

## Can you use your IRA to start a business?

By Brandon Ketron and Alan Gassman

**One potential way for an entrepreneur to fund a new business is with his or her retirement plan assets. This is known as a Rollover as Business Start Up Plan (ROBS).**

A typical ROBS plan involves forming a new C-Corporation and adopting a simple 401(k) plan. The entrepreneur can then roll over his or her IRA account into the new 401(k) plan. The 401(k) plan then purchases stock in the new corporation. This results in the funding of a new corporation with the entrepreneur's former IRA account. (See James E. Theissen et ux. v. Comm'r, 146 T.C. 7 (2016); Peek v. Comm'r, 140 T.C. 216 (2013).)

While ROBS plans do not violate the prohibited transaction rules per se, the IRS heavily scrutinizes these plans to ensure their compliance with these complex rules. If a plan participant engages in a prohibited transaction, the plan will be disqualified and result in a deemed taxable distribution of the entire account balance, which will also be subject to the 10% excise tax if the plan participant is under the age of 59½.

It is important to note that while a ROBS plan may satisfy the retirement plan rules initially, any failure to comply with the rules during the life of the plan will also result in a deemed distribution of the entire retirement plan.

### Comment

The authors do not advocate or recommend that clients use their retirement plan or IRA assets to establish a ROBS, but it should be known that this is a possible way for entrepreneur clients to find capital to start a business. No one should even think about starting a ROBS without specific written guidance from a qualified tax and ERISA lawyer. The C-corporation owned by the 401(k) plan will be taxed as a corporation and will be burdened by the compliance described herein, and possible future restrictive legislation.

The following are some potential traps for the unwary involved with establishment and maintenance of a ROBS Plan.

### Personal guarantees of corporate loans

In James E. Theissen et ux. v. Comm'r and Peek v. Comm'r the Tax Court held that a personal guarantee of a corporate loan when the Plan Owner's IRA owned stock in the corporation was a prohibited transaction. (Read James E. Theissen et ux. v. Comm'r, 146 T.C. 7 (2016); Peek v. Comm'r, 140 T.C. 216 (2013).) As a result, the taxpayers' IRAs ceased to be IRAs as of the first day of the taxable year in which the guarantee occurred, and were deemed to have received distributions on that first day of the entire fair market value of their IRA assets. (For further discussion see Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016)).

These cases involved IRAs and not 401(k)s or ESOPs. It is unclear whether the same reasoning would apply to a ROBS Plan, but account owners and parties related thereto should strictly avoid personal guarantees of loans to be safe. Unrelated parties may be paid reasonable guarantee fees, but only from the business entity. Traditional lenders will be reluctant to lend to ROBS for concern of the tax impact of disqualification.

### Payment of reasonable compensation to entrepreneur

Unlike a self-directed IRA, a 401(k) or ESOP may pay compensation to the owner of the Plan and related parties, provided that the compensation is reasonable.

In Ellis, et ux. v. Comm'r, the IRA owner purchased a used-car dealership inside of his IRA, and ran the day-to-day operations of the business. The dealership paid the IRA owner reasonable compensation for his role as the manager of the business. The Tax Court held that the payment of compensation to the IRA owner was a prohibited transaction and resulted in the indirect use of plan assets for the benefit of the individual. Accordingly, the IRA was deemed distributed to the owner and the owner was immediately liable for taxes on the entire value plus the 10% excise tax and other applicable penalties and interest. (For further discussion see Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).)

Natalie Choate points out that this is particularly problematic for IRA-owned businesses. She states that "if your IRA-owned business cannot pay you compensation, you really cannot run a small business inside your IRA. If you work with no compensation, there is a risk of an "assignment of income problem." (See Choate, What Goes in Your IRA? None of Your Small Business! (September 11, 2015).)

Had Ellis rolled over his IRA into a 401(k) using a ROBS Plan, Ellis may have been able to avoid the prohibited transaction rules. The ERISA rules do not prevent an employee from taking a reasonable salary from a 401(k)-owned business; however the IRS may argue that the immediate payment of compensation to the Entrepreneur results in the indirect use of plan assets for the benefit of the individual. Entrepreneurs may consider only taking a salary from the profits of the company in order to avoid this characterization.

Additionally, any compensation paid to the Entrepreneur should be W-2 compensation, and not classified as 1099 independent contractor compensation. (Read Curry & Esposito, You Invested 401(k) Money Into Your Company: Common Myths and Important Compliance Reminders (Presented Jan. 24, 2017, a copy of the slides can be obtained by emailing [Jewell.Esposito@jacksonlewis.com](mailto:Jewell.Esposito@jacksonlewis.com) )) In order for the entrepreneur to participate in the 401(k) plan, he or she must be a legitimate employee of the Corporation. If the Entrepreneur fails to qualify as a qualified employee the Plan may be disqualified.

