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UPDATE

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How to protect your 401(k) money

According to the Investment Company Institute's *2018 Fact Book,* an astounding *$7.7 trillion* is held in tax-qualified defined contribution plans, such as 401(k) plans. That resource will play an enormous role in the retirement security of millions of Americans over the coming years. Accumulating money in a 401(k) is one thing with many components—arrange for salary reductions to fund the plan, evaluate investment choices for the money, check on progress periodically and make adjustments as needed.

Distribution of 401(k) money is another thing entirely—one that raises a host of new and, for most people, unfamiliar issues. Care must be taken to preserve that retirement resource, typically through a rollover to an IRA. The *Fact Book* reports that IRA assets have reached some *$9.2 trillion.* That figure includes contributions to traditional and Roth IRAs, as well as employer-sponsored programs built on IRAs, such as SEP IRAs and SIMPLE IRAs, but the bulk of the funding has come from rollovers.

Will you be receiving a lump sum distribution of some or all of your retirement benefits when you retire? A lump sum distribution, from a 401(k) plan or another qualified retirement plan provided by your employer, can be rolled over into an IRA, preserving its special tax status well into your retirement. However, you will have many important choices to make during this process. It's not a hard or complicated process, exactly, but the consequences of your choices will last for the rest of your life, so make them carefully.

The direct approach

Most people will opt to roll their lump sums into an IRA in order to avoid current income taxation. There is a wrong way and a right way to handle this.

The wrong way is to accept a check for the amount of the lump sum. If you take this approach, your employer will be required to withhold 20% in income taxes on the distribution. You'll either have to be satisfied with an 80% rollover, or you'll have to come up with the difference from other savings sources.

The right way is to arrange a direct transfer from the

A lump sum distribution, from a 401(k) plan or another qualified retirement plan provided by your employer, can be rolled over into an IRA, preserving its special tax status well into your retirement.

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qualified plan trustee to the trustee of your IRA rollover—there is no withholding requirement with this approach.

Investment considerations for IRA assets

During the accumulation years, most people saving for retirement have a significant amount invested in the stock market. That exposure typically falls as one approaches retirement, and it may fall still further in retirement. Retirees need the steady stream of income that bonds can provide.

Still, one needs to keep in mind the probability of eroding purchasing power because of inflation that can occur over the course of a long retirement. Although inflation has been quite mild in recent years, that trend is not likely to last consistently for the next 20 or 30 years. Some amount of stock investing may be needed to hedge against inflation.

If you have significant savings in taxable accounts, you won't want to evaluate your investment strategy for the IRA rollover in isolation. You'll need to decide whether your stock investments belong in the IRA rollover or on the taxable side of the ledger. All the distributions from the IRA will be taxed as ordinary income, whether they are of interest, dividends, capital appreciation or return of principal. For the sake of tax efficiency, many advisors suggest focusing the IRA on providing steady income (investing primarily in good-quality bonds) and doing the stock investing outside of the IRA. This preserves the benefit of the 15% top tax rate on realized long-term capital gains, as well as the 15% tax rate for most corporate dividends.

Planning your distributions

From age 59½ through age 70½, you may withdraw as much or as little from your IRA rollover each year as you please. There's no penalty tax to worry about, but you will have to pay ordinary income tax on most withdrawals. After you reach age 70½, a program of required minimum distributions must begin. See *How large are IRA payouts?* for more details.

Naming a surviving beneficiary

You'll want to designate a surviving beneficiary for your IRA rollover. Usually, a surviving spouse is named, but another beneficiary may be appropriate, depending upon the composition of family wealth and other family circumstances. The decision can be changed at any time.

We can help

Retirement should be, fundamentally, the moment that you declare your financial independence, a declaration that lasts the rest of your life. Should there be an IRA rollover in this picture? If so, how will the assets be invested? We'll be pleased to offer you our assistance with these important financial planning issues.

We look forward to meeting with you soon to discuss your needs. ☐

How large are IRA payouts?

Required minimum distributions from an IRA won't exhaust the account before the owner lives beyond age 100, even if the account has poor investment return. Accounts that enjoy even modest returns will keep getting larger in the early years of minimum distributions. This table shows the projected size of a required minimum distribution from a $1 million IRA at various ages, for various rates of return. It also shows total distributions and the balance remaining at age 100, if only required minimum distributions are taken each year. If a 6% annual rate of return can be achieved, the account balance won't dip below $1 million until age 92.

AGE	2% RETURN	4% RETURN	6% RETURN	8% RETURN
70	$36,496	$36,496	$36,496	$36,496
80	$42,255	$51,750	$63,124	$76,700
90	$42,859	$64,606	$96,587	$143,259
100	$28,394	$53,269	$98,650	$180,439
Total payments through age 100	$1,233,056	$1,624,697	$2,387,026	$3,434,869
Remaining balance at age 100	$154,067	$295,750	$560,139	$1,047,272

Source: M.A. Co.

Rates of return are for illustration only and do not represent any particular investment.

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The “teddy bear” test

High net worth folks with several homes often strive to avoid being counted as a resident of a high-tax state. Traditionally, that’s meant keeping careful count of how many days are spent in said state, and now there are apps for that. But states such as New York and California have become more sophisticated in their efforts to tax the rich.

Days spent in state represent only one of five tests New York applies. The state also looks at the size and cost of the New York home compared with those in other states, a person’s business and family ties to the state, and a category that looks at where ‘near and dear’ items are kept.”

