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

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

By
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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 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 up end 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 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 of 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.