### Providing direct or indirect services to an IRA

Leimberg and Jones caution that providing any kind of service to an IRA-owned business may constitute furnishing of services to the IRA by a disqualified person. (Read Leimberg and Jones, Employee Benefits and Retirement Planning Newsletter #654, (April 4, 2016).) This rule does not apply to a 401(k) or ESOP, and it is therefore vitally important to roll the funds over into an employer sponsored plan prior to providing any services to the company.

### **Lack of notification of plan existence**

If current or future employees are not notified of the existence of an ESOP or 401(k) plan, then it would cause a violation of the rule that a retirement plan must "be a definite, written program communicated to employees." (See Choate, Employee Benefits and Retirement Planning Newsletter # 471.)

If employees are not notified the plan will be disqualified resulting in a taxable distribution of the entire Plan.

The IRS has cautioned against Entrepreneurs using independent contractors to avoid offering stock ownership to employees. (Read Michael D. Julianelle Guidelines Regarding Rollovers as Business Startups.) If an independent contractor is reclassified as an employee this could disqualify the entire plan in addition to the other problems caused by this reclassification.

### **Plan assets used for personal expenses**

A plan was disqualified when a corporation bought an RV for the business owner using some of the money it received in exchange for the stock of the corporation in a ROBS plan. (Read Michael D. Julianelle Guidelines Regarding Rollovers as Business Startups.) The use of corporate money or assets for personal expenses or purposes also presents other problems, so appropriate corporate formalities must be followed.

### **Stock sale must be a transaction for adequate consideration**

ERISA exempts a plan's acquisition of employer stock from the prohibited transaction rules only if the purchase was for adequate consideration. (See IRC § 4975(d)(13).) Therefore, a valuation of the business may need to be completed to have proof that the stock sale as part of the ROBS plan was for adequate consideration. (Read Michael D. Julianelle Guidelines Regarding Rollovers as Business Startups.)

### **Improper use of funds to pay promoter fees**

The IRS has stated that when a corporation uses part of the cash it raises from the stock sale to pay the fee of a promoter it may result in the indirect use of plan assets in a prohibited transaction. (Read Michael D. Julianelle Guidelines Regarding Rollovers as Business Startups.)

### **Discrimination in favor of highly compensated employees**

Natalie Choate states that this is the IRS's best argument to disarm a ROBS, but that it is only useful against ROBS plans that have employees other than the plan owner and that do not in fact offer employer stock to rank and file employees. (Read Michael D. Julianelle Guidelines Regarding Rollovers as Business Startups.)

Failure to Issue a Form 1099-R when the Assets Are Rolled Over into the ROBS Plan.

A reputable CPA should be retained to assure that all proper tax returns and forms are filed, including the Form 1099-R.

### **Failure to file 5500s**

A reputable actuary or qualified pension plan lawyer should be retained to assure that appropriate plan rules and formalities are followed, including the filing of a timely and accurately prepared Form 5500.

### **Conclusion**

In conclusion, the IRS heavily scrutinizes these types of arrangements, and has issued literature as to the technical reasons why they might be seen as problematic. The IRS has not issued any specific adverse rulings related to ROBS plans, but will target ROBS plans for other violations of retirement account rules. Entrepreneurs should consult with the appropriate advisors in order to comply with the complex rules involved with a ROBS Plan. If a ROBS plan is undertaken it will be important to make sure that all your I's are dotted and your Ts crossed due to the fact that one mistake will result in a termination and taxable distribution of the entire retirement account.

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## **This week's retirement news**

### **We find the news so you don't have to**

By [Robert Powell](#), MarketWatch

#### **From Plansponsor**

The U.S. Department of Labor has announced a proposed extension of the applicability dates of the fiduciary rule and related exemptions, including the best interest contract (BIC) exemption, from April 10 to June 9, 2017. The announcement follows a presidential memorandum issued on February 3, 2017, which directed the department to examine the fiduciary rule to determine whether it "may adversely affect the ability of Americans to gain access to retirement information and financial advice." [Read](#)

An updated landing page tracking the Office of Management and Budget's (OMB) review of the Department of Labor (DOL) fiduciary rule, championed by former President Barack Obama but now being attacked by current President Donald Trump, shows the OMB has officially labeled

the effort to halt the fiduciary regulations as “economically significant.” While the determination ostensibly makes it more burdensome for the Trump administration to unravel the initial fiduciary rulemaking, there is some disagreement as to what this will actually mean in practice. [Read](#)

Failure to manage short-term financial obligations such as budgets, debt and savings can have a lasting impact on financial health and retirement readiness, according to an independent study by retirement consulting firm AFS 401(k). [Read](#)

While America is facing a deep political divide on many policy issues right now, both Democrats and Republicans are concerned about their ability to achieve a secure retirement. The research by the National Institute on Retirement (NIRS) also finds 77% of Americans say the disappearance of pensions has made it harder to achieve the American Dream. [Read](#)

