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Planning for Today and Tomorrow

ESTATE PLANNING: IRA Withdrawals

This is the second of a three part series dealing with the subject of Estate Planning and related topics. This article deals primarily with the subject of withdrawing money from Individual Retirement Accounts.

In today's economy a great deal of importance is placed on contributory retirement plans. By contributory plan we mean that the employees contribute a portion of their salary to the plan. Three of the most popular examples of this are Individual Retirement Accounts (IRA), 401(k) Plans and Tax Sheltered Annuities (403(b) / TSA). As a point of information, when plans are referred to by a number, such as 401(k) or 403(b), that number refers to the section of the Internal Revenue Code which lays out that particular plan. For example, a 401(k) plan is called that because section number four hundred and one of the law covers that particular type of plan.

Contributions to 401(k) and 403(b) plans are made on a salary reduction basis. That means the money is deducted from the employees paycheck and deposited directly into their account. The contributions are made prior to the income taxes being taken out. Therefore, ones taxable income is reduced by the amount contributed to the plan.

Contributions to a Traditional IRA are made directly into your account and are deducted from ones income, provided the applicable income limits are met. Roth IRA contributions are, of course, not deductible but all earnings are fully tax exempt. Roth IRAs offer a unique opportunity that should be fully taken advantage of once TSAs and 401(k)s are maximized.

IRA Withdrawals - When money is withdrawn from a Traditional IRA a series of general rules and guidelines apply.

1. The dollar amount withdrawn is added directly to ones income and is fully taxable at ones current income tax rate.

2. Money withdrawn prior to age fifty nine and a half is subject to a tax penalty of ten percent in addition to the normal income taxes.

3. The ten percent tax penalty is waived if the withdrawal is for the down payment on a home provided the amount is \$10,000 or less and the buyer has not owned a home within the last two years. The home buyer may be

the IRA owner or a relative of the IRA owner.

4. The ten percent tax penalty is waived if the money is being used for post secondary education expenses at an accredited institution. This would include tuition, room and board, books and supplies. The student may be the IRA owner or a relative of the IRA owner.

5. The ten percent penalty can be waived in the case of a long term disability.

6. The ten percent penalty is waived when the withdrawals are done as a series of substantially equal payments based on the life expectancy of the owner. It's pretty rare that this is done and there are, of course, formulas and rules, but if you are retiring early and need the money, it is available - following careful guidelines.

Minimum Distributions - When an IRA investor retires or reaches fifty nine and a half they are not required to immediately begin withdrawing money from their IRA. In fact, experience shows that many IRA investors would prefer not to withdraw any money at all.

However, withdrawals must begin soon after one reaches the age of seventy and a half. From then on, certain minimum amounts, called Required Minimum Distributions must, at the least, be taken. (One can, of course, withdraw more.)

There are several different formulas for calculating the minimum distribution amount, but all are based on the cumulative value of all IRA accounts one owns. For example, if an investor owned three different IRAs worth \$50,000 each, the minimum distribution amount would be based on \$150,000 - the sum total of all the IRAs. The distribution itself could be taken from just one of the accounts or divided any way amongst the three.

The amount of these distributions may be based on the life expectancy of the owner only, which is referred to as a *single life expectancy*. There are several methods of calculating the amount to be withdrawn each year. An important point to keep in mind is that with a single life expectancy, the named beneficiary will receive the entire balance, in one payment when the account owner passes on. If the beneficiary is not the legal spouse the entire distribution is taxable when received. *Continued*

IRA Withdrawals

Minimum distributions may also be based on a *joint life expectancy*, which takes into account the ages of both the IRA owner and the named beneficiary. This method of calculation results in a lower distribution amount. The advantage being a longer time for the assets to grow.

An example of this may be as follows. Bill owns IRAs worth \$200,000. He is 70 1/2 and must start taking minimum distributions. Sally, Bill's wife is 65.

The single life expectancy of Bill - according to the IRS - is 16 years. So, Bill would have to withdraw and pay taxes on \$12,500 (\$200,000 divided by 16 equals \$12,500).

The joint life expectancy of Bill and Sally together is 23.1 years. If that method were chosen, the amount needed to be withdrawn would be \$8,658 - nearly one third less.

Should Bill pass away, Sally would have two basic options. She could continue the distributions, which would be based on her life expectancy, or more likely she would roll Bill's IRA into a new IRA of her own.

