# Making the Most Of IRA Rollovers

For many physicians, saving for retirement occurs largely within one of the employer-sponsored retirement plans described in the previous chapters. When you retire, you'll have to decide what to do with your account in such a plan.

"The first choice, for many people, is to roll over the balance to an IRA," says Ed Slott, a CPA in Rockville Centre, N.Y. "This strategy maintains the tax deferral while you control how your money will be invested."

**For many physicians,** saving for retirement occurs largely within an employer-sponsored retirement plans. When you retire, you'll have to decide what to do with your account in such a plan. Many people choose to roll over the balance into an IRA, but this is not always the best option, depending on your situation.

However, an IRA rollover is not your only choice. Instead, you can choose among the following alternative strategies:

- **Take the cash from your account.** This will put spending money in your pocket right away. Any cash you get, though, will be taxable income. You may also owe a 10-percent early withdrawal penalty, before age 59½.
- **Keep the money in the employer-sponsored plan.** "Most plan documents permit employees who leave to keep their money in the plan," says Dave Foster, a CPA and financial planner with Foster & Motley in Cincinnati.
- **Split the account.** You can withdraw some of your retirement funds, pay tax (and perhaps a penalty) on the withdrawal, and roll the balance into a tax-deferred IRA.

As mentioned, an IRA rollover might be considered the default option. Nevertheless, there are times when you might choose one of the alternatives listed above.

For example, creditor protection has been a key issue for physicians. A new federal bankruptcy law has increased the creditor protection afforded to IRAs, but the impact this legislation will have is uncertain, especially when it comes to IRAs over $1 million. Thus, you may prefer to keep your money in your employer-sponsored plan, where creditor protection is well established under federal law.

You should be aware, though, that if you die with money inside an employer's plan, and someone other than your spouse is the beneficiary, some long-term tax deferral may be lost. In this situation, then, you may have to choose between creditor protection and the opportunity to provide a child or grandchild with years of valuable tax-deferred compounding.

> **People born before 1936** qualify for a special tax break, 10-year averaging, if they take all of their money out of an employer-sponsored plan. With 10-year averaging, you may be taxed on such withdrawals at a relatively low rate, but this tax break is lost forever after an IRA rollover.

Beyond creditor protection, there may be other reasons for choosing against a rollover. "If you need to spend some or all of the money in your plan, you may as well withdraw it right away," Mr. Slott says. "That's especially true if you were born before 1936."

People in that age group qualify for a special tax break, 10-year averaging, if they take all of their money out of a plan. With 10-year averaging, you may owe tax at a relatively low rate, but this tax break is lost forever after an IRA rollover. Even if you can't use 10-year averaging, the 2003 tax law created low tax rates that may make withdrawals appealing.

Another reason for passing up an IRA rollover might be a reluctance to spend time managing your own retirement fund or to spend money hiring a professional adviser. In that situation, you may prefer to leave the money with a former employer's plan or transfer it to a new one. Inside an employer's plan, professionals handle the investment decisions. "Moreover, the plan sponsor [the employer] has a fiduciary responsibility to manage money for growth as well as for capital preservation," Mr. Slott says.

Another situation could arise for doctors who go into semi-retirement, perhaps working part-time. If you roll the money into an IRA, you must start taking distributions (and paying income tax) after you reach 70½.

"In a company plan, tax deferral can continue," says Mr. Slott. "You must still be working. And you can't own more than 5 percent of the company." Therefore, keeping your money in an employer's plan may enable you to extend tax deferral until the time you stop working.

Some employer-sponsored plans offer another advantage: they permit you to borrow half your account balance, up to $50,000. Such loans may be easier to get than bank loans, with less paperwork. Also, repayments (plus interest) go to your retirement account rather than to a bank.

On the other hand, you can't borrow from an IRA. "In fact," says Mr. Slott, "any outstanding loans must be repaid before a rollover, reducing the amount you'll have in your IRA." Therefore, if you have outstanding loans, or think you might want to borrow in the future, keeping money in an employer's plan may be the best choice.

Early retirees may face yet another judgment call. As mentioned, withdrawing money from an IRA before age 59½ may expose you to a 10-percent penalty. Thus, if you need to tap your retirement funds, you may not want to enter into a rollover before that age.

"Under the tax code," says Mr. Slott, "you can take money from an employer-sponsored plan, penalty-free, if you were at least 55 years old in the year you left your job. In between ages 55 and 59½, therefore, you're better off keeping your money in a company plan if you expect to take distributions."

Your life insurance should be considered, too. If your account in an employer-sponsored plan includes life insurance, you may want to keep your money in that plan in order to keep the policy in force. That's because you may find it costly to continue your life insurance after you leave the company plan. Especially if you're in poor health, you may not be able to buy needed coverage at a reasonable price.

## The Case for Rollovers

In sum, you may decide against a rollover if (1) you're concerned about creditor protection for your IRA; (2) you need cash right away; (3) you don't want to manage your own retirement funds; (4) you intend to keep working after age 70½; (5) you have taken or may take plan loans; (6) you're retiring between ages 55 and 59½, or (7) you have vital life insurance inside your employer-sponsored plan. If none of those apply to you, an IRA rollover probably is the best choice.

What's more, in some situations, IRAs are especially appealing. Suppose, for example, you're interested in a Roth IRA conversion. After five years and age 59½, all withdrawals may be free of income tax.

