



Advanced Planning Strategies

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Dear Reader,

There were still considerable differences between the House of Representatives and the Senate concerning tax reconciliation bills at the time this letter went to print in December. It is quite possible that they will reach no compromise before the end of January. Some tax provisions are extremely important to many taxpayers, notably relief from the alternative minimum tax and the extension of some expiring provisions. Extensions have been passed retroactively before, and there is a strong possibility that this could happen again. However, delay in these measures could affect an individual's tax-planning strategies as we enter the new year.

We reported last month about the President's Advisory Panel on Tax Reform. It makes many recommendations but primarily provides two separate plans. First, there is a "Simplified Income Tax Plan." Second is a "Growth and Investment Tax Plan." The plans have many provisions in common such as (1) retaining a progressive tax rate structure, (2) reducing the number of specialized savings plans (health, education, retirement, etc.), currently in 15 separate plans, to three simpler arrangements available to all taxpayers, (3) expanding tax benefits available to nonitemizers, (4) simplifying accounting and capital expenditure expensing rules for businesses, and (5) reducing individual and business tax rates. The Panel discussed a national sales tax and a value-added tax, but generally dismissed these alternatives. The full report can be viewed at www.taxreformpanel.gov.

Thus far, the President has stood firm in the position that the 2001 and 2003 tax cuts should be made permanent. However, there has been little reaction from the White House concerning a complete overhaul of the tax system. Tax is a key issue in developing the budget. But there are clearly important matters that must be considered in conjunction with tax proposals. These include spending on Social Security, Medicare, and Medicaid, which are forecast to grow dramatically as the U.S. population ages.

A significant opportunity in 2006 is the indexed increase in the annual per-donee gift tax exclusion to \$12,000. Some individuals, particularly those who have large estates and are in diminished health, should consider planning to reduce their estates by making gifts early in 2006.

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

ROTH 401(k) PLANS: A NEW EMPLOYEE BENEFIT OPPORTUNITY

As of January 1, 2006, companies can adopt a plan (or amend an existing Sec. 401(k), Sec. 403(b), or other qualified retirement plan) that will allow participants to make 401(k)-type contributions that will be taxed like Roth IRAs. That is, there will be no up-front federal income tax deduction, but the Roth 401(k) accounts will accumulate tax free, and Roth “qualified distributions” (as described below) will be tax free to the recipient.

ADVANTAGES OF ROTH 401(k)s

Along with the Roth taxation rules, Roth 401(k) plans have significant advantages over regular Roth IRAs:

- ? With a Roth 401(k), plan participants can make Roth contributions up to the full annual elective deferral limit of \$15,000 for 2006, plus the additional \$5,000 catch-up for participants who are 50 or over. The regular Roth IRA limit for 2006 is only \$4,000 plus a \$1,000 50-or-over catch-up.
- ? Unlike a Roth IRA, there is no restriction for Roth 401(k)s with respect to eligibility based on an income threshold. Roth IRA contributions are phased out for single taxpayer adjusted gross incomes (AGIs) of \$95,000 to \$110,000, with no Roth IRA contribution permitted for individual AGIs over \$110,000. For married taxpayers, the Roth IRA phaseout limit is \$150,000 to \$160,000 of joint AGI.
- ? In a Roth 401(k) arrangement, the benefits generally associated with employer-sponsored 401(k) plans are available. For example, the plan can feature employer matching contributions. Also, participant investments in employer stock can be made available.

KEY ISSUES WITH REGARD TO DISTRIBUTIONS

There are, however, some other differences between Roth 401(k) contributions and regular Roth IRAs. Most of these reflect the fact that the complex qualified plan rules apply. For example, Roth 401(k) amounts can be distributed only upon the various events that allow for 401(k) distributions in general: retirement, death, disability, severance from employment, attainment of age 59½, plan termination, and hardship. However, a distribution from a Roth 401(k) will be subject to income tax unless it also meets the requirements for a qualified distribution. Qualified distributions require meeting a 5-year holding period and that the distribution is made after age 59½, or upon death or disability. The “first-time home purchase” distribution provision applicable to Roth IRAs does not apply to Roth 401(k) distributions. (However, the home purchase distribution available under the Roth IRA provides only a minimal benefit because lifetime distributions under this option cannot exceed \$10,000.)

