6 Expensive IRA Mistakes & How to Avoid Them

IMPORTANT NOTE: This special report is for information and educational purposes only, based on data as of 2022. Please consult the latest issue of *Retirement Watch*, *Bob's Journal* or www.RetirementWatch.com for the latest information before taking any action.

6 Expensive IRA Mistakes & How to Avoid Them
Copyright © 2022, by Robert Carlson. All rights reserved.
No quotes or copying permitted without written consent.

Published by:
Eagle Products, LLC
122 C St. NW Suite #515
Washington, DC 20001
1-800-552-1152

Email: CustomerService@RetirementWatch.com
Website: www.RetirementWatch.com

6 Expensive IRA Mistakes & How to Avoid Them

Too many people leave too much money on the table when managing their IRAs. It's not surprising.

IRA rules and strategies can be more complicated once the early contribution and accumulation years are behind us. There are various tricks and traps in the IRA rules, and there are strategies for maximizing IRA values that aren't intuitive.

Of course, IRAs are among the most valuable assets many people own, especially after 401(k) balances are rolled over to IRAs. One or two oversights can put a lot of extra money in the IRS's hands.

Though many IRA owners aren't aware of the pitfalls, the IRS is. A few years ago it did a study that found many people don't follow the rules properly and the IRS was missing a lot of extra taxes and penalties by not closely auditing IRAs. The IRS has since modified its procedures and is taking a closer look at IRAs.

Here are 5 very common, and expensive, IRA mistakes to avoid.

1. **Contributions.** The IRS found a lot of people either don't know or pay attention to the contribution limits. When you (or your spouse) are covered by a pension plan, you can't make deductible contributions to an IRA once your income exceeds certain levels. You still can make contributions to IRAs above those limits, but the contributions aren't deductible.

   Roth IRAs also have income limits. In 2019, when your AGI exceeds $193,000 for married couples filing jointly ($122,000 for singles), Roth IRA contribution limits are reduced. They are eliminated when AGI exceeds $203,000 for married couples filing jointly or $137,000 for individual taxpayers.

   You might be able to make a backdoor contribution to a Roth IRA. First, make a nondeductible contribution to a traditional IRA. Then, convert the traditional IRA to a Roth IRA. There should be little or no tax cost to the conversion, because there won't be income or appreciation in the IRA.

   But the backdoor Roth IRA doesn't work as well if you already have traditional IRAs with deductible contributions. Then, all your traditional IRAs are aggregated to determine how much of the conversion is tax free. The percentage of total nondeductible contributions to the total balance across all your IRAs is the tax-free amount on the conversion.

2. **Fixing rollover mistakes.** The rollover might be the most common IRA transaction. You can roll over money from one IRA to another. You also can roll over money from a 401(k) or other retirement plan to an IRA (or in the other direction). Do these transactions correctly and they are tax deferred. But when there's a mistake the amount you meant to roll over can be treated as a distribution and included in gross income.

   When you roll over money from one IRA to another, you can handle the money yourself. Take a check from the first IRA and you have up to 60 days to deposit the same amount of money in another IRA or other qualified retirement plan. But if you miss the deadline, you have a taxable distribution instead of a rollover. There are a few exceptions, such as when you have a serious illness or a mistake is made by the new IRA custodian. But you have to apply to the IRS for an extension of the 60-day period, and the IRS is tough about granting extensions.

   Also, the IRS changed the rules so that each IRA owner is allowed only one 60-day rollover per 12-month period. Given the potential pitfalls, it is best not to try to use the 60-day rollover option.

   Instead, use trustee-to-trustee rollovers. You complete the paperwork and have the IRA custodians arrange the rollover between them. There's no time limit.

   But even trustee-to-trustee rollovers require care. At times a financial firm mistakenly deposits a rollover into a taxable account instead of an IRA. Or the custodian might mistakenly issue a check to you instead of making a rollover to the other custodian. There's no penalty if these errors are the custodian's fault and are fixed within 60 days. Otherwise, you have to appeal to the IRS for a waiver and show why the mistake wasn't your fault.

   The key is to open promptly and study account statements and transaction notices. Don't look simply at the changes in your investments and balances. Look at the transactions and the account title. If the custodian made a mistake, have them reverse it quickly.

3. **Taking required distributions.** Many people struggle with the rules for required minimum distributions after age 70½. The IRS knows this and is on the lookout for errors that trigger additional taxes and penalties.

   You don't have to take the first RMD until April 1 of the year after you turn 70½. But it often is better to take the first RMD in the year you turn 70½. If you wait you'll take two distributions the following year, perhaps pushing you into a higher tax bracket.

   RMDs don't have to be in cash. If you like an investment, have it transferred from your IRA to a taxable account. That will be treated as a distribution. The market value

on the date of the transfer is your RMD and will be the tax basis for determining gain or loss going forward.