"Only traditional IRAs may be converted to a Roth IRA," says Mr. Slott. "Therefore, you must first roll over your account in an employer's plan to an IRA, in order to subsequently convert to a Roth IRA." Keep in mind that Roth IRA conversions are permitted only if your income that year is not over $100,000. You'll owe tax on all the deferred income when you convert an IRA to a Roth IRA.

**When executing an IRA rollover,** always ask for a "trustee-to-trustee transfer" from your employer's plan to your IRA custodian. Keep your hands off the money being rolled over. If you handle the funds personally, you'll face mandatory 20-percent withholding on the rollover.

In any case, when executing an IRA rollover, always ask for a "trustee-to-trustee transfer" from your employer's plan to your IRA custodian. Keep your hands off the money being rolled over. If you handle the funds personally, you'll face mandatory 20-percent withholding on the rollover.

Suppose you roll over a $500,000 account from your employer's plan and you take possession of the funds. Of your $500,000, $100,000 (20 percent) must be withheld. You'll have to make up the difference with $100,000 from your own pocket to avoid owing income taxes and possibly a $10,000 (10-percent) penalty.

Besides mandatory withholding, other technical factors may complicate IRA rollovers. Take the case of Dr. Richard Brown, whose professional corporation sponsored a defined-benefit plan. About 15 years ago, he chose to freeze the plan because the costs were outweighing the benefits. Since then, Dr. Brown has filed the necessary forms each year. Now he would like to close the plan and roll the proceeds into an IRA, but he faces problems.

"The IRS won't accept an IRA rollover from a frozen plan unless that plan has been updated," says Seymour Goldberg, an attorney in Melville, N.Y. "The sponsor could wind up owing a large amount of tax."

On the positive side, the fact that Dr. Brown has filed annual returns works in his favor. "What he might do," says Mr. Goldberg, "is hire a knowledgeable professional to bring the plan up to date. It would have to be amended to comply with various tax laws that have been passed while the plan was frozen."

Then, says Mr. Goldberg, the professional adviser can approach the IRS. "Ask about the IRS Correction Program. The plan sponsor will have to accept whatever settlement the IRS offers, so some penalty may have to be paid in addition to professional fees. However, the physician may wind up with permission to do an IRA rollover and maintain the tax deferral."

Once you have executed an IRA rollover, it need not be forever. You might roll your IRA from your employer-sponsored plan to an IRA held by a bank, brokerage firm, mutual fund company or another financial institution, then decide on doing an IRA-to-IRA rollover to another custodian.

"There are several reasons why rolling over your IRA funds in this manner may make sense," says Joel Blau, president of MEDIQUS Asset Advisors in Chicago. "You could become dissatisfied with the investment return from the IRA, or you might

## U.S. Households Owning IRAs, 2000-2004

(millions of households)

| | 2000 | 2001 | 2002 | 2003 | 2004 |
|---|---|---|---|---|---|
| Any type of IRA[1] | 42.3 | 43.0 | 43.2 | 46.1 | 45.2 |
| Traditional IRA | 34.2 | 35.1 | 35.7 | 37.1 | 36.7 |
| Roth IRA | 10.7 | 12.2 | 13.2 | 16.2 | 14.3 |
| Employer-sponsored IRAs[2] | 7.7 | 8.3 | 8.5 | 8.3 | 9.6 |

1. Excludes ownership of Coverdell Education Savings Accounts, which were referred to as education IRAs before July 2001.
2. Includes SIMPLE IRAs. SEP-IRAs and SAR-SEP IRAs.

*Source: Investment Company Institute.*

want to pursue other investment opportunities. Alternatively, you might have a need for immediate cash."

In these circumstances, if you withdraw funds from an IRA but redeposit the funds back into an IRA within 60 days, there will be no current income tax ramifications. However, it is important to keep in mind that there are several potential pitfalls with IRA-to-IRA rollovers:

■ **Missing the 60-day rollover period.** "For years, the IRS ruled that the 60-day requirement could not be waived, even when the delay was not the taxpayer's fault," says Ronald Paprocki, CEO of MEDIQUS. "Recently, the IRS has indicated that it's more willing to grant a waiver under extenuating circumstances, but you should still play it safe and stay within the 60-day rollover period."

■ **Failure to roll over the same assets that were distributed.** To qualify for a tax-free rollover, the cash or other assets withdrawn from the old IRA must be transferred within 60 days. You are not allowed to substitute other property.

For example, in a recent Tax Court case, an individual withdrew cash from his IRA and used the money to invest in common stocks. He then transferred the stocks to a new IRA within the required 60-day rollover period. The Tax Court ruled that the transfer was taxable because there was a change in the distributed assets: cash came out, stocks went back in.

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■ **Rolling over to the wrong IRA.** A tax-advantaged rollover is valid only if you make a timely rollover to an IRA that you personally own. "If you mistakenly transfer the rollover funds to your spouse's IRA, for example, the transfer is fully taxable," says Mr. Blau.

■ **Initiating more than one rollover during the year.** You are allowed to roll over funds from one IRA to another IRA only once a year. The one-year period begins on the date you receive the distribution, not the date on which you roll over the funds into the IRA. The one-year rollover rule applies separately to each IRA that you own.

- **Rolling over a mandatory distribution.** The tax law requires you to begin minimum distributions from an IRA by April 1 of the year after you reach age 70½. "You cannot avoid the minimum distribution rules by rolling over the distribution to another IRA," says Mr. Paprocki.