Nineteen percent of households who are at risk for being financially unprepared in retirement feel they are not at risk, while 24% of households who are not at risk, feel they are at risk, according to research from the Center for Retirement Research at Boston College. Researchers suggest more education could help. [Read](#)

Public plans that reduce their return assumption in the face of diminished near-term projections will experience an immediate increase in unfunded liabilities and required costs, according to NASRA. [Read](#)

A memorandum issued to Internal Revenue Service (IRS) Employee Plans (EP) Examinations employees sets forth standards for examining whether a section 401(k) plan hardship distribution is “deemed to be on account of an immediate and heavy financial need” under safe-harbor standards set out in the Income Tax Regulations. [Read](#)

In order to weather potential storms like market downturns, plan sponsors are looking to diversify portfolios with alternative investments. These asset classes aim for returns less correlated to market swings than stocks, bonds and other traditional assets. Among them is real estate. And even though defined benefit (DB) plans have been investing in real estate for decades, this asset class is relatively new to the defined contribution (DC) plan space. But it has been gaining traction in the past few years. [Read](#)

#### **From Kaiser Family Foundation**

A new analysis from the Kaiser Family Foundation estimates that the average health insurance premium tax credit received by consumers in 2020 would be at least 36 percent lower under replacement proposals being discussed by Republicans in Congress than under the Affordable Care Act. [Read](#)

Interactive Maps: Estimates of Enrollment in ACA Marketplaces and Medicaid Expansion. [Read](#)

Health Insurance: What If You Could Take It With You? — “Portability” will likely be a buzz word in the health law repeal-and-replace debate, but the concept raises a number of complicated policy issues. [Read](#)

For Some Hospice Patients, A 911 Call Saves A Trip To The ER — Hospice groups are teaming up with specially trained paramedics to deal with common problems that worried patients or families incorrectly think need hospital care. [Read](#)

Liberal Vermont Tests The Waters On GOP Health Care Overhaul — Vermont embarks on a six-year experiment to redesign health care and how it's paid for. [Read](#)

To Pay Or Not To Pay – That Is The Question — With the future of Obamacare up in the air, many consumers are wondering if they must comply with the tax requirements related to the law, including whether to pay the penalty for being uninsured. [Read](#)

#### **From LifeHealthPro**

Democrat asks for CMS pick's views on Medicare — Republican hearing no-shows slowed Senate Finance efforts to approve Seema Verma. [Read](#)

Irrevocable trusts remain powerful in estate planning — Incorporating a flexible, irrevocable life insurance trust (ILIT) into an estate plan can produce meaningful results. [Read](#)

#### **From SmartBrief**

A power percentage is a metric that measures a person's financial health by comparing their monthly savings and debt payments to their monthly income. Any score below 10% suggests a person is too reliant on their income. [Read](#)

Refusal to cut Medicare, Social Security and other entitlement programs in favor of reducing taxes to boost the economy is part of the fiscal 2018 budget proposal that President Donald Trump will outline tonight before a joint session of Congress, Treasury Secretary Steven Mnuchin says. Other proposals are a border adjustment tax and a push by Rep. Jeb Hensarling, R-Texas, to provide alternative funding to the Consumer Financial Protection Bureau and remove its oversight of financial companies. [Read](#)

A report from the Congressional Budget Office suggests significant benefit cuts are necessary to prevent Social Security from running out of funding by 2029. For the program to remain intact, the government will have to cut future benefits, raise the retirement age or increase Social Security tax revenue, Mike Causey writes. [Read](#)

Different financial rules and practices apply at different stages of life in preparation for retirement. Kerry Hannon walks through the decades and the best strategies for each. [Read](#)

Many self-employed workers prefer their independent status and ability to adjust their work life. They hope to bring similar independence to retirement, but experts advise that might require harder thinking about savings, as well as societal adjustment to account for the growing gig economy. [Read](#)

Securities and Exchange Commission acting Chairman Michael Piowar did not call for an SEC fiduciary rule in his first major address. However, the commission could change its messaging after a permanent chairman is confirmed and other posts are filled. [Read](#)

The Securities and Exchange Commission should let ordinary investors buy unregistered securities, said acting Chairman Michael Piowar. “In my view, there is a glaring need to move beyond the artificial distinction between ‘accredited’ and ‘non-accredited’ investors,” he said. [Read](#)

Robo-advisers have become an important segment of the financial services industry. Publications issued Thursday by the Securities and Exchange Commission provide guidance to investment advisers who operate robo-advisers and investors who use their services. [Read](#)

People planning for retirement face an array of savings options that can prove confusing, but Rob Berger has a simple alternative that he calls the 25x Rule to Early Retirement. If a retiree expects annual expenses of \$75,000, for example, the person needs a \$1.875 million nest egg, excluding income such as Social Security, which might not be available at first. [Read](#)

