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Adviser's Guide to Tax Planning Strategies for Retirement

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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William R. Bischoff, MBA, CPA

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William R. Bischoff, MBA, CPA

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Chapter 1

The New Retirement-Planning Environment and Data Gathering to Identify and Implement Tax-Smart Strategies

Objectives

After completing this chapter you should be able to

- *Understand the current environment for retirement planning.*
- *Update clients on tax-advantaged retirement-savings options after all of the recent tax law changes.*
- *Collect client data for purposes of identifying and implementing retirement-planning strategies suitable for that particular client.*

Introduction

There is no doubt the economic environment for retirement-age individuals has changed significantly since a generation ago. Here we identify key changes and the implications for retirement-planning professionals and their clients.

Among the most important environmental changes are a host of retirement-savings tax incentives made available by the Economic Growth and Tax Relief Reconciliation Act of 2001 and reduced individual income tax rates thanks to the Jobs and Growth Tax Relief Reconciliation Act of 2003. The changes made by the recent the American Jobs Creation Act of 2004 (AJCA) and the Working Families Tax Relief Act of 2004 (WFTRA) are highlighted in Chapter 9, "Legislative Developments," which summarizes the key points, with special emphasis on expanded opportunities for small-business owners.

Also included in this chapter is a client data-gathering checklist that should prove useful for identifying and implementing retirement-planning strategies (as explained later in Chapters 2 through 8) for each retirement-minded individual on your client list.

The New Retirement-Planning Environment

You have heard the phrase "The more things change, the more they stay the same." While this is often true, we can all probably agree it is definitely *not* true in the context of planning for retirement now versus 25 or 30 years ago. Think about the scenario faced a generation ago by a 45- to 50-year-old individual as he/she contemplated retirement. Compare that to what a 45- to 50-year-old person in similar financial circumstances faces now. Here are the factors that have changed significantly:

- People are retiring at an earlier age. Or at least many people are hoping to do so.
- A generation ago, breadwinners could reasonably expect to continue working for their present employers until age 62-65. Obviously, that is no longer true.
- Many people in "the good old days" were covered by defined-benefit pension plans that guaranteed a certain level of retirement income for the rest of the participant's life. Largely a thing of the past.
- Many retirees could also expect to receive company-subsidized health insurance benefits for the rest of their lives. Also, largely a thing of the past.
- Social Security appeared to be rock solid. Nobody was talking about cutting benefits or increasing the eligibility age. The Social Security tax hit on salaries and self-employment income was almost negligible. Maybe those really *were* the good old days.
- Retirees today are more active. That tends to make living expenses during retirement years that much higher.
- People today can also expect to live longer. According to the National Commission on Retirement Policy, the life expectancy for women is expected to rise to 81.2 years in 2020, up from 79.7 years in 2000 and only 65.7 years in 1940. The life expectancy for men is expected to rise to 75.3 years, up from 73 years in 2000 and only 61.4 years in 1940.

What do these trends mean in the context of planning for retirement? Simply this: The process of becoming financially prepared for retirement is now a completely different ball game than it was 25 or 30 years ago.

First, it is crystal clear that people now must depend more on themselves to finance their retirement-age expenses. Government programs cannot be relied upon as much as in the past. While employer-sponsored qualified retirement plans are probably more prevalent than ever, today's employees usually have to supply most of the contributions to these plans with their own money.

Second, not only do people need to build more of their retirement nest eggs with their own dough, they also need to build *bigger* nest eggs. Why? Because they will probably live longer in retirement and be more active. Greater financial resources will be needed to pay for a satisfactory lifestyle. Unfortunately, the National Commission on Retirement Policy reports that, on average, Americans between 30 and 49 have accumulated only one-third of what they will need to finance their retirement years. Chapter 8 of this book includes a methodology for assessing whether your clients are currently saving enough for retirement. One of your jobs as a retirement-planning professional is to help make sure they are.

The preceding mostly negative message is offset by some really good news in the form of significantly expanded retirement-savings tax incentives, thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001 and significantly lower individual income tax rates thanks to the Jobs and Growth Tax Relief Reconciliation Act of 2003.

One of your other jobs as a retirement-planning professional is to help your clients take advantage of available retirement-oriented tax breaks and tax-avoidance strategies, be they brand new or time-honored. In fact, that is exactly what most of this book is about. So let us get started.

Retirement-Savings Incentives Provided by the Economic Growth and Tax Relief Reconciliation Act of 2001

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) makes life much better for those who want to contribute more to their tax-advantaged retirement accounts. Here is the story in a nutshell.

Higher Contribution Limits for Individual Retirement Accounts (IRAs) and Salary-Reduction Plans

401(k) Deferral Limits

Internal Revenue Code (IRC) Section 402(g) sets a limit on the amount of elective deferrals that may be excluded from gross income by an individual in a single calendar year. This limit is applied on an individual taxpayer basis and applies across multiple employers (if there are multiple employers). Thus, a single taxpayer cannot exceed the annual maximum limit by contributing to two plans with two different employers. The amount deferred is reported on the Form W-2 of the employee.

For 2004, the maximum regular limit that can be deferred under a 401(k) plan is $13,000. This amount increases by $1,000 each year for the next two years so that it is $14,000 in 2005 and $15,000 in 2006.

Catch-Up Contributions

An individual who is at least 50 years old and who participates in a 401(k) plan has an additional amount available that can be deferred. These catch-up contribution rules under IRC Section 414(v) allow an individual to exclude from his or her gross income elective deferrals that exceed the IRC Section 402(g)(1)(A) limit, up to an annual catch-up limit.

For 2004, the additional catch-up contribution allowed is $3,000. That increases by $1,000 in each of the next two years, so that in 2005, the catch-up amount is $4,000 and in 2006 the catch-up amount will climb to its currently scheduled maximum of $5,000. If a participant is over age 50 in 2006, he would be able to get a maximum IRC Section 415 maximum of $41,000 (currently) *plus* an additional $5,000 for the catch-up which brings the overall maximum allocation to $46,000 in 2006.

As Example 1-1 illustrates, the contribution limits for SIMPLE (*Savings Incentive Match Plan for Employees of Small Employers*) IRAs are also increased.

Example 1-1
Increased Contribution Limits for Salary-Reduction Plans and IRAs

If the account owner is under 50 at the end of the tax year, the maximum for salary-reduction plan and IRA contributions for post-2003 years will be as follows:

Tax Year	401(k), 403(b), and 457 plans	SIMPLE IRA	Traditional or Roth IRA*
2004	13,000	9,000	3,000
2005	14,000	10,000	4,000
2006	15,000	10,000**	4,000
2007	15,000**	10,000**	4,000
2008	15,000**	10,000**	5,000**

If the account owner is 50 or older at the end of the tax year, the maximum for salary-reduction plan and IRA contributions, including catch-up contributions, will be as follows:

Tax Year	401(k), 403(b), and 457 plans	SIMPLE IRA	Traditional or Roth IRA*
2004	16,000	10,500	3,500
2005	18,000	12,000	4,500
2006	20,000	12,500**	5,000
2007	20,000**	12,500**	5,000
2008	20,000**	12,500**	6,000**

* If married, each spouse can contribute the listed amounts to his/her own IRA.
** These amounts may be adjusted upward for inflation.

Improvements for Executives and Self-Employed Types

Next up are a slew of favorable changes that mainly benefit high earners, shareholder-employees of closely held corporations, and self-employed individuals (sole proprietors, partners, and LLC members). Here is a quick summary of the most important changes for these folks.

- The maximum deductible contribution dollar amount for a *defined-contribution* plan account is $41,000 for 2004 ($42,000 in 2005). Defined-contribution plans include Keogh profit-sharing plans and corporate profit-sharing plans.

- The maximum deductible contribution percentage for a defined-contribution plan account is now 25% of employee compensation or 20% of self-employment income. For this purpose, compensation or self-employment income up to $205,000 is taken into account for 2004 ($210,000 for 2005).

- Therefore, the maximum 2004 deductible contribution to a defined-contribution plan account is the lesser of (1) $41,000 or (2) 25% of employee compensation or 20% of self-employment income.

- The maximum deductible contribution dollar amount for a *Simplified Employee Pension (SEP) account* is $41,000 for 2004. The SEP contribution limits are now the same as those for defined-contribution plan accounts, thus permitting contributions of up to 25% of compensation or 20% of self-employment income, with a dollar amount maximum of $41,000 ($210,000 for 2005).

- The maximum annual benefit payable from a *defined-benefit* pension plan account is $165,000 for 2004 ($170,000 for 2005). This translates into larger annual deductible contributions to defined-benefit plans.

- Here is the last major change. Sole proprietors, partners, limited liability company (LLC) members, and more-than-2% shareholder-employees of S corporations are allowed to borrow from their qualified retirement plan accounts. In other words, they are now treated the same as "regular" employees and are therefore generally permitted to borrow up to $50,000 or half the vested account balance, whichever is less. However, borrowing against IRA and SEP accounts continues to be prohibited.

"Quick and Dirty" Guide to Small-Business Retirement Plans

Among owners of small- to medium-sized businesses, there is understandable confusion regarding available tax-advantaged retirement plans. In summary fashion, here are the most popular options for these clients after updating for changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001.

The Basics

Tax-advantaged retirement plans available to sole proprietors, LLC members, and partners (including LLP partners) and shareholder-employees of closely held corporations come in two basic flavors. These are (1) defined-contribution plans and (2) defined-benefit pension plans.

With a *defined-contribution plan*, annual deductible contributions can be made to participants' accounts, up to a maximum figure specified by the tax law. The amount accumulated in a specific participant's account by retirement age will depend on (1) how soon contributions commence, (2) the size of the contributions, and (3) the rate of return earned on investments held in the account. When contributions are started at a relatively early age, the maximum allowable amount is contributed each year, and a healthy rate of return is earned, the account could have a huge value by the participant's retirement age. In fact, there is no tax-law limit on how much wealth can be accumulated in a participant's defined-contribution plan account.

With a *defined-benefit pension plan*, annual deductible contributions to a participant's account are determined by actuarial computations. The variables are (1) the participant's remaining years until retirement age, (2) the expected rate of return on the account's investments, (3) the promised level of annual benefits (the "defined benefit") to be paid after retirement, and (4) the participant's current account balance. A defined-benefit plan promises a "target" level of annual benefits, usually based on a percentage of the participant's earnings during the last few years of work. The concept is that the yearly deductible contributions to the participant's account will be just enough to fund the promised level of annual retirement-age withdrawals. If the account earns returns above the expected levels, additional contributions may not be allowed for some years, because the account becomes "overfunded." In contrast, continuing annual contributions can be made to a participant's defined-contribution plan account, no matter how enormous the account becomes.

The key selling point for a defined-benefit pension plan is this: Large annual deductible contributions can be made to a participant's account if he/she does not become covered until relatively late in life. Why? Because in this scenario, there are only a few years left to build up an account balance big enough to deliver the promised level of annual payouts after retirement. Since the promised annual benefit levels can be quite large (assuming the participant has relatively large annual self-employment income or employee compensation), tax law permits pumping in large deductible contributions each year, until the participant's account balance finally catches up with the promised level of benefits.

Key Point. When the small-business owner is age 50 or older, a defined-benefit pension plan is usually the best choice when the objective is to maximize annual deductible contributions to the owner's account. If the owner is younger, a defined-contribution plan usually allows greater annual deductible contributions to the owner's account.

All of the following types of tax-advantaged retirement accounts are potentially available to small-business owners. Except for the defined-benefit pension plan option, they are all essentially defined-contribution arrangements.

Key Point. As explained in the preceding section, the Economic Growth and Tax Relief Reconciliation Act of 2001 substantially increased annual contribution limits for all types of plans discussed in this section. So, small-business owners can now make bigger annual deductible contributions to their retirement plan accounts than before. This is, of course, good news for dedicated retirement savers and their retirement-planning advisers.

Following is summary information about the most common types of small-business retirement plans and the pros and cons for each, including those resulting from changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001.

Simplified Employee Pension (SEP)

The simplified employee pension (SEP) is a stripped-down retirement plan intended for self-employed individuals and small-corporation employers [IRC Sec. 408(k)]. For all practical purposes, an SEP is a defined-contribution plan. However it is not actually labeled as such by the Tax Code.

"Self-employed" means a sole proprietor, a member (owner) of a single-member LLC treated as a sole proprietorship for tax purposes, a member of a multi-member LLC treated as a partnership for tax purposes, or a partner. Annual contributions can be up to 20% of self-employment income [IRC §§ 408(k)(7)(B), 414(s), and 415(c)(3)]. The deduction is reported on the self-employed person's Form 1040. For a sole proprietor or single-member LLC owner, self-employment income for this calculation equals the net profit shown on Schedule C, less the deduction for 50% of self-employment tax on page 1 of Form 1040. For a member of a multi-member LLC or a partner, self-employment income equals the amount reported on the member's or partner's Schedule K-1, less the deduction for 50% of self-employment tax on page 1 of the member's or partner's Form 1040.

For an SEP plan set up for a shareholder-employee of a C or S corporation, the corporation can contribute and deduct up to 25% of the shareholder-employee's salary. The contribution is a tax-free fringe benefit and is therefore excluded from the shareholder-employee's taxable income.

With an SEP plan, there is no requirement to contribute anything for a particular year. So when cash is tight, a small amount can be contributed or nothing at all.

SEP Pros

- If the business owner has a healthy amount of self-employment income or employee compensation, relatively large deductible contributions (potentially up to $41,000 for 2004) can be made to his/her account.

- The business owner has flexibility to contribute less than the tax-law maximum, at his/her discretion.

- For a one-person business, an SEP is extremely simple to set up at a brokerage house or financial institution. The required paperwork (Form 5305-SEP) can be completed in about five minutes (honestly).

- An SEP can be established as late as the extended due date of the return for the year in which the initial deduction is claimed. For example, a sole proprietor who extended his calendar 2004 return to October 15, 2005, has until that date to establish the SEP and make the initial contribution. That initial contribution can then be deducted on the sole proprietor's 2004 Form 1040.

- Once the SEP is established, there are essentially no administrative details to worry about. Therefore, there is generally no need to incur the expense of hiring a professional plan administrator.

SEP Cons

- From the business owner's perspective, there are really no negatives, unless (1) the business has other employees or (2) the owner wishes to contribute more than the maximum allowable amount for an SEP.

- Contributions are generally required for employees who have worked for the plan sponsor during at least three of the past five years. Since all contributions vest immediately, an employee can hit the road at any time without losing any of his/her SEP money [IRC §408(k)(2) and (4)]. For this reason, SEPs are generally not a great idea for businesses with more than a few employees (although there is no tax-law restriction on the number of employees). Contributions on behalf of employees are, of course, deductible.

- As discussed below, some other types of plans may permit contributions well in excess of the maximum amounts allowed for an SEP.

Conclusion Regarding SEPs

Because of their simplicity and flexibility, the author feels SEPs are often the best choice when only one person (the small business owner) will be covered by the tax-advantaged retirement plan.

Defined-Contribution Keogh and Corporate Profit-Sharing Plans

A sole proprietor, single-member LLC owner, member of a multi-member LLC, or partner can participate in a defined-contribution Keogh plan.

A shareholder-employee of a C or S corporation can participate in an equivalent corporate profit-sharing plan, which is really just another type of defined-contribution arrangement.

Annual deductible contributions to a self-employed person's Keogh defined-contribution plan account are limited to 20% of self-employment income, with a maximum dollar limit of $41,000 for 2004.

Annual deductible contributions to a C or S corporation employee's profit-sharing plan account are limited to 25% of the employee's compensation, with a maximum dollar limit of $41,000 for 2004.

The maximum amount need not be contributed to these plans. So when cash is tight, contributions can be minimal or even zero.

Defined-Contribution Plan Pros

- When the business owner has healthy self-employment or compensation income, large annual deductible contributions can be made to his/her account (up to $41,000 for 2004). For example, up to $37,500 could be contributed on behalf of a shareholder-employee with a $150,000 salary (25% × $150,000 = $37,500).

- The business owner has flexibility to contribute less than the tax-law maximum, at his/her discretion.

- Deductible contributions can be made as late as the extended due date of the return for the year in which the plan sponsor claims the deduction. For example, say a single-member LLC owner has set up a defined-contribution Keogh for his/her business. If he extends his 2004 Form 1040 filing to October 15, 2005, he/she has until that date to make a deductible contribution for the 2004 tax year [IRC § 404(a)(6)].

- When the small business has employees, a Keogh or equivalent corporate profit-sharing plan can be set up with vesting provisions that will help prevent short-timers from taking off with the employer money contributed to their accounts [IRC § 411(a)(2)]. In contrast, SEP contributions made for employees become vested immediately, regardless of length of service [IRC § 408(k)(4)].

- **Key Point.** A defined-contribution Keogh plan or equivalent corporate profit-sharing plan must be in legal existence by the end of the tax year for which the initial deduction will be claimed. For example, a plan must be put into effect by December 31, 2004, in order to claim a deduction for the calendar 2004 tax year. This entails adopting a plan document by year-end. In contrast, an SEP can be established as late as the extended due date of the sponsor's tax return.

Defined-Contribution Plan Cons

- A plan document is required. Brokerage houses and financial institutions offer "prototype plans" with "check the box" formats. These may be relatively inexpensive to set up.

- If the plan covers only one person (the business owner), annual reports need not be filed with the government until the account balance reaches $100,000. At that point, Form 5500-EZ must be filed every year. Professional assistance may be required.

- If the business has other employees, they may have to be covered under complicated rules intended to prevent business owners from covering themselves generously without providing adequate benefits for employees. When there are other covered employees, professional assistance is generally required to ensure compliance with applicable IRS and Department of Labor rules.

What About "Paired Plan" Arrangements?

Under the tax rules that applied to 2001 and earlier years, larger deductible contributions to a business owner's account could be made by combining a standard defined-contribution plan (as explained above) with a money-purchase pension plan.

For instance, a solely owned corporation could have set up a defined-contribution corporate profit-sharing plan (calling for pay-ins of up to 15% of the shareholder-employee's compensation) in tandem with a money-purchase pension plan (calling for mandatory pay-ins equal to 10% of compensation). In 2001, this "paired plan" arrangement would have allowed the corporation to make a deductible contribution of up to $35,000 to the shareholder-employee's account. This compares to a 2001 maximum of only $25,500 if the corporation had a standard profit-sharing plan alone. The only problem with the "paired plan" strategy is that contributions to the money purchase pension plan are *mandatory*. They must be made regardless of the plan sponsor's cash situation.

Here is the good news. Now, deductible contributions can be maximized without any need for the "paired plan" arrangement. In other words, a stand-alone defined-contribution plan now allows annual deductible contributions that are just as large as those allowed under the old "paired plan" arrangement. And with a stand-alone defined-contribution plan, pay-ins are always completely discretionary. So the business owner can choose to contribute less than the maximum allowable amount, or even nothing at all, when cash is tight.

Key Point. "Paired plans" are now obsolete because they no longer offer any tax advantage and because they create mandatory contribution obligations. Small-business owners who still maintain "paired plan" arrangements should consider freezing their money-purchase pension plans and amending their defined-contribution plans to permit the larger pay-ins currently allowed.

Conclusion Regarding Defined-Contribution Plans

When the business has no employees (other than the owner), the SEP is often a better choice than a defined-contribution Keogh or corporate profit-sharing plan. This is because SEPs are simpler to set up, administer and maintain.

SIMPLE IRA Plan

A SIMPLE IRA plan — *Savings Incentive Match Plan for Employees of Small Employers* — is an IRA-based plan that allows employees to elect to defer a part of their salaries into the plan for retirement. Because this is a simplified plan, the administrative costs should be lower than for other, more complex plans. Under a SIMPLE IRA plan, employees and employers make contributions to Individual Retirement Arrangements (IRAs) set up for employees, subject to certain percentage-of-pay and dollar limits.

With a SIMPLE IRA plan, you:

- Make either a contribution matching your employees' contributions dollar-for-dollar up to 3% of pay or a 2% nonelective contribution for each eligible employee. (Under the "nonelective" contribution formula, even if an eligible employee doesn't contribute to his or her SIMPLE IRA, that employee must still receive an employer contribution to his or her SIMPLE IRA equal to 2% of his or her salary.)

- Cannot have any other retirement plan.

- Need to complete just a form or two.

SIMPLE IRAs are intended to be for self-employed people and employees of small corporations (including shareholder-employees). [See IRC §408(p).]

To be eligible for a SIMPLE IRA, the plan sponsor must have no more than 100 employees. For this purpose, only employees who earned at least $5,000 during the previous year are considered.

Under a SIMPLE IRA, the business owner can set aside up to $9,000 of her 2004 ($10,000 for 2005) self-employment income or corporate salary in a tax-deferred account. For a shareholder-employee, the company then matches the owner's contribution dollar for dollar, not to exceed 3% of salary. For example, say the shareholder-employee of a solely owned C corporation has a 2004 salary of $75,000. She contributes the $9,000 maximum. The corporation can make a matching deductible contribution of $2,250 (3% × $75,000). If the business owner is instead a sole proprietor or single-member LLC owner with $75,000 of self-employment income, she can make the additional $2,250 matching contribution (3% × 75,000) on her own behalf [IRC §408(p)(8)].

Thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001, the SIMPLE IRA contribution limits for post-2003 years are increased as follows:

- $9,000 for 2004
- $10,000 for 2005 and thereafter

Additional "catch-up" contributions are allowed for participants who are age 50 or older on December 31 of the year in question. Catch-up contributions are limited to the following amounts for post-2003 years:

- $1,500 for 2004
- $2,000 for 2005
- $2,500 for 2006 and thereafter

For example, the maximum 2006 SIMPLE IRA contribution for a participant age 50 or older with $75,000 of compensation or self-employment income will be $14,750 [$10,000 "regular" contribution + $2,500 "catch-up" contribution + $2,250 "matching" contribution (3% × $75,000)].

SIMPLE IRA Pros

- When the business owner has relatively low self-employment income or a relatively modest salary from his/her corporation, the maximum deductible contribution to a SIMPLE IRA may be considerably larger than what would be allowed under the other types of tax-advantaged plans.

For example, say a 55-year-old sole proprietor has $30,000 of self-employment income in 2004. The maximum SIMPLE IRA contribution is $10,900 [$9,000 "regular" contribution + $1000 "catch-up" contribution + $900 "matching" contribution (3% × $30,000)]. In contrast, the maximum deductible pay-in to an SEP account would be only $6,000 (20% × $30,000 = $6,000). The maximum deductible contribution to a defined-contribution Keogh account would also be only $6,000 (20% × $30,000 = $6,000).

- The preceding advantage for SIMPLE IRAs will compound as the SIMPLE IRA contribution maximums continue to increase over the next few years.
- SIMPLE IRAs allow additional catch-up contributions for older individuals. Catch-up contributions are *not* allowed for SEPs, defined-contribution Keogh plans, or corporate profit-sharing plans [other than 401(k) plans].
- Contributions are discretionary, so little or nothing can be contributed when cash is tight.
- A SIMPLE IRA can be established by filling out a fairly easy plan document available at brokerage houses and financial institutions. Annual reports need not be filed with the federal government.

SIMPLE IRA Cons

- A SIMPLE IRA must be set up by October 1 of the tax year for which the initial deductible contribution is desired. However, the contribution itself can be made as late as the extended due date of the plan sponsor's return for that year [IRC §408(p)(6)(C)].
- If there are other employees, contributions may have to be made for them, and those contributions become 100% vested immediately.
- When a SIMPLE IRA has been installed, no other tax-advantaged retirement plan (SEP, defined contribution plan, etc.) can exist.
- Other types of plans allow larger contributions to the accounts of business owners with relatively high levels of compensation or self-employment income.

Conclusion Regarding SIMPLE IRAs

A SIMPLE IRA is much better than nothing. And, as illustrated above, it can be considerably better than the alternatives when the business owner has only a modest amount of compensation or self-employment income. The latter point is especially true when the owner is age 50 or above and is thus eligible to make additional catch-up contributions.

Defined-Benefit Pension Plan

A defined-benefit pension plan is designed to deliver a target level of annual payouts from each participant's retirement account after he/she reaches a stipulated retirement age.

The plan's sponsor is allowed to make annual deductible contributions sufficient to fund the target payouts [IRC §415(b)]. The amount contributed each year must be calculated by an actuary.

Target payouts can be based on,

- A fixed percentage of the participant's average self-employment income or salary over his/her entire career or over a certain number of years near the end of his/her career;

- A flat monthly dollar amount; or

- A formula based on years of service.

A defined-benefit plan cannot deliver target payouts in excess of $165,000 annually for 2004. This limitation is adjusted periodically for inflation.

When the business owner is a sole proprietor, single-member LLC owner, member of a multi-member LLC, or a partner, the defined-benefit arrangement will be in the form of a defined-benefit Keogh pension plan.

When the business owner is a shareholder-employee of a C or S corporation, the defined-benefit arrangement will take the form of a corporate defined-benefit pension plan.

For example, say the defined-benefit plan is intended to deliver payouts equal to 75% of the business owner's average self-employment income or salary income over her final three working years. Assume payouts are to start upon the designated retirement age of 65. If the owner's income will average about $170,000 over the last three years and the plan is up at age 54, the first-year deductible contribution to a defined-benefit Keogh plan would probably be in the $70,000 range (depending on the rate of return assumed on her retirement account investments and certain other factors). As you can see, this is a whopping big number compared to the deductible contribution maximums for all of the other types of tax-advantaged retirement plans discussed earlier in this section.

Now let us say the business owner is 35 years old with the exact same defined-benefit plan as described above. In this case, the first-year deductible contribution will be in the $3,000 range. Peanuts! This is why younger people are usually much better off with a defined-contribution arrangement, such as an SEP, defined-contribution Keogh, or corporate profit-sharing plan.