## Making Early Withdrawals

Just as insufficient withdrawals after age 70½ can cause a 50-percent penalty, premature withdrawals (before age 59½) can generate a 10-percent penalty; this can be a huge issue for a physician who retires before age 59½. "Many people who retire in their early 50s have few investments other than what's in their IRAs," says Bob Keebler, partner in the accounting firm Virchow, Krause & Co. in Green Bay, Wis.

Suppose, for example, Dr. Nora Collins retires at age 52 and rolls the $2 million in her employer-sponsored retirement plan into an IRA, which she needs to tap for living expenses. Say she withdraws $100,000—and pays about $35,000 in federal and state income taxes. In this situation, she'll have to tread carefully in order to avoid a 10-percent early-withdrawal penalty. "Until age 59½," says Mr. Keebler, "early retirees are living off of Section 72(t)."

That is, Section 72(t) of the tax code offers several exceptions to the 10-percent early-withdrawal penalty. For example, the penalty won't be assessed if you're disabled. In practice, if you're receiving a disability check from Social Security or from a disability insurance policy, you probably can avoid the penalty.

Other exceptions include the money taken from an IRA to pay hefty medical bills or post-high school education costs. "Eligible expenses include tuition, room and board, fees, books, supplies and required equipment," says Mr. Slott. "Qualifying expenses can be yours, your spouse's, your children's, even your grandchildren's."

Nevertheless, the most common way to avoid the penalty is by taking substantially equal periodic payments (SEPPs). These payments must continue for five years or until 59½, whichever comes later. Thus, if you begin at age 52½, you commit yourself to seven years of SEPPs. If you take out less than the SEPP amount—or more—you must pay penalties and interest on all the prior withdrawals.

The proper SEPP amount can be calculated in three different ways. One—the life expectancy method—is fairly straightforward. At age 52, you have a 32.3-year life expectancy, so 1/32.3 (3.1 percent) can be withdrawn tax-free. Each year the SEPP is recalculated, using a shorter life expectancy. This method is also known as the "minimum-distribution method" because it results in a relatively small SEPP. If an even smaller distribution is desired, a joint life expectancy can be used or the IRA can be split and the 72(t) rules applied to a smaller account.

> **The most common way** to avoid the early-withdrawal penalty is by taking substantially equal periodic payments (SEPPs). These payments must continue for five years or until 59½, whichever comes later. If you take out less than the SEPP amount—or more—you must pay penalties and interest on all the prior withdrawals.

This method may be fine if Dr. Collins, with her $2 million IRA, is satisfied with penalty-free distributions of around $62,000 (3.1 percent) per year. If larger distributions are desired, you can use the "amortization" or "annuitization" (also known as the "annuity factor") methods. With these methods, you calculate that your initial account balance will grow by a "reasonable" rate, often 120 percent of an Applicable Federal Rate (AFR), published monthly by the IRS. These methods may allow someone age 52 to withdraw 7 percent or more of an IRA each year without penalty.

In practice, most people choose the annuitization or amortization methods because they want to take out as much as they can, without having to pay the penalty. However, there is a risk to these high-withdrawal SEPP methods. Many people using them have to withdraw relatively large amounts from their IRAs each year, and some of those IRAs were reduced by the 2000-2002 bear market. As a result, some people who have been receiving SEPPs are facing the complete or near-complete depletion of their IRAs.

Suppose, for example, Dr. Collins had a $2 million IRA when she began taking SEPPS of around $140,000 (7 percent) per year. The bear market slashed her IRA, which has shrunk $1 million, but those $140,000 distributions are scheduled to continue until she is 59½. By then, there may not be much left in her IRA.

"In Revenue Ruling 2002-62, the IRS provided some relief," says Bill Stecker, a CPA who heads the Marble Group, a retirement planning firm in Conifer, Colo. "This ruling says that taxpayers can make a one-time, irrevocable switch from either the amortization or annuitization methods to the required minimum distribution method. No penalty will be applied."

Thus, if the $2 million IRA in this example had fallen in value to $1 million, Dr. Collins could have switched to the required minimum distribution method and take out about $25,000 per year, rather than $140,000. Such a switch could allow her to avoid complete distribution of her IRA, and no penalties would have to be paid.

Of course, living on $25,000 a year will be difficult after getting used to annual withdrawals of $140,000. As an alternative, doctors who are mulling early retirement might consider going beyond the three major SEPP methods that are described above. "In several private letter rulings, the IRS has permitted the use of hybrid methods that combine the best features of the minimum distribution method with the other two methods," says Mr. Slott. "These hybrid methods generally result in higher payments than

**Where Households Hold Their IRA Assets, 2004**

(percent of households)

| | Households With Traditional IRAs | Households With Roth IRAs |
|---|---|---|
| Full-service brokerage | 33% | 26% |
| Mutual fund company | 30 | 26 |
| Independent financial-planning firm | 28 | 31 |
| Bank or savings institution | 26 | 16 |
| Insurance company | 9 | 10 |
| Discount brokerage | 9 | 10 |

Note: Multiple responses included. Number of respondents varies.