Annuities, life insurance, stocks and bonds can be valuable tools in dealing with longevity risk in retirement, says Michael Finke of the American College of Financial Services. [Read](#)

Clients planning for retirement can adopt tax-efficient strategies to boost savings. Possibilities include Roth conversions, after-tax contributions to 401(k)s, contributions to health savings accounts and nondeductible contributions to individual retirement accounts. [Read](#)

More than two-thirds of workers who have access to 401(k)s and similar retirement savings plans don't use them, the Census Bureau has found in research involving tax records. The findings suggest that millions of Americans will face financial hardship in retirement. [Read](#)

The Everplans website, in existence since 2010, has upgraded to improve estate planning. The site can store information and instructions, benefiting not only the user but also the family, friends, associates and advisers in the event of death. [Read](#)

Qualifying as a real estate professional has a number of tax advantages, including avoiding having any losses classified as passive and escaping the net investment income tax. Here is a step-by-step guide to the complex requirements a taxpayer must meet to be a real estate professional. [Read](#)

The personal funded ratio can be a useful tool for advisers working with pre-retirees to make sure their financial needs will be met after they leave the workforce. Here's a look at how to calculate the ratio and how to interpret it based on a client's goals, preferences and circumstances. [Read](#)

Financial industry organizations and lawmakers are building support for the SeniorSafe Act to help prevent financial abuse of the elderly. The proposed law would protect financial firms, advisers and brokers who report cases of suspected elder financial exploitation from civil litigation. [Read](#)

High-income Medicare recipients may benefit from a provision that allows them to donate up to \$100,000 from an individual retirement account directly to a qualifying charity. This strategy could allow beneficiaries who are at least 70½ years old and taking required minimum distributions reduce their Medicare surcharges. [Read](#)

Traditional planning techniques assume retirees maintain constant spending levels, but the truth is that spending tends to decline throughout the course of retirement. This discrepancy means clients and advisers may be underestimating the safe withdrawal rate. [Read](#)

A study from the Bureau of Labor Statistics found that older employees who continue working past the retirement age can help boost the country's labor force. While workers have continued in their positions for longer periods of time since the 1990s, experts say an increase in older workers could help keep the workforce larger for a longer amount of time. [Read](#)

Republican efforts to repeal the Affordable Care Act might lead to the creation of a tax-advantaged Roth health savings account. Sens. Bill Cassidy, R-La., and Susan Collins, R-Maine, back legislation to create Roth HSAs to cover insurance premiums and out-of-pocket expenses. [Read](#)

#### **For financial advisers**

Lincoln Financial has introduced a variable annuity that invests solely in exchange-traded funds and is tailored to fee-based advisors' needs. Total costs of the annuity are less than 1.9%, and it has no surrender charge. [Read](#)

The Insured Retirement Institute is calling for Congress to draft a best-interests standard of care for retirement advice. The standard should “preserve access to advice and products that consumers need to achieve secure retirement,” said Lee Covington, IRI's senior vice president and general counsel. [Read](#)

An aging population is sparking a rise in reports of elder abuse. Download this free FVS Eye on Fraud report to learn today's top financial scams targeting seniors, such as investment schemes, bank account manipulation and even grandparent scams. You'll also find case studies and educational resources, plus practical tips to help you better protect clients. [Read](#)

Advisers should ensure they have thorough knowledge of buffer annuities, which combine characteristics of indexed and variable annuities, write William Byrnes and Robert Bloink. “Because the buffer annuity is only a few years old, it is especially important for advisers to become educated in the product to ensure that interested clients are getting a suitable product that they understand fully in order to prevent unpleasant surprises down the road,” they write. [Read](#)

Voya CEO: DOL rule or no rule, it's time to upgrade your game — The leap to an investment advisory model is good news for customers. [Read](#)

5 pitfalls to avoid when assisting clients with a life settlement — Most seniors who lapsed a life insurance policy would have considered a life settlement had they been aware of the possibility. [Read](#)

Research by Cerulli Associates found that 64% of advisers affiliated with broker-dealers plan to shift to a fee-based compensation model, rather than a commission-based one. Despite uncertainty of whether the Trump administration will let the Labor Department's fiduciary rule take effect, advisers say the fee-based model will position them to comply with the rule if it is implemented. [Read](#)

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## **How to create tax-free income from ‘tax-infested’ retirement accounts**

**Remember this universal truth: Most people are unprepared for the unexpected**

**By Brad Pistole**

**I have had the privilege of meeting some truly amazing people during my extensive career as a financial planner. Since 2011, I have been one of the hosts of the nationally aired program Safe Money Radio. I authored a book in 2014, titled “Safe Money Matters — Finding Safe Harbor in a Storm-Filled World”. I have also taught retirement-planning classes on college campuses for several years. These opportunities have allowed me to meet people who are both retired and planning for their retirement from all different walks of life and from many different locations all across this great nation.**

Whether the family is extremely wealthy and plans to pass all their retirement savings on to their children and grandchildren, or whether they will need every single penny from their hard-earned income to survive in retirement, one fact remains. Most people are not prepared for the unexpected.