Defined-Benefit Plan Pro

- A defined-benefit pension plan is "the answer" for business owners who do not start up their retirement plans until late in life. If the owner earns a healthy income, large annual deductible contributions will be allowed until his/her account becomes fully funded.

Defined-Benefit Plan Cons

- Defined-benefit plans are complicated creatures. Generally, a customized plan document is required. Annual actuarial computations are required to determine how much can be contributed each year. These things cost money.

- Once the actuary determines how much should be contributed, pay-ins are mandatory rather than discretionary [See IRC §§ 412 and 4971].

- If there are other employees, they must generally be covered, too. However, the plan can include vesting provisions to help prevent short-timers from taking off with employer contributions.

Conclusion Regarding Defined-Benefit Plans

If the business owner fits the profile, a defined-benefit pension plan is just what the doctor ordered. But the hassle factor is significant. Annual administrative expenses will definitely be incurred. Plus annual contributions are mandatory (until the plan becomes fully funded or overfunded). The business owner should understand exactly what he/she is getting into before establishing a defined-benefit plan.

Solo 401(k) Plan

For owners of one-person business operations, the hot new retirement plan alternative is the *Solo 401(k) Plan.* The advantage: potentially much larger annual deductible contributions to the owner's account.

You may also see the solo 401(k) plan called a "mini-401(k)," a "uni-401(k)," a "one-man 401(k)," and so on. All these terms are meant to describe a 401(k) plan that covers only the business owner and that is therefore exempt from the nasty nondiscrimination and coverage rules that afflict "normal" multi-participant 401(k) plans.

As explained earlier in this chapter, "traditional" one-person defined contribution retirement arrangements (SEPs, Keogh plans, corporate profit-sharing plans, and SIMPLE IRAs) permit annual deductible contributions equal to a percentage of either: (1) the owner's *compensation income* (if the owner is employed by his/her own corporation) or (2) the owner's *self-*

*employment income (*if the business is operated as a sole proprietorship or as a single-member LLC treated as a sole proprietorship for tax purposes).

Specifically, contributions can be up to 25% of corporate salary income or 20% of self-employment income, up to a maximum dollar cap of $41,000 for 2004. [See IRC §§ 402(h)(2), 404(a)(3)(A)(i), 404(h)(1)(C), 408(j), 408(k)(7)(B), 415(c)(1)(A), and 415(c)(3).]

For instance, say the business owner's solely owned corporation pays him/her an $80,000 salary. The maximum deductible contribution by the corporation to a corporate profit-sharing plan set up to benefit the owner would be $20,000 (25% x $80,000).

Now say the business owner operates his/her shop as a sole proprietorship or single-member LLC and earns $80,000 of self-employment income. The maximum deductible contribution to the owner's SEP or Keogh account would be $16,000 (20% x $80,000).

While these are fairly healthy contribution levels, the owner might wish to funnel more (maybe a lot more) into his/her tax-deferred retirement account. Assuming the owner has sufficient cash to do so, that would be a great idea. Bigger deductible contributions reduce the owner's annual tax bills and generate more tax-deferred earnings for his/her retirement nest egg as well.

Enter the solo 401(k) plan. Thanks to favorable changes included in the Economic Growth and Tax Relief Reconciliation Act of 2001, the solo 401(k) is ideal for the one-person small business operator whose objective is to max out on deductible pay-ins into his/her tax-deferred retirement account. With a solo 401(k), annual deductible contributions to the owner's account are composed of two different parts.

Here is the first part: for 2004, up to $13,000 of the owner's corporate salary or self-employment income can be contributed to his/her account, or $16,000 if he/she will be 50 or older at year-end. [The $16,000 figure includes the extra $3,000 "catch-up" contribution allowed to older 401(k) plan participants.] This first part is considered to be an *elective deferral contribution* made by the owner. [See IRC §§ 402(g), 414(v), and 415(c)(1).]

In the case of a corporate solo 401(k) plan, the elective deferral contribution is funded with salary reduction amounts withheld from the owner's paychecks and contributed to the owner's account.

In the case of a solo 401(k) set up for a sole proprietorship or single-member LLC, the owner simply pays the elective deferral contribution amount into his/her account.

For 2005 and 2006, the elective deferral contribution limit is scheduled to increase each year, as shown below.

Year	Under 50	50 and Older
2005	$14,000	$18,000 (with $4,000 catch-up contribution)
2006	$15,000	$20,000 (with $5,000 catch-up contribution)

Here is the second part: on top of the elective deferral contribution, the solo 401(k) arrangement permits an additional contribution of up to 25% of the owner's corporate salary, or 20% of the owner's self-employment income. For this purpose, self-employment income is defined as the owner's Schedule C, E, or F net income reduced by the above-the-line deduction for 50% of self-employment tax. [See IRC §§ 401(c)(2), 404(a)(8)(B) and (D), 408(k)(7)(B), and 408(p)(6)(A)(ii).]

This second pay-in is considered to be an *employer contribution.* For purposes of calculating the employer contribution, the owner's compensation or self-employment income is *not* reduced by his/her elective deferral contribution [IRC §404(n)].

With a corporate plan, the corporation makes the employer contribution on the owner's behalf. With a plan set up for a sole proprietorship or single-member LLC, the owner is treated as his/her own employer [IRC §402(i)]. Therefore, the owner makes the employer contribution on his/her own behalf.

To see how the elective deferral and employer contributions add up to maximum tax-saving results, consider the situations depicted in Examples 1-2 and 1-3.

Example 1-2

Lisa, age 40, is the only employee of her corporation (it makes no difference if it's an S or C). In 2004, the corporation pays Lisa an $80,000 salary. The maximum deductible contribution to a solo 401(k) plan set up for Lisa's benefit is $33,000. That amount is composed of: (1) Lisa's $13,000 *elective deferral contribution*, which reduces her taxable salary to $67,000, plus (2) a $20,000 *employer contribution* made by her corporation (25% x $80,000), which has no effect on her taxable salary. The $33,000 amount is well above the $20,000 contribution maximum that would apply to a traditional corporate defined contribution plan (25% x $80,000). The $13,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Variation: Now assume Lisa will be age 50 or older as of December 31, 2004. In this variation, the maximum 2004 contribution to Lisa's solo 401(k) account is $36,000 [$16,000 *elective deferral contribution* plus $20,000 *employer contribution* (25% x $80,000)]. Again, that is much more than the $20,000 contribution maximum that would apply to a traditional corporate defined contribution plan (25% x $80,000). The $16,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Example 1-3

Assume Lisa, age 40, operates her business as a sole proprietorship (or as a single-member LLC treated as a sole proprietorship for federal income tax purposes). In 2004, Lisa has self-employment income of $80,000 (after deducting 50% of her self-employment tax bill). The maximum deductible contribution to a solo 401(k) plan set up for Lisa's benefit is $29,000. That amount is composed of: (1) a $13,000 *elective deferral contribution* plus (2) a $16,000 *employer contribution* (20% x $80,000). The $29,000 amount is well above the $16,000 contribution maximum that would apply to a traditional self-employed plan set up for Lisa's benefit (20% x $80,000). The $13,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Variation: Now assume Lisa will be age 50 or older as of December 31, 2004. In this variation, the maximum 2004 contribution to Lisa's solo 401(k) account is $32,000 [$16,000 *elective deferral contribution* plus $16,000 *employer contribution* (20% x $80,000)]. Again, that's much more than the $16,000 contribution maximum that would apply to a traditional self-employed defined contribution plan (20% x $80,000). The $16,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

For 2005 and beyond, the solo 401(k) contribution limits will be even higher, because the elective deferral contribution maximums are scheduled to increase each year through 2006 (see the table on page 1-17).

That means the solo 401(k)'s advantage over traditional defined contribution plans will continue to grow, as the elective deferral contribution maximums continue to increase. However, this assumes the owner does not have "too much" compensation or self-employment income (more on that later).

The solo 401(k) advantage is even greater if the owner is 50 or older, because he/she is allowed to make additional "catch-up" elective deferral contributions ($3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and beyond). See Examples 1-4 and 1-5 below.

Example 1-4

Lisa, age 40, is the only employee of her corporation (it makes no difference if it's an S or C). In 2006, the corporation pays Lisa a salary of $80,000. The maximum contribution to a solo 401(k) is $35,000. That amount is composed of: (1) Lisa's $15,000 *elective deferral contribution*, which reduces her taxable salary to $65,000, plus (2) a $20,000 *employer contribution* made by her corporation (25% x $80,000), which has no effect on her taxable salary. The $35,000 amount is far above the $20,000 contribution maximum that would apply to a traditional corporate defined contribution plan (25% x $80,000). The $15,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Variation: Now assume Lisa will be age 50 or older as of December 31, 2006. In this variation, the maximum 2006 contribution to Lisa's solo 401(k) account is $40,000 [$20,000 *elective deferral contribution* plus $20,000 *employer contribution* (25% x $80,000)]. That is a much larger amount than the $20,000 contribution maximum that would apply to a traditional corporate defined contribution plan (25% x $80,000). The $20,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Example 1-5

Assume Lisa, age 40, operates her business as a sole proprietorship or as a single-member LLC treated as a sole proprietorship for federal income tax purposes. In 2006, Lisa has self-employment income of $80,000 (after deducting 50% of her self-employment tax bill). The maximum deductible contribution to a solo 401(k) is $31,000. That amount is composed of: (1) a $15,000 *elective deferral contribution* plus (2) a $16,000 *employer contribution* (20% x $80,000). The $31,000 amount is far above the $16,000 contribution maximum that would apply to a traditional self-employed plan (20% x $80,000). The $15,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Variation: Now assume Lisa will be age 50 or older as of December 31, 2006. In this variation, the maximum 2006 contribution to Lisa's solo 401(k) account is $36,000 [$20,000 *elective deferral contribution* plus $16,000 *employer contribution* (20% x $80,000)]. That is far more than the $16,000 contribution maximum that would apply to a traditional self-employed defined contribution plan (20% x $80,000). The $20,000 difference is due to the solo 401(k)'s elective deferral contribution privilege.

Solo 401(k)'s Advantage Shrinks At High Income Levels

Say the business owner makes more than the $80,000 illustrated in all the preceding examples. Even larger amounts can be contributed to his/her solo 401(k) account, up to the applicable dollar cap.

- When the owner is under age 50, the solo 401(k) dollar cap on combined elective deferral and employer contributions is $41,000 for 2004 [IRC §415(c)(1)(A)]. In no event, however, can combined contributions exceed 100% of the owner's corporate salary or self-employment income.

- When the owner is 50 or older, the solo 401(k) dollar cap depends on the year. It is $44,000 for 2004, $45,000 for 2005, and $46,000 for 2006 and beyond. [See IRC §§ 402(g)(1), 414(v) and 415(c)(1)(A).] In no event, however, can combined contributions exceed 100% of the owner's corporate salary or self-employment income.

- Traditional defined contribution plans are subject to a flat $41,000 cap, regardless of the owner's age [IRC §415(c)(1)(A)].

Examples 1-6 through 1-9 below illustrate the impact of the dollar cap.

Example 1-6

Zelda is 45 years old and operates her business as a sole proprietorship (or as a single-member LLC treated as a sole proprietorship for tax purposes). In 2004, she has $150,000 of self-employment income (after deducting 50% of her self-employment tax bill). She can contribute up to $41,000 to a solo 401(k) plan. The $41,000 amount is composed of: (1) a $13,000 *elective deferral contribution* plus (2) a $28,000 *employer contribution* (20% x $150,000 = $30,000, reduced to $28,000 to comply with the $41,000 cap). Compare the $41,000 amount to the $30,000 maximum allowable contribution to a traditional self-employed defined contribution plan (20% x $150,000). Under the facts in this example, the solo 401(k) delivers a solid $11,000 advantage.

Example 1-7

Now assume Zelda's 2004 self-employment income is $205,000 (after deducting 50% of her self-employment tax bill). She can contribute up to $41,000 to a solo 401(k) plan. The $41,000 amount is composed of: (1) a $13,000 *elective deferral contribution* plus (2) a $28,000 *employer contribution* (20% x $205,000 = $41,000, reduced to $28,000 to comply with the $41,000 cap). Zelda could contribute the same $41,000 to a traditional self-employed defined contribution plan (20% x $205,000). Under the facts in this example, the solo 401(k) does not allow larger contributions. Here, a SEP may be a better choice than a solo 401(k), because a SEP is easier and cheaper to operate.

Example 1-8

In this example, assume Zelda is 50 or older with 2004 self-employment income of $205,000 (after deducting 50% of her self-employment tax bill). She can contribute up to $44,000 to a solo 401(k) plan. The $44,000 amount is composed of: (1) a $16,000 *elective deferral contribution* plus (2) a $28,000 *employer contribution* (20% x $205,000 = $41,000, reduced to $28,000 to comply with the $44,000 cap for someone Zelda's age). Zelda could contribute only $41,000 to a traditional self-employed defined contribution plan (20% x $205,000). In this case, the solo 401(k) offers a $3,000 advantage, thanks to the "catch-up" elective deferral contribution privilege. If Zelda's income stays at $205,000 or above, the solo 401(k)'s annual advantage will grow to $5,000 in 2006, thanks to the increased limit on "catch-up" elective deferral contributions. However, the solo 401(k) will be more difficult and expensive to operate than a traditional SEP.

Example 1-9

Lyle, age 40, is the only employee of his corporation. In 2004, the corporation pays Lyle a salary of $164,000. The maximum deductible contribution to a solo 401(k) plan is $41,000. The $41,000 amount is composed of: (1) Lyle's $13,000 *elective deferral contribution,* which reduces his taxable salary to $151,000, plus (2) a $28,000 *employer contribution* by his corporation (25% x $164,000 = $41,000, reduced to $28,000 to comply with the $41,000 cap), which has no effect on his taxable salary. The same $41,000 contribution maximum would apply to a traditional corporate defined contribution plan (25% x $164,000). As you can see, the solo 401(k) offers no advantage in this situation. Here, a SEP may be a better choice than a solo 401(k), because a SEP is easier and cheaper to operate.

Variation. Now assume Lyle will be age 50 or older as of December 31, 2004. In this variation, the maximum 2004 contribution to a solo 401(k) plan is $44,000 [$16,000 *elective deferral contribution* plus $28,000 *employer contribution* (25% x $164,000 = $41,000, reduced to $28,000 to comply with the $44,000 cap). Only $41,000 could be contributed to a traditional corporate defined contribution plan (25% x $164,000). Under these facts, the solo 401(k) offers a $3,000 advantage, thanks to the "catch-up" elective deferral contribution privilege. If Lyle's compensation stays at $164,000 or above, the solo 401(k)'s annual advantage will grow to $5,000 in 2006, thanks to the increased limit on "catch-up" elective deferral contributions. However, the solo 401(k) will be more difficult and expensive to operate.

The impact of the dollar caps can be summarized as follows.

- When the business owner is under 50 and operates as a sole proprietorship or single-member LLC, the $41,000 cap causes the solo 401(k)'s 2004 advantage over traditional self-employed defined contribution plans to shrink and eventually disappear between self-employment income of $140,000 and $205,000. (See Examples 1-6, 1-7, and 1-8 above.)

- When the business owner is employed by his own corporation, the $41,000 cap causes the solo 401(k)'s 2004 advantage over traditional corporate defined contribution plans to shrink and eventually disappear between salary income of $112,000 and $164,000. (See Example 1-9 above.)

- For years when the owner is 50 or older, the solo 401(k) will always permit larger annual deductible contributions than a traditional defined contribution plan. This is because the solo 401(k)'s dollar cap is increased by the additional "catch-up" elective deferral contribution amount. As a result, the solo 401(k) dollar cap for those age 50 and older is $44,000 for 2004, $45,000 for 2005, and $46,000 for 2006 and beyond. (See Example 1-8 and the variation to Example 1-9.)

Key Point. For 2004, a solo 401(k) will have the maximum advantage over a traditional defined contribution plan when the business owner has self-employment income under $140,000 or salary income under $112,000. For 2005, the thresholds will be $135,000 and $108,000, respectively. For 2006 and beyond, the thresholds will be $130,000 and $104,000, respectively. If the owner expects his annual income in future years to be substantial but still beneath the applicable threshold for those years, the solo 401(k) is an unbeatable tax-saving strategy. (The thresholds change every year between 2004 and 2006 in response to annual changes in the 401(k) elective contribution maximums.)

Solo 401(k) Mechanics

Five basic steps are required to set up and operate a solo 401(k) plan.

Step One —

If the owner has an existing retirement plan, it should be discontinued before establishing the new solo 401(k). A competent retirement plan professional should be consulted about exactly how to close down the existing plan.

Step Two —

The new solo 401(k) must be established by the end of the tax year for which the initial deductible contributions will be made [IRC §404(a)(3)(A)(i)]. However, for a valid elective deferral contribution to be made for that year, the plan must exist *before* the related self-employment income or compensation is deemed to have been earned.

- For a calendar-year sole proprietorship or single-member LLC, this apparently means the plan must be established by no later than December 30 of the year in question, because self-employment income is apparently deemed to be earned on December 31. [This conclusion is by analogy to the timing rule for partners found in Reg. 1.401(k)-1(a)(6)(ii)(B).]

- A corporate plan must be established before the salary that will be used to fund the elective deferral contribution has been earned.

Step Three —

The owner must make a written election to designate the amount of his elective deferral contribution for the year *before* the related self-employment income or compensation income is earned.

- For a calendar-year sole proprietorship or single-member LLC, the election must be made by no later than December 30 of the year in question, because self-employment income is apparently deemed to be earned on December 31. [This conclusion is by analogy to the timing rule for partners found in Reg. 1.401(k)-1(a)(6)(ii)(B).]

- For a corporate plan, the election must be made before the salary to be contributed via the elective deferral has been earned.

Step Four —

The elective deferral contribution for the year must be deposited via one or more pay-ins to the owner's solo 401(k) account.

- For a sole proprietorship or single-member LLC, the deadline for making the elective deferral contribution is apparently as soon as is reasonably possible after the related self-employment income has been earned. Since with a calendar-year business self-employment income is apparently deemed to be earned on December 31, the elective deferral contribution should therefore be deposited into the owner's solo 401(k) account in early January of the following year.

- For a corporate plan, the elective deferral pay-in (or pay-ins) must be withheld from the owner's salary and contributed to his solo 401(k) account as soon as is reasonably possible — but in no event more than 15 business days after withholding occurs [DOL Reg. 2510.3-102(b)].

Step Five —

Finally, the employer contribution for the year must be made.

- For a sole proprietorship or single-member LLC, the employer contribution can be made as late as the extended due date of the owner's Form 1040 for that year [IRC §404(a)(6)].

- For a corporate plan, the employer contribution can be made as late as the extended due date of the sponsoring corporation's Form 1120 or Form 1120S for that year [IRC §404(a)(6)].

Solo 401(k) Pros

For one-person business owners who hate to leave any tax break on the table, the solo 401(k) is a sweet deal. Many owners will be able to make much larger annual deductible contributions to solo 401(k)s than to traditional defined contribution plans (SEPs, Keoghs, profit-sharing plans, and SIMPLE IRAs). Also, the solo 401(k) alternative does *not* require uncomfortably large contributions for years when cash is tight. The owner can always decide to contribute less than the tax-law maximum or even nothing at all. In other words, the solo 401(k) facilitates major tax savings in the good years, when maximum deductible contributions can be made, while permitting lower contributions in the lean years, when conserving cash is the highest priority.

The owner can also borrow from his solo 401(k) account (assuming the plan document so permits, which should be insisted upon). The maximum loan amount is 50% of the account balance or $50,000, whichever is less. In contrast, one cannot borrow from a SEP account or SIMPLE IRA. These accounts are treated as IRAs, and borrowing from an IRA is prohibited. [See IRC §§ 408(e)(2), 4975(c)(1)(B) and (d)(1), and 4975(f)(6)(B).]

Solo 401(k) Cons

Unlike a SEP, a solo 401(k) is definitely *not* something the owner should attempt to establish and operate without assistance. Up-front paperwork and some ongoing administrative effort is required, including adopting a written plan document and arranging for how and when elective deferral contributions will be collected and paid into the owner's account. Fortunately, a number of outfits are gearing up to handle the expected rush into solo 401(k)s. For example, several brokerage firms — including Fidelity, Pioneer, Principal, and Salomon Smith Barney — will handle all the details at a fairly reasonable cost. There is little doubt that many more firms will join the party before long.

If the business employs anyone other than the owner, the tax rules may require 401(k) contributions for those employees. If so, we obviously do not have a solo 401(k) anymore. Instead, we have a "garden variety" multi-participant 401(k) with all the resulting complications. However, employees who are under 21 and employees who have not worked at least 1,000 hours during any 12-month period can be excluded from 401(k) plan coverage [IRC §410(a)(1)(A) and (a)(3)(A)]. The owner can take advantage of this exclusion rule to employ youngsters and part-time workers while effectively operating a solo 401(k) that benefits only the owner.

The elective deferral contribution maximum ($13,000 for 2004, or $16,000 for those 50 and older) applies *globally* to all 401(k), 403(b), and SIMPLE IRA plans in which an individual participates [IRC §402(g)(3)]. For example, this means if the business owner makes an elective deferral contribution to a 401(k) plan at his/her "regular" job, it reduces the elective deferral contribution maximum to a solo 401(k) set up for his/her side business. When this consideration curtails elective deferral contributions to the solo 401(k), the whole idea has less appeal. Say that in 2004 Joe makes a $7,500 elective deferral contribution to the 401(k) plan at his regular job. The maximum 2004 elective deferral contribution to a solo 401(k) set up for Joe's side business would be $5,500 ($13,000 global maximum minus $7,500). If Joe is 50 or older, the maximum elective deferral contribution to his solo 401(k) would be $8,500 ($16,000 global maximum minus $7,500).

Contributions to a solo 401(k) set up for a sole proprietorship or single-member LLC are *not* deductible in calculating the owner's self-employment tax liability. However, the same is also true for contributions to traditional self-employed retirement plans. [See *Seymour Gale v. U.S.*, 91-2 USTC 50356 (DC IL 1991).]

With a corporate solo 401(k), FICA tax will be owed on the owner's elective deferral contributions, because they are considered additional salary for FICA tax purposes. However, the elective deferral contributions will still reduce the owner's salary for income tax purposes and thereby lower his income tax bill. (Employer contributions made by the corporation are exempt from the FICA tax.) [See IRC §3121(v)(1)(A) and §3121(a)(5)(A), respectively.]

Once the solo 401(k) account balance exceeds $100,000, Form 5500-EZ (Annual Return of One-Participant Retirement Plan) must be filed annually. In contrast, SEPs and SIMPLE IRAs are exempt from any such filing requirement.

Conclusion Regarding Solo 401(k) Plans

For a one-person business, the solo 401(k) is generally the best retirement plan choice if

- The owner wants to contribute as much as the tax law allows to a tax-deferred retirement account, *and*
- The owner has substantial compensation or self-employment income, but not so much that he is adversely affected by the dollar caps that apply to solo 401(k) contributions, *and*
- The owner is not already making elective deferral contributions to another 401(k) plan, or 403(b) plan, or SIMPLE IRA plan at his/her regular job.

Key Point. As explained above, the solo 401(k) offers owners age 50 and older an extra advantage in the form of additional "catch-up" elective deferral contributions. However, owners in this age category should also evaluate (see "Solo 401(k) Evaluation Questions" below) whether a defined benefit pension plan might be a better choice than a solo 401(k). See the earlier discussion of defined benefit pension plans as well.

Solo 401(k) Evaluation Questions			
		Yes	**No**
1.	Have you determined which type of 401(k) plan best suits your business?		
2.	Have you decided whether to make contributions to the plan, and, if so, whether to make nonelective and/or matching contributions? (Remember, you can/may design your plan so that you may change your rate of contributions if necessary due to business conditions.)		
3.	Have you decided to hire a financial institution or retirement plan professional to help with setting up and running the plan?		
4.	Have you adopted a written plan that includes the features you want to offer, such as whether participants will direct the investment of their accounts?		

(continued)

Solo 401(k) Evaluation Questions *(continued)*			
		Yes	**No**
5.	Have you notified eligible employees and provided them with information to help in their decision making?		
6.	Have you arranged a trust fund for the plan assets or will you set up the plan solely with insurance contracts?		
7.	Have you developed a record keeping system?		
8.	Are you familiar with the fiduciary responsibilities?		
9.	Are you prepared to monitor the plan's service providers?		
10.	Are you familiar with the reporting and disclosure requirements of a 401(k) plan?		

The following checklist presents guidelines and sample questions regarding the client data that should be collected in order to identify and implement suitable retirement-planning strategies, as covered in Chapters 2-8 of this book.

Checklist: Gathering Client Data to Identify and Implement Retirement-Planning Strategies

This data-gathering checklist presents guidelines and sample questions regarding the client data that should be collected in order to identify and implement suitable retirement-planning strategies, as covered in Chapters 2-8 of this book. This checklist can be used by advisers to identify and implement suitable retirement-planning strategies for their retirement-oriented clients.

A. Chapter 2 "Allocating Investments to Retirement-Savings Accounts and Answering the Roth IRA Conversion Question"

Data-Gathering Objectives

1. Obtain information about how the client wants to allocate his/her retirement-savings dollars, what types of retirement-savings accounts the client has (Roth IRA, tax-deferred, or taxable), and how much money is in each type of account.

   Reason. To advise the client on which types of investment assets are best suited for each type of account.

2. Determine the client's modified adjusted gross income (AGI).

   Reason. The client is ineligible for Roth IRA conversions in years when modified AGI exceeds $100,000. (The client is completely ineligible in years when "married filing separately" status is used.)