*Source: Investment Company Institute, 2004 IRA Survey.*

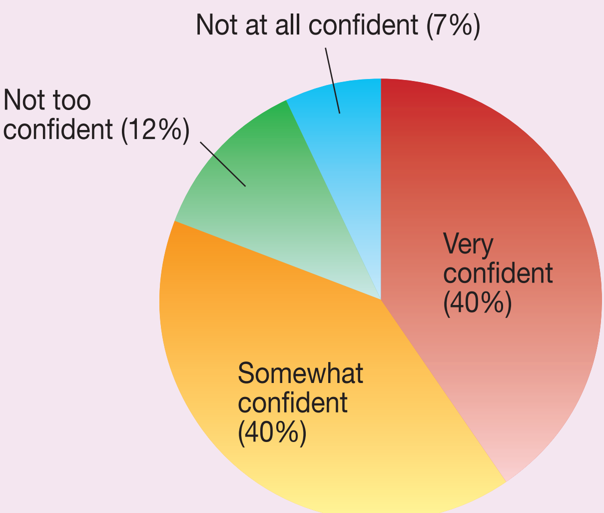
if any of the methods were used on their own. However, if the account balance declines, the 72(t) payments may be reduced."

In each of these private letter rulings, the taxpayer was allowed to recalculate the SEPP distribution using a new IRA balance and interest rate each year, along with being a year older. The IRA had to be valued on the same day each year, using the same type of interest rate in the same month.

Thus, if you use 120 percent of the June mid-term Applicable Federal Rate in the first year, you can't use 100 percent of the March long-term AFR in the second year of your SEPPs. You must select the June value for 120 percent of the mid-term AFR each year. You must also use the same IRS mortality table to make the calculation each year.

Suppose, for example, Dr. George Smith started taking SEPPs

**Retiree Confidence in Having Enough Money To Live Comfortably Throughout Retirement**




*Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2005 Retirement Confidence Survey.*

at age 43, with a $1.39-million IRA balance. Using the "annuity factor method with recalculation," his SEPP was $102,000 the first year.

Two years later, a bear market has driven his IRA value down to $970,000 (a 30-percent drop). With the method he has chosen to use, his annual SEPP would be under $66,000. Thus, Dr. Smith would be able to reduce his withdrawal by about 35 percent, penalty free, because of bear-market losses.

Moreover, penalty-free withdrawals will rise, using this method, if a bull market raises the value of Dr. Smith's IRA. Therefore, building some flexibility into a SEPP plan may allow early retirees to enjoy the best of both worlds: more income during good times but protection from disaster if stocks sink.

As Mr. Stecker points out, "More IRS rulings are needed to thoroughly reaffirm this methodology." Check with your tax pro if you're interested in this approach.

## Roth IRA Conversions

Even if you're not taking SEPPs, the damage done by the 2000-2002 bear market may have had a severe impact on your retirement planning. As of this writing, the Dow Jones Industrial Average and the S&P 500 Index are both down sharply from their peak levels of early 2000. If your IRA has suffered, this may be a good time to convert a traditional IRA to a Roth IRA.

While most retirement plans are tax-deferred, a Roth IRA can provide tax-free accumulation and tax-free withdrawals. Five years after converting an IRA to a Roth IRA, you can take out as much or as little as you want, without paying any income tax. (In addition, you must be at least 59½ to take tax-free Roth withdrawals.) If you don't have a traditional IRA, you may be able to roll your account balance from your employer-sponsored retirement plan into an IRA, then convert that IRA to a Roth IRA.

There's a catch, though. "When you convert a traditional IRA to a Roth IRA, you must pay all the deferred income tax," says Mr. Slott.

Suppose, for example, Dr. Frank Harrison's medical practice sponsored a retirement plan in which he accumulated $1.5 million. He sold his practice to a local hospital, terminated the plan and rolled the balance into an IRA. If he converts that IRA to a

Roth IRA, he'll pick up $1.5 million in taxable income, and owe around $600,000 in taxes, assuming an effective 40-percent rate.

Now suppose that Dr. Harrison had the "good fortune" to see his retirement plan shrink from $1.5 million to $1 million during the bear market and subsequent (smaller) recovery of 2003-2004. In this case, he'll pick up $1 million in income on a Roth IRA conversion, rather than $1.5 million in income, and owe about $400,000 in taxes, not $600,000. What's more, if the market rebounds and his Roth IRA recovers to $1.5 million or more, all of this growth will be tax-free if Dr. Harrison observes the five-year, age-59½ rules.

> **There are a couple of hurdles** that you have to clear in order to implement a Roth IRA conversion. For one, your income can be no higher than $100,000 in the year of the conversion, on a single or a joint return. The other obstacle is the need for a large amount of cash to pay taxes on the converted amount.

There are a couple of hurdles that you have to clear, though, in order to implement a Roth IRA conversion. As mentioned, your income can be no higher than $100,000 in the year of the conversion, on a single or a joint return. For many physicians, that test is hard to meet, so a Roth IRA conversion may have to wait until after you retire and your income drops.

The other obstacle you're likely to encounter is the need for a large amount of cash. Converting a $1-million IRA triggers a tax bill of about $400,000, and many people don't have that much cash on hand. If you take the money to pay the tax from your IRA, you'll have less in the account to benefit from tax-free growth. "In addition," says Mr. Slott, "if you pay the tax with IRA money before age 59½, you'll owe a 10-percent penalty."

