Think You Are Debt Free? If You Own an IRA, 401(k) or 403(b), Think Again

9 commonly overlooked strategies to help preserve your retirement wealth

By Christian Cordoba, RFC®, CFS

While reasonably basic to an IRA specialist, the 9 ideas below are often overlooked by consumers and many financial practitioners alike who do not specialize in IRAs. Used appropriately, they may often help individuals and families preserve their retirement wealth. Perhaps they can help you too. Consider researching in more depth on your own, or perhaps broach any of the topics you feel may apply to you in more detail with your financial consultant(s).

After 25 years in the financial service industry, what I enjoy most is sharing these types of strategies with individuals, families, their CPAs, estate plan attorneys and financial advisors to help hard-working Americans keep more for themselves rather than giving more away to their least favorite uncle – Uncle Sam! I hope it helps you learn something new as well.

The 9 ideas have been separated into 3 different life stages, so at least one of them could apply to you regardless if you are contemplating retirement, already retired, and/or interested in how a surviving spouse can maximize benefits *after* retirement (ok, at death).

To begin, let's point out the not so obvious. Consumers and financial practitioners alike may have been sold on a myth as a fact many years ago. If you think back, you likely recall the saying:

"Defer, defer, defer and when you retire you'll retire at a *lower* tax bracket!"

Sound familiar? Actually, instead what they should have told us was:

"If you don't pay taxes today, you'll get stuck with the government plan tomorrow!"

What is the government plan you ask? The government plan is where you do all the work, take all the risks, pay all the costs, and make all the emotionally gut-wrenching decisions with your 401(k) during your 30-40 year career while you contribute to a seemingly tax beneficial retirement plan. Then you discover when you retire years later, you are paying taxes not only on your contributions, but also the growth of those contributions. Additionally, you didn't know when you started saving that the government would have so much debt as you approached retirement, prompting them to potentially raise the tax rates during your retirement years.

US National Debt……….…..$19 Trillion+
US Federal Budget Deficit….$498 Billion+
US Total Debt…………….$64 Trillion+
US Unfunded Liabilities….$101 Trillion+

Source: See www.usdebtclock.org for up to date amounts.

For instance, let's say you contributed $1,000 per month to your Boeing 401(k) plan for 30 years - total $360,000 – and you earned a 5% rate of return during that timeframe growing your 401(k) to approximately $850,000 the day you retired. Rather than having paid taxes gradually on $12,000 per year, you now owe taxes on the entire $850,000 or whatever the combined total distributions from the 401(k) may be. This debt exists regardless if you take money out in installments all at once, during your lifetime or after death (when the tax liability could potentially be as high as 50% or more). Just do the math:

- Current top Federal Tax Rate (individual) 39.6% http://taxfoundation.org/article/2016-tax-brackets
- Current top CA State Tax Rate (individual) 12.3% https://www.ftb.ca.gov/forms/2015_California_Tax_Rates_and_Exemptions.shtml#itr
- Net Investment Income Tax at 3.8% https://www.irs.gov/taxtopics/tc559.html

To put this in perspective and keep it simple, let's say your $850,000 401(k) balance had eventually grown to $1 million at the time of your death. You were survived by two daughters, each of whom are 50/50 beneficiaries after your spouse passes away. Since the $1 million amount is clearly enough to land your retirement distributions into the 39.6% federal tax bracket (as is with this assumption) and up to 12.3% CA, it may be safe to assume that the IRS would potentially receive a much larger portion of your retirement assets than either of your two daughters who would be splitting what's left. In this example, you inadvertently allowed Uncle Sam to become the largest beneficiary of your retirement wealth – and he's not even your real uncle! If this is not your intent, perhaps awareness of the following 9 items along with this new thought process may serve as a financial wake-up call to help preserve your wealth and protect your family.