What do I mean by unexpected? This could be one of several events. And sooner or later, almost every single person will face one of these events. And yes, this means you! Are you prepared for the unexpected event you will face in your retirement years?

**Here are some examples of the unexpected things you might face in retirement:**

- Required minimum distributions (RMDs) — Many people don't expect these and they don't find out what they are until they turn age 70. (More on this in a minute.)
- Taxes — Many people don't plan for a vast array of taxes that come their way in retirement. They are unaware of the taxes on Social Security, income, and their estate. They find out the hard way after it's too late.
- Health-care costs — Many people do not have long-term care coverage and find out in retirement just how expensive it is to be self-insured. They end up being devastated by the unexpected costs. [Read: You might need nearly \\$350,000 to pay for health care in retirement](#)
- Loss of income — Many people do not realize they will lose one of their two Social Security payments and many times another source of income if there is a pension involved when a spouse passes away.

Most people learn about these unexpected circumstances the hard way; after experiencing a tragedy. You see, I often meet my clients after they have experienced the death of a loved one. And more often than not, the loved one who passes was usually the one who handled all the finances. Those finances are normally all held in tax-deferred accounts and the person who has contacted me for help doesn't know anything about the investments. Imagine what it's like to suddenly lose your spouse, and then be left to pick up the pieces. And most of the time, because income is needed immediately, they are forced to start taking distributions from the accounts that are left behind, not knowing where or how to start. Does this sound familiar?

[Read: Why switching jobs late in your career could help you work longer — by choice](#)

Remember, if your current plan for leaving income to your heirs involves leaving them an IRA or 401(k) this will be 100% taxable to your heirs, which means they will have less money to live on after they pay the taxes due from those distributions.

Let me ask you a question to help get your attention.

What do you think IRA stands for?

Now be careful before you answer. I will tell you that 99% of all financial advisers get this question wrong. Do you think IRA stands for “individual retirement account?” That's OK. That's what every else thinks, too. But that's not right! Don't believe me? Go to the [irs.gov](http://irs.gov) website and type in “IRA” in the search bar. When you do, you will find the definition for an IRA. It stands for “individual retirement arrangement.”

You see, when you have an IRA, you have an “arrangement,” yes, an “agreement” with the IRS. They agree to let you defer those taxes, until you take distributions, or until you reach age 70½, at which point distributions are required. Have you ever heard of an RMD? This is known as a required minimum distribution and if you do not take your RMD beginning at age 70½, there is a 50% penalty on the amount you are required to take. Do you think the IRS is kidding about this? Trust me, they aren't.

This individual retirement “arrangement” is a very serious arrangement. You will always pay taxes on those distributions and so will your heirs or any other beneficiary who touches that money. Now do you realize just how firmly your retirement accounts are connected to the IRS? And if you're like many people, your IRA represents 75% to 100% of your retirement plan. Are you comfortable with this or would you like a different plan that doesn't expose you to so much taxation?

Many people are forced to think about this when something happens they cannot control. Yet it is always better to have a plan for this before you are forced to deal with this. So, let me ask you: Have you ever stopped to think about how much money your family would need to survive if something were to happen to you?

If you currently earn \$50,000 per year, it would require \$1 million, earning 5% per year to provide the income your family needs to survive once you have passed or become disabled. But what if your current investments are only making 1%, like in a CD or a current money market account? You would need \$5 million in assets to replace that income. And that is for someone who is earning \$50,000 annually. What if your annual income is \$100,000? What if you earn \$200,000? Please keep in mind this amount doesn't include the amount that is required by the IRS to pay taxes on the distributions from your tax-deferred accounts. Perhaps now you can see why it is estimated that 95% of all people are currently underinsured. Don't let this happen to you. This is why I personally own 10 tax-free life insurance policies.

There are so many factors to consider here. If your spouse is under the age of 60, they cannot receive survivor benefits from your Social Security when you die, which would be another major loss of income. If you don't have a pension from your current job that passes on to your spouse when you die, this would be another major loss of income.

In instances like these, life insurance becomes even more important. Best-selling author Tom Hegna says, “Death is a permanent problem that we all have to face. It should be solved with permanent life insurance.” I highly recommend reading Ed Slott's book “Stay Rich for Life—Growing and Protecting Your Money in Turbulent Times.” In Chapter 12, he discusses how to select the right life insurance policy and the right agent for you and explains how this will benefit your overall financial plan and estate. I sit in front of Ed several times a year and serve as an Ed Slott Master Elite IRA Advisor and I often hear Ed say, “Life insurance doesn't cost — it pays.”

