



BOB CARLSON'S
Retirement Watch

THE ESSENTIAL GUIDE FOR RETIRING IN THE 2020s

Bob Carlson

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The Essential Guide for Retiring in the 2020s

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Bob Carlson, Editor – Retirement Watch

Introduction

What happens if you outlive your money? It's the number one question on the minds of Americans in or near retirement. And it's the most important one at that.

Once you stop working, the only money you can depend on is the money you have worked hard to save in your IRA, 401 (k) and other retirement accounts. But economic forces outside your control are lining up to attack your nest egg.

For example, Social Security benefits alone won't come close to providing you with a cushy retirement. In 2024, the maximum monthly payout is \$3,822 for someone who files at full retirement age (FRA) at age 66... no matter how much money the government took from your paycheck during your working years.

Since the 77 million baby boomers began turning age 65 beginning in 2011, serious changes to Social Security are on the horizon. They could include age increases, means testing, benefit cuts--just to name a few. As a result, you could be cheated out of a good chunk of the Social Security income you may have counted on.

With the government and employers bailing on retirees, your savings and investments will bear most of the burden of seeing you through your retirement years.

But it's not just the greedy hands of the government you need to watch out for. The ongoing scourge of rising inflation will continue to eat away at your nest egg. One of the fastest rising costs for retirees is medical costs. According to the Employee Benefit Research Institute, out-of-pocket healthcare costs on average will be more than \$300,000 in retirement for a couple age 65 today.

Meanwhile, we've already seen prices for everything from gas to oil to food to clothing soar in the past decade. Imagine what the basics will cost 10, 20, and 30 years from now when you are established in retirement and living on a "fixed" income?

Perhaps like many, you trust your investments will see you through and provide you with much needed "inflation protection." Yet the stock market has taken us on a pretty wild ride in recent years. It's nearly impossible to count on steady profits.

But if you were to try and sidestep this market volatility by moving your money into "safe" interest bearing accounts at today's yields, you wouldn't even be able to tread water (especially with inflation hovering between 2% and 4%).

You also have to plan on making your retirement savings last longer. More people are living longer, healthier lives thanks to new medical insights and breakthroughs. So, if you're one of those lucky folks, you'll need to stretch your portfolio even further - another 20, 30 years or more. That means the money you earn on your investments has to work harder than your fathers ever had to.

Fortunately, your IRA is still the most powerful — if not potentially the largest — tool in your retirement arsenal. A well-managed IRA can help you achieve every one of your much deserved retirement dreams ... and overcome every one of these potential hurdles and challenges you face.

But one simple mistake in saving for, investing in or taking distributions from your IRA could be the difference between a life of constant comfort and peace of mind... or a life of worry, sacrifice and increasing burden on your children.

It's why I want to make sure you're maximizing your IRA's growth and profits to constantly outpace inflation. But I also want to help you protect your wealth from the greatest threat to your IRA nest egg after inflation: a cash-strapped government looking to pay for its spending splurges.

It's why I wrote "The New Rules of Retirement." This report is jam-packed with new strategies and big secrets that turn conventional IRA thinking on its ear. I've packed 30+ years' worth of unbiased retirement answers, solutions, strategies and tactics into this report. It gives you in-depth, step-by-step advice on putting the retirement secrets I tell you about here to work, so you can safely build and strengthen your retirement security.

The secrets to a worry-free retirement are now in your hands. The little-known strategies you're about to discover can show you how to stop worrying about outliving your money and enjoy every moment of your retirement years. So, get settled into a comfortable chair and prepare yourself for some eye-opening reading!

Why Breaking the So-called "Tried-and-True" IRA Rules Can Mean a Richer Retirement for You

IRAs seemed so simple when they started. Make the maximum contribution, invest the money until retirement, and then take the money out over time to pay for

retirement.

But managing your IRA in today's more complex world gets tricky. Things change. The law. The economy. The markets. The trends. And for too many years, we've been told the same old rules over and over again to prepare for retirement ... rules that are no longer working.

Let's begin by talking about how much money you should be saving in your IRA and other retirement accounts. Any retirement spending estimate is better than none. But for years at *Retirement Watch*, we've been researching and developing the best ways to make reliable estimates of retirement spending and savings needs. Most popular methods of projecting retirement needs tend to dramatically understate or overstate retirement spending.

Secret #1. Better ways to plan retirement spending.

The traditional retirement plan projects spending to rise steadily each year in line with inflation. That model does not work well for today's retirees. When retirement lasts 20 or 30 years or longer, a more realistic model of spending and scheduled withdrawals is needed.

Unlike the projections in most models, retirement spending does not increase in a straight line. It varies over time. In addition, markets also do not move in a straight line. They are volatile and can have extended bear markets and bull markets. These fluctuations in the portfolio value should influence annual spending.

Over the years I have found two models that accommodate real-life retirement spending and portfolio fluctuations. They are more realistic than the straight-line models generally in use.

One model is to adapt the spending formula used by the Yale University endowment.

The first step is to set the withdrawal percentage for the first year of retirement. Most studies conclude that the maximum safe rate is just over 4% of the portfolio's value. After the first year, the distribution is determined by using two separate formulas. The first formula is last year's distribution plus the inflation rate for the last year. Multiply that amount by 70%.

The second formula is your initial withdrawal rate multiplied by the fund's value at the start of the second year. Multiply that result by 30%.

Add the two results together to get the distribution for the year.

Here's an example. The withdrawal rate is set at 4.5%, and the initial portfolio value is \$600,000. The first year's withdrawal is \$27,000. After the first year, the portfolio's value is \$625,000, and inflation was 2%. Using the first formula, 2% inflation is added to \$27,000, then multiplied by 70%. That result is \$19,278. Under the second formula, \$625,000 is multiplied by 4.5%, and then by 30%. The result is \$8,437.50. Add the two products together and the second-year distribution is \$27,715.50.

Under this formula, spending fluctuates with the markets and inflation, but the changes are not as volatile as the markets and inflation are. If the markets experience an extended decline, spending declines gradually. During bull markets, spending increases faster than inflation. That allows you to enjoy some of the excess gains of the bull market. But that spending does not rise enough to absorb all the investment gains. The formula leaves a cushion against the inevitable market downturns.

The other model is based on the spending cycles that occur during retirement.

Spending varies by age. Even after retirement there are several cycles. For most people, annual spending peaks around age 50 and then steadily declines, according to the Department of Labor's Consumer Expenditures, which it revises every few years.

There are additional fluctuations after 50. For many people, there is a bump in spending immediately after retirement. There is a burst of spending on pent-up demands such as travel and recreation. After age 75, spending declines somewhat rapidly.

Retirees can plan for a three-stage spending cycle.

The first cycle can be referred to as the honeymoon period of the first few years. This is when the retiree has pent-up demands and also is relatively young and healthy.

After that period, the lifestyle becomes more normal and regular. Spending settles at a level that is lower than during the initial years of retirement.

Sometime after age 75, spending is likely to downshift again. The Department of Labor study indicates that spending by those over age 75 is 25% or more below that of younger retirees. People simply become less active at some point, even when they are healthy.

There might be a fourth spending stage in which major medical expenses or long-term care expenses are incurred. Often when this occurs other living expenses decline. The total expenses incurred by the retiree during that period depend on the extent of insurance coverage.

Under this model, a retiree plans to spend more in the first years of retirement. Perhaps spending could rise to as much as 8% of the portfolio that many pre-retirees say they are planning. After a few years, the plan has a spending decline, following by another decline in later years.

A variation of the spending cycle approach is to divide your retirement portfolio into two portions. One portion is 85% of the portfolio. You spend this amount in roughly equal installments until age 85. If you retire at 65, you can spend one twentieth the first year, one nineteenth the second year, and so on.

In the meantime, the other 15% is invested in a portfolio designed to grow in value over the 20 years. At age 85, if you are still alive, this second portfolio can be spent or used to purchase an annuity.

These variable spending models recognize the realities of retirement spending, including that most retirees have flexibility in their budgets. A number of expenses can be deferred or eliminated, such as travel, auto purchases, and home repairs or remodeling. Other expenses can be increased or reduced from year to year, including dining out and entertainment.

Retirees should plan on flexibility in their spending. Adjust expenditures for inflation, portfolio volatility, health, and other factors. Varying spending and withdrawals from the portfolio increase the probability of having financial security through retirement and leaving an inheritance for heirs.

Secret #2. The #1 factor most people overlook when deciding how much they can afford to spend.

What's the biggest mistake in retirement plans? From what I see, it is failing fully to factor inflation into their planning. Make this common mistake and you'll unknowingly drain your IRA and other accounts so fast it will make your head spin.

Retirement these days often lasts 20 years or more. To be safe, you should plan on living to age 90 or older. Over that time, inflation can make a safe, comfortable stream of income uncomfortably tight, even at low inflation rates.

For example, after 10 years of only 2% inflation, you need almost \$12,200 to buy what \$10,000 used to buy (a 22% increase). After 15 years, you'll need almost \$13,500. If inflation doubles to 4%, you'll need almost \$15,000 after 10 years and \$18,000 after 15 years. Here's another way to look at it. A 1982 dollar today has the purchasing power of less than 59 cents. A 1967 dollar equals less than 19 cents today.

The inflation rate cited most is the CPI-U, the Consumer Price Index for Urban Consumers. There are other CPI indexes, but are any of these indexes a good planning tool for your retirement?

Your purchases almost certainly don't follow the basket of goods in the survey. You likely spend more of your income on medical care, and perhaps on eating out, recreation, and other leisure activities. You also might spend a higher percentage on the necessities, such as food, fuel, housing, and travel. You likely spend less on education, clothing, and work-related expenses, among others.

Another potential problem is that the CPI is based on a survey of national prices. If you live in an area in which prices are rising faster, using the index could understate your needs.

The ideal option is first to figure out your itemized monthly or annual budget. Then apply an inflation factor to each spending item. For example, you can inflate your food expenses by the actual food inflation of the last five or 10 years (or your estimate for the future). Or you can go a step further and separate "food eaten away from home" and "food eaten at home," because restaurant costs have been rising faster than grocery store costs for several years.

Secret #3. Two FREE, incredibly useful websites to help you more accurately predict your future spending.

You can get the national inflation factor for each item from the Department of Labor's inflation report on the websites www.dol.gov or www.bls.gov. Or you can get the Monthly Labor Review, available by subscription from the Government Printing Office and in many libraries.

You also can use one of the regional price indexes that the Department of Labor issues. These are issued monthly, bimonthly, or semiannually, depending on the area. These indexes are available from the same sources as the regular CPI reports.

Secret #4. Why taking Social Security benefits as early as possible might no longer guarantee you the most money from "Uncle Sam."

What is the best age to begin taking your Social Security benefits? The answer might be changing.

As with everything else about retirement, the right decision changes over time and isn't the same for everyone.

Most people know that the earlier you begin Social Security benefits, the lower the payment will be. Begin benefits before normal retirement age, and you receive a reduced monthly benefit. The amount the benefit is reduced depends on how long before normal retirement age it begins. You can begin taking benefits as early as 62. Starting the benefits at age 62 results in a monthly benefit equal to about 75% of the normal retirement benefit.

But delaying receipt of benefits increases the monthly benefit. Delay benefits past normal retirement age, and the benefit increases by 6% to 8% per year.

