



Advanced Planning Strategies

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Dear Reader,

The legislation to extend expiring tax provisions was introduced in the Senate last month. Senator Baucus hopes to have a completed markup of the bill on the floor of the Senate by the end of this month. The bill (The Alternative Minimum Tax and Extenders Tax Relief Bill of 2008) would extend the alternative minimum tax (AMT) relief, the deduction for state and local sales taxes, the college tuition credits, the research and development credit, and a number of renewable energy credits. The legislation would provide a two-year extension and would be made retroactive for provisions that were not renewed by the end of last year. The cost estimate is approximately \$50 billion and there was no discussion of revenue offsets.

Senator Baucus also indicated that significant reform of the tax system will be deferred until a new President takes office. The thrust of the new legislation will have to begin with how to handle the many provisions of the 2001 and 2003 tax laws that expire soon, many in 2010. It seems that neither party is interested in having the entire package expire, which would cause a return to the tax law as it existed in June 2001. There would be significant immediate tax increases if this occurred. However, some components of the legislation are going to be subject to heated debates and there may be proposals to revamp the structure of certain taxes. For example, there have been hearings about the federal estate tax and alternative proposals that would change the nature of the tax were discussed.

The Congressional Research Service published a report about the asset distribution in taxable estates. One fundamental criticism of the federal estate tax is its impact on family businesses and farms. The report concluded that about 14 percent of the taxable estates' value consisted of family business or farm assets. The distribution varied by sizes of estates. The largest percentage of farm assets was found in estates of \$10 to \$20 million. Estates over \$20 had the largest percentage of assets in closely held businesses; over 17 percent of such estates. Estates over \$10 million represented 7.2 percent of all taxable estates, yet provided 47.8 percent of the total estate tax revenue.

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

TAKING DISTRIBUTIONS FROM QUALIFIED RETIREMENT PLANS AND IRAs

OPPORTUNITIES AND PITFALLS

Decisions concerning retirement are complex and are certainly not all economic. However, many of us will have important economic choices with respect to taking the benefits from our qualified retirement plans and IRAs. The choices involve tax rules that penalize taking too much too early and too little too late. What's more, tax rules will continue to restrict the flexibility for our heirs if we leave benefits from a retirement plan or IRA to them. These rules were made somewhat less complicated by regulations issued a few years ago, but they still retain enough complexity to indicate the need for professional help in planning to take distributions at retirement. This report gives some general guidelines, but it cannot provide every detail that might affect specific planning situations.

THINGS TO KEEP IN MIND ABOUT RETIREMENT PLAN DISTRIBUTIONS

The personal needs of the participant and his or her family will dictate the timing and amount of each distribution from a qualified retirement plan or IRA. However, there are certain legal constraints that also have to be kept in mind when considering a distribution from a plan:

- The terms of the qualified plan or IRA must be examined carefully. Distributions can be taken only according to the terms of the plan or IRA documents.
- The rules provide for minimum required distributions (MRDs) each and every year once a participant attains "the required beginning date" (generally age 70 1/2). A 50 percent excise tax applies for the failure to withdraw the MRD. MRDs are generally required after the participant dies as well.
- A 10 percent penalty tax is generally applicable to distributions prior to age 59 1/2, with certain exceptions.
- 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.

RESTRICTIONS ON EARLY DISTRIBUTIONS

Internal Revenue Code Section 72(t) generally provides that distributions from a qualified plan or IRA are subject to a penalty equal to 10 percent of the amount of the taxable portion of the distribution. Generally, the whole distribution is subject to taxation unless the participant made after-tax contributions or was previously taxed on money in the plan. There are some notable exceptions to the 10 percent penalty. Exceptions that apply to both qualified plans and IRAs include distributions

- made to a beneficiary after the death of the participant
- made after the participant's disability
- as part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the participant or the joint lives (or joint life expectancies) of that participant and a designated beneficiary
- made for the payment of qualified medical expenses

Exceptions that apply only to IRAs include distributions

- made for the qualified higher educational expense of the participant, his or her spouse, a child, or a grandchild
- made for the purchase of a principal residence of a first-time homebuyer (generally limited to a \$10,000 distribution)
- made to pay health insurance premiums for an individual who is collecting unemployment insurance

Finally, distributions from qualified plans made to an employee after separation from service after age 55 and QDRO distributions relating to divorce or child support are exempt from the penalty tax.

