5 IRA Misconceptions and How You Can Make the More Informed Choice

Presented by Nancy LaPointe

Some IRA planning and investment strategies may appear easy to execute, but errors can lead to unexpected taxes or penalties, loss of the IRA's tax-exempt status, and even disinherited beneficiaries. Where can things go wrong? Here are five common IRA misconceptions, as well as tips for making a more informed choice.

Misconception #1: Naming an IRA Beneficiary Is the Simple Part
Sure, naming a beneficiary is easy when you first open an IRA, but it can lead to problems if you fail to review beneficiary information regularly or plan properly.

It's common to name a spouse as the IRA's primary beneficiary. This provides a range of options when the beneficiary inherits the funds. But what happens if you get divorced or you or your spouse passes away? If you neglected to update the beneficiary information on your account before your passing, for example, a former spouse could be entitled to your IRA assets, causing legal headaches for those whom you intended to inherit the IRA.

Naming your estate as the primary beneficiary is a common choice as well. This may seem prudent, as the intention is to let the will or trust document decide how assets will be distributed, but it can be a costly mistake. An estate beneficiary has no age or life expectancy, which leads to fewer distribution options. For example, beneficiaries determined by the estate could be forced to deplete IRA assets within five years or take distributions over the decedent's life expectancy instead of their own. This would result in larger distributions and potentially higher taxes.

Creditor protection is something else to consider. Generally, leaving assets to a named beneficiary offers protection from creditors. With assets left to the estate, however, the probate court would include the estate in the decedent's total assets, opening the door to creditors' claims.

Making the more informed choice. Be sure you understand the pros and cons of the options you choose, and reconfirm beneficiary information each year, as well as whenever you experience a major life event.

Misconception #2: You May Borrow from Your IRA
Loans are not permitted from IRAs. As an alternative, you may take advantage of the 60-day rollover rule.

Under IRS regulations, you may withdraw (or, in effect, borrow) assets from an IRA and roll over all or a portion of that withdrawal back into the IRA within 60 days. This is allowed once during a 12-month period. Sounds straightforward, but the 60-day rule has caused issues for countless investors who didn't execute the rollover properly.

Here are three reasons why:

1. Completing the rollover contribution after the deadline. The rollover into the IRA must be completed 60 calendar days after the distribution is received. Account owners sometimes forget that holidays and weekends count among the 60 days and therefore miss their deadline.
2. Violating the once-per-year rule. The IRS counts the number of distributions taken within the 12-month period, not the number of contributions into the IRA. Sometimes investors take two separate distributions and roll over both into the IRA as one payment, thinking the IRS will count this as one 60-day rollover.
3. Breaking the same-property rule. When you take the distribution of a stock or bond, for example, you must roll the same asset back into the IRA. Sometimes, investors withdraw a bond, sell it, and roll over the proceeds from the sale of the bond into the IRA instead of the bond itself.

Making the more informed choice. Avoid borrowing from your account until you have exhausted all other external options. If you decide on a 60-day rollover, be sure you understand the process, as taxes and penalties on failed rollovers can be considerable!

Misconception #3: Backdoor Roth Conversions Are Always a Good Idea

To contribute to a Roth IRA, your modified adjusted gross income cannot exceed specific income thresholds. To work around this, you may consider funding a Roth with a "backdoor conversion." This involves making a nondeductible, post-tax contribution to a traditional IRA and immediately converting the amount to a Roth IRA, as there are no income limits for this conversion. If you don't have any other IRAs (e.g., SEP or SIMPLE IRAs), this strategy may be worth considering.

But what if you have an old IRA rolled over from a previous employer? Can you isolate the contribution to the traditional IRA and convert it to a Roth? No! When assessing Roth conversions, the IRS requires all IRA assets to be aggregated and treated as one account. This means that your pre- and post-tax IRA assets will be lumped together, and only a certain percentage of the recent conversion would be tax-free. Making the more informed choice. Review all aggregate IRA assets before considering the backdoor Roth conversion option. If you're in a high tax bracket, this strategy may not be in your best interest.