In my book, I discuss how tax-free beats taxable every single time. Let me ask you a question. If you have a IRA with \$1 million in it when you retire will you be pleased? Think about this before you answer. Unfortunately, Uncle Sam may have a lot more impact on your answer than you think.

At the time you retired, and due to your Social Security distributions and all your other required distributions for you and your spouse, your combined federal and state tax rate is 50%. And remember, this \$1 million account is held in an IRA. That means it is a tax-deferred, tax-infested account. This means all distributions are 100% taxable at ordinary income tax rates and all future distributions to any heirs are also 100% taxable at ordinary income tax rates. So, how are you feeling about this \$1 million account now? Do you think you will have enough money to last the rest of your life? Do you think you will leave enough behind to your heirs if they are going to be taxed on every penny they withdraw from this tax-infested account?

I have \$1 million in my retirement account also. But over the years, I have saved my money in a tax-free account which means the distributions both now and in the future will be 100% tax-free. So, let me ask you, when does \$1 million in one person's hand look completely different than \$1 million in another person's hand? When one is taxable at the 50% rate and when one is tax-free. Which one do you want in retirement?

Do you know what most people do with their RMD when they are forced to take it at age 70½? You guessed it; they either spend it or go put it in the bank. And what does the bank pay them for this deposit? Less than 1%, and at the end of the year, they give them a 1099 that creates tax on the interest earned.

Does this sound like a good plan to you? Me neither.

Make sure you are using the tax code to your advantage. There are ways to take your RMD and turn that tax-infested distribution into a forever tax-free distribution for you and your heirs. Let's beat Uncle Sam at his own game! Tax-free beats taxable every day of the week.

*Brad Pistole is president of Trinity Insurance & Financial Services, the host of Safe Money Radio, author of "Safe Money Matters", and a member the Ed Slott Master Elite IRA Advisor Group, an organization of financial advisers dedicated to the ongoing study and mastery of advanced IRA financial planning strategies .*

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## How to fix a broken retirement withdrawal strategy

### What does a tax-efficient retirement strategy mean to you?

By Brian Vnak

#### Paying \$0 in tax this year? Your retirement withdrawal strategy is likely broken.

What does a tax-efficient retirement strategy mean to you? I love asking my clients this question, as the majority of the time the response is: "Paying as little tax as possible."

This is a great answer when considered over a long period of time. The reality, however, is that the vast, vast majority of folks approach tax minimization transaction-by-transaction in a one-year vacuum. This shortsighted approach is highlighted by one of my favorite pride-filled client statements: "Last year I paid \$0 in tax!"

Paying \$0 in tax every year is a great goal, but when you know that you will unavoidably pay tax in the future, that one-off \$0 tax bill was a wasted opportunity.

If long-term tax efficiency is a goal of yours (and really, why wouldn't it be?), here's what you need to consider to implement a tax-efficient retirement strategy with respect to your nest egg.

#### The nuts and bolts of tax-efficient retirement savings

Creating long-term tax efficiency with your retirement savings is about taking advantage of controllable decisions that impact your after-tax rate of return. This is especially valuable in light of planning for longer retirement horizons due to early retirement and/or increased lifespans. Converting your retirement savings into a lasting tax-efficient retirement plan is achieved across three key strategies: Portfolio Structure, Asset Location, and Withdrawal Sourcing.

#### Portfolio structure is about how you invest.

- Do your investments create income taxed at ordinary rates (up to 39.6%), qualified rates (0%, 15%, 20%), or are they tax-exempt (0% by IRS and state)?
- Is your portfolio managed to minimize taxable income/gains annually?
- Does your portfolio have high turnover that generates short-term capital gains?
- Does your portfolio pay out high capital gain distributions?
- Are you realizing losses each year to offset gains (or vice versa)?

Asset location is about where you invest, not in terms of geographical location (e.g. Europe or emerging markets), but the accounts in which you place securities.

- Do you own investments in tax-advantaged accounts (e.g. traditional IRA/401(k), Roth 401(k)/IRA, health savings account (HSA), etc.)?
- Are you taking advantage of the lower qualified dividend and long-term capital gains rates (0%, 15%, 20%) by locating equities in taxable investment accounts, or are they subject to tax at ordinary income rates when withdrawn from a tax-advantaged account?
- Are you avoiding ordinary tax rates on interest and ordinary dividends by locating them in tax-advantaged accounts, or are they annually creating taxable income by being owned in taxable non-retirement accounts?
- Are your tax-free municipal bonds located in a tax-deferred account where they will be taxed at ordinary tax rates when withdrawals occur?



Withdrawal sourcing is about how much to take from which account—and when to take it.

