



Advanced Planning Strategies

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Dear Reader,

The legislative process has begun to take shape for 2002. It appears unlikely that a large comprehensive tax bill will be enacted this year. However, there are some interesting individual proposals that are being considered. The House Ways and Means Committee approved the "Encouraging Work and Supporting Marriage Act of 2002" (H.R. 4626). In last year's legislation, provisions were included to reduce the marriage income tax penalty. The new proposal would begin the relief through increased standard deductions starting in 2003. The relief is currently scheduled to begin in 2005.

The legislation to enhance charitable contributions has met with resistance on one key element: the charitable deduction for taxpayers who do not itemize deductions. The bill is being debated in the Senate where some feel that the nonitemizers already benefit from a substantial standard deduction in lieu of itemized deductions. The Senate will consider removing the sunset provision on the estate tax repeal. Senate Democrats will probably offer relief in the form of higher exemptions and lower rates in lieu of complete repeal. At this point, it is likely that neither proposal will receive enough votes to be enacted.

It may be an appropriate time to review the average deductions taken by taxpayers who itemize deductions on their returns. The table below gives a short summary of 1999 results provided by the IRS. Of course, your return may not avoid an audit merely because the deductions fall within the normal range.

<u>Adjusted Gross Income</u>	<u>Interest Deduction</u>	<u>Charitable Deduction</u>	<u>State and Local Tax Deduction</u>	<u>Medical Expense Deduction</u>
\$30,000 to \$50,000	\$6,247	\$1,774	\$2,991	\$4,992
\$50,000 to \$100,000	\$7,544	\$2,282	\$4,918	\$5,950
\$100,000 to \$200,000	\$10,806	\$3,727	\$9,262	\$10,494
over \$200,000	\$21,735	\$19,454	\$35,592	\$32,259

Knowledge is not power. Only knowledge in use is power.

NEW REGULATIONS PROVIDE TAX RELIEF FOR RETIREMENT BENEFITS IN QUALIFIED RETIREMENT PLANS AND IRAs

Early last year, the IRS issued new proposed regulations for determining the minimum required distribution (MRD) from qualified retirement plans and IRAs (Prop. Treas. Reg. Secs. 1.401(a)(9)-0 to 8, 1.403(b)-2, 1.408-8, and 54.4974-2). The proposal contained some surprisingly generous provisions that generally allowed more income tax deferral for participants and their heirs than was available under prior regulations. In addition, the rules were dramatically simplified for determining the MRDs during the participant's lifetime. These proposed regulations were covered in some detail in a prior letter. The IRS finalized these regulations in April of this year and clarified some issues with last year's proposed regulations that concerned many practitioners. (See. Treas. Reg. Secs. 1.401(a)(9)-08, 1.403(b)-2, 1.408-8, 54.4974-2.)

EFFECTIVE DATES

The new regulations substantially modify existing proposed regulations originally issued in 1987 and also make some important changes to the 2001 proposed regulations. The new regulations have an effective date of January 1, 2003, but the IRS indicated that the new regulations could be used immediately. Technically, it appears that the 2002 distributions could be determined based on the new rules or either the 2001 or 1987 proposed regulations. However, as we will discuss below, most retirees looking to defer income taxes as long as possible should calculate their minimum distributions based on the final regulations.

THINGS TO KEEP IN MIND ABOUT RETIREMENT PLAN DISTRIBUTIONS

Although the rules concerning the MRDs from qualified retirement plans or IRAs are voluminous, the following common sense points must be remembered:

- The terms of the qualified plan or IRA must be examined carefully. Distributions can be taken only according to the terms of the plan. The new regulations indicate that qualified plans and IRAs should be amended to comply with the new MRD rules.
- The rules provide for *minimum* required distributions for federal income tax purposes at the required beginning date, generally age 70 1/2. A 50 percent excise tax applies for the failure to take at least the MRD. It is generally permissible that the participant take distributions larger than the MRD and begin taking distributions earlier than the required beginning date. (A 10 percent penalty tax is generally applicable to distributions prior to age 59 1/2, with certain exceptions.)
- The personal needs of the participant and his or her family and the provisions of the retirement plan or IRA will dictate the timing and amounts of the distributions. The goal of deferring federal income tax is secondary.
- A beneficiary (and a contingent beneficiary) should always be designated for a qualified retirement plan or IRA. As we will discuss below, this will increase flexibility and income tax deferral potential at the time of the participant's death.

PRIMARY CHANGES CREATED BY THE NEW RULES

Although there are many important aspects of the new rules, there are two changes that have the most significant impact. First, the MRD at age 70 1/2 (or the appropriate required beginning date if

the participant continues to work and is eligible to further defer MRDs) is based on only two possible choices. Most participants will determine their MRDs based upon a uniform distribution table that assumes a payout over the joint life expectancy of the participant and another beneficiary 10 years younger. The only other option is for participants who are married to a spouse more than 10 years younger. In this instance, the participant can opt for MRDs based on a joint life expectancy of the participant and the younger spouse. The new regulations indicate that marital status is determined at the beginning of the year for this purpose.