3. If the client is eligible for and interested in a Roth IRA conversion transaction, determine how much money is in the client's traditional IRA and/or SEP accounts.

   Reason. Converting all of the client's traditional IRA and/or SEP balances to Roth status in one year may be inadvisable, because that would trigger too much taxable income. This could push the client into a significantly higher tax bracket and have other detrimental tax effects under various AGI-based phase-out rules.

See Chapter 2 for full details.

B. Chapter 3 "Planning for Employer Stock held in Qualified Retirement Plan Accounts"

Data-Gathering Objectives

1. If the client will receive (or has very recently received) a lump-sum distribution that includes shares of employer stock, determine the cost basis and current market value of the shares.

   Reason. It may be inadvisable to roll over the company shares into an IRA. Instead, the client may be better off leaving the shares in a taxable account and paying the resulting tax hit.

See Chapter 3 for full details.

C. Chapter 4 "Planning for Early Retirees and Early Retirement Account Withdrawals"

Data-Gathering Objectives

1. If the client intends to retire before age 59½ (or has already done so very recently), determine how much of any money distributed from company qualified retirement plan accounts should be rolled over tax-free into an IRA. This will entail assessing the client's income and expenses through age 59½.

   Reason. The IRA rollover option is generally advisable for all such distributions, unless the client will need some of the money before age 59½. In that case, planning may be needed to avoid the 10% premature-withdrawal penalty tax.

2. For qualified retirement plan distribution amounts the client intends to roll over into an IRA, determine if the client has arranged for a "direct" or "trustee-to-trustee" transfer.

   Reason. To avoid automatic 20% federal income tax withholding.

3. If the self-employed client needs to withdraw money from his/her Keogh or SEP account before age 59½, determine if the client can take advantage of various exceptions to the 10% penalty tax.

   Reason. To avoid the 10% premature-withdrawal penalty tax.

4. If the client thinks he/she needs to withdraw money from tax-advantaged retirement accounts before age 59½, determine if the client can instead utilize various other tax-smart ways to increase cash flow.

   Reason. To avoid the 10% premature-withdrawal penalty tax and avoid depleting tax-advantaged retirement accounts (thereby forever diminishing their tax-saving powers) for as long as possible.

See Chapter 4 for full details.

D. Chapter 5 "Planning for Divorcing Clients"

Data-Gathering Objectives

1. Determine if the divorcing client will, pursuant to the divorce property settlement, be transferring or receiving retirement-savings investments held in taxable accounts.

   Reason. If the client will transfer such investments, any built-in tax liability on appreciated "capital gain" assets will generally be transferred to the other party. However, the client will be taxed on any accrued ordinary income inherent in investments he/she owns that are transferred to the other party. If the client will receive appreciated "capital gain" assets, he/she will generally be responsible for any taxes when the investments are ultimately sold.

2. Determine if any post-divorce transfers of investments held in taxable accounts are contemplated.

   Reason. Unexpected tax results may occur without proper planning.

3. Determine if the divorcing client will, pursuant to the divorce property settlement, be transferring or receiving money in qualified retirement plan accounts.

   Reason. Unexpected (and often unfair) tax results may occur, unless QDRO language is included in the divorce papers.

4. Determine if the divorcing client will, pursuant to the divorce property settlement, be transferring or receiving money in IRAs or SEP accounts.

   Reason. Unexpected (and often unfair) tax results may occur without proper planning.

See Chapter 5 for full details.

E. Chapter 6 "Planning for Older Clients"

Data-Gathering Objectives

1. Obtain current balances for client's retirement-savings accounts (both taxable and tax-advantaged, if applicable) and current asset allocation information for these accounts [i.e., percentages of each account invested in (1) cash equivalents, (2) bonds and bond funds, and (3) stocks and stock funds].

   Reason. To assess the client's current asset allocation and determine if it should be changed (for example, to allocate more or less to stocks and equity mutual funds).

2. Obtain copies of beneficiary designations for the client's tax-advantaged retirement accounts. Do not take the client's word for it regarding such designations. The client's memory may be faulty or the intended designations may have been screwed up or lost by the retirement account administrator or IRA trustee.

   Reason. Properly completed beneficiary designation forms should be on file to make sure money in these accounts will go to whom the client intends after the client's death.

3. Determine if the client intends multiple beneficiaries for money in his/her IRAs.

   Reason. The client should consider setting up separate IRAs for each intended beneficiary.

4. If the client is approaching age 70½, obtain qualified retirement account and traditional IRA account balances.

   Reason. To prepare for upcoming required minimum distributions. If the client has large account balances, the required payouts could substantially increase his/her tax bill, unless offsetting tax-planning moves are taken.

5. If the client has already turned 70½, determine if he/she has already taken the initial required minimum distribution from his/her traditional IRA(s).

   Reason. To avoid the 50% penalty when required minimum distributions are not taken on time. Also, the client may be better off taking the initial required distribution in the year to which it relates rather than in the following year.

6. If the client has already turned 70½, determine if required minimum distributions are being properly calculated and withdrawn on time.

Reason. To avoid the 50% penalty when required minimum distributions are not taken on time. New rules applicable to 2002 and later years generally allow smaller required minimum distributions compared to prior rules.

7. Determine if the client is eligible for favorable tax treatment of qualified retirement plan lump-sum distributions.

   Reason. The client may decide to pay tax on the entire lump-sum distribution (under favorable special rules) rather than roll the money over into an IRA.

8. If the client is approaching retirement, determine if he/she intends to roll over some or all of his/her qualified retirement account distributions into an IRA.

   Reason. To avoid automatic 20% federal income tax withholding. Also, if the client is over age 55 but under age 59½, he/she may decide to *not* roll over all of the money in order to avoid the 10% premature-withdrawal penalty tax.

9. Determine if the client has a bypass trust arrangement set up via his/her will or living trust document.

   Reason. Tax-advantaged retirement accounts are lousy assets for funding bypass trusts. If possible, more appropriate assets should be used for this purpose.

10. Determine if the client is eligible for and interested in making a Roth IRA conversion for estate-planning reasons.

    Reason. The client can reduce the value of taxable estate while effectively setting up income-tax-free annuity for heirs.

See Chapter 6 for full details.

F. Chapter 7 "Planning for Inherited Accounts"

Data-Gathering Objectives

1. Determine if required minimum distributions from inherited tax-advantaged retirement accounts are being properly calculated and withdrawn on time.

   Reason. To avoid the 50% penalty when required minimum distributions are not taken on time. In most cases, the new rules in effect for 2002 and later years allow reduced minimum distributions compared to the prior rules.

2. If the client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, determine if the client should treat the account as his/her own account.

   Reason. For minimum required distribution purposes, this is generally advisable. An exception is when the surviving spouse is under age 59½ and needs to withdraw money from the inherited account.

3. If the client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, determine if the client wants to disclaim the account in favor of other account beneficiaries.

   Reason. The other beneficiaries will generally receive better treatment under the required minimum distribution rules when the account is disclaimed by December 31 of the year following the year the deceased spouse dies.

4. If the client is a non-spouse who has inherited a tax-advantaged retirement account, determine if required minimum distributions are being properly calculated and withdrawn on time.

   Reason. To avoid the 50% penalty when required minimum distributions are not taken on time. A decision regarding when and how to liquidate the account should be made by December 31 of the year following the year the original account owner dies.

5. If the client is one of several designated beneficiaries of an inherited tax-advantaged retirement account, determine if required minimum distributions are being properly calculated and withdrawn on time.

   Reason. To avoid the 50% penalty when required minimum distributions are not taken on time. A decision regarding when and how to liquidate the account should be made by December 31 of the year following the year the original account owner dies.

6. Determine if the client has inherited investments held by the deceased in taxable retirement-savings accounts.

   Reason. Special tax rules apply to such assets.

See Chapter 7 for full details.

G. Chapter 8 "Pulling It All Together and Making Specific Client Recommendations"

Data-Gathering Objectives

1. Determine if the client is saving enough for retirement.

   Reason. If not, steps should be taken to increase retirement savings, especially in the form of contributions to tax-advantaged retirement accounts.

See Chapter 8 for full details.

Summary

The retirement-planning environment has changed significantly in the last generation. These days, your clients cannot depend on as much retirement-financing help from employers and the government. Also, your clients are likely to live longer and be more active in retirement.

These trends mean your clients must accumulate more money before retirement and manage it better during retirement. Fortunately, recent legislation has provided valuable tax incentives that should make it easier for many clients to accumulate more wealth in their tax-advantaged retirement accounts. These changes are covered here, along with updated information on tax-advantaged retirement plans available to small-business owners.

The data-gathering checklist can be used to identify and implement suitable retirement-planning strategies (as explained later in Chapters 2-8) for each retirement-oriented client on your roster.

Chapter 2

Allocating Investments to Retirement-Savings Accounts and Answering the Roth IRA Conversion Question

Objectives

After completing this chapter you should be able to

- *Advise clients on which types of investments are best suited for which types of retirement-savings accounts.*
- *Understand when converting a traditional IRA into a Roth IRA is a good idea and when it is not such a good idea.*

Introduction

Many clients will have retirement-savings dollars stashed in three different types of accounts: (1) tax-deferred retirement accounts, (2) taxable investment accounts, and (3) tax-free Roth IRA accounts. That being the case, which types of assets are best suited for each of these three types of accounts? For example, should the client load up his/her tax-deferred retirement accounts with "ordinary-income investments" or with stocks and equity mutual funds that are expected to deliver long-term capital gains and qualified dividends? These questions are addressed in the first section of this chapter, after the discussion of the impact of the Jobs and Growth Tax Relief Reconciliation Act of 2003.

The second section of this chapter is devoted to analyzing when and whether converting a traditional individual retirement arrangement (IRA) or simplified pension plan (SEP) account into a Roth IRA makes sense (or not), given current federal income tax rules and current investment realities (i.e., reduced tax rates and the fact that we can no longer assume outrageous rates of return on equity investments).

Impact of 2003 Tax Law Changes on Retirement Savers

As you know, the Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act) significantly reduced individual federal income tax rates on (1) ordinary income, (2) long-term capital gains, and (3) qualified dividends.

Example 2-1 below summarizes the individual federal income tax rate structure for 2004.

Example 2-1
Individual Federal Income Tax Rates for 2004

	Single	Joint	HOH	MFS
10% tax bracket	$0 – 7,150	0 – 14,300	0 – 10,200	0 – 7,150
Beginning of 15% bracket	7,151	14,301	10,201	7,151
Beginning of 25% bracket	29,051	58,101	39,901	29,051
Beginning of 28% bracket	70,351	117,251	100,851	58,626
Beginning of 33% bracket	146,751	178,651	162,701	89,326
Beginning of 35% bracket	319,101	319,101	319,101	159,551

* Long-term capital gains and qualified dividends in 10% and 15% rate brackets 5%

* Long-term capital gains and qualified dividends in higher rate brackets 15%

Sunset Rules: After 2010, ordinary income rates will return to 15%, 28%, 31%, 36%, and 39.6% unless Congress takes further action. After 2008, capital gains taxes will revert to the "old-law" rates and dividends will again be taxed at ordinary rates.

Of course, the 2003 Act is also a huge boon for retirement savers. Here are the details.

Reduced Capital Gains Rates for Sales After May 5, 2003, and Before 2009

Most long-term capital gains earned by individuals from selling investments *after May 5, 2003,* and through the end of 2008 will be taxed at significantly lower federal income tax rates. The reduced rates also potentially apply to the deferred gain component of installment note principal payments received after May 5, 2003. Specifically,

- Most long-term capital gains are now taxed at a maximum rate of only 15%.

- Most long-term capital gains that would otherwise fall within the 10% and 15% ordinary income rate brackets are now taxed at only 5% for sales after May 5, 2003 and through the end of 2007.

- For 2008 — and for that one year alone — most long-term capital gains that would otherwise fall within the 10% and 15% ordinary income rate brackets will be taxed at 0%.

- Many more folks than you might think will pay a marginal ordinary income rate of only 10% or 15% and will thus be eligible for the 5% rate on long-term capital gains (0% for 2008).

- Gains from selling qualified small business corporation (QSBC) stock held for more than six months can be rolled over tax-free if the seller reinvests the proceeds in other newly issued QSBC stock. This provision is the same as under "old law."

- Capital gains from principal residence sales can be entirely excluded from federal income taxation to the extent of up to $500,000 for joint filers and up to $250,000 for unmarried individuals (assuming the IRC Sec. 121 qualification rules are met). This provision is the same as under "old law."

Some Gains Do Not Qualify for Reduced Rates

Unfortunately, the reduced 15%/5% rates were *not* extended to all types of capital gains. Specifically,

- The reduced rates have no impact on investments held inside a tax-deferred retirement account (traditional IRA, Keogh, SEP, solo 401(k), and the like). So the client will pay taxes at her regular rate (which can be as high as 35%) when gains accumulated in these accounts are withdrawn as cash distributions. (Gains accumulated in a Roth IRA are still federal-income-tax-free as long as the requirements for tax-free withdrawals are met.)

- The "old-law" tax rates (explained in detail below) apply to long-term capital gains from sales before May 6, 2003. (Under a sunset rule, the "old-law" rates will also apply to gains from sales after 2008 unless Congress takes further action.)

- Clients will still pay taxes at their higher regular rates on short-term capital gains from selling investments held for one year or less. These short-term gains count as ordinary income, just as they did under "old law." So if the client holds appreciated stock in a taxable account for exactly one year, he could lose up to 35% of his profit to the IRS. If he instead holds on for just one more day, his tax rate drops to no more than 15%. The moral: selling just one day too soon could mean losing up to 20% more of one's profit to the tax collector.

Key Point. For tax purposes, the client's holding period begins the day *after* he acquires securities and includes the day he sells. For example, say your client buys shares on November 1 of this year. His holding period begins on November 2. Therefore, November 2 of next year is the earliest possible date he can sell and still be eligible for the reduced 15%/5% rates on long-term capital gains. (See Rev. Ruls. 66-7 and 66-97.)

- Section 1231 gains attributable to depreciation deductions claimed against real estate properties are called *unrecaptured Section 1250 gains*. These gains — which would otherwise generally be eligible for the 15% maximum rate — are still taxed at a maximum rate of 25% as they were under "old law" [IRC §1(h)(6)]. The good news: any Sec. 1231 gain over and above the amount of unrecaptured Sec. 1250 gain from a real property sale is generally eligible for the 15% maximum rate. The same treatment applies to the deferred Sec. 1231 gain component of installment note payments received after May 5, 2003, from an earlier installment sale transaction — even though the sale date may have been several years ago. See the Committee Reports on amendments to IRC Sec. 1(h) made by the 2003 Act.

  Key Point. Distributions from real estate investment trusts (REITs) and REIT mutual funds may include some unrecaptured Sec. 1250 gains from real property sales. These gains, which are still taxed at a maximum rate of 25%, should be separately reported to the investor and entered on the appropriate line of the investor's Schedule D.

- The "old-law" 28% maximum rate continues to apply to (1) long-term capital gains from selling collectibles and (2) the taxable portion of five-year gains from selling QSBC shares under the IRC Sec. 1202 gain exclusion rule [IRC §1(h)(5) and (7)].

Sunset Rule. After 2008, the "old-law" capital gains rates explained immediately below will return unless Congress acts.

"Old-Law" Capital Gains Rates Apply to Sales Before May 6, 2003, and After 2008

The "old-law" capital gains rates can be summarized as follows:

- Short-term gains from selling assets held for one year or less are taxed at ordinary income rates.
- For most long-term capital gains, a 20% maximum rate applies.
- For most long-term capital gains that would otherwise fall within the 10% and 15% ordinary income rate brackets, a 10% maximum rate applies.

- Most long-term capital gains from selling assets held over five years that would otherwise fall within the 10% and 15% ordinary income rate brackets are taxed at a maximum rate of only 8%.

- Beginning in 2009, an 18% maximum rate will apply to most long-term capital gains from selling assets held over five years. (The 2003 Act eliminated the 18% rate for sales before 2009.)

- A 25% maximum rate applies to unrecaptured Sec. 1250 gains. These are Sec. 1231 gains from selling depreciable real estate that would otherwise generally qualify for the 20% maximum rate on long-term capital gains.

- A 28% maximum rate applies to (1) long-term capital gains from selling collectibles and (2) the taxable portion of five-year gains from selling qualified small business corporation (QSBC) shares under the IRC Sec. 1202 gain exclusion rule [IRC §1(h)(5) and (7)].

- Gains from selling QSBC stock held for more than six months can be rolled over tax-free if the seller reinvests the proceeds in other newly issued QSBC stock.

- Capital gains from principal residence sales can be entirely excluded from federal income taxation to the extent of up to $500,000 for joint filers and up to $250,000 for unmarried individuals (assuming the qualification rules are met).

Alternative Minimum Tax (AMT) Treatment of Capital Gains

The preferential capital gains rates under the 2003 Act and under "old law" apply equally for both regular tax and AMT purposes. However, significant capital gains can still push individuals into the AMT mode. The additional taxable income from the gains can cause the individual to lose some or all of her AMT exemption due to an unfavorable phase-out rule. In addition, the additional taxable income from the gains can trigger higher state income taxes. Since the deduction for state income taxes is disallowed under the AMT rules, this increases the odds the individual will owe the AMT.

Qualified Dividends Now Taxed at Capital Gains Rates, Too

Under the 2003 Act, qualified dividends are now taxed at the same federal income tax rates as long-term capital gains. This change is retroactive to January 1, 2003, and applies through the end of 2008. Specifically,

- Qualified dividends are taxed at a maximum rate of 15%.

- Qualified dividends that would otherwise fall within the 10% and 15% ordinary income rate brackets are taxed at only 5% for 2003 through the end of 2007.

- For 2008 — and for that one year alone — qualified dividends that would otherwise fall within the 10% and 15% ordinary income rate brackets will be taxed at the unbeatable rate of 0%.

- Many more folks than you might think will pay a marginal ordinary income rate of only 10% or 15% and will thus be eligible for the 5% rate on qualified dividends (0% for 2008).

Not All Dividends Are Eligible for Reduced Rates

The reduced 15%/5% rates on dividends apply only to *qualified dividends* paid on shares of corporate stock [IRC §1(h)(11)]. However, lots of payments that are commonly called "dividends" are not qualified dividends under the tax law. Specifically,

- The 15%/5% rates do not apply to dividends earned inside tax-deferred retirement accounts (traditional IRA, Keogh, SEP, solo 401(k), and the like). Clients will be taxed at their regular rates when dividends accumulated in these accounts are withdrawn as cash distributions. (Dividends accumulated in a Roth IRA are federal-income-tax-free as long as the client meets the requirements for tax-free withdrawals.)

- Dividends paid on credit union accounts are really interest payments. As such, they are considered ordinary income and are therefore taxed at regular rates — which can be as high as 35%.

- The same is true for dividends paid on some preferred stock issues that are actually publicly traded "wrappers" around underlying bundles of corporate bonds. Therefore, clients should not buy preferred shares for their taxable accounts without knowing exactly what they are buying.

- Mutual fund dividend distributions that are paid out of the fund's short-term capital gains, interest income, and other types of ordinary income are taxed at regular rates. So, equity mutual funds that engage in rapid-fire trading of low-dividend growth stocks will generate payouts that are taxed at up to 35% rather than at the optimal 15%/5% rates your client might be hoping for.

- Bond fund dividends will also be taxed at regular rates, except to the extent the fund is able to reap long-term capital gains from selling appreciated assets.

- Here is the good news: mutual fund dividends paid out of (1) qualified dividends from the fund's corporate stock holdings and (2) long-term capital gains from selling appreciated securities *are* eligible for the 15%/5% rates. This means mutual fund annual tax information statements will now have to separately identify dividends eligible for the 15%/5% rates as well as ordinary income dividends that are taxed at regular rates.

- Most REIT dividends will *not* be eligible for the 15%/5% rates. The main sources of cash for REIT payouts are usually not qualified dividends from corporate stock held by the REIT or long-term capital gains from asset sales. Instead most payouts are derived from positive cash flow generated by the REIT's real estate properties. Therefore, most REIT dividends will be ordinary income taxed at regular rates. As a result, clients should not buy REIT shares for their taxable accounts with the expectation of benefiting from the 15%/5% rates.

- Dividends paid on stock in qualified foreign corporations are *theoretically* eligible for the 15%/5% rates. Here is the rub: these dividends are often subject to foreign tax withholding. Under the U.S. foreign tax credit rules, individual investors may not necessarily receive credit for the full amount of withheld foreign taxes. So, investors can wind up paying the advertised 15%/%5 rates to the U.S. Treasury plus some incremental percentage to some foreign country. The combined U.S. and foreign tax rates may exceed the advertised 15%/5% rates. Sorry about that! [See IRC §§ 1(h)(11)(C)(iv) and 904.]

Warning. To be eligible for the 15%/5% rates on qualified dividends earned in a taxable account, the stock on which the dividends are paid must be held for more than 60 days during the 120-day period that begins 60 days before the ex-dividend date (the day following the last day on which shares trade with the right to receive the upcoming dividend payment). Bottom line: when shares are owned only for a short time around the ex-dividend date, the dividend payout will count as ordinary income taxed at regular rates [IRC §1(h)(11)(B)(iii)].

Sunset Rule. After 2008, dividends will once again be taxed at ordinary income rates unless Congress takes action.

Many Individuals Now Occupy 10% and 15% Brackets and Pay Only 5% on Their Investment Profits

As explained earlier, long-term capital gains and qualified dividends earned in an individual's taxable retirement savings accounts are now taxed at only 5% when they would otherwise fall within the 10% or 15% federal rate bracket. Thanks to other changes made by the 2003 Act, many more people than you might initially think are now eligible for these bottom two brackets. Remember, a person's marginal rate bracket is determined by the amount of taxable income which equals gross income reduced by allowable personal and dependency exemptions and by the standard deduction amount (if the taxpayer does not itemize) or total itemized deductions (if he does itemize).

- Say the client is a married joint filer with three dependents (including his spouse). Assuming the client claims the standard deduction, his gross income for 2004 can be as high as $80,200, and he will still be within the 15% rate bracket. In other words, if his total income — including long-term capital gains and qualified dividends earned in taxable accounts — equals $80,200 or less, he will owe the IRS only 5% on those dividends and gains.

- Say the client is a single parent with two dependent kids. Assume he/she claims the standard deduction and uses head of household filing status. His/her 2004 gross income can be as much as $55,350, and he/she will still be in the 15% bracket. So he/she too can take advantage of the 5% rate on long-term capital gains and qualified dividends earned in his/her taxable account.

- Say the client is single with no dependents. Assume he/she claims the standard deduction. His/her 2004 gross income can be as much as $37,000 and he/she will still be in the 15% bracket.

- If your client itemizes deductions, his/her gross income can be even higher than the figures listed above and he/she may still be within the 15% bracket.

Key Point. Despite mainstream media statements to the contrary, you certainly do not have to be "poor" (or anything close to "poor") to be eligible for the rock-bottom 5% rate on long-term capital gains and qualified dividends. However, individuals should still take full advantage of all opportunities to make deductible contributions to their tax-deferred retirement accounts. Then they can invest the resulting tax savings, along with any other surplus cash, in taxable accounts and lock in that nice, low 5% rate.

Tax-Smart Investing Strategies After the 2003 Act

All the federal income tax rate cuts explained earlier in this chapter obviously have ultra-favorable implications for clients who save for retirement using taxable accounts. As always, however, clients must play their cards right in order to cash in. Plus there are *sunset rules* to keep in mind. Here is what you and your clients need to know about tax-smart investing after the 2003 Act.

Tax-Smart Strategies for Capital-Gain Assets

- Clients should try even harder than before to satisfy the more-than-one-year holding period rule before selling appreciated investments held in taxable accounts. That way, they will qualify for the reduced 15%/5% long-term capital gains rates. The higher the client's tax rate on ordinary income, the more this advice rings true. Of course, the client should never expose an accrued profit to great downside risk solely to be eligible for a lower tax rate. (The client is always better off bagging a short-term profit and paying the resulting higher tax bill than hanging on too long and losing his/her profit altogether.)

- Clients should hold equity index mutual funds and tax-managed funds in taxable investment accounts. These types of funds are much less likely to generate ordinary income distributions that will be taxed at higher regular rates. Instead, these funds can be expected to generate qualified dividends and long-term capital gains that will be taxed at the preferential 15%/5% rates.

- Clients should hold mutual funds that engage in rapid-fire asset churning in tax-advantaged retirement accounts. That way, the ordinary income generated by these funds will not cause any tax harm.

- If the client insists on engaging in rapid-fire equity trading, he should confine that activity to his tax-advantaged retirement accounts where there is no tax disadvantage to lots of short-term trading.

Key Point. If the client's equity investing style involves nothing but rapid-fire trading in stocks and ownership of quick-churning mutual funds, he/she should try to do this inside his/her tax-advantaged retirement accounts. Using this style in a taxable account generates ordinary income taxed at higher regular rates. Inside a tax-advantaged retirement account, however, there is no harm done. If the client therefore devotes most or all of his/her tax-advantaged retirement account balances to such rapid-fire equity trading, he/she might be forced to hold some or all of his/her fixed-income investments in taxable accounts. Even though he/she will pay his/her higher regular rate on the ordinary income produced by those fixed-income assets, he/she should still come out ahead on an overall after-tax basis. There is more on that later in this chapter.

Tax-Smart Strategies for Fixed-Income Investments

- The 2003 Act penalizes holding ordinary-income-producing investments in a taxable retirement savings account compared to stocks that the client expects to generate qualified dividends and long-term capital gains. Strategy: clients should generally put fixed-income assets that generate ordinary income (like Treasuries, corporate bonds, and CDs) into their tax-deferred retirement accounts. That way they will avoid the tax disadvantage.

