985. Pam activated her CPA certification with the State of Maryland from 1987 to 1989, and has been an inactive CPA since. She has been working at Mallard Advisors since 2000. To maintain her CPA certification, Pam will be taking 80 hours of continuing education training every 2 years.

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Notices

Paul's Schedule /Newark Office:
Mark will be attending the NAPFA Conference in Bethesda, Maryland, from October 26th to 28th. Paul is scheduled to have toe surgery on December 1st, and may be out of the office the following week.

Bill's Schedule / Hockessin Office:
Bill will be on vacation with his family in Walt Disney World the week of October 7th.

Office Closings:
The Newark and Hockessin offices will be closed on November 23rd and 24th in observance of Thanksgiving, and on December 25th in observance of Christmas, and will be lightly staffed during the last week of December.

Next Newsletter:
The next newsletter is expected to be mailed in early January 2007.

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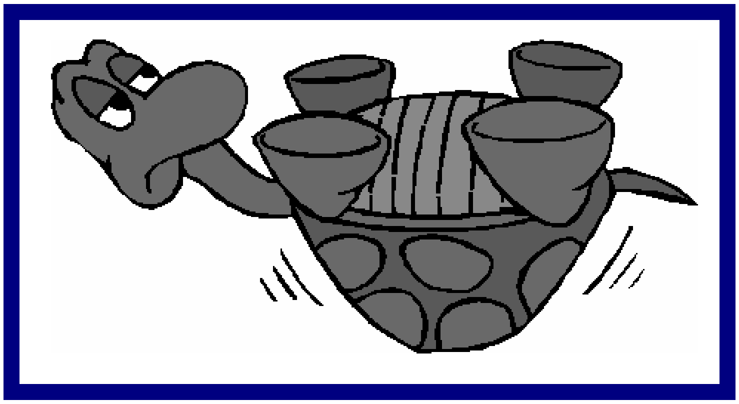
own beneficiary. This can dramatically extend the stretch. The custodian should permit a non-spouse beneficiary to request a trustee-to-trustee transfer. Your custodian should also permit a 'per stirpes' payout (equally to my 3 children, but if one of my children dies before me, then their 1/3rd would go equally to that deceased child's children—my grandchildren). Finally, the custodian should permit your beneficiary to stretch their distributions over their own lifetime. While the IRS permits all of these strategies, the IRS does not require that all custodians support them. Slott's **obsession with beneficiaries** is due to the tremendous benefit that comes from optimizing the income tax deferral available with rollover IRAs. A restrictive custodian (banks are notoriously inflexible in this regard) can prevent you from gaining the full benefit of a proper stretch.



Multiple Beneficiaries—Your rollover IRA can have a single beneficiary, or a hundred. To maximize the stretch (tax savings), you can either split your IRA up, one per beneficiary, or you can rely on your beneficiaries to do this. The risk is that they will need to split it up on time, by the end of the calendar year following the year of the IRA owner's death. If they don't do this, then the IRS cheers, for your beneficiaries will need to pay taxes much sooner. If the IRA owner is older than 70½, then the split should occur by September 30th of the year after death, to ensure that the required minimum distribution is properly calculated. You can simplify your heirs' deadlines by separating your IRA into one (ultimately) for each beneficiary.

There are also different types of beneficiaries. You can specify individuals (a child, niece, grandchild, spouse or partner, etc), or an entity (your estate, a trust, a charity). Slott recommends that you not mix these as beneficiaries to a single IRA, to avoid situations in which a grieving beneficiary is receiving pushy phone calls from a charity/trustee/executor urging the beneficiary to complete some paperwork so they, the charity/trust/estate, can 'get their share'. If you wish to have both individuals and entities be beneficiaries to your retirement accounts, then you can divide up your IRA into one piece for entities and one for individuals.

Consider the following example to illustrate the impact of proper rollover planning. John Smith, age 65, is married to Jane Smith, age 60, and they have two children (Ann, age 40, and Andy, age 35). They do not expect to be subject to estate taxes. They would like to provide for each other first, and then their children (and their grandchildren). They both have IRAs, and each designates the other as 100% primary beneficiary, and they each designate Ann and Andy as equal per stirpes contingent beneficiaries.

