15 Subtle but Costly Retirement Mistakes

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Read about the finer details of retirement planning to avoid seemingly small errors that can cost your clients substantial sums.

Much has been written about the simplification of retirement distribution planning over the past few years. While lifetime distribution planning for the great majority of clients has been simplified, clients should not get lazy. Listed below are a number of potential situations where errors can easily occur.

1. **Doing spousal rollover when spouse is young and will need the money**

When a husband or wife dies, naming their surviving spouse as sole beneficiary of an IRA account, the surviving spouse often roll the account over to their own name without a second thought. Few are aware that they have a second option, which may be more suitable under the right circumstances. Suppose a younger spouse is the beneficiary of her deceased husband's IRA. The IRA represents the bulk of the couple' s assets. If the spouse rolls over the IRA to her own name and she is under 59 1/2, withdrawals will be subject to a 10% penalty. If, however, she leaves the account titled in the name of her deceased husband, she can withdraw funds without penalty. A spousal rollover will potentially allow a longer payout schedule, but if the spouse needs access to the funds, the ability to take withdrawals without penalty is likely to be the overriding factor in any distribution decision.

2. **Not asking if spouse is a citizen**

Non-citizen spouses are subject to special rules. Advisors should routinely record the citizenship of clients and their beneficiaries.

3. **Waiting too long to do a spousal rollover**

In cases where a spousal rollover is clearly the preferred strategy, there is a strong argument for completing the rollover as soon as possible. What happens if the spouse dies before completing the rollover? In a case where the husband dies, and the custodian for the husband's IRA sends the wife (the beneficiary) a check, the wife has 60 days to complete a spousal rollover. If the wife subsequently dies before the rollover can be completed, the opportunity to implement a stretch-out IRA will be lost. According to Seymour Goldberg, an attorney and CPA specializing in retirement distribution, "An incomplete spousal rollover can't be completed by the executor of the estate of the second to die."

4. **Ignoring the downside of 72(t)**

Clients occasionally ask their advisors if there is a way to withdraw funds from an IRA account before age 59 1/2, without triggering the 10% early withdrawal penalty that is generally applicable under section 72(t) of the tax code. While there are a number of narrow exceptions to 72(t) (such as

death, disability, qualified higher education expenses, and qualified first time purchase of a home, disaster dispensations), these exceptions often do not allow clients to achieve their desired results.

The one exception that does allow a reasonable amount of latitude for planning purposes is the "substantially equal periodic payments" exception. Under this exception, payments must be made until the account holder reaches age 59 1/2, or until five years have elapsed, whichever occurs later. When advisors wish to help their clients set up "a series of substantially equal periodic payments" to avoid the 10% penalty for withdrawals before age 59 1/2, all to often the downside of 72(t) is ignored. Clients must be reminded that if the series of payments is incorrectly modified before five years have passed (or before the client reached age 59 1/2, whichever period is longer), all payments in the series are subject to the 10% penalty—and that the penalty applies retroactively.
In the case of persons planning to take substantially equal payments over the last few years, how many do you suppose considered the possibility that the growth stocks in their portfolios might shrink 50% or more in value? If the account were to shrink due to poor investment results to the point where there was not enough money to take the required 72(t) payment, the IRS does allow a one-time change to the method used in calculating substantially equal payments under 72(t).
Any taxpayer currently taking distributions using the amortization method or the annuity method may switch to the minimum distribution method in any subsequent year. The minimum distribution method results in the smallest distribution, so the retirement account will be depleted at a slower rate. Once the change is made, all subsequent distributions must be conducted under the minimum distribution method; it is not possible to change back to the original method, or another method, at a future date.

5. **Not understanding when the five-year period for the purpose of 72(t) starts and ends**

The five-year period starts with the date of the first payment. The period ends on the fifth anniversary of the first payment, or if later, the date at which the participant turns 59 1/2. In her book, Life and Death Planning for Retirement Benefits, Natalie B. Choate cites the case of Arnold v. Commissioner (1998). In this case, a participant, age 55, took the first of a series of equal annual payments in December of 1989. He took subsequent annual payments in January of 1990, 1991,1992, and 1993. In September of 1993 he turned age 59 ½. Thinking that he had taken his 5 payments and attained age 59 ½, he took an additional distribution in November of 1993. The Tax Court ruled that he had modified his payment schedule within five years. As a result, his exception to the 10% penalty was revoked retroactively. He owed the 10% penalty, plus interest, on all five of his withdrawals in the series.