The key is that the increase and decrease rates are set so that anyone who lives to life expectancy receives the same lifetime payouts regardless of the age benefits begin. That makes the normal life expectancy the "breakeven point." Live beyond that point and you will benefit by waiting to receive benefits. Your lifetime benefits will exceed what you would receive by starting at age 62.

But the increase and decrease rates were set in 1983, the last time Social Security was reformed, using life expectancy tables available at the time. Life expectancies have increased considerably since then. About half of men currently age 65 will live past age 85.

Another factor is that the annual cost of living increases also increases the initial benefit for those who delay benefits. If you actually wait until age 70 to begin benefits, you should receive a higher benefit than the one estimated when you were age 62, because of the cost-of-living factor.

About two thirds of beneficiaries begin their benefits early, and for many years that made a lot of sense. But the change in life expectancy is a reason many should at least consider delaying benefits. If you have no reason to believe your life expectancy will be below average, the delay might make sense. Since half of your age group will live beyond life expectancy, and that life expectancy is higher than

what was assumed in 1983, most people will receive a higher lifetime benefit by waiting.

Secret #5. For some people, taking Social Security benefits early is the best move.

Delaying Social Security benefits is not for everyone.

Some people simply need the income as soon as they are eligible. They left their employment and are unable or unwilling to seek other work. They also do not have enough savings to wait for benefits.

Another reason not to delay benefits is if there are health or other reasons to doubt a person will reach the breakeven point of normal life expectancy. If that is the case, there is no reason to delay benefits except perhaps to increase benefits for a surviving spouse.

Some people who do not need the benefits still want to begin them early. Their reasoning is that they can invest in the benefits. They believe the return they earn will be high enough to offset the higher benefits they would receive from waiting. They might be right. But be sure to consider all the factors. The benefit at age 70 can be twice the age 62 benefit, after considering the age adjustment and inflation increases. In addition, that higher benefit will continue for life and will increase with inflation. There also will be a benefit for a surviving spouse. It will take some good returns to equal that package.

Secret #6. When you begin Social Security benefits can affect your spouse.

If you were the higher income earner and pass away first, your spouse's benefits after your demise likely will be based on your benefits. Delay your benefits, and your spouse's benefits will be based on the higher benefits you received. But take benefits early, and your spouse's current and survivor benefits will be reduced. If you don't need the money, delaying benefits is an easy way to increase your spouse's lifetime security. Many advisors view delayed Social Security benefits as a very low-cost form of life insurance. Your spouse receives a higher benefit that is indexed for inflation and guaranteed for life, no matter how long that lasts. For the cost of foregoing Social Security benefits for a few years that can be a good deal if you do not need the money early.

Secret #7. How to avoid the "means-testing" surtax hike on Medicare premiums.

This surtax has been around since 2007. It tripled in 2009! Now it increases steadily each year. In 2015, Congress passed a law that will increase the premiums on some higher-income beneficiaries that began in 2019. Here's how you can use your IRA to lower its impact.

Medicare beneficiaries with higher incomes face higher premiums in 2007 and thereafter. The premiums are not fixed; future amounts can only be estimated. But beneficiaries have to factor these higher costs into their financial plans.

The higher premiums, called surtaxes, are imposed on a sliding scale. They begin rising for single beneficiaries whose incomes exceed \$80,000 and for married beneficiaries whose joint incomes exceed \$160,000. The trigger levels are indexed for inflation each year. Adjusted gross income, with some modifications, from tax returns is the basis for calculating the premiums. The modifications are that AGI is increased by tax-exempt interest, EE bond interest used for education expenses, and any excluded foreign earned income.

The IRS will give your tax return information to the Social Security Administration (SSA). In turn, SSA will determine the year's premiums for each Medicare beneficiary from the tax return from one year earlier and inform them between mid-November and December how much their premiums will be. For example, 2022 premiums were determined using 2020 tax returns, and beneficiaries were told their premiums in late 2021.

The premium decision can be appealed. If a person's financial situation has changed — say because of a divorce, death of a spouse, retirement, or reduced working hours — SSA can be asked to consider a different income figure. Details about the reconsideration process and reasons that will be considered valid are included with the premium notice.

A beneficiary can choose to have the higher premiums withheld from Social Security benefits as with the regular premiums or can pay the premiums separately.

Currently, the basic premium is set at a level that will cover 25% of total estimated Medicare spending for the year. The other 75% is paid by the program. The subsidy will decline under means-testing so that the highest income taxpayers eventually will pay 80% of the estimated per capita cost.

The means-tested premiums are for Part B and Part D of Medicare only. Part A coverage does not have a premium. For Part D policies, you pay the premium set by the individual plan plus the surtax.

The surtax can be avoided or reduced only by reducing modified adjusted gross income. For future years MAGI can be kept low by limiting withdrawals from retirement plans or annuities to amounts needed for spending and those required by minimum distribution rules. Earning tax-exempt interest does not help, since that interest is added to AGI to determine premiums.

Capital gains planning becomes more important. Higher capital gains not only incur taxes but can increase Medicare premiums. Retirees might want to make fewer sales outside of tax-deferred accounts or be careful to offset gains by selling assets with paper losses whenever possible.

Itemized deductions, such as for mortgage interest and charitable contributions, do not help. But losses from businesses and from capital assets do reduce MAGI.

Secret #8. Why Florida may not be every retiree's dream tax haven.

Sure, paying no state income tax is nice, but some states that aren't known as tax havens offer retirees even juicier tax breaks.

State tax laws discriminate based on age, and that can be a good thing for some taxpayers. Even notoriously high tax states can be tax havens for retirees. In fact, Florida and other retiree magnets might not be the tax havens they are promoted as when the full tax picture is considered. Florida has no income tax, but it does have high sales and property taxes (at least for some property owners), and its high homeowner's insurance premiums can be considered a tax for living in the Sunshine State.

What's interesting is that retirees can be in a different category than the general population. A generally high-tax state can be a tax haven for retirees, while a generally low-tax state might not be a haven for retirees.

You need to evaluate state and local taxes and stay up to date on them. They've changed a lot since the financial crisis. A few states that were tax havens for retirees no longer are, or they are less favorable to retirees than they were.

Michigan, for example, used to exempt all pension and retirement income (including IRA distributions) from its income tax. After the financial crisis, however, the rules were changed. Now, those types of income are exempt only for

taxpayers with incomes up to certain levels and only for taxpayers born before 1954.

Likewise, Ohio used to allow tax credits for retirement plan income, including lump sum distributions, to all taxpayers. Now, the credits are allowed only to taxpayers whose individual or joint adjusted gross income is less than \$100,000.

Pennsylvania, on the other hand, is not generally a low-tax state but still can be a retiree tax haven. Most distributions from employer retirement plans and IRAs are tax exempt when received after age 59½. Social Security income also is tax exempt. But you have to keep in mind that Pennsylvania has an inheritance tax while many states have eliminated estate and inheritance taxes, and real estate taxes are relatively high in Pennsylvania.

To determine if a state is tax-friendly in retirement, you need to examine more than the income tax rate. A state might have low-income tax rates or even no income tax but more than make up for that with steep taxes in other categories, such as sales and property taxes. Washington has no state personal income tax, but it has a high state sales tax and localities can add to the sales tax. The average combined sales tax in the state is 8.89%.

Real estate taxes also are relatively high, though there are exemptions and other relief for some low-income seniors. Washington further has an inheritance tax on estates worth more than \$2 million. That's why you want to focus on all the taxes, including local taxes, imposed in a place you are considering for your retirement home. Importantly, consider your sources of income, spending and property owned and how those will be taxed. Don't simply consider the general tax levels.

State tax laws change regularly, so be sure to check the latest law and any proposed changes.

Secret #9. Moving to a state with no income tax will help your nest egg last longer, right? Wrong!

Five other taxes imposed by these "low tax" states will gouge your retirement savings.

Social Security is your base retirement income. Determine if your state is one of the few that still taxes all or part of the benefits. Seven states piggyback on the federal tax code and tax up to 85% of benefits. Eight states tax lesser amounts. The others exempt the benefits.

Pension and retirement account income might be exempt in full or in part. A few states fully exempt retirement income. Many have a partial exemption, but you have to read the details. It is common for a state to exempt only traditional defined

benefit pension payouts, not IRA and 401(k) distributions. Some give government pensions a bigger break than private pensions. A minority of states gives IRA distributions or other nontraditional retirement savings breaks similar to those for other pensions.

Take a look at how other income is taxed and at any miscellaneous tax breaks. Some states give seniors special exemptions for investment income or allow deductions for various expenses, including contributions to 529 plans for the grandkids. Others effectively impose penalties on retirees, for example by taxing capital gains and investment income at higher rates than other income.

Real estate and sales taxes can be significant expenses. Some states and localities reduce or defer property taxes for seniors. Others finance most of their government spending through these taxes, and they are high. In some states, taxes on a home can jump significantly for a new owner.

Estate and inheritance taxes are a factor in only 18 states and the District of Columbia in 2024. The taxes can be higher than federal counterparts in many of these states, so study the effects carefully before moving.

State and local tax laws change. Do a web search for “most tax-friendly states for retirees,” and visit www.tax-rates.org for all the overviews of all the taxes that each state imposes. Don't forget to look at county and city taxes before deciding where to live.

Secret #10. What to do if you roll over your IRA after the 60-day filing period expires.

Most people know the basic rules about IRA rollovers. An account balance can be rolled over tax free from a qualified retirement plan (such as a 401(k) plan) to an IRA or from one IRA to another. There is no deadline if the balance is rolled over directly from one trustee to another. If the account owner takes the balance from one account, he or she has up to 60 days to get the same amount of money deposited in the same or another retirement account to avoid taxes.

Mistakes often happen with rollovers. For example, a plan trustee might transfer an IRA to a taxable account instead of to another IRA. Or the trustee might issue a check to the owner instead of transferring the account to another trustee.

In the past, the account owner had no remedy. If the rollover was not executed properly, it was treated as a taxable distribution. The reason for the improper rollover didn't matter. The owner was stuck with the tax bill and perhaps a 10% early distribution penalty.

The 2001 tax law changed that. The IRS has the discretion to grant waivers of the 60-day rule, allowing additional time for the owner to deposit the funds in a qualified retirement account. Even better, in 2016, the IRS issued new rules that make it easier to claim a waiver. The IRS uses an honor system, or self-certification process. Under this process, a taxpayer who inadvertently didn't meet the 60-day deadline because of mitigating circumstances can file a letter with the retirement plan administrator or trustee claiming a waiver from the 60-day deadline. The IRS indicated that it and the plan officials ordinarily will accept this self-certification. The plan officials will report the rollover as meeting the 60-day deadline but also will report to the IRS that the self-certification was made. The IRS always can audit the taxpayer and review the rollover.

In Revenue Procedure 2016-47, the IRS provides 11 conditions that qualify as mitigating circumstances under which a taxpayer can self-certify the waiver. The circumstances include a distribution check that was misplaced and never cashed, the taxpayer's home being severely damaged, a family member's death, the taxpayer or a family member being seriously ill, the taxpayer being incarcerated, or restrictions imposed by a foreign country. The revenue procedure also provides a sample certification letter a taxpayer can send to the plan officials. The revenue procedure can be located on the IRS website at www.irs.gov.

Keep in mind that because of a court ruling in 2014, a taxpayer is allowed only one tax-free 60-day rollover within a 12-month period. That limit is per taxpayer, not per IRA or retirement plan.

