

Help Your Clients **GROW** Their Money

By Kary Bartmasser, CPA and Neal Frankle, CFP®



If your clients have the choice of paying \$100,000 in taxes now, or spreading those tax payments over the next 50 years, you'll have them pay it over the next 50 years, right? That way, they'll use the government's money to generate interest for themselves. Uncle Sam says they can defer tax on their retirement account contributions and earnings, and for once he's looking out for their best interests.

The tax code allows most of your clients' retirement money to exist in tax-deferred bliss for their lifetimes and, in many cases, for generations after they've signed their last tax return in the sky. That's right, if they name the right beneficiary, they can continue to grow their retirement accounts and defer the taxes for decades after they're gone and, thus, grow a once modest retirement account into a fortune. This is called an "inherited IRA" or "stretch IRA." Of course, your clients' beneficiaries will have to take a small taxable distribution each year, based on their life expectancy [Code Section 408(d)(3)(c)], but the bulk of the money grows without the IRS putting its paws on it.

However, to be eligible for this tax-deferral windfall, your clients must name the right beneficiary. For example, let's say your client is a widow with three children and she wants to make sure each child receives a third of her retirement account [Code Section 401(a)(9)] when she passes away.

For the kids to take advantage of the inherited IRA, all she has to do is name them as the beneficiaries. That's a no-brainer, and it's the easy part. Once the kids are named as beneficiaries, she needs to take three additional steps:

- Make sure her current custodian (bank, insurance company, or mutual fund company) will allow the kids to take advantage of the inherited IRA once she passes away. Believe it or not, many don't!
- Make sure her financial advisor is well-versed in how to help her beneficiaries take advantage of the inherited IRA. In our experience, Fat Albert can do more sit-ups than you can find advisors who'll set this up correctly.
- Make sure the kids understand how important this is so they don't blow the money.

Let's tackle the first point, making sure your clients' retirement account custodian will allow their beneficiaries to take advantage of the laws. As you probably know, when it comes to retirement accounts, there are two sets of rules; the IRS has one set of rules and the custodian has another. The trick is, you must comply with the stricter of the two, and often *the custodian* is more stringent than the IRS.

Why is this important for you? Because even though the IRS allows your clients' beneficiaries to stretch distributions of their retirement accounts over their life expectancy, many banks and mutual funds don't. So if their bank is among the many who feel they know better than the IRS, they'll force your clients' beneficiaries to withdraw all their retirement assets (and pay taxes on them) over one to five years, losing the opportunity to stretch those payments and defer those taxes over decades to come.

To put some teeth into this, assume your client's daughter, Martha, inherits \$1 million from a retirement account

when her mom dies. Let's assume Martha is 40 years old when her mom passes away. In this situation, the IRS will allow Martha to take distributions over 42 years, and if we assume she can earn six percent on the money, she'll withdraw more than \$3.1 million over the 42 years.

That's *if* the bank is at least as lenient as the IRS. What if the bank forces Martha to withdraw the retirement assets within one year? Well, she'll withdraw \$1 million and pay taxes on that, leaving her with about \$600,000 to spend.

Come on, now. Even out here in California, we'd rather have \$3.1 million and pay tax on it than have \$1 million and pay tax on it. The bank can cost your clients a fortune if you don't solve this problem for them.

Fortunately for everyone, the solution is straightforward, and it's an opportunity for you to vastly expand your practice. Invite your client to come to your office and bring her beneficiaries with her. Explain the problem and then call the custodian and ask to speak to the retirement department. Ask if they allow beneficiaries to take advantage of the inherited IRA provisions. You'll receive one of three answers.

- No.
- What's an inherited IRA?
- Yes.

If you receive answers #1 or #2, help the client shop for a new retirement custodian. If you receive answer #3, confirm that the custodian will allow the beneficiaries to withdraw retirement funds over their lifetimes as provided by the IRS—and get it in writing.

Regardless of what happens, you've accomplished three very important goals:

- You've helped the client avoid a financial meltdown.
- You've solved a problem for the kids and, as a result, had an opportunity to compete for their tax business.
- You've become the hero and saved the day, yet again. This helps cement your relationship with your clients and their beneficiaries. Next time your client plays golf with friends and recounts this story, the golfing buddies will wonder why their financial advisor didn't make that call for them. This is yet another chance for referral business for you.

But there is another reason to be proactive. Consider this nightmare that almost was, from one of our clients in Los Angeles.

Lenny and his wife Gabby had been divorced for more than five years, but since they had no children and had remained friends, they'd kept each other on as beneficiaries on their retirement accounts. Gabby died suddenly in May 2005 and Lenny found himself the beneficiary of over \$500,000.

So far so good (except, of course, for Gabby). Lenny went to the bank to ask the "investment advisor" what to do with that money. After all, he explained, he certainly didn't want to pay any taxes on the windfall if he could help it.

"No problem" said the advisor, "we'll just roll this money over to a spousal IRA. That way, you won't have to pay any tax at all."

"But I wasn't married to Gabby when she died!" explained Lenny.

"No worries," responded the soon-to-be-sued advisor. "Since she was your spouse, you can do the spousal rollover." To make matters worse, the bank "investment advisor" sold Lenny some annuities for the IRA.

No doubt you realize this was wrong, dangerous, and expensive advice. Lenny could no more roll that money to a spousal IRA than your son can use a spousal rollover when he inherits your IRA.

When Lenny showed up in Neal's office, Neal immediately called the advisor at the bank (as soon as he put his eyes back in their sockets, that is). Neal explained the situation and asked her to retitle the IRA from a spousal rollover to an inherited IRA. She didn't even understand the problem. He called the compliance officer at the bank. No comment.

