10 IRA Traps to Avoid
Don’t let the complexity of these powerful retirement savings tools trip you up.

BY BRIAN DOBBIS

Experience has shown us that taxpayers can miss opportunities, fail to take advantage of their options, or inadvertently get into trouble when it comes to their individual retirement accounts (IRAs). While each individual’s situation is different, many of the missteps are the same. Here’s a look at common mistakes and potential solutions to help investors get the most from their savings while avoiding potential pitfalls.

1. ELIGIBILITY MISHAPS
According to the Internal Revenue Service, approximately 86% of all eligible taxpayers fail to contribute to an IRA. While poor saving habits may be the most familiar explanation, another reason is that taxpayers confuse deduction eligibility with IRA eligibility.

There are only two requirements to make you eligible to contribute to a traditional IRA: earned income and being under 70½ years of age. If a Roth IRA is desired, then the under-age-70½ requirement does not apply, but income must be less than or equal to threshold amounts.

It is important to recognize that contributing to a 401(k), SIMPLE IRA, or 457 governmental plan on a pretax basis can potentially make you and, if married, your spouse, eligible to have a deductible IRA or a Roth IRA, since participation can lower your income below IRS threshold amounts. Also remember that deductibility of IRA contributions is affected by whether you or you and your spouse are covered by a qualified retirement plan, but income has no effect if there is no plan participation. Other deductions, such as charity and mortgage interest, do not help toward Roth or traditional IRA eligibility.

2. TRACKING BASIS WHEN MAKING AFTERTAX CONTRIBUTIONS TO AN IRA
If an individual is not aware of how much aftertax money he or she has contributed to a traditional IRA, the account holder could face a nasty surprise: distribution may also be fully taxable. In general, given myriad potential scenarios, financial institutions do not track deductible IRA contributions, so the burden shifts to the taxpayer. You simply file Form 8606 with your tax return, showing what was nondeductible on the way in, and Form 8606 again to reconcile the distributions and get the proper income credit on the way out. Form 8606 assists you by recording your remaining basis (i.e., the amount not taxed). Knowing your basis is extremely helpful in minimizing any taxes payable if you choose to avail yourself of the Roth conversion opportunity.

The basis also is an important figure for your beneficiary to know because double taxation will occur when distributions after death are taken.

3. REQUIRED MINIMUM DISTRIBUTIONS
Many taxpayers are unaware that all IRAs (traditional, SEP, and SIMPLE) must be totaled to determine how much needs to be taken at age 70½, when taxpayers must begin making required minimum distributions (RMDs). There is an excise tax penalty equal to 50% of the RMD shortfall if not withdrawn in a timely manner. Roth IRAs (while the account owner, or spouse if sole beneficiary, is alive) and Coverdell (Education) IRAs are exempt.

4. COMBINING IRA RULES AND STRATEGIES HAVE CHANGED
Prior to the Economic Growth and Tax Relief Reconciliation Act [EGTRRA] of 2001, it was important to leave rollover and contributory IRAs separate in the event that an individual wanted to roll an IRA account into a new employer’s retirement plan. EGTRRA now allows full portability of all traditional (non-Roth) IRA accounts as long as no aftertax monies are...
transferred to an employer plan receiving funds from an IRA.

By combining IRA accounts, a taxpayer can save custodial fees, more easily monitor accounts, and rebalance portfolios. (Note that the process of rebalancing may carry tax consequences.) This also can ensure an easier beneficiary transfer upon death, provided no overlooked accounts surface once payouts must begin.

5. INHERITING OPTIONS

When a spouse inherits an IRA and he or she is under age 59½, making the account his or her own reattaches the 10% penalty for early withdrawals. In other words, this forces the inheriting spouse to wait until age 59½ to make penalty-free withdrawals. A way to avoid this issue is to leave the IRA in the decedent’s name, which allows the surviving spouse to make penalty-free withdrawals as needed. Once age 59½ is attained, the account can be made the surviving spouse’s own.