DISTRIBUTIONS AT THE REQUIRED BEGINNING DATE

With an IRA, a minimum required distribution must be made for the calendar year in which the participant attains age 70 1/2 and for each subsequent year. The first year's distribution can be delayed until the required beginning date, which is April 1 of the following year, but the distribution for the second year and all subsequent distributions must be made by the end of each calendar year. For a qualified plan, if an individual (who is not a 5% owner) works past 70 1/2, the required beginning date is April 1 following the calendar year of retirement. MRDs are calculated using a uniform distribution table that assumes a payout over the joint life expectancy of the participant and a beneficiary 10 years younger. However, if the beneficiary is the participant's spouse, and the spouse is more than 10 years younger than the participant, the minimum distribution can be based on the actual joint life expectancy of the participant and the younger spouse. The regulations indicate that marital status is determined at the beginning of the year for this purpose.

The life expectancy calculation is recomputed each year, which means that the rules permit a long income tax deferral period for monies in a retirement plan. 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, 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 uniform table, her MRD would be \$37,736. By taking only the MRD each year and receiving a reasonable rate of return on the account, she will have a significant balance for many years to come.

POSTDEATH DISTRIBUTION RULES

The regulations also require distributions after the participant dies for each year over a fixed "applicable distribution period." Again, the heirs will generally be able to take the account balance faster than this minimum required payout. After death, the choice of beneficiary has a significant impact on the remaining distribution period. With a nonspousal beneficiary (who is a person, not an entity), the applicable distribution period is the fixed life expectancy based on the age of the beneficiary at the end of the year following the participant's death. If the spouse is the beneficiary, the spouse is allowed to roll

over the account to the survivor's IRA. If the spouse is not yet age 70 1/2, distributions may stop until that time. When the spouse is 70 1/2, the MRD is calculated using the uniform table just as when the participant was alive. After the spouse dies, the applicable distribution period becomes fixed based on the age of the spouse's beneficiary. For a group of beneficiaries, the payout is based on the life expectancy of the oldest beneficiary unless separate accounts are created for individual beneficiaries. For individual beneficiaries other than a surviving spouse, recent changes to the law provide for rollover of the decedent's account. This does not provide the same advantages as a spousal rollover. That is, the required payout is based on the individual beneficiary's fixed term life expectancy and must begin in the year following the year of the participant's death. Generally, the most unfavorable outcome (i.e., distributions have to be taken faster for income tax purposes) is to have the participant's estate as the designated beneficiary.

Of course, we often recommend marital and family trusts as part of an estate plan. A trust is treated no more favorably than the estate as a beneficiary unless the trust meets certain qualification requirements. The trust must be a valid trust under state law, be irrevocable at the participant's death or earlier, name identifiable beneficiaries, and provide certain information to the plan's administrator. If the trust qualifies, then the applicable distribution period is based on the life expectancy of the oldest beneficiary of the trust. 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. Choosing a trust does mean that a rollover by the surviving spouse will generally not be permitted even if a marital trust provides for the spouse and the trust qualifies for the federal estate tax marital deduction.

For purposes of calculating the length of the remaining distribution period after the death of the participant, the beneficiary does not have to be determined until September 30 of the year following the year of the decedent's death. Because the choice of beneficiary has an impact on the length of the remaining distribution period, it is critical for the participant to select the appropriate beneficiaries and contingent beneficiaries carefully. The participant can change beneficiaries at any time. Choosing appropriate contingent beneficiaries allows for postmortem planning as well. The chosen beneficiary 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.

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. Securities and Investment Advisory Services offered through Capital Analysts Incorporated, Member FINRA/SIPC. AEG and CAI are independent non-affiliated entities.

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