In the above example, Dr. Harrison converts a $1-million IRA and incurs a $400,000 tax bill. If he uses $400,000 from the IRA to pay the tax, he'll also owe a $40,000 (10-percent) penalty, before age 59½, and have only $560,000 left in his Roth IRA for tax-free growth.

In such circumstances, life insurance may provide an excellent source of cash. If you've had an insurance policy in place for many years, you may be able to take policy loans or withdrawals, tax-free, from the cash value in order to pay the tax bill on a Roth

IRA conversion. Yet another alternative is to sell your policy to a "life settlement" company, which eventually will collect the death benefit.

If neither of these alternatives appeals to you, you might take out a new life insurance policy, payable to your spouse. At your death, your spouse can inherit your regular IRA and roll it over to his or her own name. Then he or she can use the insurance proceeds to pay the tax on a Roth IRA conversion. Your spouse and, ultimately, your children may collect tax-free income for decades.

Partial Roth IRA conversions may be a solution for IRA owners who can't afford a full Roth IRA conversion. Suppose, in the above example, Dr. Harrison has $100,000 in cash on hand. He might divide his $1 million IRA into a $750,000 IRA and a $250,000 IRA, which can be done, tax-free. Then he can convert the $250,000 IRA to a Roth IRA, using $100,000 in cash reserves to pay the tax bill. In future years, more partial IRAs can be created and converted to Roth IRAs, as he accumulates more cash, provided his income doesn't top $100,000 per year. Moreover, a series of partial conversions won't extend the five-year waiting period for tax-free withdrawals. This clock starts at the beginning of the year in which the Roth IRA is established.

Suppose, for example, Dr. Harrison converts $250,000 of his traditional IRA to a Roth IRA on Aug. 31, 2005. This makes Jan. 1, 2005, his official starting date. Each year, he converts additional amounts. By Jan. 1, 2010, when he reaches the five-year mark, Dr. Harrison might have a total of $750,000 in his Roth IRA, counting investment income. At that time, he can withdraw

## Tax-Free Roth IRA Distributions

Your contributions to a Roth IRA will always be distributed tax-free, since they are made with after-tax dollars,. Withdrawals of earnings from Roth IRAs will be free of tax if you have had the Roth IRA for five calendar years and one of the following conditions applies:

- You are at least 59½.
- You are using the earnings for a first-time home purchase (lifetime limit of $10,000).
- You are permanently disabled.
- You are deceased.

as much or as little as he wishes, tax-free, even though the funds have been in the account less than five years.

Even if you can afford to convert your Roth IRA all at once, there may be another advantage to dividing your IRA into mini-IRAs. "You can arrange these IRAs according to your asset allocation," says Mr. Keebler. "This will give you excellent opportunities the following year to choose which Roth IRAs you want to recharacterize."

That is, after you convert an IRA to a Roth IRA, you have until Oct. 15 of the subsequent year to decide whether you want to go through with the transaction. For a 2005 Roth IRA conversion, you'd have until Oct. 15, 2006, to make a final decision. That's true if you file your tax return next April 15 or if you request a filing extension until Aug. 15 or Oct. 15.

Suppose, in the above example, Dr. Harrison converts a $1-million IRA to a Roth IRA this year and triggers a $400,000 tax bill. He'll settle up with the IRS in 2006.

However, suppose that the stock market slumps again so that his IRA is worth only $900,000 in October 2006. Dr. Johnson can "re-characterize" the Roth IRA back to a traditional IRA and avoid paying the $400,000 tax bill. (If he has already paid, he'll get a refund.) After 30 days, he can convert back to a Roth IRA.

## How to Earn Under $100,000

The benefits of a Roth IRA may be so appealing that you'll want to take specific measures to bring your income down below $100,000. "You can convert a traditional IRA to a Roth IRA in any year that your income falls below $100,000," says Barry Picker, a CPA and financial planner in Brooklyn, N.Y. "No matter how much you earn in future years, your Roth IRA conversion won't be rescinded."

To get below the $100,000 mark, you might take early retirement or semi-retirement, reducing your income one year. There is no reason you can't go back to work full-time the following year.

Another tactic is to avoid taking capital gains or offset any gains with losses. In addition, you can put money into deferred annuities and municipal bonds, which don't produce taxable income, rather than into bank accounts or taxable bonds.

Reducing your income below $100,000, even if only for one year, can pay off in decades of tax-free income.

Thus, if his IRA is worth $900,000 then, the conversion will cost him $360,000 in tax, not $400,000.

A more sophisticated approach is the one suggested by Mr. Keebler. Suppose that Dr. Harrison's $1-million IRA consists of $400,000 in medical company stocks, $400,000 in technology stocks and $200,000 in bonds. He could create three IRAs, along those lines, and convert them all to Roth IRAs in 2005.

In October 2006, Dr. Johnson might see that his medical stocks have grown to $500,000 but his tech stocks have dropped to $250,000 and his bonds have fallen to $150,000. In that case, he would pay tax on the $400,000 medical stock Roth IRA, which now includes $100,000 worth of tax-free growth.

At the same time, he can recharacterize the tech stock and the bond Roth IRAs, bringing them back to regular IRAs. After 30 days, assuming no change in value, he can convert a $250,000 technology IRA and a $150,000 bond IRA to Roth IRAs, picking up $400,000 in taxable income rather than the $600,000 in taxable income that was generated by the 2005 conversion of those IRAs.