It is best to have rollovers made by the plan administrators or trustees. An unlimited number of these rollovers can be made, and there is no 60-day deadline. You still have to monitor the transactions to be sure the plan officials don't make a mistake, such as depositing your rollover in a taxable account. But it's less risky than trying a 60-day rollover.

Secret #11. Why reaching age 72 changes everything and could force you to deplete your IRA too fast.

IRA owners over age 72 are required to begin taking required minimum distributions (RMDs). The starting age was changed to 72 for people turning age 70 ½ after 2019. Before that, the starting age was 70 ½. But the IRS learned that many people either don't take their RMDs or don't compute them properly, so it is cracking down on them.

Be sure you take your RMDs and compute them properly. Generally, you take your aggregate IRA balances as of Dec. 31 of the previous year and divide it by your life expectancy. You must use the life expectancy from one of the tables provided by

the IRS in the back of its free publication 590-B. The publication is available on the IRS website at www.irs.gov. We also posted the life expectancy tables on the members' section of our website at www.RetirementWatch.com.

Secret #12. Thinking of naming your estate as your IRA beneficiary?

Think again! I always advise people not to either name their estates as the IRA beneficiary or fail to name a beneficiary. Doing either can require the IRA to be distributed quickly, causing your beneficiaries to lose the tax deferral. If the estate is beneficiary or there is no named beneficiary and you had not reached age 72 and were not taking required minimum distributions, the IRA must be distributed within five years after your passing. The beneficiaries won't be able to stretch the distributions over their life expectancies, as some still are allowed to do, or even over 10 years as most are allowed to do.

In the second case, some custodians make the problem worse. They will not make distributions to the individual beneficiaries. They will insist on paying the estate and let the estate distribute the money to beneficiaries. This requires the estate to remain open until the IRA is empty. These custodians do not understand that the IRA legally can be assigned by the estate to the beneficiaries named in the will or other documents. There is no reason to require the estate to be kept open for the distribution period.

The lesson is to be sure to designate one or more individuals as primary beneficiary of the IRA and also to name contingent beneficiaries in case the primary beneficiary is not able to inherit the IRA. Otherwise, your loved ones will lose the valuable tax deferral of the IRA.

Secret #13. The one simple question to ask your IRA custodian that could save your grieving spouse a world of anxiety and hassle.

Some custodians will not work with the executor of an estate. The IRA passes by the terms of the IRA beneficiary designation form, not by the will, and the IRA avoids the probate process. The executor really doesn't enter into the picture, in their view. But the executor needs verification of the IRA's value to file the estate tax return. In addition, you might want the executor to relieve the burden of your spouse and other survivors by processing the paperwork. Ask your custodian if it will communicate with and provide information to the executor.

Secret #14. How a common paperwork mistake made by your IRA custodian can change who inherits your money.

IRS beneficiary designation forms decide who inherits your IRA. Your will and other documents don't matter. If a custodian loses the form, it will consider the estate to be the beneficiary unless the estate or beneficiary provides a copy of the form. Lost forms are not unusual especially after a firm undergoes several mergers or restructurings. If you amend the beneficiary designation, ask the custodian if it will return to you the old forms so that it won't have an out-of-date designation on file.

This also is a good reason to use a customized beneficiary form instead of the form provided by the IRA custodian. An estate planner can draft a custom beneficiary designation form that directs the custodian to do exactly what you want. Not all custodians will accept such forms. But they are more likely to if the form includes a clause relieving the custodian of any liability if it follows the form.

Whether you use the custodian's form or your customized form, be sure to keep copies and let your executor know where they are.

Secret #15. Pay your IRA taxes now instead of later.

Some of you could substantially lower your tax bill in retirement by doing so. In fact, you could avoid paying tens of thousands of dollars in needless taxes!

Here's what you must consider in order to carry out this strategy.

One of the most powerful tax-saving retirement weapons that should be in every retiree's arsenal is the Roth IRA. Their unique benefits are tremendous! No age limit on contributions. No required minimum distribution after age 72. And the best reason ever to open a Roth IRA: not one dime you withdraw from it in retirement is ever taxed. No matter how much your money has grown over the years!

Many of my readers cannot open contributory Roth IRAs, because their incomes are too high. Currently Roth IRAs are unavailable to higher income taxpayers. The Roth IRA income limits for 2022 are a MAGI (modified adjusted gross income) of \$144,000 or less for single tax filers... and under \$214,000 if you are married and filing jointly. (The limits are adjusted for inflation annually.)

But since 2010, taxpayers of any income level have been allowed to convert a

traditional IRA to a Roth IRA. They are able to take advantage of the significant tax savings Roth IRAs offer.

Taking advantage of this is easy. Simply build up your traditional IRA and other tax-deferred accounts as much as possible. Then, convert your regular IRA to a Roth IRA (and consider doing the same with your 401(k) as well if you can roll it over to an IRA). You will pay taxes on the conversion, but it could be considerably less in taxes then you'd be forced to shell out in the future.

Many people aren't excited about paying taxes before they have to. But, unless your income tax rate is going to be lower in the future than it is now, it can make a lot of sense to pay taxes now and shelter all the future gains and income from taxes. I've explained the rationale for this in some detail in my books and in articles in *Retirement Watch* that are available in the Archive in the members' section of the web site. This also is discussed below in #55.

Secret #16. How to take required minimum distributions when you own more than one IRA.

When you own multiple IRAs, you have flexibility. The RMD is computed by aggregating the RMDs of all your IRAs. You can take the RMD from the IRAs in any combination you want. Take it all from one IRA or take different amounts from the IRAs. This allows you to use the RMD to rebalance your portfolio when it's out of balance or simplify your finances by drawing down one IRA at a time.

Secret #17. Over 72? How to keep your IRA pumping out cash for years — in spite of having to take required minimum distributions.

IRA owners over age 72 need to take required minimum distributions from their traditional IRAs (as well as other qualified retirement plans). The first RMD must be taken by April 1 of the year after the owner turns age 72. Subsequent RMDs must be taken by Dec. 31 of each year, including the year that the first RMD was required by April 1. The owner can always take distributions exceeding the RMD. Instructions for computing the RMDs are in IRS Publication 590-B, Individual Retirement Arrangements-Distributions, available on the IRS website at www.irs.gov.

It might be best to take the first RMD in the calendar year before it is required.

Instead of waiting until the April 1 deadline, take by the previous Dec. 31. That avoids having two RMDs on one year's tax return.

After that, it is best to take an RMD late in the year. That allows the tax-deferred compounding to work as long as possible. The exception is a year when the portfolio declines. If you can anticipate that all or part of the portfolio will decline during the year, take the RMD early in the year, converting the investments into cash. An RMD does not need to be taken in a lump sum. Periodic distributions can be taken during the year as long as the total by Dec. 31 equals or exceeds the RMD.

Secret #18. Want to convert multiple IRAs into one Roth IRA?

No problem. Follow these four easy steps to convert one or more IRAs or just part of an IRA into a Roth IRA. First, select the IRAs or the amount of each IRA you want to convert into a Roth IRA. Second, if you want to transfer specific assets, determine if they can be transferred to any Roth custodian, only a specific Roth custodian or not at all. Otherwise, be sure there is enough cash in the traditional IRAs to be transferred to the Roth IRA. Third, contact an IRA custodian and open a Roth IRA. Fourth, tell the Roth IRA custodian which assets or amount to convert from the traditional IRAs. The Roth custodian will take care of the rest of the transfer.

Secret #19. How to take required minimum distributions from an IRA without liquidating a single share of stock or mutual funds you currently own.

RMDs do not have to be taken in cash. Most IRA custodians allow you to set up a taxable account. Then, you can have specific shares or assets transferred from the IRA to the taxable account to satisfy the RMD. You still will owe taxes on the distribution as though it had been made in cash. The distribution amount will be the market value of the assets on the day they were transferred. But you won't have to liquidate an investment you like or incur expenses to buy and sell an investment just to make the RMD.

Secret #20. Common withdrawal mistake that makes your Roth IRA vulnerable to a massive IRS tax grab.

Distributions from a Roth IRA are tax-free, but not all distributions. They must be

qualified distributions. To be qualified, first at least five years must have passed since a contribution was first made to a Roth IRA.

The contribution need not be to the same Roth IRA from which the distribution is taken; the taxpayer must have made a contribution to any Roth IRA at least five years before a distribution is taken from any Roth IRA.

The five-year waiting period is a bit different for converted Roth IRAs. Then, there is a separate waiting period for each conversion.

Second, the distribution must be taken after any of one of the following: the Roth IRA owner is older than age 59½, passed away, or became disabled. Or the distribution must be no more than \$10,000 and is used for a qualified first-home purchase.

Secret #21. Have a 401(k)? When it makes sense to convert it to a Roth 401(k) — and when it doesn't.

A retirement plan account, such as a 401(k), now can be converted directly to a Roth IRA. But the 401(k) has to allow this option, and many don't. Check with your employer or 401(k) administrator to see if it's allowed. If it's not, you might still have an option. You might roll over the 401(k) to a traditional IRA, and then convert the IRA to a Roth IRA.

Before executing this strategy, determine if a rollover from the 401(k) will be viable. Generally, 401(k) amounts can be rolled over to an IRA only if the employee leaves the employer due to retirement, a new job, or disability.

Some 401(k)s allow distributions or rollovers by any employee over age 59½. Check your plan's rules and the tax law before deciding to ramp up contributions with an eye toward a conversion to a Roth IRA.

Secret #22. One little-known rule for getting back every dime of taxes you pay on your IRA conversion.

A conversion is best when the taxpayer has cash from other sources that can be used to pay the income taxes, so that the entire IRA can remain intact and maximize the income and gains that will compound. In addition, the IRA should be left alone for 10 years or longer so that the compounding can make up for the taxes

paid on the conversion, assuming an 8% rate of return.

A higher return means a lower payback period, and a lower return means a longer payback period. If money has to be distributed from the IRA to pay taxes on the conversion, then the Roth IRA should be left undisturbed for a longer period for the conversion to reach the break-even point.

Secret #23. The order in which you draw down the different retirement savings accounts affect the amount of after-tax wealth in retirement.

Most people have more than one type of retirement account. There usually is at least one tax-deferred account, such as an IRA, plus a taxable account. The standard advice is to draw down the taxable accounts and leave money in a tax deferred account as long as possible to let the tax-deferred compounding work.

My research shows that in many cases that traditional advice is correct. The retiree's wealth will last longer if the tax-deferred compounding is allowed to work for as long as possible. My conclusions are supported by other research.

The results, however, depend on the assumptions made. For some people, retirement savings will last longer if the tax-deferred accounts are tapped first.

I have identified two scenarios in which spending your IRA first makes sense.

My research shows that if the annual return in your taxable account is *at least four percentage points higher* than the return in your tax-deferred account (i.e., IRA), you should drain your tax-deferred accounts first. Why? Because the higher return in your taxable account makes up for the lack of tax deferral. This money is likely earning more for you than the money in your tax-deferred account. It might be taxed at the lower tax rate for long-term capital gains when it is time to spend the money.

The other scenario in which tax-deferred accounts should be drawn down first is when it makes sense to empty one's IRA early. Consider this strategy if your IRA is more than you'll spend during your lifetime. See details in item #32 below and also in my book, "The New Rules of Retirement" (Wiley). Details also are in the Archive on the members section of the web site at www.RetirementWatch.com.

Secret #24. The one investment you should ALMOST ALWAYS sell when you start tapping your retirement accounts.