- The 2003 Act also penalizes holding REIT shares in a taxable retirement savings account compared to garden-variety corporate shares that the client expects to generate qualified dividends and long-term capital gains. As you know, REIT shares deliver current income in the form of high-yielding dividend payouts, plus the potential for capital gains, plus the advantage of diversification. These are all nice attributes inside a tax-deferred retirement account! Inside a taxable account, however, REIT shares receive less-favorable treatment than garden-variety corporate shares (as explained earlier). So the tax-deferred retirement account is now generally the best place to keep one's REIT stock investments.

Variable Annuities Are Damaged Goods

Variable annuities are basically mutual fund investments wrapped up inside a life insurance policy. Earnings are tax-deferred, but they are treated as ordinary income when withdrawn. So the investor pays his/her regular tax rate at that time even if most or all of the variable annuity's earnings were from dividends and capital gains that would otherwise qualify for the 15%/5% rates. This factor plus the high fees charged by insurance companies on variable annuities makes these products very problematic. It can take many (too many) years for the tax-deferral advantage to overcome the inherent disadvantages. If the investor ever catches up at all, that is.

Example 2-2 highlights some of the investment strategy choices to consider.

Example 2-2

Winning Investments for Tax-Advantaged Retirement Accounts

- Stocks expected to be held for less than one year.
- Quick-churning equity mutual funds.
- REIT shares.
- High-yield junk bond mutual funds.
- Fixed-income assets in general.

Winning Investments for Taxable Accounts

- Growth stocks expected to be held for over a year.
- Dividend-paying stocks expected to be held for over a year.
- Equity index and tax-managed mutual funds.
- Tax-free municipal bonds and muni-bond funds.

Losers by All Accounts

- Variable annuities.

Making Tax-Smart Allocations of Investment Assets Between Different Types of Retirement Savings Accounts

Your typical client may use three different types of accounts to hold her retirement savings investments:

- Roth IRA.
- Tax-deferred retirement account (traditional IRA, Keogh, SEP, solo 401(k), and the like).
- Taxable brokerage firm account.

After all the Rate Changes Made by the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("the 2003 Act"), Which Types of Investments Are Best for Each Type of Account?

Initially, you might think the client should definitely put all her fixed-income investments (Treasuries, corporate bonds, CDs, and bond mutual funds) into her Roth IRA and tax-deferred accounts. These investments generate ordinary income that will be taxed at her regular rate (which can be as high as 35%) if they are held in a taxable account. The client could then load up her taxable account with stocks and equity index mutual funds that she expects to generate qualified dividends and long-term capital gains that will be taxed at the preferential 15%/5% rates. In fact, many financial media sources are now advocating this allocation strategy. However, the conventional wisdom is not necessarily correct. To see why, let us make some giant assumptions (as we always have to do) and crunch the numbers.

- Over the long haul, equities (stocks and stock mutual funds) will return 9% annually before taxes. Of that, we assume 6% will be in the form of long-term capital gains reaped after holding the shares for one year and a day. The remaining 3% will be from qualified dividends. So for equities held in a taxable account, the entire 9% return will be taxed at the preferential 15%/5% federal income tax rates.
- Fixed-income investments will return 5.5% annually before taxes. When these assets are held in a taxable account, we assume the entire 5.5% will be ordinary income taxed at regular rates.
- The imaginary client in question is 15 years away from retirement. Over the next 15 years, his/her combined federal and state marginal income tax rate on ordinary income will be 38% (33% federal plus 5% state).

- Until retirement in 15 years, the imaginary client's combined marginal rate on long-term capital gains and qualified dividends will be 20% (15% federal plus 5% state).

- At retirement age in 15 years, his/her combined marginal income tax rate on ordinary income will be 30% (25% federal plus 5% state).

- Finally, assume our imaginary client has $100,000 to invest in his/her Roth IRA, another $100,000 in his/her tax-deferred retirement account, and $100,000 in a taxable brokerage account (total of $300,000). His/her asset allocation policy calls for investing one-third of his/her money ($100,000) in fixed-income assets that will generate ordinary income and two-thirds ($200,000) in equities (stocks and equity mutual funds) that will generate capital gains and dividends.

In this scenario, the client has three different ways to divide up his/her $300,000 of investable money.

- *Option 1* – Allocate the $100,000 worth of fixed-income investments to the Roth IRA and allocate the $200,000 worth of equities to the tax-deferred and taxable accounts ($100,000 to each).

- *Option 2* – Allocate the $100,000 of fixed-income investments to the tax-deferred account and allocate the $200,000 of equities to the Roth and taxable accounts ($100,000 each).

- *Option 3* – Allocate the $100,000 of fixed-income investments to the taxable account and allocate the $200,000 of equities to the tax-deferred and Roth accounts ($100,000 each).

Which option allows our imaginary client to accumulate the most after-tax dollars by the time he/she hits retirement age in 15 years?

Outcome for Option 1 (Fixed Income Assets in Roth IRA)

The after-tax value of the client's Roth IRA will grow to $223,250 ($100,000 invested for 15 years at 5.5% with zero federal or state taxes).

The after-tax value of his/her tax-deferred account is $254,975 ($100,000 invested for 15 years at 9% with 30% of the balance lost to retirement-age taxes).

The after-tax value of your taxable account is $283,740 [$100,000 invested for 15 years at an after-tax rate of 7.20% (.80 x 9%)].

Bottom Line. Option 1 delivers a total of $761,965 after paying the tax collectors ($223,250 + $254,975 + $283,740). Not bad, but we can do better.

Outcome for Option 2 (Fixed Income Assets in Tax-Deferred Account)

The after-tax value of the client's Roth IRA will be $364,250 ($100,000 invested for 15 years at 9% with no taxes).

The after-tax value of his/her tax-deferred account is $156,275 ($100,000 invested for 15 years at 5.5% with 30% lost to retirement-age taxes).

The after-tax value of his/her taxable account is $283,740 [$100,000 invested for 15 years at 7.20% (.80 x 9%)].

Bottom Line. Option 2 nets $804,265 after taxes ($364,250 + $156,275 + $283,740). That is about $42,000 more than the client would collect by following Option 1.

Outcome for Option 3 (Fixed Income Assets in Taxable Account)

The after-tax value of the client's Roth IRA will grow to $364,250 ($100,000 invested for 15 years at 9% with no taxes).

The after-tax value of his/her tax-deferred account is $254,975 ($100,000 invested for 15 years at 9% with 30% lost to retirement-age taxes).

The after-tax value of his/her taxable account is $165,365 [$100,000 invested for 15 years at an after-tax rate of 3.41% (.62 x 5.5%)].

Bottom Line. Option 3 yields a total of $784,590 ($364,250 + 254,975 + $165,365). That is about $22,000 more than Option 1, but about $20,000 less than Option 2.

Conclusions

As you can see, Option 1 produces by far the worst results. The message here is simple.

- Clients should use Roth IRAs to hold the assets they expect to earn the highest rates of return, which generally means stocks and equity mutual funds.

- Clients should *not* use Roth IRAs to hold lower-yielding fixed-income investments just because that would avoid the higher tax rates on the ordinary income generated by these assets.

As you can also see, there is not a huge difference between Option 2 and Option 3 under our assumptions. Still Option 2 comes out ahead by a meaningful amount. However, watch out for this:

- The results under Option 2 can be measurably *worse* than under Option 3 if the client fails to hold equities in his/her taxable account long enough to qualify for the preferential 15% rate on long-term capital gains.

- The same goes if the client's equity investments are in the form of fast-trading mutual funds.

- The same goes if the tax rates on capital gains and dividends go back up in the future (which is a distinct possibility).

Under all three options illustrated above, the mix of investments and the underlying assumptions are exactly the same. The only difference is the accounts in which the investments are placed. But the projected after-tax results vary by tens of thousands of dollars. These differences are entirely due to taxes. Taxes really do matter! How clients allocate investments between accounts really does matter! In summary, this is what we learned here:

- Investments allocated to the Roth IRA should be those that the client expects to earn the highest rates of return (probably stocks and equity mutual funds). In other words, do not let the client follow Option 1.

- After all the client's Roth IRA money has been allocated, he/she probably will not go too far wrong by allocating his/her remaining equity investment dollars first to his/her tax-deferred retirement account, even if that forces him/her to allocate some or all of his/her fixed-income investments to his/her taxable account. In other words, following Option 3 is usually a solid choice. (Note that this commentary ignores any favorable impact from an income tax basis step up to the date-of-death fair market value for investments that are held in the decedent's taxable accounts.)

- However, when the client is quite certain that almost all of the returns earned on certain equity investments will be long-term capital gains and qualified dividends that will continue to be taxed at the current 15%/5% rates, he/she should reverse course and allocate those equity investments first to his/her taxable account. This may in turn force the client to allocate some or all of his/her fixed-income assets to his/her tax-deferred retirement account. In other words, follow Option 2 in this circumstance. (Note that following Option 2 could also result in a favorable income tax basis step up to the date-of-death fair market value for investments held in the decedent's taxable accounts.)

Key Point. All things considered, the author feels it requires lots of faith to conclude that Option 2 is really the client's best choice. Option 3 is probably the most rational choice in most cases. That said, Option 3 is not a sure bet, because we cannot predict the future!

Yet Another Reason to Use Roth IRA to Hold Equity Investments

There is one other really good thing that can come from holding equity investments in a Roth IRA. If the account owner dies before liquidating the Roth IRA, the heirs will not owe any federal income tax on all the income and gains that have accumulated in the account (assuming the qualification rules for tax-free Roth IRA withdrawal rules are met). In other words, the heirs can liquidate the Roth IRA tax-free (immediately or gradually over a number of years under the required minimum distribution rules for inherited accounts explained in Chapter 7, "Planning for Inherited Accounts").

In stark contrast, all the accumulated income and gains in an inherited tax-deferred qualified retirement plan account or an inherited traditional IRA will ultimately be taxed at ordinary income rates when the heirs liquidate the inherited account.

Contributing to Tax-Deferred Retirement Accounts Is Still the Tax-Smart Move

Argument: after the reduced federal income tax rates ushered in by the 2003 Act, contributing to tax-deferred retirement accounts is no longer such a great idea.

The logic for this argument goes like this: (1) deductions for retirement account contributions are now worth less because the federal income tax rate on ordinary income has been reduced and (2) dividends and gains earned in a retirement account do not qualify for the 15%/5% rates. Therefore, so the argument goes, the updated retirement savings strategy should be to invest in stocks (meaning common stocks and stock mutual funds) via *taxable accounts*. That way, the individual reaps the tax-saving benefits of the 15%/5% rates on qualified dividends and long-term capital gains. According to this argument, tax-deferred retirement accounts are now basically obsolete.

There is only one thing wrong with the argument. It is incorrect! Even after the 2003 Act, your clients are still almost certain to be much better off making deductible contributions to their tax-deferred retirement accounts. As you will soon see, the numbers tell the story. But first we must make some giant assumptions. (Anything having to do with taxes always involves lots of giant assumptions!)

Assume the following for an imaginary client

- Over the long haul, stocks (meaning common stocks and stock mutual funds) will return 9% annually before taxes. Of that, assume 6% will be in the form of long-term capital gains reaped after holding the shares for one year and a day. The remaining 3% will be from qualified dividends. So, the entire 9% return from stocks held in a taxable account will be taxed at the preferential 15%/5% federal income tax rates.

- Our imaginary client is 15 years away from retirement. Over the next 15 years, his combined federal and state marginal income tax rate on ordinary income will be 33% (28% federal plus 5% state).
- Until retirement in 15 years, his combined marginal rate on long-term capital gains and qualified dividends will be 20% (15% federal plus 5% state).
- At retirement age in 15 years, this imaginary client's combined marginal income tax rate on ordinary income will be 28% (25% federal plus 3% state).

Under these assumptions, should our imaginary client make a deductible $25,000 contribution to his tax-deferred retirement account ("Strategy 1") or should he instead invest the exact same $25,000 in a taxable account ("Strategy 2")? Let us run the numbers and find out.

Outcome for Strategy 1 (Make Retirement Account Contribution)

After 15 years, our imaginary client's $25,000 retirement account contribution has grown to an after-tax figure of $65,565 ($25,000 invested for 15 years at 9% with 28% of the resulting balance lost to retirement-age taxes). But, there is more. The imaginary client also invested his $8,250 of tax savings (.33 x $25,000) in a taxable account. After 15 years, that $8,250 has grown to an after-tax figure of $23,410 [$8,250 invested for 15 years at after-tax return of 7.20% (.80 x 9%)]. So this imaginary fellow accumulates a total of $88,975 after paying his taxes ($65,565 plus $23,410). Remember, this is just one year's worth of action.

Outcome for Strategy 2 (Skip Retirement Account Contributions and Invest in Taxable Account)

After 15 years, our imaginary client's $25,000 investment in the taxable account has grown to an after-tax figure of $70,935 ($25,000 invested for 15 years at after-tax return of 7.20%).

Conclusions

As you can see, our imaginary client comes out $18,040 ahead ($88,975 versus $70,935) by making a deductible retirement account contribution and investing the resulting tax savings in his taxable account. That is a little over 25% more retirement-age cash from following time-honored Strategy 1 instead of new-but-misguided Strategy 2. Remember, these numbers are only for one year. Over an extended number of years, following the Strategy 1 policy of making annual retirement account contributions and investing the tax savings will put your client way ahead of hapless advocates of Strategy 2.

Alternatively, the client can choose to make a bigger deductible retirement account contribution each year by using his tax savings to finance a portion of each annual contribution. Either way, the client comes out well ahead.

He will come out even further ahead by following Strategy 1 if the tax rates on dividends and long-term capital gains happen to go back up again in the future. Needless to say, that is a distinct possibility.

He will also come out even further ahead under Strategy 1 if equity investments held in taxable accounts (under Strategy 2) are not owned long enough to benefit from the 15%/5% rates on long-term capital gains. With daily corporate accounting scandals and a very unpredictable world, can your client really count on always being able to follow a long-term "buy-and-hold" investment style? Probably not.

To sum up, the 2003 Act does not change the time-honored wisdom of contributing as much as one can afford to one's tax-deferred retirement account. This conclusion applies under almost any plausible set of assumptions. See Example 2-3.

Example 2-3
Contributing to Retirement Account and Investing Tax Savings (Strategy 1) Beats Investing in Taxable Account (Strategy 2)

Tax Rate Assumptions	**Strategy 1**	**Strategy 2**
33% combined ordinary rate now;		
20% rate on LTCGs and dividends.	$25,000	$25,000
28% combined ordinary rate at	grows to:	grows to:
retirement age in 15 years.	$88,975	$70,935

Conclusion. Contributing to retirement account (Strategy 1) wins by $18,040.

Tax Rate Assumptions	**Strategy 1**	**Strategy 2**
40% combined ordinary rate now;		
20% rate on LTCGs and dividends.	$25,000	$25,000
33% combined ordinary rate at	grows to:	grows to:
retirement age in 15 years.	$89,385	$70,935

Conclusion. Contributing to retirement account (Strategy 1) wins by $18,450.

Tax Rate Assumptions	**Strategy 1**	**Strategy 2**
18% combined ordinary rate now;		
8% rate on LTCGs and dividends.	$25,000	$25,000
20% combined ordinary rate at	grows to:	grows to:
retirement age in 15 years.	$87,690	$82,445

Conclusion. Contributing to retirement account (Strategy 1) wins by $5,245.

Answering the Roth IRA Conversion Question

Roth IRAs are a terrific tax break, assuming your client qualifies and assuming Congress leaves the rules alone. Unlike traditional deductible IRAs, there is no upfront write-off for contributions to Roth IRAs. However, Roth account earnings and gains are allowed to build up tax-free and can then be withdrawn without any federal income tax bill (or any state tax bill in most cases).

Roth IRA Basics

For the 2004 tax year, up to $3,000 can be contributed to a Roth IRA, or $6,000 for a married couple. These expanded contribution limits are courtesy of the Economic Growth and Tax Relief Reconciliation Act of 2001.

For the 2004 tax year, account owners who are age 50 or older as of December 31 of the applicable year are allowed to contribute up to an additional $500 to a Roth IRA ($1,000 for a married couple if both spouses are age 50 or over). These so-called catch-up contributions for older taxpayers are also due to the Economic Growth and Tax Relief Reconciliation Act of 2001.

Key Point. For the 2004 tax year, up to $7,000 can be contributed to Roth IRAs by a married couple when both spouses are age 50 or older as of the end of the year in question.

There are only two basic limitations on the Roth IRA contribution privilege:

1. The account owner must have earned income at least equal to the amount contributed for the year (the same rule applies to traditional IRAs).

2. The contribution limit is phased out between *modified adjusted gross income (AGI)* of $150,000 and $160,000 for joint filers, between $95,000 and $110,000 for singles, and between zero and $10,000 for "married filing separate" status. For this purpose, modified AGI equals "regular" AGI before any deductible IRA contribution, before any IRC Sec. 135 exclusion for interest from U.S. Savings Bonds redeemed to pay certain higher-education expenses, before any IRC Sec. 137 exclusion for employer adoption-assistance payments, before any IRC Sec. 221 deduction for student loan interest, before any IRC Sec. 222 deduction for certain higher-education expenses, and before any IRC Sec. 911 exclusion for certain foreign earned income and housing allowances. [See IRC §§ 408A(c)(3)(C)(i) and 219(g)(3)].

As is more fully explained in Chapter 4, "Planning for Early Retirees and Early Retirement Account Withdrawals," tax-free Roth IRA withdrawals are allowed after the account has been open over five years and the account owner is age 59½ or older [IRC §408A(d)(2)].

In contrast, withdrawals from regular deductible IRAs are fully taxable at ordinary income rates (up to 35%).

Earnings from traditional nondeductible IRAs are taxable as well, while the nondeductible contributions come out tax-free. Unfortunately, however, the account owner cannot simply withdraw his/her nondeductible contributions first. Instead, when the account owner has made nondeductible contributions to one or more traditional IRAs, each withdrawal from any traditional IRA owned by the account owner is treated as part tax-free and part taxable, based on the ratio between total nondeductible contributions and total account value for all of the account owner's traditional IRAs as of the end of the previous year.

Other really nice things about Roth accounts compared to traditional IRAs include the following:

- The account owner can continue making annual Roth IRA contributions after age 70½ provided (1) he/she has earned income at least equal to the amount contributed and (2) his/her AGI is low enough to permit contributions [IRC §408A(c)(4)]. In contrast, contributions to traditional IRAs are prohibited after age 70½.

- There is no requirement to start taking annual required minimum distributions from Roth IRAs after the account owner reaches age 70½ [IRC § 408A(c)(5)]. Instead, the account owner can choose to continue investing the entire Roth IRA balance and continue earning tax-free income on the entire balance for as long as he/she wishes. In contrast, account owners must begin taking required minimum distributions from their traditional IRAs (and from their other tax-deferred retirement plan accounts) after reaching age 70½. Of course, these annual required minimum distributions will also trigger annual income tax bills for account owners. (See Chapter 6, "Planning for Older Clients," for full details on the required minimum distribution rules.)

- When the Roth IRA account owner dies, neither the account owner's estate nor his/her heirs will owe any federal income tax on Roth IRA withdrawals from accounts open over five years [IRC §408A(d)(2)(A)(ii)]. As with traditional IRAs, however, the required minimum distribution rules apply after the Roth IRA account owner's death. (See Chapter 7, "Planning for Inherited Accounts," for full details on the required minimum distribution rules for inherited Roth IRAs.)

Should the Client Convert a Traditional IRA into a Roth?

Because Roth IRAs are so attractive, Congress decided to allow taxpayers to convert their existing traditional deductible or nondeductible IRAs into Roth IRAs. Post-conversion earnings can then build up tax-free, and the Roth account can eventually be drained with no federal income tax due. However, the conversion transaction is treated as a deemed taxable distribution from the regular IRA, meaning the account owner will be taxed, at ordinary income rates, just as if he/she liquidated the account and pocketed all of the proceeds. Fortunately, the IRC Sec. 72(t) 10% premature-withdrawal penalty tax that generally applies to IRA distributions before age 59½ does not apply to deemed distributions from conversion transactions [IRC §408A(d)(3)(A)(ii)].

The conversion option is unavailable if the taxpayer's *modified AGI* for the year (not including the taxable income triggered by the conversion itself) exceeds $100,000. The same $100,000 limit applies to both joint filers and singles. However, married taxpayers filing separate returns are completely ineligible for conversions [IRC §408A(c)(3)(B)]. For this purpose, modified AGI equals "regular" AGI before any deductible IRA contribution, before any IRC Sec.135 exclusion for interest from U.S. Savings Bonds redeemed to pay certain higher-education expenses, before any IRC Sec. 137 exclusion for employer adoption-assistance payments, before any IRC Sec. 221 deduction for student loan interest, before any IRC Sec. 222 deduction for certain higher-education expenses, and before any IRC §911 exclusion for certain foreign earned income and housing allowances. [See IRC §§ 408A(c)(3)(C)(i) and 219(g)(3)].

Clients who are under the $100,000 AGI limit should strongly consider converting some or all of their traditional IRAs into Roth accounts. The key word here is "consider."

Converting can be a good idea, as long as the client makes a fully informed decision.

Key Point. IRS regulations confirm that SEP accounts can be converted to Roth IRA status under the same rules that apply to conversions of "regular" traditional IRAs (Reg. §1.408A-4).

To properly answer the "should I convert?" question, someone (you or the client) must make some assumptions and "run the numbers."

When such projections are made, they are quite likely to present a good case for conversion. The notable exception is when the client is currently in the 25% bracket or higher and expects to be in only the 10% or 15% bracket at the time money will be withdrawn from the IRA in question. While this seems like an obvious point, make sure the client understands that "a projection is only a projection." The actual outcome will be close to the projected outcome only if the assumptions turn out to be accurate. (See Exhibit 2-1 for some illustrative projections.)

In making these projections, the relevant variables are

- The tax rate the client expects to pay on the conversion income. Remember: The conversion income will be piled on top of all taxable income from all other sources in the conversion year. Therefore, converting a large IRA may push the client through several higher tax brackets. Obviously, the absolute best case for conversion is when the client would pay 15% (or less) in the conversion year (however, this will be relatively unusual).

- The tax rates the client expects to pay in future years when he/she will be taking IRA withdrawals (be they from traditional IRAs or Roth accounts). The higher the expected rates for those years, the better the case for conversion, because converting means avoiding those high rates on all of the post-conversion account earnings. Of course, conversion is much less appealing if the client expects to be in only the 10% or 15% bracket in the years over which the IRA will be liquidated.

- If the client intends to leave the IRA to his/her heir, the relevant future tax rate is the rate the heir would be expected to pay upon liquidating the IRA after inheriting it. (If the client would prefer not to take any IRA withdrawals during his/her lifetime, converting could be a smart move. See Chapter 6, "Planning for Older Clients" for discussion of using the Roth IRA conversion privilege as an estate-planning device.)

- The expected rate of return on IRA investments. Other things being equal, the higher the expected return, the better the case for conversion. On the other hand, if little or nothing is earned from now until the IRA is liquidated (perhaps because all of the money was invested in stocks during an extended market downturn), conversion simply means income taxes were paid sooner rather than later. (Not the best tax-planning strategy.)

- Whether or not Congress will later twiddle with the tax laws in ways that make conversion less beneficial. For instance, what if somewhere down the road we get a new tax system based on "consumption"? Would Roth IRA withdrawals still be tax-free? Nobody knows, and this may not really be worth worrying about. But let the client be the one to make that call.

In reality, only one thing is absolutely certain. If the client converts, he/she will owe extra income taxes for the year of conversion. On the other hand, not converting holds the IRS at bay until further notice.

Key Point. Although the four-year spread privilege for income triggered by Roth IRA conversions applied only to 1998 conversions, clients can still spread out conversion income over several tax years. This is because there is no requirement to convert an entire traditional IRA balance to Roth status in one year, nor is there any requirement to convert all of an account owner's traditional IRAs. So a client can, for example, spread conversion income over four or five tax years (or more) to avoid being pushed into much higher tax brackets. Or the client can choose to convert only traditional IRAs with relatively modest balances. Or the client can do both. Of course, this presupposes the client will be under the $100,000 AGI threshold for all years in which conversions are contemplated.

Conversion Cons

Clients should not be allowed to think they can avoid the conversion tax simply by withdrawing all of their nondeductible traditional IRA contributions and rolling them over into a new Roth IRA. (See the scenarios illustrated in Examples 2-4 and 2-5.) As mentioned earlier, that will not work because the account owner is considered to convert *pro rata* nontaxable and taxable amounts, based on the combined value of all of his/her traditional IRAs [IRC §408(d)]. This includes any balances in SEP accounts as well, because they are treated as IRAs for distribution taxation purposes.

Clients also need to remember that converting big accounts means triggering big taxable amounts. This could easily push the client into higher brackets and have harmful side effects on various AGI-sensitive tax items (like personal exemptions, itemized deductions, the taxable amount of

Social Security, the credits for dependent children and college tuition, the write-off for college loan interest, the $25,000 passive loss exception for rental real estate, and so on and so forth).

Remember that when a traditional IRA is converted into a Roth account, the money to pay the tax on the resulting conversion income must come from somewhere. Congress does not want people under age 59½ dipping into their IRAs to pay the tax. So if money is siphoned away from the regular IRA before conversion to pay the tax, the IRC Sec. 72(t) 10% premature-withdrawal penalty tax will generally apply on top of the income tax liability.