"You can keep doing this type of cherry-picking, year after year, as long as your income does not exceed $100,000," says Mr. Slott. "In this way, you may wind up paying the lowest possible amount of tax to convert an IRA to a Roth IRA."

In 2005, a provision of a 1998 tax law has taken effect. Now more people can get below the $100,000 income limit for Roth IRA conversions. "Starting this year, minimum required distributions [MRD] from a traditional IRA won't count towards the $100,000 income limit," says Barry Picker, a CPA and financial planner in Brooklyn, N.Y.

Suppose Dr. Jean Nixon is beyond age 70½, so she is required to take MRD from her rollover IRA. Each year, her other income (excluding MRD) is around $85,000 while her MRD runs to about $30,000 per year.

In 2004, her $30,000 MRD and her $85,000 of other income put her over the $100,000 ceiling so she could not convert her traditional IRA to a Roth IRA. Starting in 2005, Dr. Nixon's MRD won't count in this calculation. As long as Dr. Nixon (who files as a single taxpayer) keeps her other income below $100,000, she can convert all or part of her traditional IRA to a

Roth IRA. Eventually, she can take tax-free withdrawals.

"If you are interested in a Roth IRA conversion, keep in mind that the amount of the MRD can't be converted to a Roth IRA," says Mr. Picker. In this example, if Dr. Nixon has an $800,000 traditional IRA and must withdraw (and pay tax on) at least $30,000 this year, she can convert no more than $770,000 to a Roth IRA.

## Maximizing Minimum Distributions

Roth IRAs have another tax advantage: no distributions are required. If you can afford to keep your Roth IRA intact throughout your lifetime, the account can be passed on to heirs, who'll take tax-free withdrawals.

**People who don't need the money** from their IRA generally take out as little as possible—the required minimum distribution. If you take out a smaller amount you face a 50-percent penalty. For example, if you're required to take out $60,000 this year but withdraw only $50,000, you'll be hit with a $5,000 penalty—50 percent of the $10,000 shortfall.

That's not the case for traditional IRAs, though. Under the tax code, every owner of a traditional IRA has a required beginning date (RBD), which occurs on April 1 of the year after the year he reaches age 70½. If you reached the 70½ mark in 2004, your RBD is April 1, 2005, for example. At that point, you must take at least a certain amount from your IRA and other tax-deferred plans. Every year thereafter, required minimum distributions must continue.

Note that these are required minimum distributions. If you have $1 million in your IRA, you can take out $300,000, $600,000, even the full $1 million. However, you'll owe tax on everything that comes out. The more you take out, the more tax you'll owe right away, and the less that will be left for ongoing tax-free buildup.

Thus, people who don't need the money that has been accumulated in their IRA generally take out as little as possible—the required minimum distribution. If you take out a smaller amount, you face a 50-percent penalty. For example, if you're required to take out $60,000 this year but withdraw only $50,000, you'll be hit with a $5,000 penalty—50 percent of the $10,000 shortfall.

The challenge, then, is to figure out the required distribution. If you have $1 million in your IRA, how much do you need to take out to avoid the 50-percent penalty?

In 2001, the IRS issued new rules that established one distribution schedule for most IRA owners, known as the "10-year rule." That is, no matter whom you name as your beneficiary, that person will be considered 10 years younger than you are, for the purpose of figuring joint life expectancy.

Suppose you begin required distributions at age 71 and your spouse is your beneficiary. No matter whether your spouse is 67 or 66 or 65, the IRS will use age 61 for this purpose. Your joint life expectancy will be 26.5 years, and the minimum withdrawal will be 3.8 percent of your IRA balance. If you have $1 million in your IRA, you must withdraw at least $38,000.

The next year you will be 72, your beneficiary will be an "automatic" 62, and your joint life expectancy will be 25.6 years.

## IRA Help Wanted

Households often seek assistance before making withdrawals from IRAs. Sources consulted prior to making withdrawals from traditional IRAs in the 2003 tax year included both professional advisers and published materials. Here is the breakdown, by percentage of traditional IRA households that withdrew assets from IRAs in 2003:

| | |
|---|---|
| **Professional financial adviser (total)** | **66** |
| Accountant | 19 |
| Bank of savings institution representative | 17 |
| Broker | 16 |
| Independent financial planner | 16 |
| Mutual fund company representative | 11 |
| Insurance agent | 6 |
| **Written information, software or Website (total)** | **26** |
| IRS rules or publications | 22 |
| Financial software program | 4 |
| Internet Website | 2 |
| Book or article in a magazine, newspaper or newsletter | 2 |

Note: Multiple responses included. Number of respondents varied.

*Source: Investment Company Institute, 2004 IRA Survey.*

You'll have to withdraw at least 3.9 percent of your IRA to avoid a penalty. And so on, year after year. At age 90, your beneficiary will be considered to be 80 and your joint life expectancy will be 11.4 years, so your minimum withdrawal will be 8.8 percent of your IRA balance. (Note that your IRA can keep growing, even then, if the investments inside the account earn 9 percent or more.)

The only exception to this rule? If you're married to a spouse who's more than 10 years your junior, the true life expectancy can be used. Thus, if you're 71 with a 55-year-old spouse, you can use a 30.9-year life expectancy and withdraw only 3.3 percent of the IRA balance.

**If you're married** to a spouse who is more than 10 years your junior, the true joint life expectancy can be used. Thus, if you're 71 with a 55-year-old spouse you can use a 30.9-year life expectancy and withdraw only 3.3 percent of the IRA balance.