Investments with paper losses held in taxable accounts usually should be sold first. The realized losses offset any capital gains for the year, including distributions from mutual funds. Losses that exceed gains offset other income up to \$3,000 per year. Any additional losses are carried forward to future years to be used in the same way until exhausted. You'll whittle your tax liability to the bone by using this simple strategy.

In addition, you give the winning investments more time to compound income and gains before they are tapped. The only exception to this rule is when you believe the losing investment is ready to turn around and begin earning a higher return than the rest of the portfolio.

Secret #25. How to determine the best investment to sell for the lowest possible tax bill.

When it is time to draw down taxable retirement accounts, care should be taken with the choice of investments to sell each year. Good tax management can make the accounts last longer and provide greater after-tax wealth. The rule to follow is to sell first the assets with the lowest tax cost. I favor selling the assets with the lowest taxes as a percentage of their value.

To compute this, divide the taxes that would be due on the sale by the value of the asset to be sold. Using this simple calculation incurs the lowest taxes each year. You will have to sell a lower value of assets, because less of the sale proceeds will be used to pay taxes, leaving more after-tax money for spending.

Secret #26. Three little-known rules for outfoxing the tax man when trading stocks in your taxable investment accounts.

There are other strategies that will reduce taxes on taxable investment accounts. Most retirees don't know these trading secrets of professional and institutional investors. They could save each retiree thousands of dollars in taxes each year, and make the retirement fund last that much longer.

In the taxable account you want to minimize the number of trades made each year. Numerous trades mean short-term gains, taxable at the top tax rate. Sell investments only when one of these conditions is met:

The prospects for the investment are poor or mediocre. A higher return in another investment can make up for the taxes you will pay to sell the first investment.

The investments are high risk. Your nest egg should primarily have investments that have margins of safety. Most retirees cannot afford to see a large portion of their nest eggs decline in value.

There will be low taxes on the trade. The best way to meet this requirement is to hold a security for more than one year before selling, qualifying for the long-term capital gains rate.

Secrets #27 & #28. The one and only time it makes sense to hold stocks in an IRA. When to place an equity mutual fund into an IRA—and when not to.

Most investors own both taxable and tax-deferred accounts. Some also own tax-free accounts, such as Roth IRAs. Few investors consider which investments are best held in these different accounts. Yet, properly allocating the investments between the accounts can change the amount of after-tax income available for retirement.

A typical investor will hold stocks and equity mutual funds for the long term. The mutual funds will have low annual distributions that are subject to taxes. For this investor, the best advice is the conventional advice. Hold in a taxable account investments that already are tax-advantaged, such as stocks, equity mutual funds, and real estate. Gains from these investments will be taxed at the long-term capital gains rate. If the investor incurs losses in the taxable account, these can offset gains from other investments in the account or other income.

If these tax-advantaged investments instead were in a tax-deferred account, the investor would be converting tax-advantaged income into ordinary income. That is because distributions from an IRA are taxed as ordinary income. Long-term capital gains earned in the IRA would be taxed at the ordinary income tax rate instead of the long-term capital gains rate.

The conventional advice does not work for every investor. Suppose an investor owns stocks and equity mutual funds but rarely holds them for more than one year.

Or the mutual funds do a lot of trading and distribute a lot of taxable gains each year. The gains earned by this type of investor would be taxed at ordinary income rates in a taxable account because they would be short-term gains. The investor could be better off holding those investments in tax-deferred accounts.

Secret #29. The simple rule of thumb that makes it a snap to avoid needless taxes.

Few people can hold all of their stocks and mutual funds for the very long term. They need to sell at least a few investments each year, or the mutual funds make some distributions. What is the break-even point? When does it make sense to hold stocks and equity mutual funds in an IRA (where taxes on the gains are deferred but are imposed at the top ordinary income tax rate when distributed) instead of in taxable accounts? Here is the rule developed from my research: Stocks and equity mutual funds should be held in a taxable account unless at least 25% of the annual return from them is taxed at ordinary income tax rates.

Secret #30. Safest retirement account for "junk" bonds.

Interest earned on bonds is taxed as ordinary income, at the top tax rate. Junk or high-yield bonds earn higher interest than other types of bonds. Bonds and other investments that generate ordinary income should be held in tax deferred vehicles when possible. Real estate investment trusts also generate high ordinary income and generally should be owned through tax-advantaged accounts. If you also have a Roth IRA, generally the highest returning investments should be held in the Roth, because that maximizes the amount of tax-free income down the road.

Secret #31. The type of retirement account you should almost always tap last

When deciding the order in which to withdraw money from different types of retirement accounts, my research shows that Roth IRAs and any other tax-exempt accounts should be tapped last. The combination of tax-exempt compounding and distributions maximizes wealth when the compounding is allowed to work for as long as possible. As a general rule, the IRAs with nondeductible contributions should be allowed to compound longer than fully taxable IRAs, since distributions from nondeductible IRAs will be only partly taxable.

Secret #32. How to avoid taking required minimum distributions after age 72.

Owners of traditional IRAs are required to take distributions from their IRAs each year. The amount of the required minimum distributions is determined by an IRS formula. For a number of older Americans, the RMDs exceed their spending needs. It means they are taking money out of their IRAs and paying taxes on income they do not need.

A solution for some people is to withdraw money from their IRAs before they need to. Pay income taxes now so that future gains can compound in a taxable account and be subject to the long-term capital gains rate instead of the ordinary income tax rate. My research shows that there are people for whom it makes sense to do this instead of following the traditional advice of letting money compound in the tax deferred account as long as possible.

Briefly, there are people with sufficient assets outside of their IRAs that they are not likely to need the IRAs during their lifetimes, or at least not need the bulk of the IRAs. Yet, the tax law requires them to begin distributions after age 72. These distributions are taxable as ordinary income and will increase as the individual ages. When children or other heirs inherit the IRA, they will owe income taxes on distributions from the IRA.

In these situations, the investor could be better off taking money out of the IRA early, paying the taxes at the current value, and letting the after-tax amount compound in a tax-deferred account. This is discussed more fully in the Archive on the web site and in my books. You should consider this option if you have a large IRA or significant assets outside the IRA so that you do not need the IRA to maintain your standard of living.

Secret #33. Invest your IRA in real estate, privately issued company stock, hedge funds, separately managed accounts and a host of other assets in your IRA.

Most IRA custodians say that only publicly traded securities and mutual funds can be purchased through an IRA. This is not part of the tax law. It is their internal policy. Their systems are not set up to handle assets that are not publicly listed and traded. They also do not want to charge the additional fees they would have to charge to handle other types of assets.

Yet, you are allowed to own many of these assets in your IRA. To do this, you may need a different IRA custodian who's willing to allow you the flexibility to set up a Self-Directed IRA. Only a small number of IRA custodians offer these types of IRAs. Some people call it the Super IRA. Others call it the "Secret" IRA. Its more common name is the Self-Directed IRA or true Self-Directed IRA.

You can find them by going to any Internet search engine and typing in "self-directed IRA."

Secret #34. Greatly expand the use of the Super IRA and reduce its costs.

One of the disadvantages of the true Self-Directed IRA is that the custodians charge higher fees than other custodians. In addition, there are paperwork requirements and usually additional fees for every transaction the IRA makes. These factors make the true self-directed IRA impractical for small IRAs and for IRAs making a large volume of transactions.

Even these disadvantages can be reduced or eliminated by taking another step that very few advisors know about. You can set up a limited liability company and have that wholly owned by the IRA. Then all your investments and other transactions are made through the LLC. The LLC is a separate taxpayer and investor, the IRA simply owns the LLC the way a conventional IRA might own Microsoft or GE.

The LLC can buy any investment that is suitable for an IRA. But it makes the purchases through its own accounts using its own funds. Some people refer to this as the Checkbook IRA, because all the IRA investments are made through the LLC's checkbook or brokerage account.

You might have to prepare a tax return each year for the LLC and have to pay attention to other details. You should not attempt it without an experienced custodian and an attorney to help set up the LLC. The LLC documents must have certain language to allow ownership by an IRA. Without the language, the plan could have big problems.

By using this strategy, you'll enjoy complete control over your IRA assets. You can uncover a wide range of profit-making opportunities that most investors never consider for their IRAs. And you can better protect your nest egg from the ravages of a long-term bear market by moving away from a traditional stock and bond portfolio.

Secret #35. How to safely add timber, gold, commodities, and other fast-rising assets to your traditional IRA—without setting up a Self-Directed IRA.

The traditional retirement portfolio is mostly stocks and bonds, with an overweight to bonds and other income investments. Retirees need to move away from the traditional stock and bond portfolio.

The retirement portfolio should have assets that earn equity-like returns over the long term but that are not tied closely to the returns of the major stock and bond indexes.

Pension funds are starting to do this by adding commodities, timber, and other investments to their portfolios. You can do this in your portfolio, too. One way to add these assets to your portfolio is to buy exchange-traded funds (ETFs) that own these assets or proxies for them, such as futures contracts. While most ETFs own traditional stocks and bonds, others invest in commodities, currencies and other nontraditional assets. Some buy diversified baskets of these assets, while others own a single type of asset.

There also are some mutual funds that have nontraditional assets in their portfolios. Some buy and hold the assets, while others buy and sell as they see opportunities. Morningstar, for example, recently had 124 mutual funds in its “Commodities Broad Basket” category.

A portfolio that is more diversified than traditional portfolios and that adjusts its allocation based on extreme market valuations will avoid the worst effects of sustained bear markets in stocks. By considering the entire toolbox and using those tools that are appropriate for him or her, the retiree greatly increases the likelihood that the portfolio will last through retirement.

Secret #36. Little-known IRA trap that can get you and your family members in big trouble.

Even a true Self-Directed IRA cannot be invested in everything. There are six prohibited transactions between IRAs and related parties. The first four are specific, and the last two are general. These prohibitions apply to all IRAs, whether they are true Self-Directed IRAs or those with traditional custodians.

The specific prohibitions are a sale, exchange, or lease of property; a loan of money; furnishing goods, services, or facilities; a transfer to or the use of the income or assets of the IRA; and the transfer to or use of the income or assets of the IRA. The general prohibitions are an act in which the related party deals with the IRA income or assets as his or her own; and the receipt of any benefit for the related party's personal account in connection with a transaction involving the income or assets of the IRA.

The list basically can be summed up as, "no deals involving the IRA and the owner or a related person." That sounds rather restrictive, but that isn't always true.

It is possible to engage legally in transactions that seem prohibited.

A related person is the IRA owner; anyone who makes decisions for the IRA; anyone providing services to the IRA; an ancestor, spouse, or descendant of the IRA owner, spouse, decision maker, or anyone providing services to the IRA; a corporation, trust, partnership, or estate that is 50% or more owned by any of the above persons; an officer, director, highly compensated employee, or 10% or greater owner of any of the above; and a partner of any of the above.

Not included as related persons are brothers, sisters, step relatives, nieces, and nephews. Also not included are friends and neighbors. A "significant other" to whom you are not married also is not a related person.

What about Roth IRAs? They are subject to the same rules as traditional IRAs and other qualified retirement plans. In addition, the IRS issued a notice in 2003 in which it stated that any transaction between a Roth IRA and a "related party" would be considered a tax shelter or an abusive transaction, and that requires registration with the IRS. For this notice, the IRS considered brothers and sisters as related parties. (IRS Notice 2004-8)

Secret #37. How to avoid IRA penalties for helping family members.

Here's an example of what you can do without a penalty once an LLC IRA is created.