6. **Starting a second 72(t) series incorrectly**

It's possible to start a second series of substantially equal periodic payments from another IRA (if that IRA was not aggregated with the first for the purpose of establishing the original series). If a second series of payments is started based on the same IRA as the first series, the 10% penalty will apply.

7. **Not coordinating estate tax or GST planning with distribution planning**

Some distribution plans are well conceived from an income tax perspective, but less well conceived from an estate planning perspective. For clients with total gross estates in excess of the exclusion amount, it is essential to coordinate estate tax planning and generation-skipping tax planning (GST) with retirement distribution planning.

8. **Poorly drafted trust documents**

In many situations, it may be appropriate for retirement plan benefits to be payable to a trust. In order to take full advantage of the distribution rules, trusts must be drafted with care. Ed Slott outlines

10 points to consider when naming a trust as a beneficiary.

9. **Disclaimers**

As we have discussed in previous articles the use of disclaimers in distribution planning is becoming common due to changes in the distribution rules over the years. This is an area where errors are sure to increase, and we suspect them to fall into one of three categories:

- **Disqualified disclaimers.**

For a disclaimer to be valid, it must be in writing. To avoid errors, it should be drafted by an expert in distribution planning. Acknowledgement by the custodian, also in writing, is a must.

- **Improper transfer.**

Beneficiaries who want to disclaim cannot take possession of any assets. This would seem obvious, but custodians sometimes transfer assets quickly based on primary beneficiary designations, potentially damaging a well-constructed plan.

- **Missing the disclaimer deadline.**

As most advisors are aware, under the new proposed IRS regulations, the determination of an IRA beneficiary does not have to be made until December 31 of the year following the participant's death. Far fewer know that a qualified disclaimer must generally be made within nine months of the participant's death, when the estate tax return is due.

10. **Failure to take an income tax deduction for IRD estate tax**

Retirement accounts are generally subject to both federal income tax and estate tax. Federal estate tax is paid on "income in respect of a decedent" (IRD). An income tax deduction is available to persons who receive IRD. All too often, this deduction is overlooked.

11. **Community property**

Little is written in the professional journals or in the popular press about the implications of community property as it relates to retirement assets. While it is beyond the scope of this article to address community property issues, we suggest you find out whether clients live in, plan to retire to, or have ever lived in a community property state.

12. **Rolling over company stock**

Distributions of employer securities from a qualified plan are eligible for favorable tax treatment. The difference in value between the time the securities were placed in the participant's account and their value at the time of distribution is referred to as net unrealized appreciation (NUA). If all of the securities are distributed as part of a lump sum distribution, all of the NUA is taxed as a long-term capital gain at the time the securities are sold. If the securities are distributed and held for more than 12 months, appreciation subsequent to the distribution is also taxed as a long-term capital gain. Many financial advisors are unaware of this provision, and many of the widely used comprehensive financial planning software packages are not capable of illustrating the advantages of NUA planning to your clients.

13. **Not understanding the different characteristics of IRAs and 401(k)s**

Before you advise a client to roll over a qualified plan balance to an IRA, you should be familiar with the potential implications. While there may be advantages to a rollover, there could be disadvantages for certain clients, such as different levels of creditor protection and different spousal rights to the account.

14. **Incorrect repayment of qualified plan loan**

Balloon payments are prohibited. Loan repayments must be at least quarterly, and the payments must be sufficient to pay off the loan within five years (unless an exception applies, such as qualified home purchase).

15. **Misunderstanding loss or basis provisions**

According to Ed Slott, "If you do not have basis, you cannot deduct your IRA losses." Most advisors are aware that a deductible IRA has no basis, but beyond that, little is known. It may be possible to deduct losses attributable to a non-deductible IRA or a Roth, but only if the total account balance is withdrawn.

As you can see, even with simplified rules, retirement distribution planning is anything but simple. When in doubt, don't hesitate to consult an expert.

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