Example 2-4

As of December 31, 2004, your client Bernie owns two traditional IRAs worth $21,000. One of the accounts originally had $9,000 worth of nondeductible contributions made over several years. During 2004, Bernie took exactly $9,000 out of that account and rolled that amount over (i.e., converted it) into a new Roth IRA. He assumed the conversion transaction was nontaxable, since the $9,000 amount equaled his previous nondeductible contributions to the traditional IRA from which the conversion money was withdrawn.

Unfortunately, Bernie's $9,000 withdrawal is considered to be composed of both taxable and nontaxable portions. To determine the nontaxable amount, Bernie must add back the $9,000 to the remaining balances in his traditional IRAs as of December 31, 2004. The total is $30,000 ($9,000 + $21,000 = $30,000). Then the total amount of his nondeductible contributions ($9,000 in this example) is divided by the $30,000. The resulting fraction of 0.30 ($9,000 ÷ $30,000 = 0.30) is then multiplied by the amount withdrawn. The answer is the nontaxable portion of the withdrawal. So the nontaxable portion in this example is $2,700 (0.30 × $9,000 = $2,700). Bernie must include the remaining $6,300 ($9,000 – $2,700 = $6,300) in his 2004 taxable income.

Key Point. Note that a married account owner makes the preceding computations separately taking into account only the traditional IRAs set up in his/her name, even though the account owner may file jointly with the spouse. (As mentioned earlier, married people who file separately are completely ineligible for Roth IRA conversions.) Also remember to include any SEP account balances in the preceding computations.

Example 2-5

Suzanne is married with expected 2004 joint taxable income of $75,000 (before any Roth IRA conversion income). Her 2004 marginal federal income tax bracket is thus 25%. Suzanne has traditional IRAs worth $180,000, mainly from rolled-over qualified retirement plan money from her former jobs (assume no nondeductible component). If Suzanne converts the entire $180,000 in 2004, most of that amount will be taxed at 28% and 33%, rather than at the much lower 25% rate that Suzanne might expect.

If the new Roth IRA is tapped to pay the conversion tax bill instead, the 10% premature-withdrawal penalty tax will still apply [IRC §408A(d)(3)(F)]. Plus the Roth IRA balance is now that much smaller, meaning the account cannot earn as much tax-free income in the future.

If the account owner instead borrows to pay the conversion tax, the true cost of converting is increased by the resulting interest charges (which are nondeductible). In effect, the interest charges are just another penalty on the transaction.

Key Point. For the preceding reasons, it generally does not make sense to convert if the client does not have ready cash to pay the conversion tax hit.

Finally, remember that the conversion tax dollars that are forked over to the IRS could have otherwise been invested in taxable accounts until retirement age (at least). So the true cost of conversion is higher than it first appears, because the taxpayer loses the future value of the dollars sent to Uncle Sam (and the state tax collector as well, in most cases). Projections to assess the advisability of converting should always take this factor into account. (See Exhibit 2-1 for some illustrative computations.)

How Are Roth Conversions Accomplished?

There are effectively three ways to withdraw funds from traditional IRAs and place them in Roth accounts.

First, the client can simply "convert" an existing traditional IRA (deductible or nondeductible) into a "new" Roth account managed by the same IRA trustee (bank, brokerage house, or whatever). This can be done with some or all of the client's traditional IRA balances. In this case, all that should be required to effect a conversion is filling out a form. With such an "in-house" conversion, there is no need to liquidate the converted account's holdings. Any stocks, mutual funds, etc. are simply automatically transferred between the "old" and "new" accounts in paper transactions.

Second, if the client wants to switch IRA trustees as part of the conversion process (for example, by taking an existing Merrill Lynch traditional IRA and converting it into a new T. Rowe Price Roth IRA), the initial step is to make a "trustee-to-trustee" transfer of the traditional IRA's assets from Merrill Lynch to T. Rowe Price. This step is tax-free, and it keeps the account's assets intact. Then the client can make an "in-house" conversion of what is now a T. Rowe Price traditional IRA into a new T. Rowe Price Roth IRA. Of course, this last step of the process is a taxable event.

The third way to convert is to withdraw some or all of the funds from one or more traditional IRAs and then roll over the funds into one or more new Roth accounts under the familiar 60-day rule for IRA rollovers.

All three of the above conversion procedures are referred to as "conversions" for purposes of this section.

Let the Client Make the Call

With the preceding factors in mind, your client is prepared to make an intelligent decision on the Roth conversion issue. You may be asked to help with projections (one format for doing so is shown in Exhibit 2-1 later in this chapter).

In general, you will find that conversions make the most sense when

- The client has a long period before he/she expects to liquidate the IRA (at no earlier than age 59½), which provides time to recover from the conversion tax hit with years of accumulated tax-free earnings. (Roth accounts must be open at least five years anyway to qualify for tax-free withdrawals.)

- The expected tax rate when the IRA will be liquidated is about the same as or higher than the expected rate during the client's working years (for instance, conversion will be a bad idea when the current tax rate is 25% or higher and only a 10% or 15% rate is expected when the IRA is liquidated).

- The income triggered by the conversion is not enough to (1) shove the client out of the current 10% or 15% bracket into the 25% bracket (or higher) or (2) wipe out significant deductions or credits the client would otherwise be entitled to in the conversion year.

- A good part of the converted funds represent nondeductible contributions, which greatly reduces the upfront tax hit.

Key Point. The 2003 Act's reduced individual income tax rates may make the Roth conversion idea more attractive for two reasons. First, reduced rates mean a reduced tax hit in the conversion year. That is a good thing! Second, our current individual income tax rates may be at a historic low point. So, converting now would grant tax-free status to account earnings that might otherwise be taxed at significantly higher rates in future years when money is withdrawn from the IRA in question.

Roth Conversion Tax Details

The IRS Restructuring and Reform Act of 1998 supplied the answers to a number of questions about conversions. In addition, the Treasury released final regulations on Roth IRAs in early 1999 (Reg. §§ 1.408A-1 through 1.408A-9). Here are the most important clarifications.

AGI Exceeds $100,000 or Taxpayer Wants to "Unconvert"

If AGI for the conversion year turns out to exceed the magic number, the taxpayer can unwind the whole deal ("unconvert" is the terminology used in this book) by making a trustee-to-trustee transfer of the Roth account money (including any earnings) back into a regular IRA. As long as this is done before the due date of the return for the year of the conversion (including extensions), the "erroneous conversion" will be ignored by the IRS and the client can file his/her return as if the conversion never occurred. [See IRC §408A(d)(6) and Reg. §1.408A-5.]

In fact, the taxpayer can unwind the conversion for any reason, for example, because an equity-laden Roth account has declined in value due to a stock market downturn. (Sound familiar?)

Even if the taxpayer has already filed the return for the conversion year, he/she can still unconvert as late as six months after the unextended filing deadline (i.e., October 15 with adjustments for weekends). The taxpayer must then file an amended return to reflect the unconversion.

When an account is converted in one tax year (say 2004) and unconverted in the following tax year (say 2005), the earliest possible date to "reconvert" that same account back to Roth status is 30 days after the "unconversion" date. For this purpose, start counting with the date the "unconversion" takes place; the 31st day is the earliest date for "reconversion."

There's another "reconversion" date limitation for accounts that are converted and "unconverted" in the same tax year. For example, say the account owner converts an account in 2005 and then "unconverts" that same account later in the same year. The account owner cannot "reconvert" that account back to Roth IRA status until the later of: (1) January 1, 2006 or (2) 30 days after the "unconversion" date. (See Reg. 1.408A-5, Q&A-9.)

Key Point. Conversions, unconversions, and reconversions are all handled by completing Form 8606. Typically, IRA trustees issue a 1099-R for each conversion (treated as a distribution from the regular IRA), another one for each unconversion (treated as a distribution from the Roth IRA), and yet another one for each reconversion (another distribution from the regular IRA). To prevent IRS computer-matching problems, the total from all 1099-Rs should be reported on the appropriate line of Form 1040. The net taxable amount (if any) from all conversions, unconversions, and reconversions should then be reported on the corresponding line.

Why Returns for Conversion Years Should Often Be Extended

If the client converts a traditional IRA into a Roth account and then uses the account to invest in equities, it is almost a given that the return for the conversion year should be extended to August 15. If the market tumbles, the client then has the option of unwinding the Roth conversion by making a trustee-to-trustee transfer back into a regular IRA by the extended due date of the return for the conversion year. If possible, the client should hedge to October 15 by filing Form 2688 with a legitimate reason for the second extension. If the client then decides to unconvert, he/she can consider reconverting sometime later at a lower tax cost.

Key Point. As mentioned earlier, if the taxpayer has already filed the return for the conversion year, he/she still has until six months after the unextended due date of the return to unconvert. However, in this case, an amended return must then be filed to reflect the unconversion. [See the instructions to Form 8606 (Nondeductible IRAs).]

When Conversion Spans Year-End

What if the taxpayer liquidates his/her traditional IRA in December of one year and then rolls over the money into a Roth IRA in January of the following year? As discussed earlier, conversion transactions are allowed as long as the taxpayer's AGI is $100,000 or less. But to which year does the $100,000 rule apply in this circumstance? The answer: The AGI for the earlier withdrawal year is the relevant number. The taxpayer's AGI level in the later rollover year — no matter how high — will not disqualify the conversion transaction as long as the rollover occurs within 60 days of the withdrawal [IRC §408A(c)(3)(B)].

Conversion After Taxpayer Reaches Age 70½

If the taxpayer has attained at least age 70½ by the end of the conversion year, he/she must take that year's required minimum distribution before converting all of his/her traditional IRAs to Roth status. In other words, only the balance left after taking the conversion year's required minimum distribution can be converted. If conversion occurs in the year the taxpayer turns 70½, the initial required minimum distribution amount cannot be converted, even though the deadline for that initial distribution is actually April 1 of the following year (Reg. Sec. 1.408A-4, Q&A-6). See Chapter 6, "Planning for Older Clients," for full coverage of the IRA required minimum distribution rules.

Exhibit 2-1, below, illustrates sample projections made to analyze the advisability of Roth conversions.

Exhibit 2-1
Sample Projections to Assess Whether Client Should Convert Traditional IRA into Roth Account (or Not)

All the cases illustrated below assume your client is considering converting a traditional IRA currently worth $30,000 into a Roth IRA.

Example 1: Lower Tax Rate at Retirement

- *Assumptions* – Traditional IRA balance is 100% taxable and will be liquidated at retirement in 25 years; 8% annual rate of return on IRA balance between now and then; 25% tax rate on ordinary income during all pre-retirement years (including Roth conversion year); 15% tax rate on ordinary income in year IRA is liquidated; 6.48%* annual after-tax rate of return on Roth conversion tax amount that could have otherwise been invested in a taxable account.

Future value of traditional IRA after taxes:	$174,636
Future value of Roth IRA:	$205,454
Future value of $7,500 conversion tax cost:	(36,038)
Net future value of Roth alternative:	$169,416

- *Conclusion* – Not converting beats converting by $5,220.
- *Explanation* – When the income triggered by the conversion is taxed at a significantly higher rate than the expected tax rate that is avoided at retirement age, you will find that converting does not make sense.
- *Assume* – 40% of 8% pretax return will be ordinary income taxed at 25%; remaining 60% of 8% pretax return will be long-term gains and qualified dividends taxed at only 15%. This equates to a "blended" after-tax return of 6.48%.

Example 2: Constant Tax Rate Before and After Retirement

- *Assumptions* – Same as Example 1, except this time assume a 25% tax rate will apply when the IRA is liquidated in 25 years.

Future value of traditional IRA after taxes:	$154,091
Future value of Roth IRA:	$205,454
Future value of $7,500 conversion tax cost:	(36,038)
Net future value of Roth alternative:	$169,416

- *Conclusion* – Converting beats not converting by $15,325.

- *Explanation* – Converting works best when the tax rate expected to be avoided at retirement age is the same or higher than the current tax rate on the income triggered by the conversion.

Example 3: Only 10 Years until Retirement

- *Assumptions* – Same as Example 2, except this time assume the client has only 10 years until the IRA will be liquidated.

Future value of traditional IRA after taxes:	$48,576
Future value of Roth IRA:	$64,768
Future value of $7,500 conversion tax cost:	(14,052)
Net future value of Roth alternative:	$50,716

- *Conclusion* – Converting beats not converting by $2,140.

- *Explanation* – Converting still makes sense, but not as much sense as when the client has more years until retirement.

Example 4: Only Five Years until Retirement

- *Assumptions* – Same as Example 2, except this time assume the client has only 5 years until the IRA will be liquidated.

Future value of traditional IRA after taxes:	$33,060
Future value of Roth IRA:	$44,080
Future value of $7,500 conversion tax cost:	(10,266)
Net future value of Roth alternative:	$33,814

- *Conclusion* – Converting beats not converting by $754.

- *Explanation* – Converting still makes sense, but not nearly as much sense as when the client has more years until retirement.

Example 5: Traditional IRA Includes Nondeductible Contributions

- *Assumptions* — Same as Example 1, except this time assume the client's $30,000 traditional IRA balance includes $10,800 of nondeductible contributions.

Future value of traditional IRA after taxes:	$176,256
Future value of Roth IRA:	$205,454
Future value of $4,800 conversion tax cost:	$ (23,064)
Net future value of Roth alternative:	$182,390

- *Conclusion* — Converting beats not converting by $6,134.
- *Explanation* — Significant amounts of nondeductible contributions will significantly reduce the up-front conversion tax hit. This can make converting a good idea even when the expected tax rate at retirement is well below the current tax rate on the income triggered by the conversion.

Key Point. The projections in this exhibit are illustrative only. The outcomes are very sensitive to the assumptions that are used (tax rates, rates of return, years until retirement, etc.).

Summary

This chapter analyzes the issue of which types of investments are best suited for which types of retirement-savings accounts. The conclusion is equity investments should usually be allocated first to the client's Roth IRAs, because that strategy will generally produce the highest total after-tax return on the client's retirement-savings dollars.

This chapter also analyzes the Roth IRA conversion question and concludes that converting will often appear to be a good idea, as long as the client fully understands all of the implications. Exhibit 2-1 illustrates sample projections made to analyze the advisability of Roth conversions.

Chapter 3

Planning for Employer Stock Held in Qualified Retirement Plan Accounts

Objectives

After completing this chapter you should be able to help clients with employer stock held in qualified retirement plan accounts to make tax-smart decisions regarding those shares.

Introduction

These days, many employer-sponsored qualified retirement plans encourage or require participants to hold stock in the employer corporation in participant accounts. Careful tax planning is required for such shares. This chapter covers what practitioners need to know to skillfully advise clients who own employer shares in their qualified retirement plan accounts.

Should Employer Shares Be Rolled Over into an IRA or Not?

In general, clients who retire, quit, or otherwise separate from employment are well advised to roll over any money or assets held in their employer-sponsored qualified retirement plan accounts into IRAs.

The tax-free IRA rollover strategy avoids any immediate tax hit and allows the departing employee to continue to benefit from tax-deferred earnings growth until money is actually withdrawn from the rollover IRA.

However, when the client's qualified retirement plan account holds appreciated employer stock, he/she may be better off withdrawing the shares and holding them in a taxable account rather than rolling the shares over into an IRA.

As long as the shares are part of what qualifies as a lump-sum distribution from the client's qualified plan accounts (as defined later in this chapter), only the amount of the plan's cost basis in the employer shares—generally the fair market value (FMV) of the shares when they were acquired by the plan — is taxed currently as ordinary income [IRC §402(e)(4)(B)]. The net unrealized appreciation in the shares (NUA) goes untaxed until they are actually sold. (The NUA equals the difference between the shares' cost basis to the plan and the shares' current market value as of the date they are distributed to the employee.)

If the shares have appreciated substantially over the years, the plan's cost basis could be a relatively small percentage of the shares' current market value as of the distribution date. Remember, however, that the cost basis number may still be a significant amount in absolute dollar terms, so the tax hit may also be more than a nominal amount.

If the client is under age 55 when she separates from service, the 10% premature-withdrawal penalty tax will generally be added to the income tax hit [IRC §72(t)(1)]. However, the 10% tax will also only apply to an amount of income equal to the plan's cost basis in the employer shares. So if this is a small amount, paying the 10% penalty tax may still be small potatoes.

Here are the offsetting benefits from taking a current tax hit on the employer shares:

- The NUA goes untaxed until the shares are sold.
- When the NUA *is* taxed, it automatically qualifies as long-term capital gain eligible for preferential capital gains rates (IRS Notice 98-24). This assumes the shares are ultimately sold for at least their value as of the distribution date. If not, the actual taxable gain (if any) will be less than the NUA amount, but it will still automatically qualify as a long-term capital gain eligible for preferential rates.
- Any post-distribution appreciation (after the shares come out of the qualified plan account) will also qualify for preferential capital gains rates as long as the shares are held for more than 12 months [Reg. 1.402(a)-1(b)(1)(i)]. For this purpose, the employee's holding period is considered to commence on the day after the shares are delivered by the plan to the stock transfer agent with instructions to reissue the shares in the employee's name (Rev. Rul. 82-75).
- If the employee dies while still owning the shares, her heirs are entitled to an income tax basis step-up for any post-distribution appreciation [IRC §1014(a) and (c)]. However, when the heirs sell the shares, the NUA amount will be taxed as a long-term capital gain under the "income-in-respect-of-a-decedent rules" (per Rev. Rul. 75-125). (See Chapter 7, "Planning for Inherited Accounts" for more on income in respect of a decedent.)

In contrast, when the employer stock is rolled over tax-free into an IRA, there is effectively no tax on the value of the shares until they are sold, and the resulting proceeds are withdrawn from the account. The problem with a rollover is the employee (or her heirs who inherit the IRA) will eventually pay tax on the NUA and any post-distribution appreciation at ordinary income rates rather than at much lower capital gains rates. (There is no tax-basis step-up for the employee's heirs when the shares are held inside an IRA. See Chapter 7, "Planning for Inherited Accounts" for more on this issue.)

Examples 3-1 and 3-2 illustrate two sides of the rollover question.

Example 3-1

Assume your client, Bruce, retires from a large corporation at age 62. As part of a lump-sum distribution from his several qualified retirement plan accounts, Bruce receives 2,000 shares of employer stock with a cost basis to the plan of $10,000. The current market value of the shares is $80,000. Bruce expects the stock to continue to appreciate, so he does not intend to sell the shares anytime soon. Instead of rolling the shares into his rollover IRA, Bruce heeds the advice of his CPA and deposits the shares in a taxable brokerage-house account. Bruce then pays tax at his ordinary rate of, say, 25% on the $10,000 cost-basis amount. (Because of his age, Bruce does not owe the 10% premature-withdrawal penalty tax.) Bruce's tax basis in the shares is now $10,000.

Bruce rolls over all of the other money received in his lump-sum distribution tax-free into an IRA.

Years later, Bruce dies after the employer shares have appreciated to $180,000. Under IRC §1014(a), Bruce's heirs receive a tax-basis step-up equal to the post-distribution appreciation in value ($100,000 in this case). When the heirs sell the stock, they will owe capital gains tax on the $70,000 worth of NUA ($80,000 market value as of the plan distribution date less the plan's $10,000 cost basis in the shares). Of course, the heirs will also owe capital gains tax on any additional appreciation that occurs after Bruce's death.

Assume there is no further appreciation and that the heirs pay the usual 15% rate on long-term capital gains. Under these assumptions, the total federal income and capital gains tax paid on the $180,000 worth of stock is a mere $13,000: $2,500 by Bruce when he received the shares as part of his lump-sum distribution plus $10,500 (15% of the $70,000 of NUA) by the heirs when the shares are finally sold years later. That amounts to an effective federal tax rate of only 7.22% ($13,000 tax divided by $ 180,000). Wow!

In contrast, if Bruce had rolled the employer shares over into an IRA, his heirs would eventually owe tax at ordinary income rates on the entire $180,000. In all likelihood, the resulting federal income tax hit would be at least 25%, or $45,000.

Example 3-2

Assume the same basic facts as in Example 3-1, except this time Bruce is age 53 when he leaves his job, and the employer shares have a cost basis to the plan of $30,000 and a current market value of $40,000. In this example, Bruce would be taxed on $30,000 if he does not roll over the employer stock, plus he would owe the 10% premature-withdrawal penalty tax on that amount, because he is not at least age 55 when he separates from service. Under these circumstances, the current tax hit from not rolling the stock over is much greater than in Example 3-1. Bruce should probably roll the shares over, unless he anticipates dramatic future appreciation in the value of the stock and a long-term holding period for the shares. In that case, the more favorable tax treatment of the anticipated future appreciation might make paying a rather large current tax bill worthwhile. Bruce might want you to make some projections of the tax savings that could result under various assumptions for the amount of future appreciation.

Favorable Treatment Applies Only to Employer Shares Received in a Lump-Sum Distribution

As Example 3-1 illustrates, *not* rolling employer stock over into an IRA can save a client major tax dollars, under the right circumstances.

However, the favorable tax treatment explained above applies *only* to employer shares received as part of a lump-sum distribution

When employer shares are distributed from a qualified retirement plan and are *not* part of a lump-sum distribution, the tax consequences of not rolling the shares over into an IRA are much less favorable.

Specifically, the full market value of the shares will be taxed currently as ordinary income (except to the extent of any nondeductible employee contributions plus the unrealized appreciation attributable to such nondeductible contributions). [See IRC §402(e)(4)(A).]

The taxable amount will generally be subject to the 10% premature-withdrawal penalty tax as well, unless the employee (1) receives the shares due to separation from service at age 55 or older or (2) is age 59½ when the shares are received.

Post-distribution appreciation in the shares will still qualify for favorable capital gains rates, as long as the shares are held over 12 months before being sold.

Key Point. When employer shares are *not* received as part of a lump-sum distribution, the tax-smart move is generally to roll them over tax-free into an IRA.

What Qualifies as a Lump-Sum Distribution?

A lump-sum distribution (LSD) is a distribution, or several distributions, that result in the employee receiving his/her entire balance from a qualified pension plan, profit-sharing plan, or stock bonus plan (or several such plans) within a single year. For purposes of this "entire-balance rule," the following "aggregation rules" apply:

- All pension plans maintained by the employer are treated as a single pension plan. This includes target-benefit and money-purchase pension plans as well as defined-benefit pension plans.

- All profit-sharing plans maintained by the employer are treated as a single profit-sharing plan.

- All stock-bonus plans maintained by the employer are treated as a single stock-bonus plan.

Basically, the preceding rules mean that a distribution will qualify as an LSD if the employee receives in the same year his entire balance from all plans of the same type in which he participates. (Multiple payments are permitted as long as they are all received in the same year.)

For example, if the employee receives his entire balance from all pension plans in Year 1, the pension-plan payout(s) qualify as an LSD even if the employee did not receive his entire balance from the employer's profit-sharing plan(s) until Year 2.

In order for a distribution to be an LSD, it must be received because of the employee's

- Death,

- Attainment of age 59½, or

- Separation from service [IRC §402(e)(4)(D)].

An employee age 59½ or older can receive an LSD without separating from service if the plan(s) permit such distributions. [See Private Letter Rulings (PLRs) 8852034 and 8952010.]

"Separation from service" means leaving one's job due to retirement, quitting, being laid off, being fired, etc.

Example 3-3 illustrates an LSD situation and choices when considering the "entire-balance rule."

Example 3-3

Assume your client retires from her job on September 15, 2004. Her employer sponsors a 401(k) plan, a separate profit-sharing plan, and a money-purchase pension plan. In October 2004, the client receives all of her 401(k) plan balance plus part of her profit-sharing plan balance (which includes some company stock). In November 2004, she receives the remainder of her profit-sharing plan balance.

She does not receive her balance from the money-purchase pension plan until January 2005.

For purposes of the "entire-balance rule," all profit-sharing plans in which the client participated are aggregated. Since she received 100% of her balances in calendar year 2004 from all profit-sharing plans in which she participated as a result of separating from service, the profit-sharing plan and 401(k) plan distributions together comprise an LSD. The 2005 money-purchase pension plan distribution also qualifies as an LSD, because the client receives her entire balance from all pension plans in which she participated (there is only one in this example) in that year.

Because the client receives the employer stock as part of an LSD, she can take advantage of the favorable tax rules explained earlier in this chapter by *not* rolling over the employer shares into her IRA. (She can still roll everything else over tax-free if she wishes.)

Variation. Assume the same basic facts as in the preceding example, except this time the client did not receive her entire balance from the 401(k) plan until sometime in 2005. In this variation, the distributions from the profit-sharing and 401(k) plans do *not* comprise an LSD, because the client did not receive her entire balance from all profit-sharing plans in which she participated in a single year. Therefore, the client *cannot* take advantage of the special rules for employer shares. As a result, the tax-smart move in this variation is probably to roll the shares over into an IRA.

Summary

Employer shares received as part of a lump-sum distribution and *not* rolled over into an IRA, qualify for favorable tax treatment. Depending on the size of the potential tax savings, the taxpayer may be well advised to *not* roll the employer stock over and to pay the resulting current income tax hit. However, before recommending this strategy, the practitioner should make certain that the employer shares are, in fact, received as part of a lump-sum distribution.

Chapter 4

Planning for Early Retirees and Early Retirement Account Withdrawals

Objectives

After completing this chapter you should be able to

- *Help clients who retire before age 59½ to get the most tax-saving mileage out of their tax-advantaged retirement accounts.*
- *Advise clients who are under age 59½ on how to gain access to money in their tax-advantaged retirement accounts without being hit with the 10% premature-withdrawal penalty tax.*
- *Suggest some tax-smart alternatives to raiding the early retiree's tax-advantaged retirement accounts.*

Introduction

Oftentimes, people want to retire at relatively young ages. For purposes of this chapter, "relatively young" means under age 59½. Tax-wise, several issues arise when a client retires at such an early age.