Misconception #4: Funding a Start-Up with an IRA Is a Sensible Move

Another commonly considered strategy is the "rollover as business start-up" (ROBS), which invests IRA assets to back a new venture.

To fund a start-up, an individual establishes a C corporation. The corporation then sets up a retirement plan, which offers employees the option to purchase company stock. The owner rolls his or her IRA or 401(k) from a previous employer into the new retirement plan and uses these assets to purchase the start-up's stock. The business now has the capital to operate.

Although each step described is generally acceptable, ROBS has been garnering increased IRS scrutiny and has the potential to be viewed as a prohibited activity. Why?

- The business owner pays himself or herself a salary, even though he or she is among the disqualified persons whom the IRS says cannot benefit from ROBS in specific ways. The IRS may see the salary as a transfer of plan assets for the employer's benefit, which is prohibited.
- The purchase of company stock is only available to the employer. With a C corporation, the option to purchase company stock must be available to all employees.
- The valuation of the employer's IRA assets at the time of purchase is inaccurate. This could affect individuals who are taking required minimum distributions (RMDs). An inaccurate valuation of the purchase could lead to taking less than the correct RMD amount.
- Promoter fees are part of the deal. Some franchisors hire promoters to reel in potential ROBS candidates. If the promoter is a fiduciary, the payment of promoter fees from plan assets could be considered a prohibited transaction.

Making the more informed choice. Reconsider this strategy. The violations listed would lead to hefty IRS taxes and penalties. More important, the strategy could significantly deplete your retirement assets.

Misconception #5: Investing in Real Estate Within an IRA Is a Good Opportunity

An IRA owner has multiple options for investing account assets, including buying mutual funds, individual stocks, and bonds. One risky investment strategy is purchasing real estate within a self-directed IRA. Although the potential to generate income from rent and capital gains on the property is an attractive lure, numerous prohibited transactions could be part of the package. If you are considering such an investment, be aware that:

- The property cannot be used by disqualified people, and these include any fiduciary to the plan, the IRA owner, and direct family members.
- Expenses directly related to the real estate must be paid with the IRA's assets.
- Management and maintenance of the real estate (e.g., collecting rent, paying taxes) must be handled by the account's custodian.
- IRA assets must be valued and reported to the IRS annually. Real estate investments are generally illiquid, and their value can't readily be assessed, which could lead to inaccurate reporting to the IRS.

Making the more informed choice. Unless you fully understand the rules and have the wherewithal to abide by them, purchasing real estate in an IRA may not be worth the trouble. It could result in the disqualification of your IRA, meaning that it could even lose tax-exempt status.

There are a host of issues to consider when making decisions about IRAs. We can help you work through the details and make an educated choice based on your particular situation. If you have questions about the strategies and misconceptions shared here, please call our office.

This material has been provided for general informational purposes only and does not constitute either tax or legal advice. Although we go to great lengths to make sure our information is accurate and useful, we recommend you consult a tax preparer, professional tax advisor, or lawyer.

NAVIGATE FINANCIAL

Charting Your Journey

Nancy LaPointe, CFP®, ChFC®, CLU, CASL, RICP®

Navigate Financial

3663 College St SE | Suite B | Lacey, WA 98503

360.628.8175 | 360.338.0450 fax | www.navigatefinancialnw.com | nancy@navigatefinancialnw.com

Nancy J. LaPointe uses the trade name/DBA Navigate Financial. She can be reached at 360.628.8175 and 3663 College St SE, Ste B, Lacey, WA 98503. All securities and advisory services are offered through Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser. Financial planning services offered by Navigate Financial, a WA Registered Investment Adviser, are separate and unrelated to Commonwealth. Fixed insurance products and services are separate from and not offered through Commonwealth Financial Network®.

© 2023 Commonwealth Financial Network®