Suppose you have a stepchild who is ready for college.

Your LLC IRA can lend the tuition money to the stepchild. Over time the stepchild pays back the IRA with interest (perhaps using annual gifts from you). The loan

plus interest goes back into your IRA, tax deferred. In addition, the interest might be deductible by the stepchild. This is how your LLC IRA can be used both to earn money and help a loved one. The transaction also works for brothers, sisters, nieces, and nephews.

Or suppose you help someone buy a home or other property by having your IRA write the mortgage. The person gets a loan. Your IRA earns interest income as mortgage payments are received. The loan is secured by the property, protecting your nest egg. And the borrower gets to deduct the interest payments. These are just the tip of the iceberg. There are many other interesting and profitable transactions IRAs are allowed to make.

Secret #38. How to buy your dream vacation home using your IRA.

While the list of prohibited transactions is extensive, it is not absolute. The law requires the Department of Labor to create a procedure for obtaining exemptions from the prohibited transactions rule. This has been done, and the Department grants a number of exemptions each year.

Here is a sample of exemptions granted over the years:

- An IRA owner sold real estate to his IRA.
- An IRA owner sold stock to his IRA.
- An IRA owner purchased stock from his IRA.
- An IRA owner purchased real estate from his IRA.
- An IRA owner lent money to a corporation of which he was the sole owner.

That means when the loan was repaid, the corporation paid tax deductible interest to the IRA.

The Department of Labor, through its Employee Benefits Security Agency, reviews applications for exemptions. The office also grants "class exemptions." These are available to anyone meeting the qualifications stated in the class exemption.

To be granted an exemption, you have to show the office that a transaction is administratively feasible, is in the interest of the plan and its participants and beneficiaries, and that it protects the rights of plan participants and beneficiaries. An individual exemption is put on a fast track to approval if you show that the transaction is substantially similar to two or more exemptions granted in the last five years.

The web site is revised regularly, but at the time of this writing, here's how you can get full details of past exemptions at the web site www.dol.gov/ebsa/. In the right column, click on "EXPRO Exemptions," "Individual Exemptions," and "Class Exemptions." For full details about exemptions and procedures, get the booklet "Exemption Procedures Under Federal Pension Law."

The possibility of an exemption widens your financial options. For example, your IRA might be able to write the mortgage on your next home or vacation home. Instead of writing mortgage checks and paying interest to a bank or other lender, you will be making the payments to your IRA. And the interest likely will be deductible. That's a pretty good deal. When in doubt, work with a tax advisor who is well-versed in the rules for making nontraditional investments in IRAs.

Secret #39. Simple way to maximize your cash flow — while preserving retirement capital.

One strategy we have recommended for some time and that has been adopted by others is the emergency fund or cash reserve fund.

Set aside a portion of your portfolio equal to one to three years of estimated spending. You choose the amount. Invest this part of the portfolio in super-safe assets such as money market funds and certificates of deposit.

The rest of the retirement assets are invested for the long term.

Interest, dividends, and sales of shares from the main portfolio are used to pay for living expenses when the portfolio is rising or stable. But when a bear market knocks down the value of the portfolio, there is no need to sell assets at depressed prices. Instead, use the safety fund to pay for expenses. After the markets recover, profits from the main portfolio can be used to replenish the safety fund and again to pay for expenses.

The size of the safety fund depends on how bad a bear market the retiree wants to defend against and on the value of the total portfolio.

Not everyone has a large enough retirement fund to set aside several years of expenses in a low-yielding safety fund. An option for them is to put part of the retirement portfolio in immediate annuities paying a fixed amount for life.

Studies show that, on paper at least, immediate annuities extend the life of a retirement portfolio and decrease the risk of outliving one's assets. I discussed this in detail in my book, *The New Rules of Retirement*.

Secret #40. Be sure your heirs do not make the #1 mistake with inherited IRAs.

Heirs, often with the help of the IRA custodian, often make a big mistake when they inherit IRAs that triggers immediate and large tax bills. They lose the tax deferral of the IRA. The mistake they make is to change the title of the inherited IRA to their names. This simple name change triggers a rapid distribution of all the IRA's assets. This means your heirs could get whacked with an enormous tax bill and have to fork over 35% or more of their inherited IRA in income taxes to the IRS!

To prevent this tax tsunami from swallowing up your wealth, it's very important to tell your heirs this: An inherited IRA needs 3 things in its title to keep it safe from the greedy clutches of the IRS ...

- 1) The name of the owner who passed away
- 2) The word 'IRA'
- 3) The statement that it is "for the benefit of" the heir.

So, an appropriate title for an inherited IRA would be, "John Sample IRA (deceased), F/B/O Bob Sample, beneficiary."

These three simple title changes can provide ironclad protection for your heirs and the maximum flexibility the law allows. Now, they can let the tax-deferred compounding of the IRA work for up to 10, the maximum the law now allows for most beneficiaries.

#41: Protect your heirs from the SECURE Act

There's a tax bill attached to each traditional individual retirement arrangement (IRA) and 401(k), and Congress recently tried to accelerate and increase that tax bill.

That's why, following enactment of the Setting Every Community Up for Retirement Enhancement (SECURE) Act, many IRA and 401(k) owners need to revamp their estate planning strategies. The SECURE Act ends the Stretch IRA. When an IRA or other retirement plan is inherited, now most of the time the beneficiaries must distribute the entire account within 10 years. There are exceptions for a surviving spouse, minor children, a disabled beneficiary and a few others. But in most cases, the ability to make the tax deferral of an inherited

account last more than 10 years is eliminated.

The end of the Stretch IRA greatly reduces the after-tax wealth available to beneficiaries who inherit traditional IRAs and 401(k)s. Fortunately, there are strategies to avoid the diluting effects of the SECURE Act and deliver your beneficiaries after-tax results that are similar to or even better than those beneficiaries would have garnered before the SECURE Act.

For example:

Empty your IRA early. Take the money out, pay the taxes and invest the after-tax amount in a taxable account. You can leave it directly to heirs or to a trust, ensuring they can't spend it early.

Convert to a Roth IRA. After you pass away the Roth IRA still has to be distributed within 10 years to most beneficiaries. But you can have it distributed to a trust where it is protected.

Use a charitable trust. You can take the money out of the IRA now, pay the taxes and put the after-tax amount in a charitable trust. Or you can name the charitable trust as beneficiary, so it inherits the IRA. Either way, the trust pays annual income to your heirs for life. After the last of them passes away, whatever is left goes to the charities you name.

Use life insurance. There are a number of strategies we've unveiled in *Retirement Watch*. You can take distributions from the IRA now and use the after-tax amount to buy a permanent life insurance policy. You can do this in annual installments or in a lump sum. The life insurance policy can be owned by you or by a trust.

The advantages of life insurance are that the benefit is likely to be the same as or greater than the pre-tax value of the IRA. Your heirs are guaranteed to inherit that amount. It won't fluctuate with market values. Also, they inherit the life insurance benefit tax free. With a trust you can ensure the money is invested well and isn't spent quickly and wastefully.

Secret #42. How to be sure an IRA goes to the loved ones you want to receive it.

One of the easiest things you can do to ensure your IRA custodian follows your wishes is to scrap their standard beneficiary forms. Most of the mistakes made by IRA custodians are tied to this beneficiary form, which IRA owners often spend a minute or less filling out.

But a little bit more of careful planning can save a large portion of your wealth for your heirs and keep it out of the greedy hands of the IRS. That's why I recommend you submit your own customized beneficiary forms with detailed instructions. This simple step can prevent a lot of headaches and needless taxes.

Most estate planners have experience drafting customized beneficiary forms and working with custodians to accept the forms. Customized forms should be considered seriously when an IRA is large, there are multiple beneficiaries, or it is not desired to split the IRA equally among the heirs.

Secret #43. A mistake you don't want an IRA custodian to make.

Here's another common mistake IRA custodians make. Most IRA custodians assume that multiple beneficiaries to your IRA are meant to inherit equal shares of it. But that may not be your plan. You may want one beneficiary to inherit a larger share than another.

Most standard beneficiary forms don't even consider your wishes in this. They don't even have enough space to designate different portions for each beneficiary. That's why customized forms are so important in order to make your intentions clear. If you are thinking of something other than an equal split of the IRA, consider having an estate planner draft a custom beneficiary designation form. An alternative: split the IRA into separate IRAs for each beneficiary.

Secret #44. A key issue about passing on IRAs that most estate plans ignore.

An IRA is going to be included in the owner's estate, and estate taxes will be incurred if the estate is large enough.

When estate taxes are incurred, the next issue is who pays the taxes attributable to the IRA.

Most standard wills provide that estate taxes are paid from the residuary estate or from the surviving spouse's share. Other estates apportion the taxes against specific assets or shares of the estate. If the IRA is a large percentage of the estate and taxes are paid from the residuary estate or surviving spouse's share, the taxes could really shrink those shares of the estate.

Having the taxes paid by the beneficiaries of the IRA could create problems. If the beneficiaries do not have sufficient other assets to pay the taxes, they will have to take a distribution from the IRA to pay the taxes. The distribution will be included in gross income, so they will have to take an extra amount to pay the income taxes on the distribution they take to pay the estate taxes.

The best solution depends on the particular estate. The IRA owner should take care to consider how much the estate taxes will be, and which part of the estate will pay them or whether life insurance should be purchased to pay the taxes.

Secret #45. A little-known tax saver that people who own employer stock in their 401(k)s must know.

Many workers own shares of employer stock through 401(k) or other retirement plans. Few of these workers, or even their financial advisers, know the tax break that is available to substantially reduce the tax burden from selling those shares. With a little planning and by following a few steps, workers can substantially reduce the tax burden on selling the employer stock and increase their after-tax retirement funds.

The tax break is known as net unrealized appreciation or NUA. The rules work like this.

If you sell the employer stock while it is in your 401(k) or other retirement account, you do not get the tax break. The proceeds from that sale eventually will be distributed to you (from either the 401(k) or an IRA rollover) and be taxed at ordinary income rates.

To maximize tax breaks, you do not want to sell employer stock while it is in your 401(k). There might be non-tax reasons for selling the stock. If you have doubts about the long-term future for the stock or believe too much of your net worth is in the stock, you might want to sell some or all of it. Otherwise, the shrewd tax strategy is to hold the employer stock while it is in the retirement account.

To qualify for the tax break, you also cannot take any withdrawals from the retirement plan before taking a distribution of the stock, even required minimum distributions after age 72. If you do, you are ineligible for the tax break.

That is what not to do. Here is what to do when you retire or otherwise leave the employer to grab the tax break.

Take a lump sum distribution from the 401(k) plan. This means that all of the

account must be withdrawn from the account in the same calendar year. The rule is firm. The entire account must be withdrawn within the same year. It does not have to be distributed at once, but the full account must be distributed within the same tax year.

Have the employer stock deposited in a taxable brokerage account in your name. It usually is best to have the other assets rolled over to an IRA. The IRA rollover means that those assets are not taxed until withdrawn from the IRA. If you follow these rules, the employer stock receives special tax treatment.

You include in gross income in the year of the lump sum distribution the original value or cost basis of the shares. No other taxes are due at that time, no matter how much the shares appreciated since you acquired them.

As you sell the employer shares, long-term capital gains taxes are due on the appreciation that occurred since you acquired the shares. The long-term gain treatment is allowed regardless of how long the shares have been owned either inside or outside of the 401(k).