As Jane and John have sufficient income to meet their spending needs for several years, John is not taking any distributions from his IRA in his 60s. John dies at age 70, and Jane (age 65) rolls it into her own IRA (where she removes John as primary beneficiary), and moves Ann and Andy up to primary beneficiaries, per stirpes. She also has no strong need for additional income, and so she doesn't begin taking distributions until required at age 70½. She takes required minimum distributions until her death at age 80. At this point, Andy is 55 but Ann passed away, leaving her two twin daughters Amy and Abby, who are now 35. Jane's heirs divide the IRA, with half going to Andy, and a quarter each to Amy and to Abby. In this manner, Andy can spread his distributions over 30 more years, while Amy and Abby can spread distributions over almost 50 years. How is that for stretching tax savings?

As you can see, a properly designed IRA rollover can dramatically delay (and in some cases reduce) income taxes, thus increasing growth. This leads to increased distributions not only during your lifetime, but also for your childrens' and perhaps even your grandchildrens' lifetimes. These benefits, however, require extra steps and planning. Who ever said that building a dynasty was easy?

Paul Baumbach is the managing partner of Mallard Advisors' Wealth Management Division

The Case for Tax Diversification

William D. Starnes

Most everyone is familiar with the importance of diversifying their investments in order to minimize risk. Because we cannot predict the precise nature of the risks that may impact our portfolio's we diversify—across market capitalization, style, number of securities, etc.. We do this so that we may better withstand the unexpected risks that come our way.

However, what about the uncertainty of U.S. tax law? Since we live in a world of ever changing tax rates and tax laws, we should also consider tax diversification. There is no way to predict accurately the amount of our future tax liability or the method used to collect this tax. Historically, in the U.S. nearly every aspect of economic activity that can be taxed is taxed, or has been taxed, by one level of government or another at one time or another. This will continue and we cannot predict how it will unfold and affect us.

In fact, the more money you pay in taxes, the less you have left to spend and invest. The effect of taxes on your ability to spend may be obvious, but the impact on your investing (<u>and therefore on your future spending</u>) is more subtle.

<u>So how can you be tax-diversified?</u> By having both tax-deferred and tax-free retirement assets. Most of us already have tax-deferred retirement assets (i.e., 401(k)'s , IRA's, and 403(b)'s). The only tax-free retirement assets are the Roth IRA, Roth 401(k), or Roth 403(b) obtained in one of the following methods.

1. Roth IRA Contributions
2. Roth IRA Conversions
3. Roth 401(k) or 403(b) Contributions

Roth IRA Contributions

The enactment of the Taxpayer Relief Act of 1997 created the Roth IRA, and expanded the ability to obtain more tax diversification. With a Roth IRA, unlike a Traditional IRA, you pay the tax up front when you contribute (or convert) to it, not at the back end when you begin distributions. Why does this matter? Because after you pay the tax up front, you never pay it again; your money in the Roth keeps growing tax-free forever, and that's what can boost your after-tax investment values over time.

It's like paying tax on the seed so the crop can grow for free!

Making Roth IRA contributions is a "no-brainer" if you qualify and have the available funds or cash flow. If available, you almost always want to contribute to a Roth IRA versus investing the same dollars in a taxable investment account. This is because your contributions (not the earnings) are <u>always</u> available for withdrawal, and 100% of the earnings are tax-free. Tax-free is always better than taxable.

Roth 401(k) or 403(b) Contributions

Beginning in January of 2006, the Roth 401(k) and Roth 403(b) became available <u>to employers who adopt this optional provision</u>. The benefit here is the ability to make substantial ($15,000/year + $5,000 catch-up if 50 or older) contributions to a tax-free vehicle without the usual income limitations of a Roth IRA contribution (limitations beginning with adjusted gross income of $150,000).

Roth IRA Conversions

Currently, anyone with a Traditional IRA and an adjusted gross income of $100,000 or less, has had the ability to convert all or a part of the Traditional IRA to a Roth IRA. However, in 2010 (and later years) conversions will be available to all without the above stated income limitations.