Roth 401(k) funds are also subject to the regular minimum distribution rules rather than those applicable to Roth IRAs. That means that distributions from a Roth 401(k) account must begin at age 70½ (or in some cases at retirement, if later). By comparison, minimum distributions from a Roth IRA do not have to begin until the participant’s death. In any case, of course, the distributions are tax free to the recipient. The disadvantage of required minimum distributions is that the tax-free treatment no longer applies to the earnings on the amount distributed when these distributions are reinvested in regular savings or investment accounts.

It appears that the disadvantage of the regular minimum distribution rules for a Roth 401(k) plan

can be avoided by rolling over the Roth 401(k) amount to a Roth IRA. The Roth IRA minimum distribution rules (beginning date at death) would then apply. There are no Code provisions that would appear to prohibit this technique, and the IRS has not issued any guidance at this time. Most practitioners currently believe that this method of avoiding minimum lifetime distributions is permissible.

CONTRIBUTING TO ROTH 401(k) PLANS

Plan participants must elect to have their 401(k) elective deferrals treated as Roth 401(k) amounts. The annual dollar limit on elective deferrals (\$15,000/\$20,000 for 2006) applies to the total of all elective deferrals: Roth plus regular 401(k), 403(b), etc. It is a per-participant limit, not a per-plan limit. Roth 401(k) amounts must be kept in a separate account within the plan, which increases the administrative cost of adopting this feature.

If the employer matches a participant's contributions to the Roth 401(k) account, the employer matching contributions are treated the same as matching contributions to regular 401(k) plans. That is, they are pretax contributions that will be taxable when distributed to the employee or beneficiary. In doing nondiscrimination testing, the amounts contributed to a Roth 401(k) account are subject to the ADP (actual deferral percentage) tests that also apply to regular 401(k) elective deferrals. They are not subject to the ACP or "401(m)" tests that apply to other after-tax contributions.

IMPORTANT DECISIONS

Should a company adopt a Roth 401(k) arrangement? The chief issue is whether the benefit of additional flexibility for participants justifies the additional administrative complexity. Ideally, the administrative cost can be institutionalized and minimized, much as 401(k) administrative costs have evolved.

Should a participant elect Roth 401(k) treatment? The question is similar to evaluating the choice between a regular and Roth IRA. With a Roth contribution, taxes are paid up-front; there is no deduction. A Roth 401(k) contribution provides a better result at retirement (if tax rates remain the same or increase) than a 401(k) contribution if the Roth contribution can be "grossed up" to the full amount permitted (\$15,000/\$20,000) in the case of a Roth 401(k). To do this, the participant must, in effect, save a pretax total of \$15,000/\$20,000 plus the taxes on this amount. If the amount contributed is only the total of \$15,000/\$20,000 less the income tax cost of making the contribution, then the result is not generally as good as a regular deductible 401(k) contribution of \$15,000/\$20,000.

As with Roth IRAs and rollovers of regular IRAs to Roth IRAs, the big obstacle to overcome is that income tax must be paid up-front. If tax rates increase or remain the same, the Roth arrangement will be advantageous. If future taxes go down, the regular 401(k) contribution might be more favorable. This will particularly be true if taxes on investment income are eliminated in the future. Future tax rules are inherently unpredictable, so there is an element of chance in any choice between regular and Roth tax treatment.

RECENT CASES AND RULINGS

DISTRICT COURT APPROVES CHARITABLE DEDUCTION FOR DISTRIBUTION RESULTING FROM TERMINATION SETTLEMENT AGREEMENT

The decedent created a revocable trust that provided her with income and principal while she was alive. At her death, the trust provided four of her nieces and nephews an income interest for life. At each income beneficiary's death, one-fourth of the principal was payable to a qualified charity. After the decedent's death, the attorney recommended that the beneficiaries take action to terminate the trust to avoid some conflicts of interest and potential dissatisfaction with the income interests. The parties agreed to a termination agreement that provided a lump sum actuarial equivalent of a life income interest to each income beneficiary and distributed over \$229,000 to the charity.

The district court (*Jackson v. US*, 96 AFTR 2d 2005 (N.D.W.Va)) allowed the federal estate tax charitable deduction for the amount distributed to charity. The tax law explicitly does not allow the charitable deduction for the remainder interest in a trust that does not qualify as a charitable remainder annuity or unitrust under IRC Sec. 664. However, the court examined the legislative history and concluded that the law was enacted to encourage charitable bequests while preventing abuses of the deduction. Because the charity did receive the funds, the court concluded that such abuse did not occur. This conclusion was somewhat surprising, but the dispute underscores the importance of planning and implementing charitable strategies carefully.

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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