Also, RMDs are *minimum* distributions. You always can take more. Taking more in the early years can be a good idea, because the RMDs will increase over time. That can increase your taxable income, forcing you to take distributions that exceed your spending needs.

4. **Update beneficiary designations.** There continue to be too many court cases and IRS rulings that result from failures to update IRA and 401(k) beneficiaries. Your will and other documents don't control who takes over a retirement account after you. Only the beneficiary designation on file with the account custodian determines who inherits.

   Many people haven't updated their beneficiaries for decades. Their beneficiaries are an ex-spouse or someone who passed away. Or they didn't add a child who was born after the IRA was opened, or they have other oversights. Also, the estate might have changed so that a different beneficiary makes more estate planning or financial sense.

   Failing to name a beneficiary or naming your estate means tax deferral won't be maximized. The retirement account will have to be emptied within five years.

   Naming a trust as an IRA beneficiary also could accelerate the distribution schedule if the trust isn't drafted to comply with the IRS's rules for tax deferral.

   Beneficiary designations should be part of your estate planning. You and your estate planner should determine which beneficiaries would receive the highest after-tax value from the IRA and be sure your forms are updated.

5. **Inherited IRAs.** Communicating with heirs is an important step in maximizing the value of an IRA to them. Casual mistakes and misunderstandings by beneficiaries trigger a lot of taxes and penalties.

   For example, when an heir decides to move an inherited IRA to a different custodian, the rollover must be directly from one trustee to another. With changes for other types of IRAs, you can receive a check from the IRA custodian and take up to 60 days to deposit the same amount with the new custodian. But the 60-day rule doesn't apply to inherited IRAs. If it's not a trustee-to-trustee transfer, the entire amount is treated as a distribution.

   The beneficiary needs to be sure the IRA is properly retitled. If the inherited IRA simply is converted to the beneficiary's name, that will be treated as a distribution. The proper title contains the name of the original owner, the fact that he or she is deceased, and that the IRA now is "for the benefit of" or FBO of the beneficiary. Also, required

minimum distributions must begin by Dec. 31 of the year after the year the original owner passed away.

There are a host of other things heirs need to know about inherited IRAs. I compiled them in my report, *Bob Carlson's Guide to Inheriting IRAs*. You can read more about it on the website by clicking on the Bob's Library tab.

6. **Taxable investments.** There's a category of investments that aren't prohibited by IRAs but could trigger taxes on your IRA.

An IRA or other retirement account might have to pay taxes on unrelated business taxable income (UBTI). UBTI generally is income generated by an operating business owned by the IRA. The rules also apply when the IRA owns any interest in a pass-through business entity (partnership or limited liability company).

This rule most often trips up individuals who invest their IRAs in master limited partnerships (MLPs) or real estate partnerships. MLPs are traded on major stock exchanges, and many people think of them as being the same as corporate stock. In fact, these are limited partnership units, and the income and expenses of the partnerships pass through to the owners at tax time. When an IRA's taxable income from MLPs exceeds $1,000, the IRA must pay taxes on that income. The IRA also might have to file Form 990 and pay estimated taxes.

When an IRA does own MLPs and earns income of more than $1,000 for the year, some tax advisors recommend taking the easier and cheaper route of reporting any IRA-owned pass through income on the IRA owner's individual tax return instead of preparing a separate return for the IRA.

Also, any type of income becomes UBTI when debt is used to finance the property that generates the income. For example, if an IRA receives a margin loan from its custodian or broker, income generated by the securities purchased with the loan proceeds would be UBTI. A mortgage on real estate also converts exempt income into UBTI. An IRA may own real estate and earn rental income, and that rental income will be tax deferred. If the real estate is financed with a mortgage, however, the rental income becomes UBTI.

The UBTI rules also apply to Roth IRAs the same as traditional IRAs.

UBTI can be avoided by owning an open- or closed-end mutual fund or an ETF that itself owns publicly-traded MLPs.

Do you want to learn more about this and the other financial issues of retirement and retirement planning?

Give us just 90 days, and we'll help you build a richer, worry-free retirement…or your money back. You'll receive the monthly advisory, *Bob Carlson's Retirement Watch*, plus access to our feature-rich, members-only web site. On the members' website you'll find regular updates, early access to each monthly advisory, an Archive to enhance your retirement research, Bob's Journal, and more.

Click here to learn more about *Retirement Watch*, and "The New Rules of Retirement."

For more than 25 years Bob Carlson and *Retirement Watch* have been helping retirees and soon-to-be retirees plan and enjoy rewarding, worry-free retirements. They can help you, too.

With each monthly issue, you'll quickly discover the answers to your most pressing questions on investing and your portfolio, avoiding little-known IRS tax traps, making the right decisions on medical care and insurance, creating a rock-solid estate plan, choosing the best Medicare options, managing your IRA for maximum after-tax wealth, and much more.

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 $4 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.

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*.