- From which account(s) is the money you need coming?
- Are your withdrawals coming from “qualified” tax-deferred accounts where every dollar withdrawn generates income taxed at ordinary rates?
- Are your withdrawals coming from non-retirement accounts where capital gains may occur?
- Or are they coming from tax-free accounts?
- Are penalties imposed when you access money in an account?

Addressing these questions and implementing/maintaining the Portfolio Structure, Asset Location, and Withdrawal Sourcing strategies is when the “[tax alpha](#)” benefit of comprehensive planning kicks into gear. But the key here is that these three elements are not independent of each other; they are linked and the ongoing integration can be complex.

For example, when implementing an asset-location strategy, all of the investments in a household are viewed as one big portfolio (instead of each account individually), and specific securities are located in specific accounts to optimize the after-tax rate of return. When this is combined with a Withdrawal Sourcing strategy, withdrawals rarely come equally from all accounts. Instead, they might come from one account one year, a different account the next year, and a combination the following year.

The unequal reduction of one account impacts not only the asset-location strategy, but also the portfolio-structure strategy, since the household asset allocation likely becomes skewed by taking a withdrawal from one specific account. These intertwined elements add complexity during the implementation of a tax-efficient retirement strategy.

In order to navigate this opportunity, you must balance a long-term strategic view of your tax situation with short term tactical decisions. It’s an annually changing, multi-time horizon, multi-variable analysis that occasionally encounters counterintuitive solutions.

Let’s dive into a mini case study to understand how a tax-efficient withdrawal strategy could play out in real life.

### Meet the Nelsons

Chad and Sarah Nelson are 55-year-olds who want to make the most of their “best years” by immediately pursuing an early retirement since both have a family history of poor longevity. Like many families, the Nelsons have primarily saved in tax-deferred accounts throughout their careers: Sarah has a \$600,000 traditional IRA, while Chad has a \$600,000 traditional IRA and a \$600,000 401(k). They jointly own a \$250,000 non-retirement taxable account.

From a cash flow perspective, the Nelsons spend \$100,000 annually (after taxes), and their only income source will be each of their Social Security benefits, which won’t begin until age 62 at the earliest. Tax-wise, the Nelsons live in a state with no income tax and, as a result, claim the standard deduction.

Like many retirees, the Nelsons planned to spend their retirement accounts first because of the significant balances in the accounts and the fact that they are retirement accounts. Unfortunately, IRA withdrawals before age 59½ come with a 10% penalty in addition to the income tax on the withdrawal (taxed at ordinary rates). In the Nelson’s case, they would need a \$134,000 IRA withdrawal in order to access enough cash to pay for their \$100,000 of lifestyle expenses, roughly \$20,600 tax bill, and \$13,400 for the 10% early IRA withdrawal penalty.

If the Nelsons instead used their non-retirement funds to pay the penalty, they would only need a \$115,000 IRA withdrawal. This highlights the issue created by accessing cash from your retirement account to pay the penalty: You end up paying income tax on the penalty, which means you need a bigger withdrawal to generate additional cash, which then creates an even bigger penalty. I call that “Circular Tax Armageddon.”

### The four critical elements of a holistic tax-efficient withdrawal strategy

Implementing a tax-efficient withdrawal strategy requires evaluating all withdrawals with respect to four factors which may apply across different ages throughout retirement:

- 1.Satisfying current/future cash flow needs,
- 2.Minimizing exposure to retirement account penalties,
- 3.Benefitting from low tax rates in early retirement, and
- 4.Reducing exposure to higher taxes in later retirement.

As is the case for many early retirees, the Nelsons’ overarching tax goal is to pay as much tax at 15% for as long as possible. Under current tax law, for a married filing jointly couple, that means targeting taxable income of ~\$75,000, which equates to generating about \$95,000 of ordinary gross income. Staying in the 15% tax bracket is difficult, however, when so much of their savings are in tax-deferred accounts that are taxed at ordinary tax rates when they choose to take withdrawals or the IRS forces Required Minimum Distributions (RMDs) at age 70½. Once Social Security and these RMDs kick in, the 25%/28% tax bracket is pretty much unavoidable, so minimizing future exposure to those higher rates needs to be a priority. So how can the Nelsons better approach funding their first five years of cash flow?

Accessing Chad’s 401(k) plan presents a unique opportunity to avoid the 10% early distribution penalty. Since Chad qualifies for the age 55 separation from service rule, the expectation is that he could access this account over the next five years to fund his lifestyle needs. Unfortunately, Chad’s employer, like many employers, placed a restriction on withdrawals from the 401k plan: Former employees are only entitled to only one post-age-55 distribution, then they must roll over the account to an IRA. Uh-oh, Chad can no longer take a \$115,000 withdrawal for each of the next five years (\$575,000 in total).

Alternatively, he could take one large lump-sum withdrawal, but since it would occur all in one year, he would get slapped with a huge tax bill, some of which would be taxed at 39.6%! If Chad withdraws the entire \$600,000 balance, it creates a \$178,000 in taxes, so his net available cash of

\$422,000 won't meet his five-year cash flow need.