The advantage in making the IRA one’s own occurs when an inheriting spouse decides to transfer that IRA, minus any aftertax contributions, to his or her own qualified plan account. Less well known is the ability to postpone any RMDs until the deceased spouse would have reached age 70½. (This is more important in a case in which the inheriting spouse is younger than or equal to the deceased spouse.)

The inheriting spouse can withdraw proceeds for up to 60 days, but must return the funds or be taxed on any dollars not returned on or before the time expires, minus any aftertax dollars.

It should be noted that nonspouse beneficiaries do not have this 60-day rollover privilege. Once a nonspouse beneficiary accesses the funds, the income is taxable, and the proceeds cannot be redeposited into an IRA.

6. USING YOUR WILL TO NAME YOUR BENEFICIARY

An IRA account holder must follow the custodian’s procedures when naming a beneficiary. The executor of the estate cannot present a will at the time of death and demand payment of the assets unless beforehand the will has the named beneficiary designated on a form deemed acceptable to the IRA custodian. Sometimes the custodian’s forms are required, while many custodians will accept a written statement that clearly delineates the intention.

Not naming a beneficiary leaves the beneficiary determination to the terms of the custodial agreement, which can name the estate or distribute according to some succession order, such as spouse, children, grandchildren, or siblings, which may not be the owner’s intent.

7. NAMING THE ESTATE AS THE BENEFICIARY

If the account holder’s estate is the IRA’s beneficiary, the heirs will receive the proceeds, but potentially not in the most tax-efficient manner. (By the way, whether the estate is the beneficiary or not, the IRA proceeds are included in the estate for calculating estate taxes, if any.) If the account owner dies before his or her required beginning date (RBD)—April 1 following attainment of age 70½—the entire account must be distributed before December 31 of the fifth year after his or her death. If there is a lot of money in the account, distributions could be taxed at a very high federal tax rate.

What happens if the account owner dies after his or her RBD? Peculiar as it may sound, the estate can make distributions over the deceased person’s remaining life expectancy based on actuarial tables prescribed by the U.S. Tax Code, all of which adds new meaning to the adage about the certainty of death and taxes.

Let’s look at a hypothetical example: If an account owner with one heir died at age 75, his or her remaining life expectancy would be 13.4 years based on the actuarial tables prescribed by the U.S. Tax Code. Since distributions begin in the year following death, the estate would need to deplete the IRA account over the following 12.4 years. Had the same beneficiary of the estate (say, age 50) been named directly on the IRA, the distribution could have been spread over 34.2 years.

8. NAMING A NONPERSON (CHARITY) AS A CO-BENEFICIARY

When a charity is an IRA’s co-beneficiary along with a family member, for example, the ability to stretch the payout over the human beneficiary’s lifetime can be lost.

The custodian has until September 30 of the year following death to cash out the charity’s interest to allow the account to be distributed over the life expectancy of the human beneficiary(ies). Failure to do so will require the assets to be fully disbursed by December 31 of the fifth year after the death. The custodian does not, however, have discretionary authority to effectuate this redemption. Unless all the necessary paperwork is submitted, the custodian’s hands are tied.

This potential tax inefficiency can easily be avoided by splitting the IRAs before death and designating a charity as the beneficiary in a separate IRA.

9. NAMING A TRUST AS BENEFICIARY WHEN THERE ARE MULTIPLE BENEFICIARIES

Under a scenario when a trust is the named IRA beneficiary and there are multiple beneficiaries, the RMD in the year following death is determined by basing it on the age of the oldest named beneficiary.

Let’s take a look at another hypothetical example: A trust lists three beneficiaries of John Doe’s $300,000 IRA. They are aged 50, 45, and 40, respectively. The minimum payout would be $8,772, split three ways. The remaining life expectancy over the following 12.4 years each is 13.4 years for 50, 38 years for 45, and 20 years for 40. By combining IRA accounts, a taxpayer can save custodial fees, more easily monitor accounts, and rebalance portfolios. (Note that the process of rebalancing may carry tax consequences.) This also can ensure an easier beneficiary transfer upon death, provided no overlooked accounts surface once payouts must begin.
medical insurance premiums, if unemployed. Gross income, disability withdrawals, and the payment of options involve medical expenses in excess of 7.5% of adjusted family members, again paying taxes, but no penalty. Other withdrawn to purchase a home for themselves or immediate penalty-free withdrawal options their IRA offers. For example, distribution considerably, preserving assets.