First, we want to make sure the client preserves the benefits of his/her tax-advantaged retirement accounts (traditional and Roth IRAs, 401(k) accounts, SEP accounts, Keogh accounts, etc.) for as long as possible.

Second, we want to try to avoid the dreaded 10% premature-withdrawal penalty tax, which generally applies to the taxable portion of any withdrawals before age 59½ from the client's tax-deferred retirement accounts. The 10% penalty tax can also apply to certain Roth IRA withdrawals before age 59½ as well. [See IRC §§ 72(t) and 408A(d)(3)(F).]

This chapter also covers the more general issue of withdrawing funds in tax-advantaged retirement accounts before age 59½ (whether or not the client is retiring early). Once again, the key issue in this context is helping the client avoid the 10% premature-withdrawal penalty tax whenever possible.

Tax Planning for IRA Rollovers

After exiting a company job, your client's first big tax question is probably what to do with the money in his/her qualified retirement plan accounts [401(k), pension plan, profit-sharing plan, stock bonus plan, etc.].

The standard advice is to roll everything over into an IRA. That advice generally makes sense, because the client can take over the management of his/her retirement funds while continuing to defer taxes on the income and gains those funds generate [IRC §408(d)(3)(A)].

Do IRA Rollovers the Right Way

If your client decides to go the rollover route, be sure he/she arranges for a "direct" (or "trustee-to-trustee") rollover from the qualified retirement plan account into the rollover IRA. In other words, the check from the company retirement plan should be made out to the trustee of the client's new rollover IRA. Or the client may be able to arrange for a wire transfer directly into the rollover IRA.

Key Point. The IRA should be set up in advance to receive the upcoming rollover contribution; no money need be in the IRA before the rollover.

Here is why doing a direct rollover is critical (see Example 4-1). If your client receives a retirement plan distribution check payable to him/her personally, 20% of the taxable amount of the distribution will automatically be withheld for federal income taxes. The client will then have only 60 days to come up with the "missing 20%" and get it into the rollover IRA. Otherwise the client will owe income tax on the 20% plus the 10% premature-withdrawal penalty will generally apply if the client is under age 55 when he/she separates from service. [See IRC §§ 72(t), 402(c)(3), and 3405(c); Reg. §1.401(a)(31)-1, Q&A-3.]

Of course, if the client fails to come up with the missing 20%, he/she will be entitled to a federal income tax refund, because the withholding will exceed the actual tax (and 10% penalty, if applicable) due. But the client will not get that refund until after filing the return for the year the withholding occurs. That could be many months later.

Example 4-1

After retiring from his job at age 52, your early retiree client Bob is due $100,000 from his company 401(k) plan. Bob wants to roll over the entire $100,000 into an IRA, but he fails to arrange for a direct rollover. So he receives a distribution check made out directly to him. Surprise! The amount of Bob's check is only $80,000. The "missing" $20,000 went straight to the IRS for federal income tax withholding. Now Bob will have to somehow scrape up $20,000 and get it into his rollover IRA within 60 days to pull off a totally tax-free rollover. What if he fails to get t the $20,000, plus he will owe the 10% premature-withdrawal penalty tax on the $20,000 to boot. Plus Bob will owe state income tax in most states. Say Bob's marginal federal income tax rate is 28% and his marginal state income rate is 8%. The unexpected tax bill on the $20,000 will be $9,200 [(28% + 10% + 8%) × $20,000 = $9,200]. Ouch! Of course, Bob will eventually collect a $12,400 refund from the IRS (the difference between the $20,000 withheld and 38% of $20,000, which is the amount Bob actually owes the Feds). But he could have avoided the whole mess by simply arranging for a direct rollover in the first place.

When Retirement Accounts Contain Appreciated Company Stock

There is an exception to the general advice to roll over as much qualified retirement plan money as possible tax-free into an IRA. This is when the client's qualified retirement plan account contains appreciated company stock that is received as part of a lump-sum distribution. In this case, the client may be better off leaving the stock in a taxable account and paying the resulting income tax hit. See Chapter 3,"Planning for Employer Stock Held in Qualified Retirement Plan Accounts," for a full discussion of this issue.

Liberalized Rollover Rules

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) liberalized the rules for tax-free rollovers between tax-deferred retirement accounts. These changes were intended to make tax-deferred retirement account money more portable as individuals move from job to job over the years.

Key Point. While clients now have more freedom than ever to roll over retirement account funds, you will see that some of the new rules can have the negative effect of encouraging rollover transactions that are inadvisable in most circumstances.

Rolling Over After-Tax Contributions into IRAs

Before EGTRRA, after-tax contributions to employer-sponsored qualified retirement plans could not be rolled over into IRAs. So when an individual retired or changed jobs, her after-tax dollars had to be reinvested in a taxable account or spent. In either case, the tax deferral advantage was lost.

That was then. This is now. The updated rules allow rollovers of after-tax contributions into IRAs [IRC §402(c)(2)]. This favorable change allows clients to continue investing those dollars in a tax-deferred fashion, which is great news for folks who have made significant after-tax contributions.

In addition, individuals who change jobs can now roll over after-tax contributions from the former employer's plan into the new employer's defined contribution plan [401(k) plan, profit-sharing plan, etc.]. To qualify for this rule, however, rollovers must be affected via direct (trustee-to-trustee) transfers between the old and new plans. [See IRC §§ 402(c)(2) and 401(a)(31).] Also, the new employer's plan must be willing to accept after-tax contributions and separately track them. Before the EGTRRA changes, a qualified plan could not accept rollovers of after-tax contributions previously made to another qualified plan.

Warning. Rolling over after-tax contributions into the new employer's plan will eliminate the client's ability to later take advantage of the special lump-sum distribution tax rules for any subsequent lump-sum distribution from the new employer's plan [See § 641(f)(3) of EGTRRA]. In most cases, however, this is not a concern because the special lump-sum distribution rules are only available to clients born before 1936.

While rolling over after-tax dollars into an IRA is generally advisable (because it preserves tax-deferral benefits), rolling over after-tax dollars from one employer's qualified retirement plan into another employer's plan is generally not advisable.

Here's why. In most cases, the only real advantage to rolling over into another employer plan is simplified recordkeeping (because all of the client's tax-deferred retirement money can be kept in one place). However, rolling into another employer plan will limit the client's investment alternatives and restrict access to his money. In contrast, rolling into an IRA gives the client virtually unlimited investment alternatives without any restrictions on access to his money (ignoring the negative tax consequences when IRA money is withdrawn prematurely).

Key Point. For the reasons explained above, clients should generally be advised to roll over after-tax contributions, and before-tax contributions as well, from the former employer's plan into their own IRAs.

A notable exception to the preceding standard advice is when the client is concerned about exposure to creditors or liabilities and a rollover into the new employer's plan would offer greater legal protection than a rollover into an IRA. (This is a matter of state law, and the advice of an attorney should be sought if this becomes an issue.)

In relatively rare cases, the new employer's plan might offer such superior investment alternatives (such as mutual funds at greatly reduced fees) that rolling over into the new employer's plan looks better than the IRA rollover alternative.

Finally, the client might want to preserve the option of borrowing against his retirement account balance. An employer-sponsored plan can allow participants to borrow against their accounts, while borrowing against IRAs is prohibited.

Rolling Over IRA Money into Employer Plans

Before EGTRRA, IRA money could be rolled over into a qualified retirement plan only when the IRA in question was a conduit IRA. A conduit IRA is an account containing only funds that were previously rolled over from another qualified retirement plan.

Thanks to the EGTRRA changes, the client can now roll over any eligible rollover distribution from an IRA into a qualified retirement plan (assuming the plan permits such rollovers). An eligible rollover distribution is an IRA distribution that would be taxable in the absence of a rollover. Put another way, nondeductible IRA contribution dollars cannot be rolled over, except into another IRA. [See IRC §408(d)(3)(A)(ii).]

Warning. Rolling over the client's IRA money into a qualified retirement plan under the EGTRRA provisions will eliminate her ability to take advantage of the special lump-sum distribution tax rules for any subsequent lump-sum distribution from the qualified retirement plan [See §641(f)(3) of EGTRRA]. In most cases, however, this is not a concern because the special lump-sum distribution rules are only available to clients born before 1936.

While rolling over IRA money into an employer-sponsored plan is now generally allowed, it is not generally advisable. In most cases, the only real advantage to rolling over into an employer plan is simplified recordkeeping (because all of the client's tax-deferred retirement money can be kept in one place). However, rolling into an employer plan will limit the client's investment alternatives and restrict access to her money. In contrast, leaving her money in an IRA gives the client virtually unlimited investment alternatives without any restrictions on access to the money (ignoring the negative tax consequences when IRA money is withdrawn prematurely).

Key Point. For the reasons explained above, clients should generally be advised to not roll over their IRA money into employer-sponsored plans.

An exception to the preceding standard advice is when the client is concerned about exposure to creditors or liabilities and a rollover into an employer plan would offer greater legal protection than leaving money in the IRA. (This is a matter of state law, and the advice of an attorney should be sought if this issue becomes important.)

In relatively rare cases, an employer plan might offer superior investment alternatives (such as mutual funds at greatly reduced fees) that make rolling IRA money into the plan look like a good idea.

Finally, the client might want to preserve the option of borrowing against her retirement account balance. An employer-sponsored plan can allow participants to borrow against their accounts, while borrowing against IRAs is prohibited.

Early Retiree Strategies to Avoid 10% Penalty on Premature IRA Withdrawals

As stated earlier, clients who retire early are generally well advised to roll all of their qualified retirement plan money over tax-free into an IRA.

However, there is an important thing to keep in mind here. Once the money is rolled into the IRA, the client generally cannot take any withdrawals before age 59½ without being socked with the dreaded 10% premature-withdrawal penalty tax [IRC §72(t)]. And the penalty tax is, of course, on top of the federal and state income taxes that will apply to any withdrawals from the rollover IRA.

Key Point 1. When the client retires *after* age 55 but *before* age 59½ and will need some of the qualified retirement plan account money in the near future, he/she should be advised to *not* roll everything into an IRA (unless subsequent IRA withdrawals will qualify for one of the IRA penalty exceptions listed in Exhibit 4-1 later in this chapter). Instead, the client should be advised to keep the needed amount of cash out of the rollover IRA. The client will have to pay income taxes on that amount to be sure. But at least the 10% tax will be avoided, because the client is age 55 upon separation from service. This is one of the exceptions to the 10% penalty for distributions from qualified retirement plans. See Exhibit 4-2 later in this chapter for the complete list.

Key Point 2. If the client is *under* age 55 when he/she retires, the 10% premature-withdrawal penalty tax will apply to the taxable portion of any qualified retirement plan distributions that are not rolled over into an IRA, unless the client qualifies for one of the qualified retirement plan penalty exceptions listed in Exhibit 4-2. If the client does not qualify for any of the exceptions, alternative sources of cash should be strongly considered (more on that later in this chapter).

Annuitizing Retirement Accounts to Avoid 10% Penalty Tax

In many cases, the easiest way for the IRA owner or qualified retirement plan participant — the client for purposes of this discussion — to tap into his/her retirement account early without being hit with the 10% penalty tax is to arrange for what the IRS calls "substantially equal periodic payments" over the client's life expectancy [IRC §72(t)(2)(A)(iv)]. This maneuver is often referred to as annuitizing the account, because the client must receive a series of annuity-like payouts in order to avoid the 10% penalty tax. The annuity-like payouts must be received at least annually.

Key Point. When the client has several IRAs or qualified retirement plan accounts, the client need not annuitize them all. Instead, the client can annuitize one or more accounts to generate annual annuity-like payouts big enough to meet his/her cash needs. Other accounts can be left untouched until after the client reaches age 59½. This preserves the tax advantages of the client's other accounts.

There are two catches here:

1. While properly calculated annuity-like payouts are free of the 10% penalty tax, they are still subject to federal income tax (and state income tax as well in most states); and

2. Once the client begins taking these annuity-like payouts, he/she must stick with the program for at least five years or until attaining age 59½, whichever comes later. If the client stops taking annuity-like withdrawals prematurely or takes withdrawals that do not exactly equal the properly calculated annuity-like amounts, all pre-age-59½ withdrawals can be hit with the 10% penalty tax. So there can be a big retroactive penalty tax whammy if the client fails to precisely follow all the rules.

Key Point. Make sure your client's annuity-like withdrawals are correctly calculated. Next, make sure the client continues taking them for the required period. Otherwise all pre-age-59½ withdrawals can be hit with the dreaded 10% penalty tax. This should be carefully explained to the client before he/she commences receiving the series of annual annuity-like withdrawals.

Three IRS-Approved Calculations of Annuity-Like Withdrawals

IRS Notice 89-25 established three government-approved methods for calculating annual annuity-like withdrawal amounts. Much later, in Rev. Rul. 2002-62, the IRS clarified and liberalized some of the rules outlined in Notice 89-25.

The three IRS-approved methods are as follows:

1. The required minimum distribution method

2. The amortization method (referred to as the fixed amortization method in Rev. Rul. 2002-62)

3. The fixed annuitization method

The first two methods are relatively simple, while the third method is unduly complicated. Accordingly, only the required minimum distribution and amortization methods are explained here.

Key Point. Under the required minimum distribution method, annual annuity-like withdrawal amounts are recalculated each year. If the client's account balance goes down due to poor investment performance, subsequent withdrawal amounts are reduced to reflect the decline in value.

In contrast, annual annuity-like withdrawal amounts under the other two methods are calculated once – based on the client's account balance prior to the commencement of withdrawals. In other words, the withdrawal amount is fixed and cannot be changed without triggering the 10% penalty tax on all pre-age-59½ withdrawals from the account. If the account balance declines dramatically due to poor investment performance, these fixed withdrawals can drain the account much faster than the client ever intended when the program of annuity-like withdrawals was begun. The account's tax advantages will come to a premature end, which is bad for the client.

After horrible recent performance by equity investments held in many retirement accounts, this unfortunate scenario has become all too common. If the client reacts by taking smaller withdrawals, the 10% penalty tax is owed on all pre-age-59½ withdrawals from the account. (Taking reduced withdrawals is considered a prohibited modification of the series of fixed annuity-like payouts, which retroactively triggers the penalty tax.) That stinks! Fortunately, Rev. Rul. 2002-62 supplies some relief, as explained later in this section.

How to Use the Required Minimum Distribution Method

Under this method, the balance in the annuitized account is divided by a life expectancy figure based on the client's attained age as of the end of the year for which the annuity-like withdrawal is being calculated. The resulting number is the permitted penalty-free annuity-like withdrawal amount for the year in question. The following year, a new calculation is made using the updated account balance and an updated life expectancy figure that reflects the passage of a year.

Account Balance Rules

To calculate the annuity-like withdrawal amount for the year withdrawals first commence under the required minimum distribution method, use the account balance as of either (1) December 31 of the preceding year, or (2) any date between December 31 of the preceding year and the date withdrawals commence (assuming account balances are available for all such dates).

In subsequent years, use the account balance as of (1) December 31 of the preceding year, or (2) any date within a reasonable period before receiving that year's annuity-like withdrawal (assuming an account balance is available for the chosen date). [See Rev. Rul. 2002-62, Sec. 2.02(d).]

Life Expectancy Rules

Per Rev. Rul. 2002-62, clients have three life expectancy options for purposes of calculating annuity-like withdrawal amounts:

1. Use the uniform lifetime table in Appendix A of Rev. Rul. 2002-62,

2. Use the single life expectancy table in Reg. 1.401(a)(9)-9, Q&A-1, or

3. Use the joint life expectancy table in Reg. 1.401(a)(9)-9, Q&A-3.

Under the first and second life expectancy options, use the life expectancy figure based on the client's age as of the end of the year for which the annuity-like withdrawal amount is being calculated.

The third life expectancy option is only available for accounts that have one or more individuals designated as beneficiaries as of January 1 of the year for which the annuity-like withdrawal amount is being calculated. The account cannot have any beneficiaries other than real live persons. In this case, use the joint life expectancy figure [from the table in Reg. 1.401(a)(9)-9, Q&A-3] based on the account owner's age and the beneficiary's age as of the end of the year for which the annuity-like withdrawal amount is being calculated. If there are several beneficiaries, use the age of the oldest beneficiary. The third option cannot be used for a year in which no individual is designated as the account beneficiary as of January 1st of that year. For such a year, the second life expectancy option must be used [i.e., use the single life expectancy figure from the table in Reg. 1.401(a)(9)-9, Q&A-1]. Apparently, use of the third life expectancy option can resume in later years when an individual account beneficiary exists as of January 1 of such years. [See Rev. Rul. 2002-62, Sec. 2.02(b).]

Key Point. Choosing the second life expectancy option [i.e., using the single life expectancy figures from the table in Reg. 1.401(a)(9)-9, Q&A-1] will always produce the largest penalty-free annuity-like withdrawal amounts. In many cases, clients will want to receive the largest possible penalty-free payouts. (See Example 4-2 below.)

When allowed, choosing the third life expectancy option [i.e., using the joint life expectancy figures from the table in Reg. 1.401(a)(9)-9, Q&A-3] will produce the second largest penalty-free withdrawal amounts if and only if the beneficiary whose age is used to determine the joint life expectancy figures is less than 10 years younger than the client or older than the client. This will often be the case when the client's spouse is designated as the sole beneficiary of the annuitized account. (See Example 4-3 below.)

In all other cases, choosing the first life expectancy option [i.e., using the uniform lifetime table in Appendix A of Rev. Rul. 2002-62] will produce the second largest penalty-free withdrawal amounts. (See Example 4-4 below.)

Example 4-2

Cedric will be age 50 at the end of 2005. Starting in that year, he wants to begin taking monthly penalty-free annuity-like withdrawals from his rollover IRA under the required minimum distribution method. Assume Cedric wants to withdraw as much as possible without triggering the dreaded 10% penalty tax.

As of December 31, 2004, Cedric's IRA balance was $400,000. To calculate the maximum penalty-free annuity-like withdrawal amount for 2005 under the required minimum distribution method, simply divide $400,000 by his single life expectancy figure of 34.2 [the number for a 50-year-old from the table in Reg. 1.401(a)(9)-9, Q&A-1]. The result is $11,696 ($400,000/34.2). Cedric must take exactly that amount from the account during 2005. No more, no less. It can be taken out in one withdrawal, quarterly, monthly, whatever, as long as the total for the year equals the aforementioned $11,696. As explained earlier in this section, using the single life expectancy option results in the largest possible penalty-free annuity-like withdrawals for Cedric.

To calculate Cedric's 2006 annuity-like withdrawal amount, divide the December 31, 2005, account balance by 33.3 [the single life expectancy figure for a 51-year-old person from the table in Reg. 1.401(a)(9)-9, Q&A-1]. And so on for subsequent years.

Key Point. The same considerations apply if Cedric wants to annuitize a SEP account or a qualified retirement plan account, like a 401(k) or Keogh account.

Example 4-3

Same basic facts as Example 4-2 above, except this time assume Cedric's wife is the sole beneficiary of the IRA that Cedric intends to annuitize. She will be age 55 as of the end of 2005. Cedric decides to use joint life expectancy figures based on his age and his wife's age [from the table in Reg. 1.401(a)(9)-9, Q&A-3] to calculate his penalty-free annuity-like withdrawals.

As of December 31, 2004, Cedric's IRA balance was $400,000. To calculate his annuity-like withdrawal amount for 2005 under the required minimum distribution method using the joint life expectancy option, simply divide $400,000 by 38.3 [the number for a 50-year-old and a 55-year-old from the joint life expectancy table in Reg. 1.401(a)(9)-9, Q&A-3]. The result is $10,444 ($400,000/38.3). Cedric must take exactly that amount from the account during 2005. No more, no less. It can be taken out in one withdrawal, quarterly, monthly, whatever, as long as the total for the year equals the aforementioned $10,444.

To calculate Cedric's 2006 annuity-like withdrawal amount, divide the December 31, 2005, account balance by 37.4 [the joint life expectancy figure for a 51-year-old and a 56-year-old from the table in Reg. 1.401(a)(9)-9, Q&A-3]. And so on for subsequent years.

Key Point. The same considerations apply if Cedric wants to annuitize a SEP account or a qualified retirement plan account, like a 401(k) or Keogh account.

Example 4-4

Same basic facts as Example 4-2 above, except this time assume Cedric decides to use the uniform lifetime figures (from the table in Appendix A of Rev. Rul. 2002-62) to calculate his annuity-like withdrawals.

As of December 31, 2004, Cedric's IRA balance was $400,000. To calculate his annuity-like withdrawal amount for 2005 under the required minimum distribution method using the uniform lifetime option, simply divide $400,000 by the uniform lifetime figure of 46.5 (the number for a 50-year-old from the table in Appendix A of Rev. Rul. 2002-62). The result is $8,602 ($400,000/46.5). Cedric must take exactly that amount from the account during 2005. No more, no less. It can be taken out in one withdrawal, quarterly, monthly, whatever, as long as the total for the year equals the aforementioned $8,602.

To calculate Cedric's 2006 annuity-like withdrawal amount, divide the December 31, 2005, account balance by 45.5 (the uniform lifetime figure for a 51-year-old person from the table in Rev. Rul. 2002-62). And so on for subsequent years.

Key Point. The same considerations apply if Cedric wants to annuitize an SEP account or a qualified retirement plan account, like a 401(k) or Keogh account.

Key Point. As Examples 4-2 through 4-4 illustrate, the life expectancy option used to calculate penalty-free annuity-like withdrawals has a major impact on the withdrawal amounts. Under the required minimum distribution method, the same life expectancy option generally must be used for all years [Rev. Rul. 2002-62, Sec. 2.02(a)]. Therefore, the life expectancy option that is chosen should be tailored to match the client's anticipated cash needs.

How to Use the Amortization Method

If the client needs more penalty-free money than can be obtained under the required minimum distribution method, the tax planning solution is to use the amortization method to calculate annuity-like withdrawals.

Under the amortization method (see Example 4-5), the client is allowed to assume a reasonable rate of return on the money invested in the account to be annuitized. The result is higher penalty-free annuity-like withdrawal amounts. As explained earlier, however, if the investments held in the annuitized account perform poorly, the amortization method can drain the account much faster than the client may intend. In this event, the client can switch to the required minimum distribution method, as explained later in this section.

Account Balance Rule

To calculate the fixed annual annuity-like withdrawal amount under the amortization method, use the account balance as of either (1) December 31 of the preceding year, or (2) any date between December 31 of the preceding year and the date withdrawals commence (assuming account balances are available for all such dates). [See Rev. Rul. 2002-62, Sec. 2.02(d).]

Life Expectancy Rules

Under the amortization method, the life expectancy rules and the related considerations are the same as under the required minimum distribution method (see the explanation earlier in this section).

Reasonable Interest Rate Rule

When calculating annuity-like withdrawals under the amortization method, the taxpayer is allowed to assume a rate of return equal to a reasonable interest rate. Rev. Rul. 2002-62 stipulates that any rate that is not more than 120% of the federal mid-term rate (under the OID rules) for either of the two months immediately preceding the month in which annuity-like withdrawals first commence will be considered reasonable [Rev. Rul. 2002-62, Sec. 2.02(c)]. The monthly federal mid-term rates are published in the Internal Revenue Bulletin.

Example 4-5

Assume the same basic facts as in Example 4-2. However, this time assume Cedric wants to use the amortization method and his single life expectancy to annuitize his IRA, because he needs much larger penalty-free withdrawals than are allowed under the required minimum distribution method. Assume Cedric begins taking withdrawals on a monthly basis starting in January of 2005. Further assume that 6% equals 120% of the federal mid-term rate for December of 2004. Cedric's IRA as of December 31, 2004, is $400,000.

Using the amortization method with the single life expectancy option and a reasonable interest rate of 6%, Cedric's annual penalty-free annuity-like withdrawal amount turns out to be $27,788, or $2,316 per month ($27,788/12).

To compute this amount, you will need a financial calculator or program. Using the annuity calculation function, enter Cedric's retirement account balance as of the appropriate date — $400,000 in this case — as the present value. Then enter as the period Cedric's single life expectancy figure [from the table in Reg. 1.401(a)(9)-9, Q&A-1], based on his age as of the end of the year during which he will first commence receiving annuity-like withdrawals. Cedric will be age 50 as of December 31, 2005, so the appropriate life expectancy figure is 34.2 years. Next, enter the reasonable interest rate of 6%. Now ask the calculator or program to compute the annual payment amount.

The resulting number will be the annual penalty-free annuity-like withdrawal amount: $27,788 in this case. This fixed amount must be withdrawn each year. Withdrawals can be taken once per year, monthly, quarterly, whatever, as long as exactly $27,788 comes out of the account each year.

Compare $27,788 to the much lower amounts calculated using the required minimum distribution method in Examples 4-2 through 4-4 above. Remember: under the amortization method, Cedric must withdraw the same $27,788 each year. In contrast, if Cedric uses the required minimum distribution method, his annuity-like withdrawal amount must be recalculated each year. The results under this method will largely depend on changes in his account balance.

Key Point. Under the amortization method, Cedric can tweak the annual annuity-like withdrawal amount by using a different interest rate and a different life expectancy option (within the guidelines explained earlier). For example, using an interest rate below 6% will result in a lower annuity-like withdrawal amount. Ditto if Cedric uses a different life expectancy option.

The same considerations apply if Cedric wants to annuitize a SEP account or a qualified retirement plan account, like a 401(k) or Keogh account.

IRS Allows One-Time Switch to Required Minimum Distribution Method

As explained at the beginning of this section, a taxpayer who uses the amortization method or the fixed annuitization method to calculate penalty-free annuity-like withdrawals may be forced to prematurely drain the annuitized account if the account's investments perform poorly. In response to this problem, the IRS released Rev. Rul. 2002-62. The updated guidance modified Notice 89-25 to allow a one-time switch to the required minimum distribution method. If such a switch is made, the result will generally be much lower annuity-like withdrawal amounts. That, in turn, will mean extended tax-deferral advantages for the annuitized account.

