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GETTING PERSONAL:

Surfing Waves Of 401(k) Money

–Flow of 401(k), IRA money can overwhelm older account owners

–Art of managing tax on retirement savings in advance

–Many people leave IRAs untouched

By Arden Dale

When a retirement account is big and its owner gets older, the money flowing from it can turn into a tidal wave. So can the tax liabilities.

An adviser can help by planning well before things reach that stage.

Kevin Sullivan, a financial planner in Winston Salem/High Point, N.C., recalled a client with a $3.5 million IRA who was "scared to death" by how much he calculated he might have to take out each year when he turned 70 1/2. Those huge required minimum distributions would, among other things, raise his tax bracket.

The client, a retired corporate executive, was 57 and had a total estate of about $8 million at the time. Sullivan set up a plan to spend down the account significantly starting at age 59 1/2, when this type of account can be tapped without a tax penalty.

Sullivan took a holistic view of the man's circumstances. Some $350,000 a year would do for now to support a lifestyle that included a lot of travel. That pace would likely slow by the time the client hit his 70's.

Spending down the IRA to $2 million by age 70 would bring required minimum distributions from around $180,000 to $100,000. Sullivan then modeled a future income stream from brokerage accounts, cash and IRA distributions between age 59 1/2 and 70 1/2. This would keep a wave of income from crashing in at 70 1/2. It would also help keep taxes down, as more income would be taxed as capital gains and less as ordinary income.

Uncertainty about future tax rates can make this kind of projection dicey; advisers, like everyone else, are loathe to predict how high tax rates will climb, but most agree they will go up and won't go down. Income-tax rates could rise above 40% for some people if cuts now in place through the end of 2012 aren't extended.

While planning isn't foolproof, the best time to start on it is before clients retire, said Maria Bruno, a senior investment strategist at Vanguard Investment Strategy Group. People have "more tools in their toolbox" at this point to, say, fund a Roth IRA instead of a regular 401(k). There's more flexibility to diversify assets for tax purposes in general, she said.

Nonetheless, many people let assets accumulate and then sit in their retirement accounts, taking out just the required minimum distribution. The Investment Company Institute said 64% of households that took money from their traditional IRAs in 2008 based withdrawals on required minimum distributions that year; only 19% withdrew a lump sum based on needs.

Advisers who work with retirement savings said they keep an eye out for another kind of tax trap: Forgetting to take out money when required. Often these involve inherited plans, and the tax penalty is steep: In some cases, it is 50% of the amount that should have been withdrawn.

Walter Pardo, a financial planner in Basking Ridge, N.J., helped a widower deal with a mistake of this kind. The man's wife died in 2006, leaving an IRA holding more than $100,000 to their daughter. The young woman, now a 21-year-old college student, hadn't withdrawn money from the account as required each year. A $6,000 required distribution had piled up for the four years, along with $3,000 in tax penalties.

Pardo said he plans on behalf of the client to help the daughter ask the Internal Revenue Service to waive some of the penalty.

(Arden Dale is a Getting Personal columnist who writes about personal finance; she covers topics including tax and estate planning, retirement, investment strategies, and financial needs of small businesses.)

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