“Stretching” an IRA - Let's use the case of Bill again and show how to extend the earnings from his IRA.

Bill has a son Paul, 35 years old. Prior to beginning his IRA minimum distributions, Bill names Paul as the beneficiary of his IRA. (Bill may name whoever he wishes as a beneficiary).

Bill starts receiving his minimum distributions based on the joint life expectancy of himself and Paul. Five years later, Bill passes away. Paul, now 40 years old, could take all of the money in a single lump sum. It would be added directly to his income, be fully taxable and probably make the IRS very happy.

Paul could also opt to receive distributions based now on his life expectancy alone - a single life expectancy - which is 42.3 more years (based on IRS tables and required calculations). By taking this option, Paul may enjoy years of tax deferred growth of the original assets as well as an extended income stream. In addition, he does not have to pay the taxes on a lump sum distribution that would, in most cases, push his taxable income into a much higher tax bracket.

Now let's say that Bill names his spouse Sally as the beneficiary. If Bill passes away before her, then Sally could roll the IRA into a new IRA of her own and name Paul the beneficiary of it. If Sally then passes away before Paul, Paul could have the payments extended based on his life expectancy.

To expand on this further, if Bill and Sally had more than one child, they could set up separate accounts naming a different child (or grandchild or other individual) as the beneficiary. Then each account could eventually be distributed over the named beneficiary's expected lifetime. Furthermore, the accounts can be established so that if the beneficiary does not live the full length of their life expectancy, distributions will continue, for a limited time, to a new beneficiary named by the original beneficiary until the plan is exhausted. This, of course, can take years or even decades and increase the total payout from the original IRA into huge amounts.

As you can see, this is a very complex subject. One of the most complex we deal with. We have tried to present it to you in an understandable way, but we've only just touched on the subject as a whole. There are a large number of different rules and choices that can only be evaluated on an individual, case by case, basis - with help from us. But the basic concept offers some very exciting and fresh alternatives.

Please also keep in mind that if you are considering these type of distributions, you need to act well in advance. Once you have started receiving minimum distributions, the opportunities are diminished or completely eliminated.

Roth IRAs have no minimum distribution requirements and their own rules for distribution to beneficiaries. 403(b) Plans (TSAs) have similar minimum distribution rules as IRAs or can be rolled over into an IRA in most cases. 401(k) plans are more restricted and specialized from plan to plan, but can usually be rolled over when employment ends or age requirements are met.

Withdrawing money from your IRA has always required careful planning. With these recent changes, it becomes even more important. If you have any questions on this subject, please feel free to call.

***“You have to understand that the market has declines and that the next 2,000 points no one ever knows about, but the next 7,000 points will be up, and the next 15,000 points will be up, and the next 21,000 points will be up, and companies will be making a lot more money twenty years from now than they're making now and that's what makes stocks up. When you own stocks, you own companies and when companies profits go up the stocks go up.” Peter Lynch
Former Manager of the Fidelity Magellan Fund***

A personal letter from Joe

Dear Friend,

Over the past several years the stock market in general has experienced dramatic increases. The Dow Jones Industrial Average started 1995 at 3,834. It finished 1999 at 11,497 - a three hundred percent increase in just five years! Naturally, this has led to greater expectations on all of our parts. But I think it's wise to remember that there were some very steep drops during that period of time also.

When we talk about "Bull Markets" and "Bear Markets" we are talking about the increases and decreases of stock values over time. A "Bull Market" is defined as a period of time during which stock prices have risen and are expected to continue to do so. A "Bear Market" refers to a period of time when values are falling and are likely to go down further. Normally, values must go down by twenty percent or more to be considered a bear market.

A point to keep in mind is that we're dealing with periods of time as well as the values of investments. Over the past thirty five years there have been eight bear markets and an equal number of bull markets. The bear markets lasted an average of eleven months, including the extended one of the mid seventies. Remember the double digit inflation, high interest rates, oil shocks and stagflation of that period? I do. But the bull markets have lasted an average of thirty nine months. And while the bear markets saw losses averaging about thirty percent, the bull markets produced increases that averaged nearly ninety percent.

picture of
Joey

As long term investors, the greatest risk we face from volatility isn't from being in the market when it's falling; it's from not being in the market when it's rising. No one likes to see the value of their accounts go down, least of all me. But that is part of what it means to be a long term investor. And if you are not willing to accept those type of risks we have a wide variety of high quality alternatives to fulfill your needs.