Instead, a better solution is to take a withdrawal to cover the first year's cash flow need, but only enough to fill up the 15% tax bracket (about \$95,000 distribution) and then cover the remaining cash flow need with non-retirement funds (~\$20,000). After the rollover of the residual 401k balance to an IRA, the Nelsons will now have about \$1.7m in IRAs and \$230,000 in non-retirement funds.

In years two through four, the Nelsons could exclusively spend their non-retirement funds, but if they did so, they would waste the opportunity to fill up their 15% tax bracket. Spending non-retirement funds is also shortsighted since the Nelsons will run out of these funds by the fourth year, meaning that they will be forced to spend IRA money before turning 59.5, pay a 10% penalty on the distribution and increase taxable income into the 25% tax bracket sooner than planned.

The [opportunity in this case is to utilize](#) the 72(t) substantially equal periodic payments (SEPP) strategy, which provides that the 10% penalty for withdrawals before age 59½ does not apply when payments are calculated and maintained according to very specific guidelines and paid out over the greater of a 5-year period or until the individual reaches age 59½. When the 72(t) strategy is applied to an account, you cannot separately access the funds of that account without causing the strategy to implode: The 10% penalty would be retroactively assessed on all distributions from the account going back to the date the 72(t) strategy began.

In the Nelson's case, if the entire \$1,700,000 in IRA assets were applied to the 72(t) strategy, it would only generate about \$82,000 in annual payments, which would not fully satisfy their cash flow needs, nor provide flexibility if they need to access additional funds for an emergency, nor would it provide tax planning flexibility for Roth conversions. To align all these opportunities, it's necessary to map out a withdrawal strategy over the next five-year period to back into a targeted 72(t) amount that accomplishes all of these objectives.

The Nelsons could instead apply about \$827,000 of Chad's IRA assets to the 72(t) strategy and generate about \$40,000 in annual penalty-free withdrawals. These payments would occur each year for the next five years; after they reach age 59½, the Nelsons would then have access to their IRA accounts penalty-free.

While this can be a very effective method for accessing funds from retirement accounts before age 59½, it is highly recommended to implement this strategy with an experienced professional as the strategy can be ticking tax bomb if not implemented correctly throughout the required payment period. For more details on this strategy please visit [72t.net](#).

From a cash flow perspective, the Nelsons will have enough remaining non-retirement assets to cover their cash flow needs for each of the next three years. But if they are only taking \$40,000 of IRA distributions, they are not maximizing their 15% tax bracket. In this circumstance the Nelsons can utilize Roth conversions to help fill the gap. In each of the next three years, they can convert \$55,000 of their traditional IRAs to Roth IRAs (\$165,000) total. This benefits them in multiple ways:

- 1.They remove the money from the traditional IRAs at 15% (instead of 25%-plus in the future).
- 2.The \$165,000 can grow tax-free for the rest of their lives (and their beneficiaries' lives, too).
- 3.It creates flexibility in future years such that if they want/need to access additional cash, they can do so from this account instead of increasing traditional IRA withdrawals and creating additional taxable income.

Traditional IRA account owners should consider the tax ramifications, age and income restrictions in regards to executing a conversion from a traditional IRA to a Roth IRA. The converted amount is generally subject to income taxation.

### Reaping exponential benefits from integrated planning

The Nelson case study illustrates that the best decisions are not made in a vacuum, but instead are based on an integrated understanding of how each decision interacts with subsequent decisions in advance of making a decision. Only then is possible for 1+1+1=10.

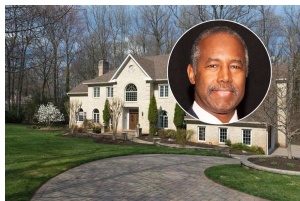
It's easy to get stuck in the abundance of minutiae when making these decisions, so it's important to retain the context that achieving a tax-efficient withdrawal strategy is only one piece of a much bigger puzzle. Retaining flexibility with respect to lifestyle spending is still the greatest determinant to sustaining your financial independence over an unknown time horizon.

While the IRS giveth you tax deductions throughout your working years, they taketh from your retirement accounts until death do you part. But that doesn't mean you lack the ability to control the outcome, especially in relation to how and when you withdraw money from your retirement accounts.

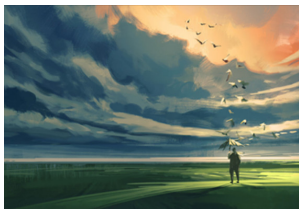
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*(The above is a hypothetical situation based on real-life examples. Names and circumstances have been changed. The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which strategies may be appropriate for you, consult your financial advisor prior to investing. This information is not intended to be a substitute for specific tax advice. We suggest that you discuss your specific tax issues with a qualified tax adviser.)*

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