The treatment is the same whether you purchased the shares through your 401(k) plan or received them as a matching contribution from the employer.

Suppose you treat the employer stock the same as your other IRA assets and roll it over to the IRA or keep it in the 401(k) until it is distributed to you. Then, the value of the stock is taxed as ordinary income when distributed the same as your other IRA or 401(k) assets.

The tax break is available even if the company's stock is not publicly traded. Many private companies periodically determine a value for their stock. These values can be used to determine the employee's basis in the stock. When the employer stock is distributed to you, the employer should tell you its basis.

The NUA treatment also is available to heirs who inherit the 401(k) account and take a lump sum distribution after the employee's death. It also is available to divorced spouses if they received part of the retirement account under a qualified domestic relations order.

An employee does not have to use the NUA treatment for all the stock in the plan. Shares that have appreciated a lot can be distributed to the brokerage account and taxes on only the basis paid today. Shares that have not appreciated much can be rolled over to an IRA with other account assets; taxes on those shares are deferred until the shares are distributed.

If a person holds the shares until death, the heirs do not get to increase the tax basis of the shares. The heirs will owe capital gains on the appreciation when they sell the shares just as the employee would have.

The 10% early distribution penalty applies to distributions of employer shares taken as part of an NUA distribution. If the employee is at least age 55 and takes the distribution after separating from the employer, the 10% penalty usually does not apply.

Secret #46. What every spouse should know about inheriting an IRA.

A spouse beneficiary of an IRA has one big advantage. He or she can roll over the IRA to a new IRA that is his or her own or to an existing personal IRA. It is treated as though it always were the surviving spouse's IRA, and none of the restrictions on inherited IRAs apply. That means the beneficiaries and required minimum distribution schedule can be reset and there are no references to the distributions taken by the original owner. This often is a good idea for an inheriting spouse. But non-spouses who are beneficiaries cannot rollover the IRA to a new IRA.

Secret #47. A deduction most heirs of IRAs overlook or misunderstand.

Most taxpayers and even many tax advisers are unaware of the deduction for income in respect of a decedent. But many people who inherit a substantial IRA are eligible for this deduction, which essentially is a deduction for the estate taxes that were paid on the IRA. The deduction is best explained with an example.

Suppose someone left a large estate with an IRA. The estate tax accountant computes that the IRA was responsible for 36.7% of the estate tax paid, and that the IRA's share of the estate tax was \$175,000. When the beneficiary takes distributions from the IRA, a miscellaneous itemized deduction (not subject to the 2% floor) of 36.7% of each distribution is allowed. This continues until the beneficiary has deducted a total of \$175,000 over the years.

The estate tax accountant should determine the data for the deduction. Details can be found in the IRS Publication 559, Survivors, Executors, and Administrators available free on the IRS web site, www.irs.gov.

Secret #48. Your heirs and executor can optimize the beneficiary selection.

The details of who should get an IRA can be left to your executor who, along with family members, can determine from both a financial and tax standpoint who should be the beneficiary. The beneficiary does not have to be selected until Sept. 30 of the year following the year of the owner's death. The first required distribution does not have to be made until Dec. 31 of that year. But the designated beneficiary must be one of a group of primary and contingent beneficiaries named by the account owner.

The way to take advantage of this provision is for you to name both primary and contingent beneficiaries. After your heirs and executor decide who should inherit, those who are ahead of that person in the beneficiary chain can disclaim their interests.

There is a procedure in the tax law for making qualified disclaimers. Your heirs and executor should be aware of your intentions and this process, and you should give the executor guidelines for making the decision and advising the beneficiaries.

Secret #49. Escape your 401(k) before retiring—with no taxes or penalties.

Saving in a 401(k) plan can be a good deal, primarily because the contributions are tax-deferred, and most plans include an employer matching contribution. There also can be disadvantages to 401(k)s. Some plans have poor investment options and high costs.

After retiring, of course, the account balance can be rolled into an IRA. What many people do not realize is that they might be able to move their money out of the 401(k) into an IRA and continue working with the same employer. A penalty-free and tax-free rollover is allowed any time after reaching age 59½. There is no need to leave the employer. Not all plans allow a rollover to an employee who continues working at the firm. Some plans have more restrictive provisions than the tax law allows. But if the plan follows the tax code, a high-cost plan with poor investment options can be escaped after reaching age 59½.

Secret #50. An IRA can shelter some assets from creditors.

A bankruptcy law enacted in 2005 increased protections for IRAs and other retirement funds from creditors. Retirement funds are exempt from the bankruptcy estate if they are exempt from federal income tax under tax code sections 401, 403, 408, 408A, 414, 457, and 501(a). This covers all qualified retirement plans, including IRAs, Roth IRAs, and 401(k) plans.

IRAs and Roth IRAs have a \$1 million limit on their exemption, which is adjusted for inflation each year, and now is well-above \$1 million. In addition, the bankruptcy court can increase this exemption at its discretion. The court generally will examine the needs of the account owner to decide if a higher limit is warranted. The limit does not apply to many rollover contributions from employer plans to IRAs. Other retirement plans are protected without limit.

Keep in mind that the protections of retirement plans apply only in federal bankruptcy court. Creditors might have access to the accounts under state law in non-bankruptcy actions.

Secret #51. A key to successful retirement is having a plan for handling the inevitable surprises.

Financial surprises in retirement can blow a hole in your plans. Particularly for early retirees surprises are very damaging to well-laid plans.

The scenario occurs with frequency. A couple diligently worked up a detailed plan that covered all the expenses of their desired lifestyle. They ventured into retirement secure in the belief that they were financially comfortable.

Then, one or more major surprises surface. Unplanned medical expenses are a major shock to plans. Major home expenses, lower than expected investment returns, and family emergencies are other sources of surprise.

When paying for unplanned expenses retirees lose not only the cash paid for the expenses but all the future income it was expected to generate. Over a retirement of 10 to 30 years, that income is quite a sum. When the unexpected jolt to cash flow arises, retirees need to know how to respond. Here are some key strategies to consider.

- Plan for it. Annual spending in a retirement plan should include the irregular

and even "unexpected" expenses. The spending plan should provide a place for the irregular cash drains. I often recommend that the monthly expenses include "sinking fund" expenses. For example, someone who plans to purchase a new car every four years would list a few hundred dollars for automobiles in the monthly spending plan. That amount won't be spent each month. The sinking fund, however, ensures that when the spending numbers are run through a computer model the retiree has a better idea of whether enough really has been saved for retirement. Sinking funds can be set up for home repairs and even for unexpected emergencies.

- Save more. An alternative to the sinking fund is to establish a cushion in the retirement fund. Don't retire until the fund has \$100,000 or more beyond what is needed to generate cash for your planned lifestyle.
- Cut spending. Most retirement spending plans are flexible. There are variable expenses that can be cut or delayed. The typical retiree can spend less on travel, dining out, spoiling the grandchildren, and other discretionary items. The reduction does not have to be significant. A cut of 5% or so is enough to get most plans back on track.
- Back to work. Those who retired just a few years before the emergency often can return to work, even on a part time basis. They might do something similar to the work they retired from or seek other work to bring in a few dollars until the plan is back on track. More and more employers are "senior friendly," so returning to work is a more viable option than it used to be. Many retirees who take jobs related to their hobbies instead of their old jobs find that the employment increases their enjoyment of retirement.

Retirees should expect the unexpected in their spending. The best solution is to have built a cushion in the retirement plan that anticipates the occasional unplanned expenses. Even when that wasn't done, there still are options that can get the plan back on track.

Secret #52. A reverse mortgage allows you to stay in your home and use its equity.

Reverse mortgages are coming back. The number of reverse mortgages insured by the federal government surged for years, tapered off after the financial crisis, and has been recovering for several years.

Several factors are behind the increase in reverse mortgages. The aging population increases demand, as does the increase in home equity. Federal insurance of the loans and new protective regulations also make reverse mortgages more attractive. Recent innovations by lenders and regulatory changes reduce costs and make the loans more appealing.

The concept of a reverse mortgage is simple.

A homeowner borrows money. The loan can be distributed in a lump sum, as a stream of equal payments for life, or through a line of credit. No payments are due as long as the borrower is living in the home. The lender is paid when the borrower moves from the home or passes away. Proceeds from the sale of the home are used to repay the loan plus interest and expenses. The amount due from the borrower or his estate never can exceed the value of the home. If the lender is due more than that, it either absorbs the loss or collects from the federal insurance, if it was an insured loan.

For the loan to be federally insured, the borrower must be age 62 or older. The borrower must be counseled by an adviser who is independent of the lender and approved by the Department of Housing and Urban Development. There is a ceiling amount on loans insured by HUD, which varies by region and is based on median home values. HUD imposes these rules because it insures the loans.

It is important for the borrower to understand the costs of reverse mortgages, because this is an expensive way to borrow.

The loan carries an interest rate similar to that on a 30-year mortgage, though the rate might be variable instead of fixed. In addition, there are costs including an application fee, origination fee, closing costs, and a monthly servicing fee, which usually is 0.5% of the loan balance. These costs often total to around 8% of the home's value. About two percentage points of this will be paid to the federal government for insurance. The costs all are backloaded; no payments are due until the home is sold, though you can choose to pay some at the time the loan is issued. The interest on the loan compounds until the loan is repaid.

The amount that can be borrowed is limited, because the lender wants to be paid in full and the government wants to limit the loans it has to cover. The older you are, the greater the percentage of the home's value that can be borrowed. But not many people are able to borrow more than 50% of a home's value. To develop an estimate of how much you might be able to borrow, click [here](#).

Reverse mortgages above the HUD ceiling are available in what are called jumbo loans that are issued by lenders and carry no federal insurance. These loans might be for a higher percentage of the home's value than the HUD loans, but they also can have higher costs and interest rates.

A reverse mortgage is a way to use home equity without moving out of the home and without having to make payments during life. But it is an expensive way to borrow and will reduce or eliminate any inheritance left for heirs.

Secret #53. Reverse Mortgage Basics (He may want the entire portion “3 Shrewd Ways Reverse Mortgages Can Enhance Retirement Security” but I am using the last portion of it because it fits more accurately length-wise.)

Reverse mortgage basics. In this article I discuss federally guaranteed reverse mortgages.

A few lenders offer private reverse mortgages, but there aren't many and they don't carry the guarantee. The money you receive from a reverse mortgage isn't taxable. You're borrowing against the home equity. Interest will accrue on the outstanding reverse mortgage balance. No payments are due until the home no longer is your principal residence.

After that, proceeds from selling the home first will be used to repay the reverse mortgage balance. If the home's value isn't enough to repay everything, the government insurance fund pays the difference to the lender. You, your estate and your heirs won't be on the hook for the difference. If any home sale proceeds remain after the reverse mortgage obligations are paid, your heirs can inherit the excess.

A reverse mortgage borrower must be age 62 or older. You can borrow only against home equity, so the home should have no existing mortgage or a small mortgage. You need to meet with a HUD-approved counselor who must certify that you understand the loan and that you have enough resources to continue paying real estate taxes, homeowner's insurance and maintenance on the property.

The determination of the maximum amount you can borrow, and the interest rate charged can be complicated. Generally, the lower current interest rates are, the more you can borrow. Also, the older you are, the higher the percentage of the home equity you can borrow.