10. Failing to name a contingent beneficiary
If the beneficiary predeceases the account holder and the account holder does not replace that beneficiary and subsequently dies, the IRA custodial agreement may name the estate or require the distribution of the proceeds according to some succession order, such as spouse, children, grandchildren, or siblings, which may not be the owner’s intent.

If the account holder and his or her beneficiary (spouse) die at the same time (in a car accident, for example) and the account holder’s will stipulates the beneficiary who died first, then the terms of the IRA custodial agreement could, in turn, name the estate or distribute the proceeds according to a familial succession order, which, again, may not be the owner’s intent.

Additional tips
There are a few other items that require an IRA account holder’s awareness. For example, many individuals under age 59½ opt to begin taking IRA distributions under an exception to the Internal Revenue Code §72(t) 10% penalty. In this situation, an individual must take annual distributions, based on his or her life expectancy, determined in the year distributions begin. Distributions must continue for at least five years or until the individual attains age 59½, if later. If these distributions are from mutual funds or a variable annuity, and the stock market is declining at the time, the account can be depleted more quickly, since most options require a fixed annual payment. Taxpayers are allowed a one-time adjustment to this fixed payout, which generally lowers the annual distribution considerably, preserving assets.

Account holders are often not aware of the other multiple penalty-free withdrawal options their IRA offers. For example, individuals may withdraw funds to pay higher-education expenses for family members and only pay taxes, not the 10% penalty, on the distribution. Up to $10,000 (lifetime) can be withdrawn to purchase a home for themselves or immediate family members, again paying taxes, but no penalty. Other options involve medical expenses in excess of 7.5% of adjusted gross income, disability withdrawals, and the payment of medical insurance premiums, if unemployed.

Individuals inheriting a retirement plan account now can choose to roll over that account to an IRA and, if they choose, simultaneously convert the rollover to a Roth IRA. (If the rollover occurs first, and then the beneficiary requests a conversion, it is too late.) The account must be titled “Joe Doe, deceased, Jane Doe, beneficiary” so that the beneficiary cannot roll this account into his or her own IRA. If the account was converted to a Roth IRA, all distributions, provided the account is maintained for five years, would be income tax-free. Unlike the rules governing an individual Roth IRA, the account does not have to be held until age 59½, since death is the exception to age 59½.

Last—and we cannot emphasize this enough—any IRA account holder withdrawing funds and intending to repay the account within 60 days must be cognizant that this can be done only once in a 12-month period, beginning on the date of the withdrawal. (If funds are withdrawn on June 1, 2011, the withdrawal window is not open again until June 1, 2012.)

In addition, 60 days means 60 days. In the above example, dollars not returned by July 30, 2011, could be taxed or penalized. The IRS has the ability to waive the 60-day rule if it feels the taxable result would run counter to fair public policy. (For example, failure to return the funds in a timely manner as a result of a hospitalization could be an exception.) However, a Private Letter Ruling (PLR) is generally needed to obtain the exemption; the filing fee (what the taxpayer pays the IRS) for a PLR ranges from $500 to $3,000 depending on the taxpayer’s income. This fee does not include the submitter’s fee (e.g., an attorney).

As we can see, an IRA is not a simple product, but it can be a very important part of someone’s retirement savings. The erosion of an IRA’s value owing to an individual’s lack of knowledge is an unfortunate circumstance we hope all taxpayers can avoid.

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1 Traditional IRA contributions plus earnings, interest, dividends, and capital gains may compound tax-deferred until you withdraw them as retirement income. Amounts withdrawn from traditional IRA plans are generally included as taxable income in the year received and may be subject to 10% federal tax penalties if withdrawn prior to age 59 1/2, unless an exception applies.