That last category is popularly known as the “teddy bear” test.

An example

Bloomberg provides an illustration of the teddy bear test with the story of Gregory Blatt, a New York City resident and a rising star. In 2009 he was recruited by Barry Diller to move to Texas to become chief executive of Match.com. For the first few months he continued to live in New York, commuting to Dallas as needed. But soon he rented an apartment there, joined a gym, and made Dallas his residence. He lived there for two years, filing his income taxes for 2009 and 2010 as a Texas resident. Then he moved back to New York City.

In 2013 Blatt was audited by New York’s tax authorities. They concluded that he had always remained a citizen of New York, and so owed more than $400,000 in back income taxes.

At trial, Blatt’s attorney’s invoked the teddy bear test. Blatt had written an e-mail noting that “Dog is the final step that I haven’t been able to come to grips with until now. So Big D is my new home.”

The trial judge was satisfied that when the dog was moved, the test was satisfied, and Dallas was genuinely Blatt’s new domicile. She cancelled his tax bill.

Steps to take

The new federal income tax cap on state and local tax deductions has further motivated the rich to flee their domiciles in high-tax states. It has also motivated the high-tax states to fight back. In addition to checking for stuffed animals or pets, states may examine cell phone records and Facebook posts.

Some of the steps commonly recommended to prove a change of domicile include:

- registering to vote in the new state;
- obtaining a new driver’s license;
- registering one’s car in the new state;
- updating estate plans, noting the new residence;
- joining a new church or temple.

Carefully documenting the days spent in each state should also prove helpful should the state tax collectors come knocking. ☐

Withholding checkup

The benefits of the Tax Cuts and Jobs Act were not distributed uniformly among all taxpayers. In addition, the withholding tables were adjusted last year to allow the tax cuts to take effect immediately. That meant that some taxpayers ended up with a smaller refund this year than they were expecting. According to the IRS, refunds distributed by early April were down about $5.8 billion, and the average refund fell $31 from a year ago, to $2,833.

If you are not happy with your tax withholding, the IRS has a solution, an online tool for calculating this figure. The tool may be found at https://www.irs.gov/individuals/irs-withholding-calculator. The IRS calls it a "paycheck checkup." Keep in mind that the standard withholding tables don't work well for some types of taxpayers, such as:

- Two-income families.
- People with two or more jobs at the same time or who only work for part of the year.
- People with children who claim credits such as the Child Tax Credit.
- People who itemized deductions.
- People with high incomes and more complex tax returns.

These types of taxpayers should make an extra effort to examine the suitability of their tax withholding arrangements.

Using the tool

You will need to have some information handy before using the new online withholding tool. A copy of your current pay stub will be helpful, as well as a completed tax return. Your 2018 tax return would be best.

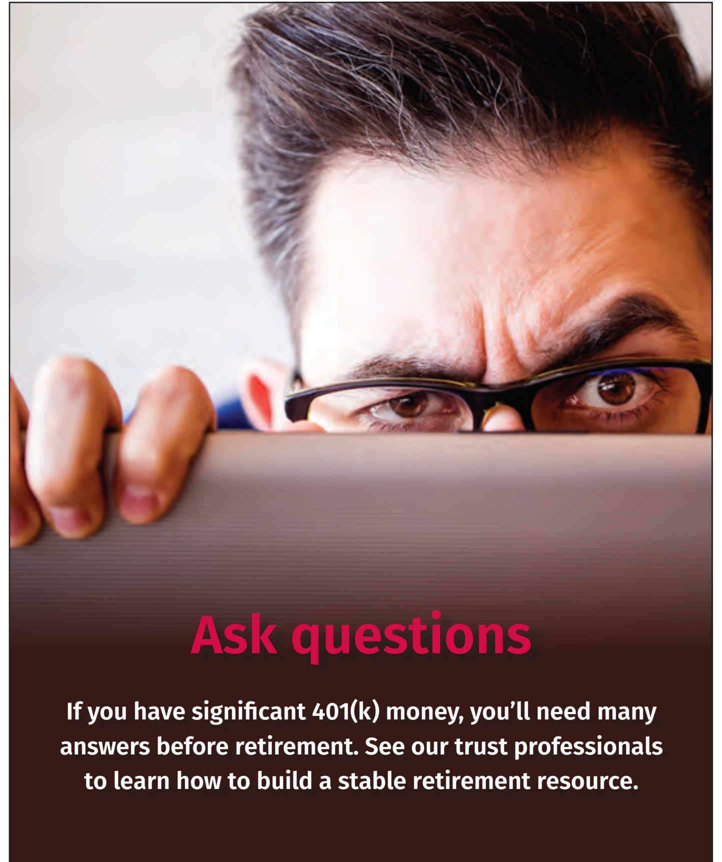
What happens if the tool shows that your withholding should be changed? Nothing, until you take the next step. IRS will not know that you used the tool; nothing that you entered will be saved or communicated to the IRS. The next step is to give your employer a new Form W-4. The advantage of using the online tool first is that you can skip the associated worksheets for the Form.

Complex situations

Although the online withholding estimator is a great help for most taxpayers, it may still not be accurate enough for those with more complicated tax situations. Such taxpayers include those with:

- self-employment income;
- tax on unearned income from dependents;
- significant capital gains and dividends; and
- exposure to the alternative minimum tax.

These taxpayers will need to consult Publication 505, Tax Withholding and Estimated Tax, to get the most accurate determination of their withholding. ☐



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