The new regulations also provide new life expectancy tables that will permit longer deferral because the new tables assume a longer life expectancy. Even for participants who reach age 115, the MRD will be less than the remaining account balance. Thus, estate planning and preservation should be considered for retirement plans because the participant who merely takes the MRD is expected to have something to leave to heirs from the plan, regardless of the time of his or her death.

As an example of the benefits of the new regulations, suppose we have an owner of an IRA with \$1 million in her account when she reaches age 70 1/2 this year. Using the new table, her MRD would be \$37,736 for 2002. Under the 2001 proposed rules, her MRD would have been \$39,526. If she had not designated a beneficiary and took a single life payout under the 1987 proposed regulations, her MRD would have been \$62,500.

The second major change affects the required payout (the “applicable distribution period”) of the remaining account balance after the participant’s death. With the new rules, the choice of beneficiary during lifetime does not affect the MRDs during lifetime. The participant can change beneficiaries as long as he or she has the capacity to do so at any time during his or her lifetime, even after the required beginning date. After the participant’s death, the beneficiary for the purpose of establishing the applicable distribution period does not have to be determined until September 30 of the year following the year of the decedent’s death. Thus, although the participant’s beneficiary designations are fixed at the time of death, the postdeath distributions can be changed by the primary beneficiary’s use of a disclaimer or by early distribution of one or more beneficiaries’ share of the account.

POST DEATH DISTRIBUTION RULES

The new regulations permit the payout to be made over the life expectancy of the beneficiary. Normally, the best deferral will occur if the participant is married and the surviving spouse is able to roll over the account to the survivor’s IRA. Under these circumstances, the surviving spouse will be able to take a joint life payout using the new life expectancy tables beginning in the year the surviving spouse reaches age 70 1/2. Any other individual beneficiary will have to use a single life payout (again, using up-to-date life expectancy tables) beginning in the year after the year of the participant’s death. For a group of beneficiaries, the payout is based on the life expectancy of the oldest beneficiary unless separate accounts are created. Generally, the most unfavorable outcome is to have the participant’s estate as the designated beneficiary.

Because the new rules permit delaying the determination of the designated beneficiary until September 30 of the year following the year of the participant’s death, considerable confusion about this provision had to be clarified in the final regulations. The primary topics are as follows:

- naming the designated beneficiary. The plan participant must have named the designated beneficiary on the appropriate plan form. The executor or heirs cannot make the designated beneficiary choice. Thus, it is critical to name all potential primary and successor beneficiaries in the plan or IRA documents.

- removal by disclaimer or early distribution. The regulations allow a primary beneficiary to be removed from the list prior to the September 30 deadline if the beneficiary makes a qualified disclaimer or has the full amount of his or her share distributed prior to the beneficiary determination date. It may be prudent to have older beneficiaries execute durable powers of attorney to permit an agent to disclaim a survivor benefit if the family's advisers recommend this route.
- creation of separate accounts. If a group of beneficiaries is named at the time of the beneficiary determination date, each beneficiary is able to use his or her life expectancy (rather than all using the life expectancy of the oldest beneficiary) if separate accounts are created for each beneficiary. The new regulations make it clear that separate accounts can be created for this purpose up to the end of the year following the year of the participant's death.
- trust as beneficiary. A qualifying trust can be the designated beneficiary and distributions must be taken over the life expectancy of the oldest beneficiary. According to the new regulations, separate accounts cannot be used for multiple trust beneficiaries. Beneficiary information for the trust must be provided to the plan administrator or the trustee or custodian of the IRA by October 31 of the year following the year of the participant's death. Rollovers will not be permitted even if the trust provides for the surviving spouse and qualifies for the federal estate tax marital deduction.

SUMMARY

The new rules provide a dramatic tax saving opportunity for participants in qualified retirement plans and IRAs. The IRS clarified many issues practitioners identified as problems in the prior proposed regulations. However, some issues will always arise. Expect to receive further guidance in the form of rulings, notices, or announcements from the IRS. At the very least, plan or IRA documents will need to be amended to adopt the new changes. We expect the IRS to provide a formal announcement with respect to these amendments in the near future.

This letter prepared, with the help of a nationally recognized tax authority, intends to promote interest in more comprehensive tax and estate planning. References are intentionally brief. If a topic interests you, you should investigate it more thoroughly with your qualified tax advisor. Effective tax and estate planning should involve competent advisors in relevant law, accounting, trusts, life insurance and investments. The knowledge and experience of each in their specialties can make the difference between a wealth transfer that works as intended and one that does not. Please seek competent counsel to determine and satisfy your individual needs.

***Positioning our clients
for the future***



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