IRA Mishaps That Can Cost a Bundle

Your IRA assets may be at risk, and not due to big dips in the stock market or lousy investment choices. There's something else to worry about: bad advice and mistakes by bankers, brokers or financial advisers who handle or advise on transactions in individual retirement accounts.

IRA mishaps can cost investors a bundle, both in terms of taxes and the loss of years of tax-deferred growth.

Here are some of the most common mistakes investors suffer at the hands of professionals who should know better:

1. Undoing Your IRA

If you have more than one IRA, nothing should be more run-of-the-mill than moving assets from one to another to consolidate accounts. But some banks or brokerages inadvertently cash out investors' accounts in the process and investors end up with a tax bill for their entire account, and the IRA they thought they had is now just a regular bank account.

This problem occurs when one institution -- either the custodian that is trying to move assets out or the institution receiving the assets -- calls the transaction a "rollover" instead of a "transfer" because the wrong box was checked off. A transfer is not reported to the IRS. A rollover is reported as a payout to an individual. When this error occurs, the investor must pay the tax bill and forgo future tax-deferred earnings on the assets. It's possible to have an IRA reinstated and the taxes refunded by appealing to the Internal Revenue Service, but the process is bureaucratic and time-consuming.

2. Blowing an Inherited IRA

Thanks to new rules that went into effect in 2003, you can stretch an inherited IRA over your lifetime as long as you were named its beneficiary. It used to be that an inherited IRA had to be cashed out by the end of the fifth year after the death of its original owner. Now, however, heirs can keep an inherited IRA for their lifetimes as long as they take minimum distributions each year and properly rename the account as an inherited IRA.

What's the difference? If you inherit a $500,000 IRA at age 50 and cash it out, you would pocket $325,000 after paying Uncle Sam at the 35% income tax rate. But, if you keep the IRA intact, take minimum distributions each year and earn 8% on the money, you could have pocketed well over $2 million by age 84.

Consider the plight of an investor who had cashed out an inherited IRA over two years without considering tax issues. Once he realized the mistake, it was too late. Unlike IRA transfers that are misreported as being cashed out, IRA cashouts made as the result of bad advice cannot be reversed.

Another common error: Investors who simply roll an inherited IRA into their own IRA. The result, is that the inherited assets will be considered cashed out and will be fully taxable.

3. Overlooking Valuable Deductions

When federal estate taxes are paid on IRA assets, the beneficiary of the IRA is allowed to take a tax deduction on withdrawals. Called an Income With Respect of a Decedent Deduction, or IRD, its value is based on how much of the estate tax paid is attributable to the IRA assets.

4. Ruining IRA Potential for Heirs

Investors who aren't sure whom to name as their IRA beneficiary are often advised to simply name their estate. That way, the IRA assets will simply be divvied up according to your will, right?

True, but then the beneficiaries miss the opportunity to stretch the IRA over their lifetimes. An IRA left to an estate, rather than beneficiaries, must be cashed out within five years of the original owner's death.

Consider this worse case scenario, a trustee of an estate who instructs the financial institution to cash out an IRA, because of the declining market and fails to immediately distribute the proceeds to the heirs. The result-the estate is forced to pay federal and state income tax on the full value, at trust income tax rates, which are the most punishing rates in existence!

5. Massachusetts taxation of IRA distributions

Often overlooked are the unique tax issues that Massachusetts residents face when it comes time to cash out an IRA. Massachusetts does not recognize a deduction for a traditional IRA on the individual tax return, therefore when you begin to draw down on your IRA retirement, you can exclude distributions from taxation, up to the amount of your initial contribution. If you look closely at the various Massachusetts resident return schedules, there are many areas entitled “Massachusetts Differences”. This is one instance where the difference works in your favor!