2 A Roth IRA is a tax-deferred and potentially tax-free savings plan available to all working individuals and their spouses who meet the IRS income requirements. Distributions, including accumulated earnings, may be made tax-free if the account has been held at least five years and the individual is at least 59 1/2, or if any of the IRS exceptions apply. Contributions to a Roth IRA are not tax deductible, but withdrawals during retirement are generally tax-free.

3 A 401(k) is a qualified plan established by employers to which eligible employees may make salary deferral (reduction) contributions on a pretax or aftertax basis. Earnings accrue on a tax-deferred basis.

4 A 403(b) is a retirement plan for certain employees of public schools and tax-exempt organizations and certain ministers. Generally, retirement income accounts can invest in either annuities or mutual funds. Also known as a tax-sheltered annuity (TSA) plan.

5 A SIMPLE IRA plan is an IRA-based plan that gives small-business employers a simplified method to make contributions toward their employees’ retirement and their own retirement. Under a SIMPLE IRA plan, employees may choose to make salary reduction contributions and the employer makes matching or nonelective contributions. All contributions are made directly to an individual retirement account (IRA) set up for each employee (a SIMPLE IRA). SIMPLE IRA plans are maintained on a calendar-year basis.

6 A 457(b) is a nonqualified, deferred-compensation plan established by state and local governments, tax-exempt governments, and tax-exempt employers. Eligible employees are allowed to make salary deferral contributions to the 457 plan. Earnings grow on a tax-deferred basis, and contributions are not taxed until the assets are distributed from the plan.

7 A simplified employee pension plan, commonly known as a SEP-IRA, is a retirement plan specifically designed for self-employed people and small-business owners. When establishing a SEP-IRA plan for your business, you and any eligible employees establish your own separate SEP-IRA; employer contributions are then made into each eligible employee’s SEP-IRA.

8 Minimum distributions must be taken from traditional IRAs by April 1 following the year that a person turns 70 1/2. A minimum distribution must be taken from the IRA in each subsequent year. Mandatory distributions that represent deductible contributions and all earnings are taxed as ordinary income. Mandatory distributions based on nondeductible contributions are tax-free.

9 Coverdell Education Savings Account (ESA), formerly called the “education IRA,” is a savings plan for higher education. Parents and guardians are allowed to make nondeductible contributions to an education IRA for a child under 18. The funds can be withdrawn tax-free when they are needed for educational purposes.

10 Combining a rollover and a contributory IRA may result in the loss of income averaging and capital gains treatment with respect to the rollover assets, if applicable. It may also affect the calculation you may need to perform to exempt your rollover IRA from any claims in the event of bankruptcy. You should consult your tax advisor before combining accounts.

11 According to the IRS’s actuarial table, a 50-year-old person’s life expectancy is 34.2 years. In this example, a $300,000 inheritance divided by 34.2 equals $8,771.93, which represents the payout the rules would require when beneficiaries are lumped together.

**Important Information:** A stretch IRA is for investors who will not need their IRA money during their own retirement. While the law does not restrict which taxpayers can select the stretch IRA option, the stretch strategy is appropriate only for those individuals who simply need and plan to receive the required minimum withdrawals, taken at the latest time the law allows, without penalty, at age 70 1/2.

Withdrawals by the account holder or beneficiaries in excess of the required minimum distribution (RMD) will exhaust the account at a faster pace, reducing or eliminating the effectiveness of the stretch strategy. Distributions greater than the RMD could subject the payment to higher federal and possibly state income taxes. When investing assets that will be used to stretch IRA payments, the investor must be cognizant of any front-end or back-end sales charges that can reduce the assets available. During an extended period of declining investment returns, investors will experience income fluctuations that may cause additional withdrawals to be made that will exhaust the account at a more rapid rate.

Consolidating assets with an IRA rollover may have administrative fees as well as other costs.

**A Note About Risk:** Investing involves risk, including the possible loss of principal.

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