Here are the mechanics for making the one-time switch,

- Taxpayers who first commenced receiving properly calculated annuity-like withdrawals before 2003 under the amortization or fixed annuitization method can make the one-time switch to the required minimum distribution method at any time. However, once the switch is made for the affected account, it is permanent. The taxpayer cannot go back to the amortization or annuity factor method with respect to that account. [See Rev. Rul. 2002-62, Sec. 3 and Examples 4-6 through 4-8.]

- Taxpayers who first commence receiving annuity-like withdrawals after 2002 under the amortization or fixed annuitization method can also make a one-time switch to the required minimum distribution method. However, the required minimum distribution method must be used for the entire year of the switch as well as for all subsequent years with respect to the affected account. [See Rev. Rul. 2002-62, Secs. 2.03(b) and 3, and Example 4-9.]

Key Point. Switching to the required minimum distribution method may produce the beneficial effect of extending the annuitized account's tax-deferral advantages. However, the client must understand that his/her annuity-like withdrawals will be reduced (often greatly reduced), unless the value of the annuitized account stages a miraculous recovery (not likely).

In other words, after the one-time switch to the required minimum distribution method has been implemented, the client is stuck with that method (and stuck with the presumably much lower annuity-like withdrawal amounts) for the duration of the annuity-like withdrawal period. [See Rev. Rul. 2002-62, Sec. 2.03(b).]

Example 4-6

Wanda, now age 49, commenced receiving annuity-like withdrawals from her IRA under the amortization method back in 1999. The IRA was invested largely in stocks and stock mutual funds that performed miserably. As a result, the value of Wanda's IRA declined drastically between 1999 and 2005. Wanda is now worried that her IRA will be exhausted in short order if she continues using the amortization method.

Under Rev. Rul. 2002-62, Wanda can switch to the required minimum distribution method at any time (Rev. Rul. 2002-62, Sec. 3).

Assume Wanda has already received her full annuity-like withdrawal amount for 2004. She can choose to make the switch effective for her 2005 tax year. Wanda's 2004 annuity-like withdrawal amount can apparently be calculated based on her IRA balance as of: (1) December 31, 2004, or (2) any date within a reasonable period before she begins receiving her 2005 annuity-like withdrawal amount (assuming account balance information is available for the chosen date). [See Rev. Rul. 2002-62, Secs. 2.02(d) and 2.03(b).]

Example 4-7

Assume the same basic facts as in Example 4-6, except now assume Wanda has already received part, but not all, of her 2004 annuitized withdrawal amount. In this Example 4-7, Wanda's status for the rest of 2004 is unclear. While Section 3 of Rev. Rul. 2002-62 clearly allows Wanda to switch to the required minimum distribution method at any time, there's no guidance on how to implement a mid-year switch.

Under these circumstances, Wanda should be advised to continue using the amortization method for the remainder of 2004 before switching to the required minimum distribution method for 2005. It's unclear how Wanda's annuity-like withdrawals should be calculated for the rest of 2004 if she makes a mid-year switch. Since all of her pre-age-59½ withdrawals will be exposed to the 10% premature-withdrawal penalty tax if Wanda miscalculates, she should stick with the status quo for the duration of 2004.

Example 4-8

Assume the same basic facts as in Example 4-6, except this time assume Wanda has not yet received any of her annuity-like withdrawal amount for 2004. In this situation, she can switch to the required minimum distribution method for 2004 without risk. To effect the switch, Wanda simply uses the required minimum distribution method to calculate her 2004 annuity-like withdrawal amount. For this purpose, Wanda can apparently use: (1) her December 31, 2003, account balance, or (2) the account balance as of any date within a reasonable time before she begins receiving her 2004 annuity-like withdrawal amount (assuming account balance information is available for the chosen date). [See Rev. Rul. 2002-62, Secs. 2.02(d) and 3.]

Example 4-9

Fred first commences receiving annuity-like withdrawals from his IRA in 2004 under the amortization method. Per Rev. Rul. 2002-62, he can switch to the required minimum distribution method. However, since Fred's annuity-like withdrawals first commenced after 2002, he must use the required minimum distribution method for the entire year of the switch (no mid-year switch is allowed). Fred decides to make the switch for his 2005 tax year. His annuity-like withdrawal amount for 2005 can apparently be calculated based on his account balance as of: (1) December 31, 2004 or (2) any date within a reasonable period before he begins receiving his 2005 annuitized withdrawal amount (assuming account balance information is available for the chosen date). [See Rev. Rul. 2002-62, Secs. 2.02(d), 2.03(b), and 3.]

No 10% Penalty Tax When Following Annuity-Like Withdrawal Rules Prematurely Drains the Account

Here's another bit of good news. Rev. Rul. 2002-62 clarified that when following the annuity-like withdrawal rules results in the affected account being completely drained before the end of the mandatory annuity-like withdrawal period (five years or after attaining age 59½, whichever comes later), the 10% penalty tax does not apply.

In other words, the inevitable cessation of payouts after the annuitized account has been zeroed out will not be considered a prohibited modification in the series of annuity-like withdrawals. [See Rev. Rul. 2002-62, Sec. 2.03(a).] The Ruling has simply clarified and codified what common sense would dictate, but we will take it.

As explained at the beginning of this section, the preceding sorry situation is most likely to occur when: (1) the amortization or annuity factor method is used to calculate annuity-like withdrawals, and (2) the value of the annuitized account drops precipitously due to poor investment performance.

Early Retiree Strategies to Avoid 10% Penalty on Premature Withdrawals From Self-Employed Retirement Accounts

When the client is self-employed and has his/her retirement money in Keogh or SEP accounts, things are pretty simple when the client retires early. There is no need for an IRA rollover, because the client is already in full control of the retirement funds. And the client's existing accounts allow continued tax deferral until money is actually withdrawn.

However, withdrawals from an SEP account before age 59½ will be hit with the 10% premature-withdrawal penalty tax, unless one of the IRA exceptions listed in Exhibit 4-1 applies.

Withdrawals from a Keogh account after retirement but before age 55 will be hit with the 10% premature-withdrawal penalty tax, unless one of the qualified retirement plan exceptions listed in Exhibit 4-2 applies.

Key Point. The easiest way for an early retiree to withdraw money in his/her SEP or Keogh accounts without getting hit with the 10% premature-withdrawal penalty tax is by arranging for annuitized withdrawals. The calculations for penalty-free annuity-like withdrawals from SEP and Keogh accounts are the same as for IRAs, as explained in the preceding section of this chapter.

Exhibit 4-1
Exceptions to 10% Penalty for Pre-Age-59½ IRA Withdrawals

- Annuitized withdrawals, as explained in this section.
- Withdrawals to finance a qualified home purchase for the account owner or certain relatives ($10,000 lifetime limit).
- Withdrawals used to pay qualified higher-education expenses for the account owner or certain relatives.
- Withdrawals after the account owner's death or disability.
- Withdrawals to pay medical expenses in excess of 7.5% of the account owner's adjusted gross income.
- Withdrawals used to pay health insurance premiums during certain periods of the account owner's unemployment.
- After age 59½, the account owner can withdraw money from an IRA for any reason without having to worry about the 10% premature-withdrawal penalty tax.

Note. The above exceptions apply equally to SEP accounts and SIMPLE IRAs, because they are considered IRAs for this purpose. The above exceptions also apply equally to Roth IRAs. These exceptions are all found in IRC §72(t)(2).

Exhibit 4-2

Exceptions to 10% Penalty for Qualified Retirement Plan Account Withdrawals

- Annuitized withdrawals, as explained earlier in this chapter.
- Withdrawals after "separating from service" (i.e., quitting, retiring, getting fired, or otherwise leaving employment) at age 55 or older. For a Keogh account, the account owner must actually retire from the self-employment activity for which the account was set up for this exception to be available. Warning: The 10% penalty cannot be avoided by the account owner retiring before age 55, leaving his/her money in the qualified retirement plan account, and then taking withdrawals after age 55. For the age-55 exception to be available, the plan participant must actually *separate from service* at age 55 or older [IRC §72(t)(2)(A)(v)].

- Withdrawals used to pay medical expenses in excess of 7.5% of the account owner's adjusted gross income.

- Withdrawals by a spouse or ex-spouse under a qualified domestic relations order (QDRO) pursuant to a divorce agreement. (See Chapter 5, "Planning for Divorcing Clients.")

- Withdrawals after the account owner's death or disability.

- After age 59½, the account owner can withdraw money from a qualified retirement plan account for any reason without having to worry about the 10% premature-withdrawal penalty.

Note. These exceptions are all found in IRC §72(t)(2).

Tax Treatment of Roth IRA Withdrawals

Roth IRAs have an interesting attribute for cash-starved early retirees who are tempted to raid their tax-advantaged retirement accounts. Namely, Roth contributions can generally be withdrawn tax-free and penalty-free before age 59½ (unlike money in traditional IRAs).

Here is the full story on how Roth IRA withdrawals are treated for federal income tax purposes.

A Roth account can potentially include money from all of the following sources:

- Annual after-tax contributions (limited to $3,000 for the 2002-2004 tax years)

- Contributions from one or more converted regular IRAs

- Earnings on both types of contributions

As you will see, different tax rules apply to each of the above layers.

All of an account owner's Roth IRAs are aggregated and treated as one account for purposes of applying the withdrawal rules explained below [IRC §408A(d)(4)]. This is consistent with the rules for handling withdrawals from traditional IRAs.

Annual Contributions

Roth IRA withdrawals are treated as coming first from the layer consisting of the account owner's annual after-tax contributions. As advertised, this layer of money can be taken out by the account owner tax-free and penalty-free at any time.

Conversion Contributions

Next, Roth IRA withdrawals are treated as coming from the layer consisting of contributions from converted traditional IRAs (if any). Within this layer, withdrawals are considered to come first from the taxable portion of converted traditional IRA money, then from the nontaxable portion (i.e., from nondeductible contributions to the traditional IRA, if any).

The Roth IRA owner will generally owe the 10% premature-withdrawal penalty tax if he/she withdraws any portion of the taxable part of a conversion contribution within five years of the beginning of the year in which the conversion takes place [IRC §408A(d)(3)(F)]. Withdrawals after age 59½ are excepted, and the other IRC §72(t)(2) exceptions (death, disability, etc.) apply as well. (See Exhibit 4-1 earlier in this chapter for the complete list of IRA penalty exceptions.)

The good news: After five years, the 10% penalty threat goes away.

After the account owner has withdrawn the taxable portion of the conversion contribution, he/she can withdraw the nontaxable part (if any) at any time without any federal income tax or penalty.

Account Earnings

After all Roth IRA contributions (annual contributions and conversion contributions, if any) have been withdrawn, any additional withdrawals are obviously coming from Roth account earnings. This money comes out tax-free and penalty-free as long as,

- The account has been open more than five years (the five-year period is deemed to start on January 1 of the year for which the initial contribution to *any* Roth account owned by the individual was made);

- The account holder is at least age 59½, disabled, or dead; or

- Withdrawals of up to a cumulative $10,000 are taken to pay for qualified home purchase costs.

Withdrawals of earnings that do not fit the above description are hit with federal income tax and, in most cases, the 10% premature-withdrawal penalty tax as well (see Examples 4-10 through 4-12). However, the IRC §72(t)(2) exceptions listed in Exhibit 4-1 apply in this context, too.

Key Point. Regardless of how many Roth IRAs the taxpayer may own, he/she will have only one start date for the five-year period in the first item above.

Example 4-10

Assume your client's initial Roth contribution was a $2,000 pay-in made for the 1999 tax year on April 15, 2000. The start date for her five-year period is deemed to be January 1, 1999 (because 1999 is the tax year for which the initial contribution was made). This date continues to apply, whether or not the client later opens up other Roth accounts. Thus, the earliest possible date she can withdraw Roth IRA earnings without owing any tax is January 1, 2004.

Variation. Now let us say your client's initial Roth contribution was a 2000 conversion contribution from a traditional IRA. In this variation, the start date for her five-year period is January 1, 2000, which is January 1 of the conversion year. In this variation, the earliest possible date your client can withdraw earnings tax-free is January 1, 2005. (See Reg. §1.408A-6, Q&A-2.)

Example 4-11

In March of 1998, your client Edna (now age 51) converted her traditional IRA worth $30,000 into a Roth account. The traditional IRA included $8,000 of nondeductible contributions. The conversion transaction therefore triggered $22,000 of taxable income, which Edna chose to spread over four years (1998-2001). In addition, in June of 2001, Edna made a $2,000 contribution to her Roth account for that year. She made no further contributions.

Under the four-year spread privilege for 1998 conversions, Edna reported $5,500 worth of taxable conversion income in each of the years 1998 through 2001 (total of $22,000).

Now assume Edna is forced to withdraw $15,000 in 2005. At that time, her Roth IRA balance is $54,000.

The ordering rules explained earlier in this section determine the tax treatment for the $15,000 withdrawal. The first $2,000 is treated as coming from Edna's 2001 annual contribution. That amount can be taken out at any time with no federal income tax and no 10% penalty. The remaining $13,000 is considered a partial withdrawal of the contribution consisting of taxable conversion money (the $22,000). All of that amount was already taxed in 1998 through 2001, so there is no federal income tax due on the $13,000 withdrawal nor is there any 10% penalty.

Example 4-12

Assume the same basic facts as in Example 4-11, except this time Edna withdraws $35,000 in 2005 (as before, her Roth IRA balance is $54,000 at the time).

Under the ordering rules, the first $2,000 is deemed to be a tax-free and penalty-free return of her 2001 annual contribution.

The next $22,000 is deemed to consist of the taxable portion of the 1998 conversion contribution money. That amount comes out tax-free, and penalty free.

The next $8,000 is deemed to consist of the nontaxable portion of the 1998 conversion contribution money. That amount comes out tax-free and penalty-free.

The final $3,000 is from Roth IRA earnings, because all of Edna's contributions have already been withdrawn. The $3,000 is fully taxable because Edna is not age 59½, dead, disabled, or using the money for a qualified home purchase. The 10% premature-withdrawal penalty tax also applies to the entire $3,000, unless Edna qualifies for one or more of the penalty exceptions listed in Exhibit 4-1.

Early Retirees Should Also Consider Other Tax-Smart Sources of Cash

There are usually some other ways beyond raiding tax-advantaged retirement accounts for early retirees to raise cash. In fact, raiding these accounts should probably be the last resort.

Why? Because once a retired client withdraws money from a tax-advantaged retirement account, it can never be replaced (except perhaps by making additional annual IRA contributions, assuming the client or spouse has enough earned income to permit such contributions).

Therefore, the advantages of leaving the money in a tax-advantaged account are lost forever. Clients should not let this irrevocable event happen without considering alternatives such as the ones discussed below.

Restructure Client's Assets

As an alternative to retirement account withdrawals, the early retiree may want to consider selling "unproductive" assets, such as a vacation home, timeshare, second or third car, recreational vehicle, boat, plane, or jewelry.

Money tied up in these types of assets obviously generates no income. Even worse, the client may be paying heavily for operating costs, maintenance, and insurance. If unproductive assets are sold, the resulting proceeds can be invested in income-producing assets like dividend-paying stocks, bonds, and mutual funds. Or the proceeds can be used to replace cash that would have otherwise been withdrawn from tax-advantaged retirement accounts.

The early retiree may also have some assets that he/she considers "investments" but that do not actually produce any current income. Examples include artwork, collectibles, gold, silver, and platinum bullion, and raw land. These types of assets may be inappropriate when the client needs increased cash flow to help finance an early retirement.

Restructure Client's Debts

If the early retiree has a heavy debt load, he/she might be able to significantly improve cash flow just by restructuring some debts. Here are some ideas on that.

Refinance the Home Mortgage

One rule of thumb says refinancing one's home mortgage should be considered whenever the interest rate can be reduced by at least 2%. In this case, the transaction costs can be recovered relatively quickly, assuming the client intends to stay in the residence for a while.

Another rule of thumb says refinancing is in order whenever the payback period is five years or less (i.e., the reduced interest payments would repay the transaction costs in five years or less). Normally, refinancing costs run roughly 2% to 5% of the loan balance, but some costs may be negotiable. Once again, the client must plan on continuing to reside in the home at least long enough to recover the refinancing transaction costs.

These rules of thumb go out the window when lenders offer "no-cost" refinancing. In this case, the homeowner pays no transaction costs but instead pays a slightly higher-than-market interest rate. The higher rate compensates the lender for covering the transaction costs. As long as the new interest rate is lower than the old one, the client comes out ahead no matter what.

Key Point. The refinancing loan origination fee (typically 1% of the new mortgage balance) and any mortgage discount points cannot be immediately deducted as qualified residence interest. Instead, the client must amortize these amounts by writing them off over the life of the new loan. [See IRC §§ 163(h)(3) and 461(g)(1); Rev. Rul. 87-22; and Rev. Proc. 87-15.]

When a home mortgage is refinanced, the client may have the choice of a 15-year or 30-year loan. The 15-year loan will almost certainly come with a lower interest rate, but there are offsetting factors to consider.

Choosing the 30-year term will result in lower monthly payments, which obviously fits the client's needs if he/she is considering taking money out of tax-advantaged retirement accounts to finance living costs.

Taking out a 15-year loan will build up home equity much more quickly. However, this may not do the client any real good, because home equity is not a liquid asset and the client needs cash.

Thus, the 30-year option will usually be the best choice for cash-starved early retirees.

Take Out a Home Equity Loan

Homeowners can often significantly increase their cash flow by taking out a home equity loan and using the proceeds to pay off other high-interest debts, such as credit card balances and auto loans. This is a so-called loan consolidation strategy.

Typically, the interest rate on a home equity loan will be far lower than the rates on other consumer loans (with the possible exception of car loans obtained on favorable terms).

In addition, the interest on a home equity loan up to $100,000 is generally tax-deductible for regular tax purposes, regardless of how the loan proceeds are used [IRC §163(h)(3)(C)].

In contrast, interest on other consumer debt is generally 100% nondeductible.

It is a potent combination when the early retiree client can consolidate his/her debts at a much lower interest rate and cut income taxes at the same time.

Note that the client may effectively be able to combine a home refinancing with a new home equity loan. For example, say your early retiree client takes out a new $225,000 mortgage and uses the proceeds to pay off his/her existing $175,000 purchase money mortgage and $50,000 of other high-interest debts. For tax purposes, the first $175,000 of the new loan is treated as acquisition indebtedness and the last $75,000 is treated as home equity indebtedness. As long as the client's home is worth at least $225,000, all of his/her mortgage interest will generally be tax deductible for regular tax purposes.

Key Point. Remember that interest on home equity debt of up to $100,000 is *not* deductible for AMT purposes unless the loan proceeds are actually used to improve the residence [IRC §56(b)(1)(C) and (e)]. Thus, the home equity loan option is less attractive for clients who are subject to the AMT.

Borrow Against Self-Employed Keogh Account

Thanks to a change included in the Economic Growth and Tax Relief Reconciliation Act of 2001, self-employed individuals (sole proprietors, partners, and LLC members) and more-than-2% S corporation shareholder-employees are now allowed to borrow from their Keogh qualified retirement plan accounts on the same basis as "regular" employees. [See Act §612 and IRC §4975(f)(6).] This means a self-employed individual or S corporation shareholder-employee can potentially borrow half of his/her vested account balance, up to a loan maximum of $50,000. This liberalization is effective for 2002 and beyond.

Borrowing from a retirement account is better than taking withdrawals, because the retirement account balance is restored as the loan is repaid. Plus, the account owner is effectively paying interest to himself or herself instead of to some lender.

Proceeds from a Keogh account loan can be used to finance the early retiree's living expenses or pay off high-interest debts. A Keogh account loan can be at a very reasonable interest rate, because the debt is secured by the borrower's vested account balance. The loan must be repaid within five years, unless the proceeds are used for a home purchase (in which case a longer repayment term is permitted).

However, if the client fails to repay the loan, he/she is treated as receiving a taxable distribution equal to the unpaid balance. As mentioned earlier in this chapter, when this happens before age 59½, the client will generally owe the 10% premature-withdrawal penalty tax on top of the federal and state income hit. So *not* repaying a retirement plan loan on time is very bad form.

Key Point. Unfortunately, account owners cannot borrow from SEP or SIMPLE IRA accounts, because they are considered IRAs for this purpose, and borrowing from IRAs is not allowed. Borrowing from Roth IRAs is prohibited for the same reason.

Summary

This chapter suggests a number of strategies to preserve the tax-advantaged retirement account wealth of clients who retire before age 59½.

Particular attention is focused on clients who retire early and then find themselves needing cash.

As explained, there are several ways to withdraw funds from tax-deferred retirement accounts without being hit with the 10% premature-withdrawal penalty tax.

Clients can also generally withdraw Roth IRA contributions without running afoul of the 10% penalty tax. However, a special five-year rule applies to Roth IRA contributions from converted traditional IRAs.

Finally, early retirees should consider sources of funds other than their tax-advantaged retirement accounts. This chapter suggests several tax-smart alternatives.

Chapter 5

Planning for Divorcing Clients

Objectives

After completing this chapter you should be able to

- *Advise divorcing clients on how to split up retirement-savings accounts (whether taxable or tax-advantaged) in an equitable fashion and without running afoul of tax traps.*
- *Understand how to use qualified domestic relations orders (QDROs) to split up divorcing clients' qualified retirement plan accounts.*

Introduction

When a couple divorces, they will generally split up one or more tax-advantaged retirement accounts (traditional and Roth IRAs, SEP accounts, 401(k) accounts, Keogh accounts, etc.) as part of their property settlement. A divorcing couple may also split up one or more taxable investment accounts that are also considered to be retirement-savings vehicles. This discussion explains how to avoid unexpected, and sometimes downright unfair, tax outcomes when divorcing clients divide up such accounts.

Primer on Tax Implications of Asset Transfers Between Divorcing Clients

How assets are split up in a divorce depends largely on where the divorcing couple lives. The following nine states are the so-called *community property states*: California, Texas, Washington, Wisconsin, Arizona, Nevada, New Mexico, Louisiana, and Idaho. In these states, the general rule is that community property assets (i.e., assets accumulated by the couple during their marriage) are considered to be owned 50/50. Assets that were owned by one spouse before the marriage or that were received by one spouse as a gift or bequest during the marriage are generally considered to belong solely to that person.

All of the other states except Mississippi are so-called *equitable distribution states*. In these states, the general rule is that the divorcing couple's assets are divided according to "whatever is fair" in the opinion of the divorce court judge. In practice, this often works out to be a 50/50 split. However, a 50/50 split is *not* mandated by law, as it generally *is* in the nine community property states. Of course, a divorcing couple can also agree out of court on their own version of "whatever is fair."

In *Mississippi*, the general rule is that each spouse walks away with the assets that are titled in his/her own name.

Generally, the division of property between divorcing spouses has no immediate federal income tax (or gift tax) consequences. This is because IRC §1041(a) generally allows spouses to make tax-free transfers of homes, cars, other real and personal property, investments held in taxable investment accounts, business ownership interests, and so forth between themselves before the divorce or at the time the divorce becomes final.

The same goes for post-divorce transfers between ex-spouses if they are made *incident to divorce*. Transfers incident to divorce mean those occurring (1) within one year after the date the marriage ends or (2) within six years after the date the marriage ends if the transfers are made pursuant to a divorce or separation agreement (including a modification to such an agreement). [See IRC §1041(c) and Temp. Reg. §1.1041-1T(b).]

When a tax-free transfer occurs under the preceding rules, the transferee takes over the transferor's tax basis in the asset (carryover basis) per IRC §1041(b)(2). The transferee also takes over the transferor's holding period in the asset (carryover holding period) per IRC §§ 1041(b)(1) and 1223(2).

Key Point 1. The IRC §1041(a) tax-free transfer rule does *not* apply to tax-advantaged retirement accounts or taxable investments with accrued ordinary income. (More on those types of assets later.)

Key Point 2. The tax-free transfer rule also does *not* apply when the transferee spouse or ex-spouse is a nonresident alien [IRC §1041(d)].

Even though the tax-free transfer rule applies to most divorce-related asset transfers between spouses and ex-spouses, taxes are still an extremely important issue.

Whichever spouse winds up owning appreciated assets — fair market value (FMV) in excess of tax basis — under the tax-free transfer rule will eventually owe taxes when those appreciated assets are sold. So if one ex ends up with 50% of everything in the form of cash and the other ex ends up with 50% of everything in the form of appreciated assets, guess who actually got the short end of the stick? The one who got the appreciated assets, that is who. If this tax outcome was not expected by that person, you do not want to be his/her tax adviser.

The bottom line is that divorce property settlements should be based on net-of-tax values (i.e., the FMV of assets minus any "built-in" tax liability for appreciated assets). Then the agreed-upon split (50/50 based on net-of-tax numbers, 60/40 based on net-of-tax numbers, whatever) can be implemented without creating unexpected or unfair tax outcomes.

Splitting Up Retirement Assets Held in Taxable Investment Accounts

Under the general rule of IRC §1041(a), your divorcing client can usually make tax-free transfers of retirement assets held in taxable investment accounts (or in the client's safe deposit box or under his/her mattress for that matter) to his/her spouse while still married or when divorce becomes final. The same goes for post-divorce transfers to the ex, provided they are made *incident to divorce* as explained in more detail below.

After an IRC §1041(a) tax-free transfer, the new owner's tax basis in the investment is the same as the old owner's, and the new owner's holding period includes that of the old owner. See Example 5-1 below.