If you take out a HELOC, the amount you can borrow can increase over time, especially if interest rates increase. At any time, you can repay amounts outstanding on a reverse mortgage. There are up-front costs to establishing a reverse mortgage. Some are imposed by HUD, and the lender charges others. You can pay the upfront costs from your resources or have them added to the reverse mortgage balance. The lender will charge an origination fee, which can't exceed

\$6,000.

Traditional real estate loan closing costs also will be charged, such as an appraisal fee, title search, recording fees and probably others. HUD charges an initial mortgage insurance premium of 2% of the home's appraised value. There also will be an annual mortgage insurance premium equal to 0.5% of the outstanding balance. The lender is likely to charge regular servicing fees if the loan is outstanding.

Shop around before taking out a reverse mortgage. Interest rates and fees vary considerably. Take a look at the "kosher mortgage" lenders listed on the website of the Mortgage Professor (www.mtgprofessor.com).

Secret #54. State income and estate taxes are a bigger threat to your plans than before.

The most important tax audit of your life is likely to take place either in the first few years of retirement or after you pass away.

It is a state residency audit and could befall anyone who moved to another state during retirement or who owns homes in at least two states during retirement.

A number of low tax states are marketing themselves to retirees who are seeking to reduce their expenses by cutting state taxes. One study found that about 1,000 Americans per day move from states with income taxes to states with no income taxes. The higher-tax states are fighting back with residency audits of former residents. They are aggressively targeting individuals who claim to have changed their residences but retained significant contacts with their old states.

The residency audit is likely to occur at either of two times. One point is shortly after you stop filing income tax returns in the old state or start filing part-year resident returns after years of filing full-time resident returns. The other point is after death.

Income taxes are not the only target of the states. While the federal government has been reducing estate taxes, 19 states and the District of Columbia had estate or inheritance taxes in place in 2022. These taxes often have lower thresholds than the federal estate taxes and can be much more significant than the federal taxes.

New York and California are the most aggressive in challenging residence status, but other states are active.

The problem for individuals is that residence and domicile are nebulous, complicated concepts. The rules and decisions often vary between the states and are reviewed only by their own courts. The states do not have to make consistent decisions. It is not unheard of for two states to each claim one person as a resident.

Most states have one bright-line rule. If you are present in the state more than 183 days (half the year) you are a full-time resident. The first step if you want to change residence is to keep a log or other proof showing that you were physically present in the new state more than 183 days of the year, or at least that you were not in the old state more than 183 days.

While being in a state more than 183 days makes you a resident, being out of the state more than 183 days does not automatically make you nonresident. Contacts with a state and other subjective factors can determine your residence.

Residency and domicile are defined as states of mind. A person is resident in the state he intends to be his permanent residence indefinitely. Facts and circumstances are used to determine a person's intent. You need to line up as many facts as possible to demonstrate your intent to change residence. Establishing the facts is important, because you won't be around to help in an estate tax audit.

Here are key steps to take:

- Change any government registration or official address. Change the address for your passport, driver's license, voter registration, and auto registration. File all federal, state, and local tax returns with the new address and file them with the office that is designated for residents at your new address.
- Have all your financial accounts sent to the new address. These include bank accounts, brokerage and mutual fund accounts, credit card statements, and other loan statements.
- Have all your mail sent to the new address. When you spend time at the other home, have mail held or forwarded only temporarily; do not register a change of mailing address with the post office.
- If you travel a lot, whether between multiple homes or on vacation, keep a log or diary of the travels. Leave for vacations from the new permanent residence.
- Execute a new will in the new state.
- Shift memberships in clubs, churches, and other organizations to the new state. Drop memberships in the old state or change them to associate, non-resident, or some other part-time status.
- Sever fixed contacts with the old state. Most advisors believe it is best to sell

the residence in the old state or rent it full-time so that you are not able to stay there. If you want to maintain some kind of residence in the old state, downsize and do not leave personal items that indicate an intent to stay there, such as photos. Also, do not leave valuables or personal items in the old state. Some people leave their important documents, jewelry, and other items in storage or safe deposit boxes in the old state. That shows an intent not to leave permanently.

- If you maintain a residence of some sort in the old state, have all bills sent to the new state and conduct any correspondence using the new address.
- Keep the evidence of your intent to move. In an audit, the state might ask for diaries and calendars, credit card statements, phone bills, and other information for three years. Make sure your heirs and executor know where this information is.

Secret #55. How to avoid (more) taxes by converting to a Roth IRA.

Many people aren't excited about paying taxes before they have to.

But, unless your income tax rate is going to be lower in the future than it is now, it can make a lot of sense to pay taxes now and shelter all the future gains and income from taxes.

You could avoid paying tens of thousands of dollars in needless taxes! Here's what you must consider in order to carry out this strategy.

One of the most powerful tax-saving retirement weapons that should be in every retiree's arsenal is the Roth IRA.

Their unique benefits are tremendous!

* No age limit on contributions.

* No required minimum distribution at age 72.

* And the best reason ever to open a Roth IRA: not one dime you withdraw from it in retirement is ever taxed. (No matter how much your money has grown over the years!)

Taking advantage of this is easy. Simply build up your traditional IRA and other

tax-deferred accounts as much as possible.

Then, convert your regular IRA to a Roth IRA (and consider doing the same with your 401(k) as well if you can roll it over to an IRA).

You will pay taxes on the conversion, but it could be considerably less in taxes than you'd be forced to shell out in the future.

A conversion is best when the taxpayer has cash from other sources that can be used to pay the income taxes, so that the entire IRA can remain intact and maximize the income and gains that will compound.

In addition, the IRA should be left alone for 10 years or longer so that the compounding can make up for the taxes paid on the conversion, assuming an 8% rate of return.

A higher return means a lower payback period, and a lower return means a longer payback period.

If money has to be distributed from the IRA to pay taxes on the conversion, then the Roth IRA should be left undisturbed for a longer period for the conversion to reach the break-even point.

There are other strategies that will reduce taxes on taxable investment accounts.

They could save each retiree thousands of dollars in taxes each year and make the retirement fund last that much longer.

For example, in the taxable account you want to minimize the number of trades made each year. Numerous trades mean short-term gains, taxable at the top tax rate. Sell investments only when one of these conditions is met:

The prospects for the investment are poor or mediocre. A higher return in another investment can make up for the taxes you will pay to sell the first investment.

The investments are high risk. Your nest egg should primarily have investments that have margins of safety. Most retirees cannot afford to see a large portion of their nest eggs decline in value.

There will be low taxes on the trade. The best way to meet this requirement is to hold a security for more than one year before selling, qualifying for the long-term capital gains rate.

Secret #56. The Most Asked IRA Question.

We're going to look at what lately has been the question I'm asked the most about Roth IRAs.

I don't know why there's increased concern about this question.

It's probably because the new tax law makes it more attractive for most people to convert a traditional IRA into a Roth IRA.

Whatever the reason, there's a lot of interest in "the five-year rule" for Roth IRAs, which is one of the more confusing rules in the tax code.

The five-year rule frequently is summarized something like this: A distribution from a Roth IRA isn't tax free until at least five years have passed.

Longtime readers know I believe rules of thumb and shortcuts are dangerous, and this is a good example.

The summary stimulates a lot of questions.

Do I have to wait five years each time I make a contribution to a Roth IRA or do a conversion?

Does the five-year period restart if I rollover the Roth IRA to a new custodian or another Roth IRA?

If I pass away does the five-year period restart for my beneficiary? Those are just a few questions that arise.

One reason there's a lot of confusion is most people don't realize there are two separate five-year Roth IRA rules that have to be considered separately.

The Five-Year Rule for Contributions The first five-year rule applies to contributions to Roth IRAs and controls whether distributions of earnings will be tax-free.

Only "qualified distributions" from a Roth IRA are tax free.

Two tests must be met for a distribution to be qualified.

One test is that five tax years must have passed since the first contribution was made to any Roth IRA by the taxpayer.

This is a broad rule, according to the Treasury regulations. The five-year period starts whenever the IRA owner puts money into any Roth IRA. Under this rule, contributions include both direct contributions and converted amounts.

Some people have thought this five-year rule applies separately to each Roth IRA.

That's not the case. Others have thought the five-year rule is applied separately to each Roth IRA conversion.

That's also not the case. There have been worries that rolling over the Roth IRA to another might restart the five-year period.

Again, that's not the rule.

The Roth IRAs of the taxpayer and the money flowing into Roth IRAs are aggregated to come up with one five-year period. Essentially, once you've satisfied the five-year rule, you've satisfied it for life.

That's a reason that some advisors say if you're interested in a Roth IRA in the future, you should convert or contribute a small amount to a Roth IRA now, so the five-year clock will start running.

The second test for qualified distributions is broader.

The distribution must be made on or after at least one of the following events: the owner turned age 59½; the IRA owner passed away, so the distribution is made to the estate or a beneficiary; the distribution is made for first-time qualified home buyer expenses of up to \$10,000.

You must satisfy both tests for a Roth IRA distribution to be tax free. For example, you must be at least age 59½ and must have had a Roth IRA for at least five years for the distribution to be tax free.

The Five-Year Rule for Conversions

The second five-year rule determines whether a distribution of principal from a converted IRA is subject to the 10% early distribution penalty. The rule applies only to the penalty.

The other rule determines whether the distribution is taxable.

This second rule states that the early distribution penalty isn't imposed if at least five tax years have passed since the principal was converted to a Roth IRA.

There are a couple of important points with this rule.

One point is that it applies separately to each IRA conversion. That means if you're doing conversions over a period of years, you have to track the amount of principal converted each year.

The second point negates the importance of this rule for most of my readers and most people who convert traditional IRAs to Roth IRAs.

This point is that there are other ways to avoid the 10% penalty and the most commonly used one is for the IRA owner to be at least age 59½. Once you've hit that age, a distribution no longer is considered early, so the early distribution penalty doesn't apply.

As an example, suppose Max Profits is 45 years old and converts a traditional IRA to a Roth IRA. At age 51, he needs the money from the Roth IRA and distributes the full account.

The early distribution penalty doesn't apply, because more than five years have passed since the conversion. But the distribution of the earnings of the Roth IRA is taxable, because Max hasn't met any of the requirements for a qualified distribution under the first five-year rule.

The distribution of the principal, or converted amount, isn't taxable, because the taxes on that were paid when the conversion was done.

Some Other Important Points:

The five-year rules aren't nearly as onerous or even as important as many people suppose for a couple of reasons.

The first reason is that each rule talks about tax years, not calendar years. A tax year starts on the first day of the year, so you really don't have to wait five full calendar years before qualifying under either five-year rule.

For example, you can make a contribution to a Roth IRA for tax year 2024 as late as April 15, 2025 (even later if the 15th falls on a weekend or holiday).

Or you can convert an IRA as late as December 31, 2024. In either case, the

five-year clock starts running on the first day of the tax year, January 1, 2024.

So, the five-year period is less than 60 months from the date of your action.

A second point is that many people overlook what are known as the ordering rules for Roth IRAs.

When you take a distribution from a Roth IRA that is less than the full IRA value, the ordering rules determine whether the distribution is of principal or earnings.

The ordering rules state that distributions are first considered to be of principal.

Only after all principal is distributed are earnings distributed. Distributions of principal from the Roth IRA aren't taxable, because you already paid taxes on them.

So, even if you're within the five-year period, income taxes aren't an issue until all the principal is distributed and earnings are being distributed.

The ordering rules also state that contributions are distributed first, then converted amounts and finally earnings are distributed.

A final point in the ordering rules is when there were conversions in different years, the conversions are considered to be distributed on a first-in, first-out basis.