Strategies BEFORE Retirement

1. **The Non-Deductible IRA Contribution**
   Were you told you can't contribute to an IRA because you make too much money? This is a common misstatement. Almost anyone still working and under age 70½ with earned income can make an IRA contribution, regardless of how much money they make. Why bother if there are no deductions, you ask? Because the more you have in a tax-deferred IRA, the more you can convert to a tax-FREE Roth IRA later. The non-deductible contribution could essentially serve as a conduit to the Roth IRA, with a portion of the IRA having already been taxed upon making the conversion.
   https://www.irahelp.com/slottreport/which-ira-right-you

2. **The 401(k) Mega Roth IRA Contribution**
   Even better, if you cannot contribute to a Roth IRA, but your employer has a 401(k), you may be able to still make after-tax contributions to your 401(k) and later, due to the new rules, directly roll over those after-tax contributions into a Roth IRA. Of course you need to have enough reserves in your checking/savings account to be certain you can still pay your monthly bills. If you haven't yet saved enough tax-FREE money for retirement, or any for that matter, this strategy can help jump start that bucket of money for your retirement years.
   http://www.kiplinger.com/article/retirement/T037-C000-S004-new-path-to-a-tax-free-roth-conversion.html

3. **Avoid RMDs after age 70½ using a Reverse Rollover to a 401(k)**
   Are you still working and don't need the additional income the IRS is forcing you to take from your IRA due to the Required Minimum Distribution Rules (RMDs) at age 70½? You may be surprised to learn that if you have a 401(k) you may be able to move one or more of your IRA accounts to your 401(k) account temporarily. Why bother? This could be a strategic move, because you aren't forced to take RMDs from your 401(k) account (even if you are over age 70 ½) until after you've separated from that employer. Rather than rolling a 401(k) to an IRA, consider a "reverse rollover" to your 401(k) from your IRA. Your plan must allow this rollover to occur and you cannot own 5% or more of the company providing the 401(k).
   https://www.irahelp.com/forum-post/22215-ira-back-401k-avoid-rmd;
   http://www.kiplinger.com/article/retirement/T047-C000-S004-moving-ira-assets-into-a-401k.html

Bonus Idea: Contribute to a charitable cause you believe in

If you don't or can't make a tax deductible contribution to an IRA while you are still working for any reason, consider making a charitable donation instead. While hardly an apples-to-apples comparison, you may still feel better about paying less to the IRS if possible, and giving more to your favorite cause, while simultaneously adding to your Roth IRA or Non-Deductible IRA. Check with your tax advisor to learn how the numbers would work for you.

Strategies DURING Retirement

4. **The Roth IRA Conversion**
   Once you retire, especially if prior to age 70½ and you do not need the income from your IRAs, consider converting a portion of your tax-deferred IRA to a tax-FREE Roth IRA. Sure you have to pay the tax to get the money into the Roth IRA. Virtually everyone with an IRA can do it, without any income limitations as was once the case. Even if you convert 5% or 10% of your account(s) per year, in just 5 years you can potentially have 25% to 50% respectively of your retirement assets in a tax-FREE Roth IRA for the rest of your life – and possibly for the lives of your beneficiaries too. Pay the tax now, reap the rewards forever! [Note: to qualify for the tax-free and penalty-free withdrawal of earnings, a Roth IRA must be in place for at least five tax years, and the distribution must take place after age 591/2 or due to a qualified distribution.]
   https://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-IRAs-Rollovers-and-Roth-Conversions Also see *To Convert or Not To Convert in 5 Easy Steps* at the end of this article.

5. **Plan ahead for your income strategy and age 70½ RMDs**
   When was the last time someone gave you advice on how to take money out of your accounts, instead of how to put money in? You may find you either get no advice at all in this area, or if you do, it is purely reactive. Many people wait until age 70½ to begin taking their distributions from their IRA, 401(k), 403(b), TSP, annuity or other retirement accounts because they simply aren't forced to take a distribution until then. Eventually the distribution creates a 1099 Form, which is provided to the tax advisor the year AFTER the distribution was taken, theoretically allowing for tax planning for the PRIOR year. But I'll argue this is reactive, not proactive planning. Take the time before you reach age 70½ to learn how you can determine which accounts you should take money from first, how much to take from each, how often, how it integrates with other income sources (pension or Social Security) and why that strategy may be more efficient toward saving money from taxes and/or helping your money last longer.