What happens after your death? Your spouse can claim the inherited IRA, name new beneficiaries and start over.

If you name someone besides a spouse (children, grandchildren) as IRA beneficiaries, the same rules apply during your lifetime. You'll have a 26.5-year joint life expectancy at age 71, a 25.6-year life expectancy at age 72, etc. After your death, though, there will be no rollover. Instead, your non-spouse beneficiaries can stretch out distributions over their remaining actual life expectancy. If that life expectancy is 37 years, for example, only 2.7 percent of the inherited IRA needs to be withdrawn that year.

After issuing temporary rules in 2001, as described above, the IRS issued final regulations on minimum required distributions (MRD) from retirement accounts in 2002. "The changes were minor, following the temporary regulations, but they did help to clear up some points," says Mr. Slott. "In addition, official life expectancies were extended about a year, in most cases."

For example, the new rules give most 71-year-olds a joint life expectancy, with their IRA beneficiary, of 26.5 years. Thus, the MRD would be 1/26.5, or 3.8 percent, as mentioned. Under the temporary regulations, issued in 2001, the life expectancy for most 71-year-olds was 25.3 years, so you would have had to withdraw over 3.9 percent. On a $1-million IRA, the final 2002 rules would enable you to reduce your MRD by $1,790 in this example, lowering the tax you will have to pay on the withdrawal and increasing the amount you can leave in your IRA, for tax-deferred compounding.

The MRD rules also apply to inherited IRAs, and those rules also were liberalized in 2001 and updated in 2002. Now the official "designated beneficiary" of an IRA will be determined on Sept. 30 of the year following death. That is, if you inherit an IRA from someone who dies in 2005, the designated beneficiary of the IRA won't be determined until Sept. 30, 2006.

"This does not mean, as some articles have reported, that a new beneficiary can be named after the IRA owner's death," says Mr. Slott. "It means that during this post-death period the designated beneficiary can be changed, but only to some other beneficiary or contingent beneficiary that was named by the IRA owner."

Suppose, for example, you are the primary beneficiary of an IRA. If you don't need the inheritance, you can disclaim in favor of your children if they're the contingent beneficiaries. Disclaimers must be made in writing within nine months of the IRA owner's death. Then your children could extend distributions over their longer life expectancy.

"On the other hand," says Mr. Slott, "the final regulations explicitly state that an estate is not a designated beneficiary and thus is not eligible to stretch out distributions from an inherited IRA." These rules underscore the importance of naming a beneficiary and give added significance to naming a contingent beneficiary, he adds.

## Naming a Trust as Beneficiary

The official designated beneficiary of your IRA need not be an individual or multiple individuals. Instead, you can name a trust as IRA beneficiary and also name the intended recipients as trust beneficiaries. Then the trustee can take money from the IRA and pass it through to the trust beneficiaries.

"In certain cases, such a plan makes sense," says Mr. Goldberg. "Rather than name a minor or an incompetent person or a spendthrift as IRA beneficiary, you'd rather rely upon a responsible trustee."

However, it is possible that the trust you name as IRA beneficiary won't conform to IRS regulations. "If that's the case," says Mr. Keebler, "your heirs may not enjoy maximum tax deferral, which can cost them a great deal of total wealth."

To achieve maximum tax deferral with a trust as IRA beneficiary, four elements must be in place:

- The trust must be valid under state law.
- The trust must be irrevocable. (You can use a revocable trust that becomes irrevocable after your death.)
- The individual trust beneficiaries must be clearly identifiable.
- Trust documents must be provided to the IRA custodian.

If all four conditions are met, the IRA may be distributed over the life expectancy of the trust beneficiary. Suppose, for example, Dr. Ben Morgan leaves his IRA to a trust and names his daughter Terri as the trust beneficiary. Further suppose that after Dr. Morgan's death, Terri has a 21-year life expectancy, so the IRA may be stretched out over 21 years, extending tax-deferred accumulation.

IRS regulations, however, may make it difficult to achieve such a desirable result with a trust as IRA beneficiary. "In many cases," says Mr. Slott, "the IRS will insist that all but remote contingent beneficiaries will be considered, for the purpose of determining a payout after your death. This may include some contingent or remainder beneficiaries."

Suppose Dr. Morgan not only named a trust as IRA beneficiary and his daughter as trust beneficiary. He also named his grandchildren as contingent trust beneficiaries while a charity was named to receive the remainder of what is in the trust after the death of all these beneficiaries.

"If the trust does not contain the right language, the IRA may have to be distributed over the shortest life expectancy among all the beneficiaries," says Mr. Keebler. "In this example, that likely would be the charity, which has no life expectancy, so the IRA would fall under a five-year rule, requiring complete distribution within five years."

Fortunately, such results can be avoided with shrewd planning. "Make sure a trust you name as IRA beneficiary is a conduit trust," says Mr. Keebler. "Such a trust might require that 100 percent of the IRA minimum distributions be immediately paid out to the trust beneficiaries."

That is, after your death, minimum distributions must be made from an inherited IRA. If you leave a $1-million IRA and the first-year required distribution is 4 percent, then at least $40,000 must be withdrawn (and made subject to income tax) that year. If this $40,000 must immediately be paid out to the trust beneficiaries, the trust will be treated as a conduit, and secondary beneficiaries won't be considered for purposes of calculating life expectancy.