Neal realized it was time to call in the big guns, so he rang up the client's CPA and attorney. Even though these two also called the bank and made the simple request to correct the title, the bank refused to do it. The excuse? The client had signed off on the paperwork and, therefore, it was the client's problem.

With nowhere else to go, we contacted the insurance companies, who agreed to retitle the accounts. Had they not done so, the client would have been forced to pay income tax on the entire IRA amount. In Lenny's case, the tax would have come up to over \$200,000 (enough to ruin anyone's weekend).

Do you need more reasons to review your client's IRA decisions? No problem. Meet Sam. When we met him, he was 32 years old and had \$800,000 in an IRA. Now, the odds of a 32-year-old having \$800,000 in an IRA are slim to none. So it was a safe guess that one of his parents had passed away, and he was the beneficiary of their IRA and he'd rolled the money.

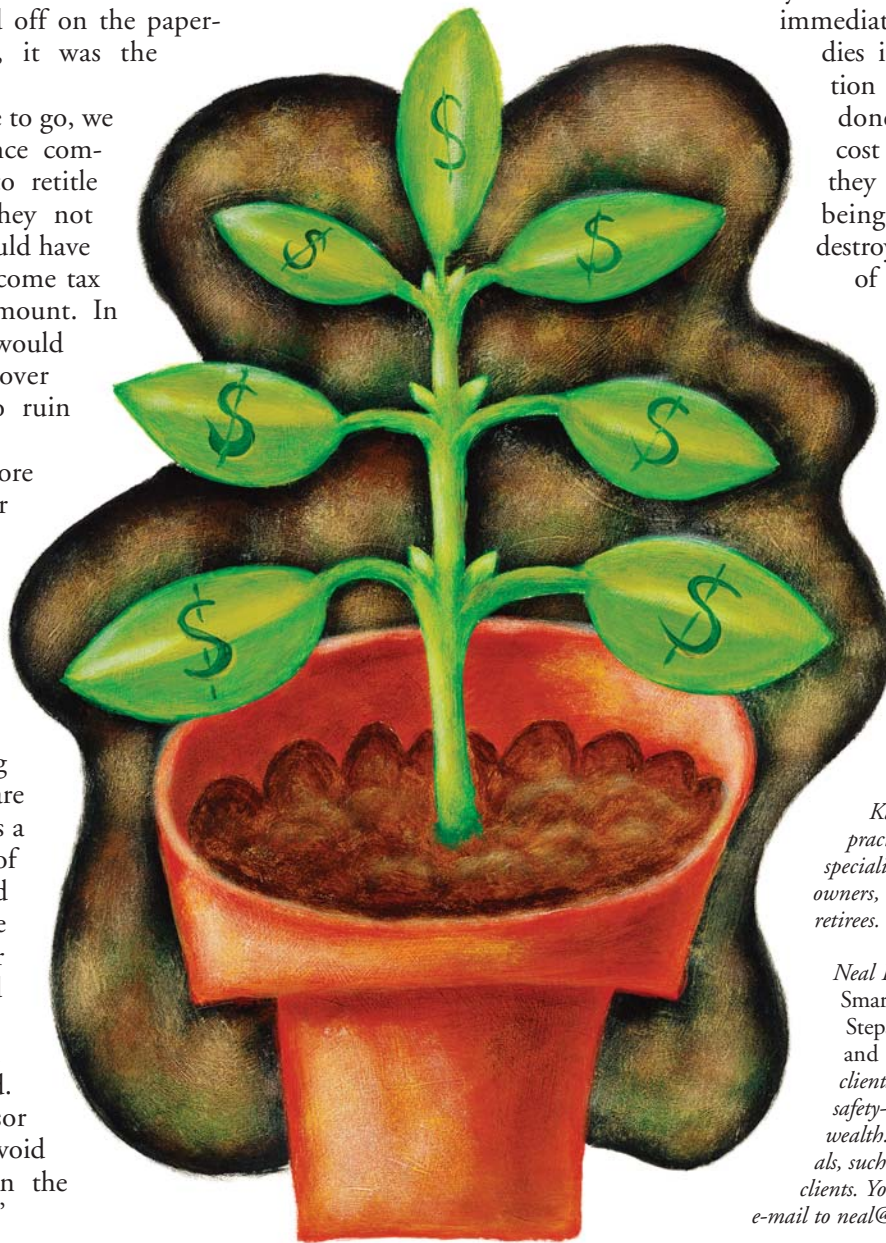
"How did you know?" he exclaimed. "My financial advisor told me to do that to avoid paying income tax on the IRA. Wasn't he clever?"

"Maybe not, Sam," Neal told him. "You see, you can't roll over that IRA from your parents. In fact, what you did was illegal."

Now comes the not-so-fun part. Sam rolled the account in 2000 before the stock market crashed. In fact, he'd inherited over \$1.5 million, but the market had pummeled his account, and it was worth less than \$800,000 when we met. Of course, he owed tax on the \$1.5 million. He had to turn over the entire account to the IRS and take out a second mortgage on his house in order to pay the tax and penalties. This is ridiculous, but it happens all the time. The advisor didn't tell Sam about filing a Form 706 estate tax return. He didn't tell Sam about estate tax, and he didn't tell Sam that he couldn't roll his parent's IRA into his own IRA.

Retirement money usually involves serious dollars. Unfortunately, the people advising your clients don't know much about it, and that poses a threat to your clients and you.

Your client's family will have to pay income tax immediately when your client dies if the beneficiary selection or the transition isn't done properly. That will cost them a fortune, and they will blame you for not being proactive. This will destroy any chance you have of gaining the children as new clients. The inherited IRA might be the best solution to this problem. This provision in the tax code allows your clients' beneficiaries to defer income tax on the lion's share of the IRA for decades, and opens the door for you to expand your practice. ♦



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