The decision to convert is complicated and many financial and non-financial issues must be considered.

Benefits of Tax Diversification

The best way to demonstrate the benefits of tax diversification is to provide a couple of examples.

Imagine that you are retired and have both tax-free and tax-deferred investment accounts available to support your current lifestyle. To generate the necessary cash flow, you must take a withdrawal from either your Roth IRA or your Traditional IRA (or some combination). Consider the control you have gained over your tax planning. For example, in one particular year, you have a lot of income (due to exercising stock options) and will be in a much higher marginal tax bracket. For this particular year, you decide to take your distribution from the Roth IRA to completely avoid a taxable distribution.

However, next year, your income is much lower. In this case, you have now dropped into the 15% marginal Federal tax bracket. Therefore,

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Tax Diversification...Cont. from pg. 3

in order to maximize the 15% bracket, you elect to take most of your needed cash flow from your (taxable) traditional IRA. With tax-diversification, you now have great control over your tax planning—leading to on-going tax savings!

Tax diversification also enables you to maximize the tax-free accumulation of your investments leading to greater wealth. For example, in the table on the left you will see an example of the impact of deferred required minimum distributions (RMD's) as allowed with a Roth IRA. The table simply shows the difference in cumulative distributions over a husband, wife, and son's lifetime. You will notice that the cumulative distributions are much higher with a Roth IRA—and they are tax-free! Without tax-diversification, you won't have the ability to maximize this tax-free accumulation.

TRADITIONAL IRA - 8% Annual Return

	Year	Age	IRA Value	RMD	Cummulative Distributions
Joe Retires	2005	65	$100,000	$0	
Joe Begins RMD's	2010	70	$146,933	$5,363	$5,363
Joe Dies	2025	85	$221,247	$14,949	$153,132
Jane Dies	2035	92	$219,171	$21	$329,655
Son Inherits	2036	58	$213,499	$7,907	$337,562
Son Dies	2063	85	$0	$0	$1,020,366

ROTH IRA - 8% Annual Return

	Year	Age	IRA Value	RMD	Cummulative Distributions
Joe Retires	2005	65	$100,000	$0	
Joe Begins RMD's	2010	70	$146,933	$0	No RMD's
Joe Dies	2025	85	$466,100	$0	No RMD's
Jane Dies	2035	92	$1,006,274	$0	No RMD's
Son Inherits	2036	58	$1,086,776	$40,251	$40,251
Son Dies	2063	85	$0	$0	$3,515,951

So, in this on-going environment of tax law changes, how should you manage the risk that taxes could be higher or lower in retirement? Or, how can you manage not only your current tax liability but also your lifetime (and beyond) tax liability? In the face of such risk, consider tax-diversification by holding both tax-deferred and tax-free retirement savings.

Bill Starnes is the managing partner of Mallard Advisors' Financial Planning Division

Tax Update

Congress has been busy. Here are three highly relevant tax law changes.

Who Would Want Your Used Underwear Anyway? —Beginning August 18th, non-cash charitable contributions must be in good or better condition and cannot be of minimal monetary value (e.g., old worn out socks or underwear).

Also, cash contributions (i.e., checks or cash) will be disallowed without a record of the contribution including a cancelled check, receipt, or bank statement. In other words, if you give coin/currency, you may not take the deduction without a receipt from the organization.

Sorry, Kiddo—This Spring a tax law was passed that the 'kiddie tax' was expanded to all children under the age of 18. It used to only apply to children under 14. The kiddie tax is the system that applies the parent's tax rate to their children's income. Families no longer enjoy lower tax rates on teens' income.

Charitable Gifts Can Be Made Directly from IRAs—Only in 2006 and 2007, taxpayers who are 70½ or older with IRAs can make tax-free transfers of up to $100,000 from their IRAs directly to qualified charities (donor advised funds and private foundations are not eligible). No "double dipping" - you cannot also take a charitable deduction on your Schedule A for the contribution. There are several hoops to jump through, so do your homework before taking this step.

This works best when 1) there is a substantial charitable intent, 2) the taxpayer's charitable deduction is either unused since they do not itemize, or is limited due to high income, and 3) the IRA custodian supports the process.