In some cases, though, you might not want to have all the money paid out from the trust to the trust beneficiary. Instead, you'd prefer to give the trustee discretion over paying out money to the trust beneficiaries. "This approach can reduce the opportunity for long-term tax deferral," Mr. Keebler warns.

**These are complicated strategies,** and physicians must be careful to ensure that the tactic used will accomplish the intended goal, which is to preserve the IRA's tax deferral. It is important to work with a knowledgeable professional who has extensive experience in this intricate area of the tax law.

To see how problems might arise, consider a private letter ruling the IRS has published. "In this situation," says Mr. Goldberg, "a grandmother named a trust as IRA beneficiary and named her two minor grandchildren as primary beneficiaries of the trust. Contingent beneficiaries were named, including the grandchildren's aunt, who was 67 years old in the year following the IRA owner's death."

Normally, required distributions would be based on the life expectancy of the oldest primary beneficiary—the older grandchild's life expectancy would be used. However, in this case the trustee had the discretion to make distributions for the grandchildren's support, health and maintenance until they reached 30. After that age, each beneficiary could withdraw his entire share.

The contingent beneficiaries were to inherit if both grandchildren died before reaching age 30. Ordinarily, this would not be a problem. "In this case, though, the trustee had the discretion on whether or not to make distributions to the beneficiaries," says Mr. Goldberg. "The IRS called this a 'contingency over and above the death of a prior beneficiary.' The language of the trust, therefore, did not require that the payments from the IRA be paid out to the grandchildren each year. It was possible that unpaid IRA distributions would be accumulated in the trust."

As a result, the contingent beneficiaries had to be included among all the beneficiaries, for the purpose of determining which one had the shortest life expectancy. So the IRA had to be drawn down over the life expectancy of the 67-year-old aunt rather than the much-longer life expectancy of the older grandchild.

Considering this ruling, if your estate plan calls for the use of a trust as IRA beneficiary, Mr. Goldberg suggests that you follow these guidelines:

- The trustee should not be told to distribute "income" from the trust to the beneficiary.
- The trustee should be required to pay out the required distributions to the primary beneficiaries. While these trust beneficiaries are minors, distributions can be made to custodial accounts. If this requirement is in place, the trustee may be given discretion to pay out additional money for the trust beneficiary's health, education, support or maintenance.
- If older contingent beneficiaries are named, they should become beneficiaries only upon the death of the primary beneficiary.

With such an approach, IRA distributions can be stretched over the life expectancy of the oldest primary beneficiary.

These are complicated strategies, and physicians must be careful to ensure that the tactic used will accomplish the intended goal, which is to preserve the IRA's tax deferral. Suppose that trust assets are to be payable to a beneficiary's estate if that beneficiary dies before reaching a certain age. Now the estate is among the beneficiaries—and an estate, like a charity, has no life expectancy.

In such a situation, if the IRA owner dies before the date he must begin to take minimum distributions, the IRA will have to be paid out within five years. If the owner dies after that date, distributions can be taken over his or her remaining life expectancy. In neither case can the distributions be stretched out over the beneficiary's life expectancy, and there may be a substantial loss of tax-deferred growth.

## Estate-Tax Considerations

Clearly, the more money you accumulate in your IRA, the more complex your planning becomes, especially when it comes to estate tax planning. Ultimately, the estate tax owed by your children on an inherited IRA will depend on the tax law in effect when IRA assets pass to the next generation. Assuming that your spouse is the beneficiary of your IRA, and that you predecease your spouse, all assets that you pass to a surviving spouse are exempt from estate tax. Your surviving spouse can roll this inherited IRA into his or her own IRA and name new beneficiaries. He or she might name your children or choose to name others, such as your grandchildren, if that seems advisable.

Assume that your surviving spouse names your children as beneficiary of her IRA (originally your IRA). "At her death, the remaining IRA balance will be included in her estate," says Mr. Goldberg, "along with all of her other assets: bank accounts, securities, real estate and so on."

Her estate may or may not owe estate tax, depending on current law. If her total estate (including her IRA) is $2 million, and the estate tax exemption is $1.5 million, her estate will owe tax on the excess $500,000. However, if she leaves that same $2 million estate when the estate tax exemption is $3.5 million, no estate tax will be due.

"In any event," says Mr. Goldberg, "deferred income tax will eventually have to be paid as money comes out of the IRA. If estate tax has been paid, it is possible to reduce the income tax on IRA withdrawals." In essence, beneficiaries' taxable income from IRA withdrawals may be reduced by the amount of estate tax paid because the IRA was included in the taxable estate.

Under current law, an individual's estate tax exemption is $1.5 million. This exemption is scheduled to reach $3.5 million by 2009. In 2010, the estate tax is due to be repealed, but it will reappear in 2011, with a $1 million exemption. It is possible that the increases in the estate tax exemption will be accelerated or even that estate tax repeal will be made permanent by the current Congress. However, some future Congress might reinstate the estate tax and lower the exemption. States also may assess an estate tax.

The bottom line is that you don't know when an IRA will pass to the next generation, how large the total estate will be, or what the tax law will be. If you expect that your surviving spouse's estate will top $1.5 million, you probably should do some tax planning. Work with a financial adviser to make sure there will be enough liquidity to handle a likely tax bill so that an inherited IRA can remain intact for extended tax deferral.