So, the first conversions are distributed first, and the most recent conversion is distributed last.

A third point is that the details of the five-year rules are a bit different for Roth 401(k)s. I won't go into those details now.

While the five-year rules are complicated and confusing, they don't matter to most people taking money out of Roth IRAs during retirement.

You'll be older than age 59½, so the early distribution penalty won't apply. You're also likely to be withdrawing money gradually over time. That means you will withdraw principal first, and that's not taxable.

Only after all your principal has been withdrawn do you have to worry about some of the distribution being taxable.

Most likely, five years will have passed by then, so the distributions will be

tax-free.

Secret #57. How to receive steady lifetime income with inflation protection.

One need of retiring Baby Boomers is for guaranteed lifetime income that replaces old-style defined benefit plans. Another need is for that income to retain its purchasing power. There are several investments and strategies that might accomplish these goals, and more are being developed by insurers.

- Buy an immediate annuity and keep saving. A traditional immediate annuity achieves the goal of lifetime income. The income payments, however, are fixed. Over time inflation erodes the purchasing power of the income. An investor searching for reliable income should consider buying an immediate annuity but not spending all the payouts. To support purchasing power over time, save and invest some of the distributions.
- Buy an inflation-indexed annuity. These annuities make regular payments for either life or a term of years, just like immediate annuities. The payments, however, are adjusted annually to reflect increases in the CPI. The payment won't be adjusted for the actual inflation rate. Instead, you decide in advance whether you want the payments increased by a fixed percentage each year. Usually, you can choose any whole number from 2% to 5%.
- Buy a variable annuity with income rider. This is a variable annuity with an option often called the guaranteed minimum income benefit (GMIB). Such annuities provide the opportunity for the income to increase with little risk of reduced income.

No matter which annuity you lean toward, review what the results would be under different circumstances. Also, realize that the additional features cost money. Review the fees and how much your income is reduced. Most important is to compare redemption or cancellation fees. Often, it is difficult to exit one of these investments without a steep cost.

Secret #58. Have a living trust? Don't make these two common mistakes.

Many people set up living trusts but neglect to fully implement them or update them as needed. There should be successor clauses for beneficiaries and trustees. The trustee succession clause determines who controls the trust after the initial

trustee is unable to. The beneficiary succession clause effectively determines who inherits the assets. The clauses should be carefully written, updated as needed, and the successors made aware of the situation.

Another detail often overlooked with living trusts is that ownership of assets must be transferred to them. Only the assets legally owned by the trust avoid probate and are controlled by its terms. Too many people do not do the work of transferring the legal title of homes, vehicles, and financial accounts to their trusts, making the trusts useless.

It also is important to check with financial institutions to determine if they need a copy of the trust on file. A number of financial institutions are hesitant to recognize succession clauses in a living trust unless a copy of the trust agreement was filed with them by the trust creator, or they have other proof of the initial trustee's intent before transferring power over the accounts.

Secret #59. Increase cash flow by automating your finances.

One of my goals is to simplify your financial life. One reason is to reduce procrastination. I also don't want you to have to work full-time on your finances. The point of financial security is to be able to spend time doing the things you really enjoy. That's why I constantly am searching for ways to simplify financial matters, and the best ways to do that are to consolidate and automate as much of your financial affairs as you can.

You start by having as few financial service providers as you can. The simplest structure is to have a discount broker where you keep all your investment accounts (taxable accounts and IRAs), checking account, and safety funds. Many brokers now have an affiliated bank, so the accounts are managed seamlessly and even issue credit and debit cards.

An alternative, which is becoming more attractive because of technology changes, is to have your financial accounts at different firms but aggregate the information in a central location. You can do this through either a web site or computer-based software.

Don't stop with consolidation.

Many bills now can be paid automatically, and that's a good idea for recurring, regular payments such as utilities. You can have the provider draft the amount automatically from your checking or other account. An alternative is to have it

charged automatically to a credit or debit card. When the amount is the same each month, you can set up automatic payments through your checking account or through personal finance software such as Quicken. A potential advantage of automatic payment through your checking account or personal finance software is you might find it easier to cancel or change the payment amount at any time.

Automatic payments mean you spend less time on your finances. You review things. You determine if the bills are accurate and compare the bills received to your checking account statement (either on paper or online).

Another way to simplify finances is to put all nonautomated expenditures on a debit or credit card. Or you can use different cards for different types of expenses. The advantages are you make only one payment per month (or none if you use debit cards) and can see where all your money went. You're likely to avoid any late payment penalties and interest charges. You also can have the credit card bill automatically drafted from your checking account if you want.

There are other advantages to making payments on a credit card. You might earn points in a reward program. You also receive some consumer protection, because a credit card company intervenes in disputes with merchants.

When you're still working, have saving and investment decisions made automatically to the extent you can. Amounts should be deducted regularly from your paycheck or checking account to be invested in your 401(k), IRA, and taxable account. Most people have automatic 401(k) contributions, but not the others. It's better to have investments made automatically instead of waiting for you to find the time to transfer money from checking to the investment accounts.

When money is transferred to your investment accounts, it should be invested right away according to instructions you set in advance, not kept in a money market account waiting for you to make changes. Most fund families and brokers let you set up automatic investing. You always can change automatic investing plan on short notice or move money after it is invested.

Automating your finances doesn't mean ignoring them. It means having most of the routine moves performed in the background by others. That frees your time to focus on reviewing, planning, and making changes.

Procrastination is reduced when you set up automatic alerts or reminders about actions that need to be taken. You can do this the old-fashioned way by making notations on your calendar. Web sites or software usually allow you to set alerts that are either e-mails or alerts that pop up on the screen when you open the program or log on to the site. You should have reminders to review your accounts

in the middle and at the end of the month. Be sure all the transactions were made as they were supposed to and review your overall financial status.

Secret #60. Curbing the high cost of retirement medical care.

The cost of medical care continues to rise and to be the wild card in retirement plans. Reports and studies update their estimates of the cost of retirement medical care each year. They show the cost to be high and also very unpredictable for individual retirees and couples. The studies focus on average or median costs. You have to be aware that individual costs vary greatly because of differences in personal health, geography, and insurance coverage. Your retirement medical costs can be substantially higher or lower than the forecasts.

We're talking about out-of-pocket costs, those expenses that aren't covered by Medicare. People on average incur higher medical costs than these estimates, but Medicare picks up some of the costs.

Annual studies from the Employee Benefits Research Institute and Fidelity Investments regularly conclude that couples retiring at age 65 will need \$300,000 or more to pay for out-of-pocket medical expenses during the next 30 years.

How will these costs be paid? EBRI estimates that Medicare covers about 62% of medical costs for beneficiaries. (I've seen other reports estimate that Medicare pays only about 50% of costs.) Another 13% comes from private insurance and about 12% is paid by the retirees. The rest is paid by state programs, employer retirement benefits, and other sources.

There are steps you can take to reduce both the out-of-pocket medical costs and the uncertainty of your exposure to the medical costs.

- Those not already retired should establish good health habits, including participating in any employment or community wellness programs.
- When you're eligible for a health savings account, take advantage of the option and fund it with the maximum amount each year. Contributions to HSAs are deductible if made by you and excluded from gross income if made by your employer. Earnings on the account compound without taxes, and all amounts withdrawn from the account are tax-free when withdrawn to pay for qualified medical expenses. It's a good way to build a tax-advantaged retirement fund for medical expenses.
- Enroll in Medicare when first eligible. You pay a penalty for life if you decide later to sign up for Medicare or Part D Prescription Drug Coverage

- after your initial enrollment period expires.
- Sign up for Part D Prescription Drug Coverage. This is private insurance that is partially subsidized by the government. Prescription drugs are the largest medical expense for most of those age 65 and older. A good policy reduces your out-of-pocket costs and the uncertainty of how much you'll pay should you have an above average or catastrophic need for medicine. When you don't have much need for prescription drugs at the start of retirement, sign up for a barebones, low-cost policy. You always can switch to a more robust policy during a future open enrollment period if you need it and will avoid the premium penalty for signing up for Part D late.
 - Consider a Medicare Supplement policy. When you're in traditional Medicare (not Medicare Advantage), there are a number of deductibles, copayments, and coverage gaps. A Medigap policy will cover some of them and reduce your uncertainty. There are 10 different Medigap policies to choose from, so you can look for the right tradeoff for you between premiums and better coverage.
 - Shop around. I can't stress this enough. Recent studies have found that premiums for identical coverage for the same person can vary by 100%. There are people paying twice as much for Part D and Medigap policies than they should because they didn't shop around. The insurance industry counts on a combination of inertia and people disliking insurance shopping. It costs people a lot of money.
 - Have flexibility. A retirement plan needs a cushion and some flexibility because of the uncertainty of medical expenses. You should minimize fixed expenses so that spending changes can be made in case uncovered medical expenses arise.
 - Plan for long-term care. Medicare won't cover much of any long-term expenses you incur, and most of you won't qualify for Medicaid. You probably don't want to rely on Medicaid for long-term coverage anyway, because the level of care by facilities accepting Medicaid usually is considered to be of lower quality than at others.

I recommend most people plan on using several sources to pay for LTC. Part of the cost can be funded from savings. There probably are expenses you incur now that you won't if you need LTC, and that money can be used to help pay for LTC.

To pay for the bulk of the coverage, you should consider obtaining either a standalone LTC policy or an annuity or life insurance policy with a long-term care rider. Or you can combine both types of coverage. Tapping the equity in your home through either a reverse mortgage or a sale can be a good way to plan for extended long-term care expenses. By using all these tools, you'll have a solid plan to cover any LTC you need.

Biography



Bob Carlson is editor of the monthly newsletter and website, *Retirement Watch*. He has served on the Board of Trustees of the Fairfax County Employees' Retirement System since 1992 and been chairman since 1995. The system has more than \$5 billion in assets. Carlson was a member of the Board of Trustees of the Virginia Retirement System, which oversaw \$42 billion in assets, from 2001-2005. He was appointed to the Virginia Retirement System Deferred Compensation Plans Advisory Committee in 2011 through 2020.

His latest book is the revised edition of “The New Rules of Retirement” (Wiley, 2016; first edition 2004). He also co-authored “Personal Finance after 50 for Dummies” (with Eric Tyson; Wiley, 2015) and wrote “Invest Like a Fox...Not Like a Hedgehog” (Wiley, 2007).

He has written numerous other books and reports, including “The New Rules of Estate Planning,” “Securing Your Lifetime Stream of Income,” “Tax Wise Money Strategies, Retirement Tax Guide,” “How to Slash Your Mutual Fund Taxes,” “Bob Carlson’s Estate Planning Files” and “199 Loopholes That Survived Tax Reform.” He also has been interviewed by or quoted in numerous publications, including *The Wall Street Journal*, *Reader's Digest*, *Barron's*, *AARP Bulletin*, *Money*, *Worth*, *Kiplinger's Personal Finance*, the *Washington Post* and many others. He has appeared on national television and on a number of radio programs. He is past editor of *Tax Wise Money*.

Carlson also was a Commissioner on the Fairfax County Redevelopment and Housing Authority. Carlson is an attorney and passed the CPA Exam. He received his J.D. and an M.S. (Accounting) from the University of Virginia and received his B.S. (Financial Management) from Clemson University. He also is an instrument rated private pilot. He is listed in many editions of *Who's Who in America* and *Who's Who in the World*.

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