6. **Using the QLAC to reduce taxable income at age 70½**
   New IRS rules allow contributions to a Qualified Longevity Annuity Contract (QLAC) to potentially enable a portion (25% of your retirement account balance or $125,000, whichever is less) of your RMDs to be postponed beyond age 70½ while still locking in a guaranteed income amount in the future. This could allow you to pay less in taxes at age 70½. Alternatively, you may contribute the amount that would otherwise have been paid to the IRS to a charity of your choice.
   http://m.kiplinger.com/article/investing/T003-C000-S002-invest-in-a-deferred-income-annuity.html
   https://www.treasury.gov/press-center/press-releases/Pages/jl2448.aspx

Bonus Idea: Use the Qualified Charitable Distribution (QCD) to contribute to a charitable cause you believe in.

If you are over age 70½, you can now legally avoid unnecessary taxable income which may otherwise come from your RMDs by distributing up to $100,000 directly to a qualified charity of your choice. This option, also known as the IRA Charitable Rollover, has now been made permanent, and you don't have to wait until the end of the year.
http://www.kiplinger.com/article/investing/T045-C001-S003-you-can-give-your-2015-ira-rmd-to-charity-now.html

Strategies AFTER Retirement (for surviving spouse at death)

Since married people generally name each other as their sole primary beneficiaries, it is important to consider the importance of commonly overlooked choices a surviving spouse may have after his/her spouse passes away.

7. **IRA Choice #1 - Spousal Rollover Beneficiary Option**
A spousal rollover option is the name given to the planning strategy where a surviving spouse moves a deceased spouse's retirement account into his/her own retirement account. At this time, the surviving spouse is no longer treated as a beneficiary, and the account is essentially considered as though it was always his or hers. This is an irrevocable decision and while often beneficial, may limit the ability to take advantage of other income, tax, and/or estate distribution planning strategies.

8. **IRA Choice #2 - Treat IRA as Own Option**
A second option available to the sole spouse beneficiary is to treat the deceased spouse's IRA account as his/her own, essentially pretending as though he/she owned it all along. This can be useful if the surviving spouse wants to maintain an existing IRA investment, but would not be able to do so if the deceased spouse's IRA account was closed. While this election may have been made on purpose, sometimes it is done inadvertently. Once this option is implemented, there is no going back to being a beneficiary. Therefore, it is important to be sure this election is only made intentionally.

9. **IRA Choice #3 – Remain as Beneficiary of IRA Option**
The third and final option a sole surviving spouse beneficiary has upon inheriting a deceased spouse's IRA account is the ability to remain a beneficiary of the account. Why elect this option? Using this option may either help the surviving spouse avoid a 10% penalty or defer the age 70½ RMD. It may be strategic depending on the age of the deceased and the surviving spouse.

Bonus Idea: Use the IRA beneficiary designation to contribute to a charitable cause you believe in.
Remember that qualified charities do NOT pay taxes upon inheriting IRA dollars. Therefore, making a charity the beneficiary of one or more of your IRA accounts can also be very strategic toward maximizing the tax efficiency of your nest egg to your family.

Many items need to be considered to determine which of these spousal beneficiary options for IRAs may be most appropriate, yet far too often a lack of knowledge and/or lack of attention limits the awareness and benefits to the surviving spouse.
https://www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Retirement-Topics-Beneficiary

Like it or not, most retirement assets have yet to be taxed. To be fair, many people may not have actually saved nearly the amount they have today had they not been incentivized to do so due to perceived tax-deferred benefit. The key is not to look back and question what you did right or wrong, but rather to think proactively of how to make the best choices going forward. Making smart choices, of course, assumes you have been made aware of your best options. Ask yourself if you and/or your advisor(s) have considered the referenced 9 options– and which may be worth learning more about. A better understanding of how to plan for the distribution of your wealth before, during and after your retirement, combined with a proactive plan to maximize tax efficiency, can help you and your family reduce the imbedded tax debt of your IRA accounts and preserve your wealth.

Christian Cordoba, RFC®, CFS is a personal wealth manager and the founding partner at California Retirement Advisors, a financial consulting and services firm in El Segundo, California. For more information please visit http://www.californiaretirementadvisors.com or e-mail at chris@CRAretire.com.
Christian Cordoba is a Registered Principal offering securities through First Allied Securities, Inc., a registered broker/dealer, member FINRA/SIPC. California Retirement Advisors Group is not affiliated with First Allied Securities Inc. and First Allied Advisory Services, Inc. CA Insurance license # 0B09076.These opinions and information are subject to change at any time without notice or obligation of notification. The information is intended for informational purposes only and is not intended to provide tax, legal or investment advice.