For the long term I remain confident in the market and in our economy as a whole. The so called "New Economy" is here to stay and the best run businesses will be part of it. Will it be a bumpy ride, yes, but that is the way it's always been. Remember, at the beginning of last century there were over a hundred operating car companies in the United States - they were a part of that times "new economy". Today we see multitudes of companies creating products we never imagined. It's easy to forget that many or most of them will not last, just as Commodore, once one of the dominant personal computer makers, no longer exists. This is why I remain firmly committed to stock market investments through mutual funds not individual stocks. The diversification and professional management allow us to participate in the growth of the economy while at the same time reducing the risk of doing so.

I look forward to seeing you at our next appointment. If you have not been in for a while, please give us a call.

All the Best,

One Way to Diversify

By Jeffrey Hahn

It is estimated that almost half the worlds assets are invested in real estate, which is nearly twice the amount that's invested in the stock market.

A Real Estate Investment Trust (REIT) is a pool of investors money which is invested in a diverse portfolio of investment properties. Patterned after mutual funds, a REIT provides professional management, diversification and greater liquidity. It also provides an opportunity to invest in buildings and land that we could usually not afford as individual investors.

For example, some REITs invest in suburban office properties, leased to large, highly credit worthy corporations, like GE, IBM, Bell South and others. Their leases are for long periods of time which provide a steady income stream that is structured to increase over the life of those leases. A typical REIT currently pays a dividend of about seven percent or more.

If you have an interest in further diversifying your long term investment portfolio, a REIT may be worth looking into.

403(B) Corner

By: John Clouden

Market Corrections can have a bright side for Tax Sheltered Annuity participants. With all the recent volatility in the stock market, it is easy to look at your overall account value and not like what you see. Most of us who invest in stock mutual funds have seen a decline in the values of our accounts over the last five to six weeks.

The hardest part of investing is to keep your focus on the long term. One of the best aspects of Tax Sheltered Annuities is that deposits are made to your account every other week. This is called dollar cost averaging. You're investing during both the highs and the lows, averaging the cost of shares purchased over time. During market corrections, it could be said that you are buying your favorite stock funds "on sale", enabling you to buy more shares of the fund. While this does not guarantee against investment loss, it is a great way to even out bumps of the market over time.

So, keep your focus on the long-term and enjoy the "sale" that is currently being offered by the market.

Recipe For Success

By Jeffrey Sgroi

Crème Brulee French Toast:

- 1 stick (1/2 cup) unsalted butter
- 1 cup packed brown sugar
- 2 tablespoons corn syrup
- 1 loaf French bread
- 5 large eggs
- 1 1/2 cups half and half
- 1 teaspoon vanilla
- 1 teaspoon Grand Marnier
- 1/4 teaspoon salt

In a small saucepan melt butter, brown sugar and corn syrup over moderate heat, stirring until smooth. Pour into a 13 by 9 by 2 inch baking dish. Cut 12 (1-inch) thick slices of bread, reserving ends for another use. Arrange bread slices in one layer in baking dish, squeezing them slightly to fit. In a bowl whisk together eggs, half and half, vanilla, Grand Marnier and salt until combined well and pour evenly over bread. Chill bread mixture, covered, at least 8 hours and up to 1 day. Preheat oven to 350 degrees and bring bread to room temperature. Bake bread mixture, uncovered, in middle of oven until puffed and edges are pale golden, 35 to 40 minutes.

Managing Expectations

By Patrick Sgroi

"According to a recent poll, U.S. investors have some fairly optimistic expectations. For example, among folks less than 40 years old, investment returns over the next 10 years are expected to average 21.9% per year. Investors older than 40 expect returns of about 23% over the next 12 months."

Last year, the NASDAQ increased a staggering 85% and according to Morningstar, 177 funds posted returns of more than 100%, only heightening our expectations. (From 1989 to 1998 that benchmark had only been crossed 10 times, five in 1993 and five in 1998).

However, even with the NASDAQ booming and the S&P 500 up about 21% last year, approximately 7 out of 10 S&P 500 stocks actually lost money in 1999, making it one of the most lopsided years in history.

So, what should you do? As a long term investor the only thing we know for sure is that buying high and selling low is a guaranteed way to lose money. Use this time of stock market volatility not only as a buying opportunity, but as a chance to reevaluate your accounts, expectations and risk tolerance with your financial advisor. Thank you.