Example 5-1

Your client's divorce property settlement calls for his soon-to-be-ex-wife to receive all of the client's long-held Microsoft shares. Assume the general tax-free transfer rule applies. As a result, there is no immediate tax impact on either party when the shares are transferred. Instead, the wife "steps into the client's shoes" and just keeps on rolling under the same tax rules that would have applied had the client continued to own the shares (i.e., carryover basis and carryover holding period). The carryover basis and holding period rule would also apply if (1) the Microsoft shares were held as community property, (2) they were jointly owned by the divorcing couple, or (3) they were owned solely by the wife. In any of these cases, when the wife ultimately sells the Microsoft shares, she (not the husband) will owe any resulting federal capital gains tax and any applicable state and local taxes as well.

That is the catch. When *your client* is the one who winds up owning appreciated investment assets, he/she will ultimately owe the "built-in" tax liability that comes attached to those investments. The bigger the appreciation, the bigger the tax bill. So from a net-of-tax point of view, appreciated investments are worth less than an equal amount of cash or other stuff that has not appreciated.

Key Point. Divorcing couples should use net-of-tax figures to arrive at an equitable property settlement. For instance, let us assume the objective in this example is to divide everything 60/40 in favor of the wife. In arriving at the desired 60/40 split, the value of any appreciated retirement assets held in the couple's taxable investment accounts should be reduced by the applicable built-in tax liabilities.

Post-Divorce Transfers Must Be "Incident to Divorce" to Be Tax-Free

As indicated earlier, special care must be taken with post-divorce transfers of appreciated assets to an ex-spouse. Such transfers are tax-free to the transferor if and only if they are considered *incident to divorce.*

Transfers within one year after the split automatically pass this test [IRC §1041(c)(1)].

For a later transfer to be incident to divorce, it must be shown that the transfer is *related to the cessation of the marriage.* This generally means the transfer must (1) occur within six years of the divorce and (2) be required under the divorce property settlement agreement (including any post-divorce amendments to said agreement). [See IRC §1041(c)(2) and Temp. Reg. §1.1041-1T(b).]

Key Point 1. If your divorcing client plans to make transfers of appreciated assets more than one year after the magic date, the divorce papers should clearly identify all such transactions as being part of the divorce property settlement. Otherwise, your client could be treated as making a deemed taxable sale to the ex (hello, tax bill) or a deemed gift to the ex (which could mean goodbye to all or part of the client's $1 million federal gift tax exemption).

Key Point 2. Assuming the client successfully arranges for any post-divorce transfers of appreciated assets to be tax-free transactions, the built-in tax liability factor should be considered in arriving at an equitable division of the divorcing couple's assets.

Beware of Transfers of Investments with Accrued Ordinary Income

The IRS says that in a divorce, the IRC §1041(a) tax-free transfer privilege only applies to what might be termed "capital gain assets." (See Rev. Rul. 87-12, FSA 200005006.) In contrast, when your client transfers investments with accrued ordinary income (e.g., Treasury securities or corporate bonds between interest payment dates, U.S. Savings Bonds with accrued interest, and the like), the client will be taxed on the accrued ordinary income as of the date of the divorce-related transfer. Again, this built-in tax liability factor should be considered in arriving at an equitable division of the divorcing couple's assets.

Special Considerations When Divvying up Tax-Advantaged Retirement Accounts in Divorce

As mentioned earlier, the IRC §1041(a) tax-free transfer rule does *not* apply to transfers between spouses or ex-spouses of money or assets held in tax-advantaged retirement accounts. To split up these accounts without unfavorable or unexpected tax results, special handling is required, as explained below.

Qualified Retirement Plan Accounts

Does your divorcing client have a qualified retirement plan account, such as a profit-sharing arrangement, 401(k), stock bonus plan, or Keogh? If so, these accounts will probably be split up as part of the divorce property settlement. Doing this the wrong way can prove to be a tax disaster for your client. Here is how to avoid problems.

Qualified retirement plan accounts should be split up by using a qualified domestic relations order, or QDRO. What is a QDRO? It is just some specific language that needs to be included in the client's divorce papers. [See IRC §414(p).]

The QDRO establishes your client's soon-to-be-ex-spouse's legal right to a designated percentage of the client's retirement account balance or benefit payments. Since the ex becomes entitled to this money, he/she will also be responsible for paying the related income taxes when that money is received in the form of a pension, annuity, or account withdrawals. In effect, the ex becomes a co-beneficiary of your client's existing qualified plan account. Regardless of the account owner's age or his/her ex's age, qualified retirement plan payouts to the ex pursuant to a QDRO are *not* subject to the IRC §72(t) 10% premature-withdrawal penalty tax [IRC §72(t)(2)(C)].

Alternatively, the QDRO arrangement permits the client's ex to withdraw his/her share and roll the money over tax-free into his/her own IRA (to the extent such withdrawals are permitted by the terms of the qualified retirement plan). The IRA rollover procedure allows the ex to take over management of the money while continuing to postpone taxes until funds are withdrawn from the IRA. [See IRC §402(e)(1)(B).]

However, if the ex withdraws money from the IRA before he/she reaches age 59½, the IRC §72(t) 10% premature-withdrawal penalty tax will apply, unless one of the exceptions for IRAs is available. Once again, the important point from your client's perspective is that the client's ex will be the one who owes the taxes on his/her share of the qualified retirement plan money. (As always, this fact should be considered in arriving at an equitable net-of-tax division of the divorcing couple's assets.)

What happens when your client's qualified retirement plan account money goes to the client's ex without a QDRO? It is treated as a taxable distribution to the client. [See, for example, *Michael D. Boudreau,* 95-1 USTC para. 50,115 (BC Fla., 1995) and *Rodoni,* 105 TC 29 (1995).]

This means your client owes the IRS for money that actually winds up in the ex's pocket. Of course, the ex will love that outcome, because it is a tax-free windfall at the client's expense. On top of the income tax bill, the client may also get stung with the 10% premature-withdrawal penalty if he/she is under age 59 ½ [IRC §72(t)]. Truly, this is adding insult to injury. (Note that in this scenario, the ex will *not* be able to roll over the money into his/her IRA. This is because the ex has received after-tax dollars from your client, rather than a before-tax retirement account distribution that can be rolled over.)

So now you understand why a QDRO is really important. To set one up, the language in your client's divorce papers must include the following:

- Name and mailing address of the "plan participant" (your client) and the "alternate payee" (the client's ex)
- Each retirement qualified plan account to be split up under the client's divorce agreement
- The dollar amount or percentage of benefits to be paid from each account to the alternate payee
- The benefits period or the number of payments covered by the QDRO.

To be safe, the divorce papers should also specify that "A qualified domestic relations order is hereby established under the domestic relations laws of [enter the state] and pursuant to Section 414(p) of the Internal Revenue Code of 1986."

There are some other procedural details, which are best explained in IRS Notice 97-11.

Key Point. When the client's qualified retirement plan accounts are with a major employer, the qualified retirement plan administrator will usually make sure that divorce papers include proper QDRO language before allowing the ex to receive any retirement plan money. The risk of a "no-QDRO fiasco" is highest when the client is self-employed or owns a small business and therefore manages the qualified retirement plan him/herself. Clients in this position often fork over qualified retirement account money to their exes without a QDRO, simply because they do not know any better. The resulting tax disaster is, of course, a very unwelcome surprise to the client.

Traditional IRAs, Roth IRAs, and SEP Accounts

A QDRO is *not* required to accomplish a tax-smart division of your client's IRA accounts. Here is the drill. Your client can transfer an interest in his/her IRA to a spouse or ex-spouse tax-free *if and only if* the transfer is required by the client's *divorce or separation instrument*, as defined by IRC §71(b)(2)(A). Assuming the transfer is so required, it amounts to a tax-free rollover of the amount in question from the client's IRA into the ex's IRA. [See IRC §408(d)(6).] Thereafter, the ex can manage the transferred money as he/she sees fit and continue deferring taxes until withdrawals are taken from the IRA containing the transferred money. At that point, the ex (not your client) will owe the taxes on the withdrawals. As always, this fact should be considered in arriving at an equitable net-of-tax division of the divorcing couple's assets.

The same applies to Roth IRAs and SEP accounts, because they are all considered "IRAs" for this purpose.

To be sure things turn out the way your client expects, the client's divorce or separation instrument should include the following magic words: "Any division of property accomplished or facilitated by any transfer of IRA funds from one spouse or ex-spouse to the other is deemed made pursuant to this divorce settlement and is intended to be tax-free pursuant to Section 408(d)(6) of the Internal Revenue Code of 1986."

When money from an IRA set up in the client's name gets into his/her spouse's or ex-spouse's hands in any other fashion (before or after the divorce), guess what? It is treated as a taxable distribution to your client, meaning he/she is on the hook for the related income taxes. (See, for example, Ltr. Rul. 9422060 and *Richard C. Czepiel,* TC Memo 1999-289.) Plus, the client will generally owe the IRC §72(t) 10% premature-withdrawal penalty if this happens before the client is age 59½. This amounts to a tax-free windfall for the client's ex at the client's expense. However, in this scenario, the money from the client's IRA cannot be rolled over into another IRA set up in the ex's name, because the money is now after-tax dollars and therefore ineligible for IRC §408(d)(6) treatment. Note that even in community property states the federal income tax results are as described in this paragraph, even though the account owner's spouse effectively owns 50% of the account owner's IRA in these states. [See *Michael G. Bunney*, 114 TC No. 17 (2000).]

Key Point 1. IRC §71(b)(2)(A) defines a "divorce or separation instrument" as "a decree of divorce or separate maintenance or a written instrument incident to such a decree." However, a "written separation instrument" as described by IRC §71(b)(2)(B) or a "decree requiring a spouse to make payments for the support or maintenance of the other spouse" as described by IRC §71(b)(2)(C) (i.e., so-called temporary support orders or temporary alimony orders) will not meet the definition of a "divorce or separation instrument." This means transfers of the account owner's IRA money made to a spouse or ex-spouse pursuant to these other divorce-related instruments will be treated as taxable distributions to the account owner (the person in whose name the account is set up), with all of the negative implications explained above. (See Ltr. Rul. 9344027.)

Key Point 2. Here is the most common way IRA problems arise in divorce situations. Before the divorce is final, the client decides to be nice and voluntarily give the other party some or all of the money in the client's IRA. Usually, the client is willing to do this because (1) the other party is hurting financially and (2) there is no doubt the other party will ultimately receive that amount of IRA money (or more) anyway. Also, the client typically believes the money can be rolled over tax-free into the other party's IRA. This belief is understandable. However, it is absolutely incorrect and will potentially have disastrous tax consequences for the client. The moral of this story is that divorcing clients should be warned to absolutely avoid transferring any IRA money to the other party except as duly required by a *divorce or separation instrument* (as defined in "Key Point 1" above). The same applies to money in Roth IRAs and SEP accounts.

So now you know all of the bad things that can happen with an ill-considered transfer of IRA money to a spouse or ex-spouse. However, you still need to know exactly how to pull off a tax-free divorce-related transfer pursuant to IRC §408(d)(6).

The most foolproof procedure is to arrange for a "direct" or "trustee-to-trustee" transfer of funds directly from the account owner's IRA into a new IRA set up in the name of the other party (i.e., the account owner's spouse or ex-spouse).

However, some IRA trustees may be unwilling to effect a transfer to an account owned by another person. In this case, the account owner should request a direct transfer of the amount to be received by the other party into a new IRA (with the same trustee) set up in the account owner's name. Ownership of the new IRA can then, pursuant to the divorce or separation instrument, be switched to the other party (the account owner's spouse or ex-spouse) by changing the title of the new IRA.

If the account owner's existing IRA trustee is unwilling to facilitate either of the above transactions, the account owner should simply withdraw the money in question and roll it over tax-free into a new IRA set up in the account owner's name — but with a more cooperative trustee. (Do not forget the 60-day rule here.) The ownership of the new IRA can then be switched to the other party (the account owner's spouse or ex-spouse). The account owner should avoid letting the transferred IRA money pass directly through the hands of the other party (the account owner's spouse or ex-spouse). Instead, the account owner should transact only with the new IRA itself. Otherwise, the IRS may contend the account owner has received a taxable distribution from his/her IRA, followed by a transfer of the distributed cash to the other party (with all of the negative tax implications for the account owner explained earlier).

Summary

There are some tricky tax implications when a divorcing couple divides up retirement savings held in taxable investment accounts or in tax-advantaged retirement accounts.

With proper planning, such divisions can generally be made on a tax-free (actually, tax-deferred) basis. For assets with built-in tax liabilities, net-of-tax values should be used to arrive at the desired overall property split (50/50, 60/40, whatever).

Special care must be taken when transferring tax-advantaged retirement account money from the account owner to the account owner's spouse or ex-spouse. Otherwise, the account owner may get stuck with the income tax bill on money that winds up in the other party's hands.

Chapter 6

Planning for Older Clients

Objectives

After completing this chapter you should be able to

- *Identify basic financial-planning strategies for retirement-savings accounts held by older clients.*
- *Help older clients deal with the new required minimum distribution rules and plan effectively for various other income and estate tax issues relevant to retirement-savings accounts.*

Introduction

The most important financial- and tax-planning issue for most older clients is how to manage their retirement accounts so as to (1) maximize investment returns with an acceptable level of risk and (2) minimize taxes.

In this context, there are two factors that warrant our consideration. First, stock market returns become more problematic after an extended period of above-average gains. Second, the IRS has released new, more taxpayer-friendly rules for computing required minimum distributions from tax-deferred retirement accounts. The required minimum distribution rules are critically important for clients age 70½ and older.

This chapter suggests some strategies to help older clients get the most mileage out of their retirement savings while minimizing Uncle Sam's cut.

Age-Appropriate Asset Allocation Schemes for Older Clients

In the context of this chapter, "asset allocation" refers to the mix of investments held by the client in accounts intended to finance his/her retirement. These may be taxable accounts or, more likely, tax-advantaged accounts (traditional and Roth IRAs, 401(k)s, etc.).

Obviously, the client would like to maximize his/her rate of return on retirement accounts without taking on an inordinate amount of risk. The higher the return earned on retirement savings before and during retirement, the bigger the retirement nest egg will be at retirement age and the longer it will last after retirement.

The key issue here is that some of your clients, particularly the older ones (say, age 62 and above), may be tempted to invest too conservatively and thereby shortchange themselves by earning an inadequate rate of return. This is an even more likely concern after the stock market's dismal performance in recent months. In this scenario, your clients should be encouraged to make an informed assessment of the risk versus return tradeoff before deciding on how to allocate their retirement-savings dollars. After making this assessment, some clients may elect to follow a somewhat more aggressive approach than was originally indicated.

Impact of Rate of Return on Retirement Savings

To illustrate just how important the rate of return factor really is, consider what will happen if your client has $100,000 in current retirement savings and 20 years to retirement. Here is what he/she would wind up with, assuming various rates of return on that $100,000.

Rate of Return	Value after 20 Years
3%	$180,611
5%	265,330
7%	386,968
8%	466,096
10%	672,750
12%	964,629

Now let us pick another way to look at the rate of return factor. Consider what will happen if your client saves and invests $10,000 for retirement annually over the next 15 years. Here is what he/she would accumulate, assuming various rates of return.

Rate of Return	**Value after 15 Years**
3%	$185,989
5%	215,786
7%	251,290
8%	271,521
10%	317,725
12%	372,797

Still not convinced? Here is another way to see the importance of the rate of return factor. Say your client is already in retirement and has a $500,000 nest egg. How long will that money last if he/she withdraws $40,000 annually to pay retirement-living costs, assuming various rates of return? (The figures below assume monthly compounding and monthly withdrawals totaling $40,000 annually.)

Rate of Return	**Client's Money Will Last**
3%	15.9 years
4%	17.7 years
5%	20.1 years
6%	23.8 years
7%	30.7 years
8%	Forever

The conclusion is inescapable. Whether the client is investing a lump sum for retirement, making annual additions to his/her retirement savings, or dipping into savings to cover retirement-age living costs, the rate of return factor is critically important.

Investment Risk and Asset Allocation

History tells us that different types of investments can be expected to generate widely different rates of return.

Equities (stocks and stock mutual funds) historically produce the highest returns over the long haul. However, the values of equity investments are also more volatile, as recent stock market performance illustrates.

Fixed-income investments offer less risk of value declines, but they also tend to produce much lower rates of return over extended periods.

Remember, the ultimate goal of the client's retirement-savings and investment program is to accumulate enough wealth to provide an income stream that will meet or exceed his/her post-retirement financial needs (more on that in Chapter 8, "Putting It All Together and Making Specific Client Recommendations").

So let us look at the client's investment options for his/her retirement-savings dollars.

As mentioned, investments expected to generate a higher rate of return also come with more risk. And vice versa. This is a fundamental law of economics, and there is no getting around it.

For example, if your client wants the safety that comes with certificates of deposit or short-term U.S. Treasury securities, he/she will earn a very limited rate of return. On the other hand, there is essentially zero chance of the client losing money.

If your client wants double-digit rates of return, he/she must accept the risk of investing in more volatile (i.e., riskier) securities that could possibly decline drastically at a moment's notice. The following table shows 30-year historical annualized rates of return for various investment asset categories (for 1971 through 2001).

30-Year Historical Rates of Return by Asset Category (1971 – 2001)

U.S. Treasury bills	6.7%
Intermediate government bonds	8.5%
Real estate investment trusts	9.4%
Foreign stocks	11.2%
S&P 500 stock index	12.2%
Small U.S. company stocks	14.9%
40% S&P 500; 20% foreign; 16% small U.S. stocks; 4% REIT; 20% bonds	12.3%

Source: Ibbotson Associates and T. Rowe Price

As you can see, history shows the stock market has generally been the best place for one's money, as long as it can be left there for a good long while. That way, periodic market plunges are more than offset by long-term upward momentum. Over the long haul, the greater risk may be earning mediocre to poor returns by *not* investing in the stock market.

Since many clients can expect a retirement lasting 25 to 30 years or more, they should consider dedicating a significant portion of their retirement savings to equities even after reaching retirement age.

Let us now begin to cover how to choose the right mix of investments for your client's portfolio. This is called "asset allocation." Asset allocation is simply the process of spreading out the client's retirement-savings dollars across various types of investment assets. The goals of asset allocation are to (1) keep risk at an acceptable level, (2) earn an adequate rate of return, and (3) match investments to expected future cash needs.

We can get a bit more specific by saying that the right asset allocation for a particular client depends on (1) how soon he/she will need the money (largely determined by the client's age), (2) the client's psychological attitude toward financial risk, and (3) how much money the client thinks he/she will need during his/her retirement years. (See Chapter 8 for how to calculate the client's retirement-age financial needs.)

A risk-averse person who stresses out whenever the stock market goes down a percentage point or two is going to be miserable with a relatively large allocation of retirement savings to equities. This person requires an asset allocation strategy that is somewhat more conservative than otherwise indicated. However, this person will also stand to gain less with his/her investments over the long haul if the stock market performs according to historical standards.

A risk-tolerant person in identical financial circumstances will be quite comfortable with a larger allocation of stocks, and his/her investments will thus have more potential to earn higher returns over the long haul.

The volatility (riskiness) of stocks is measured by their "beta" scores. A specific stock's beta score is based on its price volatility over the last 36 months compared to the S&P 500 Index. For example, a beta score of 2.0 means the stock tends to move in the same direction as the S&P 500 but with twice as much price volatility. So if the S&P went up 10%, the stock would be statistically likely to move up twice as much, or 20%. The higher the beta score, the riskier the stock. But higher beta scores (risk) are also correlated with higher rates of return (reward).

Equity mutual fund volatility (riskiness) is measured by either the fund's beta score (as explained above) or the standard deviation in the fund's rate of return. A fund with a high standard deviation number is expected to see its rate of return over a given period deviate more from its historical average than a fund with a lower standard deviation. In other words, the higher the standard deviation, the more erratic the investment performance over a given period of time. The lower the standard deviation, the more predictable the performance. However, higher mutual fund standard deviation numbers (risk) are also correlated with higher rates of return (reward).

Also remember that the maximum federal tax rate on long-term capital gains is only 20%. In contrast, interest income will be taxed at the client's regular rate, which could be as high as 38.6% for 2002. For retirement savings held in taxable accounts, the tax rules make stocks and equity mutual funds look just that much more attractive as long-term investments.

With the preceding factors in mind, let us now take a look at several specific asset allocation strategies that can be employed, according to the client's age and years to retirement. These mixes are designed to provide the opportunity for long-term growth, with some diversification to reduce investment risk.

Asset Allocation Strategies

Here is one asset allocation rule of thumb that is very easy to remember:

- The percentage invested in cash and fixed-income instruments should equal the client's age.

- The percentage invested in equities should equal 100 minus the client's age. (See Example 6-1.)

Example 6-1

Say the client is 62 years old. Therefore, he/she should allocate 62% of his/her investment dollars to cash and fixed-income assets and only 38% to stocks and equity mutual funds.

The preceding strategy has the advantage of being ultra-simple. However, a more sophisticated approach is generally called for. Consider the following asset allocation schemes as illustrated in Examples 6-2 and 6-3.

Example 6-2

Asset Allocations for Pre-Retired Individual (Age 50-62)

Low Risk Tolerance	
Cash	54%
Bonds	21%
Equities	25%

Average Risk Tolerance	
Cash	19%
Bonds	36%
Equities	45%

High Risk Tolerance	
Cash	0%
Bonds	35%
Equities	65%

Asset Allocations for Retired Individual (Age 62 or Older)

Low Risk Tolerance	
Cash	45%
Bonds	25%
Equities	30%

Average Risk Tolerance	
Cash	27%
Bonds	33%
Equities	40%

High Risk Tolerance	
Cash	0%
Bonds	40%
Equities	60%

Source: *Ernst &Young Personal Financial-Planning Guide.*

Example 6-3

The following table presents yet another approach to asset allocation. This one assumes the client has an average degree of risk tolerance, expects decent economic growth in the future, and expects a 3% annual rate of inflation.

	Years to Retirement or Age			
	20 yrs	**10 yrs**	**55-70**	**70+**
	Percentage of Portfolio			
Large-Cap U.S. Stocks	28%	28%	40%	37%
Small-Cap U.S. Stocks	18%	16%	8%	7%
International Stocks	19%	17%	5%	5%
Bonds	18%	20%	23%	25%
Cash Equivalents	17%	19%	24%	26%

Source: SmartMoney.com (February 2003).

Another way to think about asset allocation is the "laddered approach." With this strategy, the client views his/her retirement savings as being on two rungs of a ladder.

The lower rung — devoted to current and near-term needs — holds conservative investments such as cash equivalents (short-term CDs and money market accounts) and short-term bonds, which the client can draw from as necessary over the next three to five years.

The higher rung is for intermediate to long-term needs (five years out and beyond). Money in this rung can be invested more aggressively, such as via a diversified mix of longer-term bonds, stocks, and stock mutual funds.

Over time, the client can replenish the near-term rung with cash injections from selling appreciated assets held in the longer-term rung.

No matter which asset allocation philosophy the client chooses to follow, please understand that asset allocation is an ongoing process. As circumstances change, your client's investment portfolio should be updated in response.

Here is a summary of the most important points in this section:

- First, the client should choose an appropriate asset allocation strategy for retirement-savings dollars (whether held in taxable or tax-advantaged accounts). Given how long he/she will need the money to last, the client will probably want to choose a "growth" strategy that can be expected to generate a healthy rate of return over an extended period. "Going for growth" means taking some risks. While that may feel a bit uncomfortable, the client should keep in mind that the stock market's historical performance is on his/her side.

- Second, consider the "laddered approach" to asset allocation, as explained above.

- Finally, the client should periodically rebalance his/her retirement-savings portfolio as needed. This means checking on the current asset allocation percentages at least once a year. The performance of the client's investments can cause his/her portfolio to become significantly "out of balance" with the client's intended allocation. For example, if large-cap stocks take a big jump in price, the portfolio will become "overweighted" in this asset category. So if the client believes in religiously following his/her asset allocation scheme, some large-cap stocks should be sold with the resulting proceeds used to rebalance the portfolio so that it once again conforms to the client's intended asset allocation strategy.

Importance of Naming Retirement Account Beneficiaries

It is critically important for clients to understand that their "wills" will not override retirement account dispositions that occur by "operation of law" after death. For example, if the client has named a person as the designated beneficiary of a Roth IRA, traditional IRA, or other tax-deferred retirement account, that person will inherit the account by "operation of law" (i.e., automatically) when the client dies. It makes no difference if the client's will contains contrary instructions. (Note that the same "operation of law" principle applies when the policy owner designates beneficiaries for a life insurance policy.)

Key Point. At the same time the client draws up or amends his/her will, the client should also check all retirement account beneficiary designations. If they do not reflect the client's current wishes, they should be changed accordingly. This means filling out new beneficiary designation forms and turning them into the retirement plan administrator or IRA trustee. Changing the client's will without changing the retirement account beneficiary designations will have no impact on who inherits the retirement account money.

Planning for Multiple Retirement Account Beneficiaries

Clients often wish to leave tax-advantaged retirement account money to several different beneficiaries (for example, the surviving spouse and adult children). Multiple beneficiaries can be handled in two ways.

First, the client can designate multiple beneficiaries for each retirement account (for example, 50% of each account balance goes to the spouse and 25% goes to each of the client's two adult children).

Alternatively, the client may be able to set up a separate account for each beneficiary (for example, 50% of the client's total IRA money is segregated in an IRA with the surviving spouse named as the sole account beneficiary and 25% is segregated in each of two separate IRAs with each adult child named as the sole beneficiary of each account).

The second approach is strongly preferred, because the beneficiaries may have very different plans for the inherited money. For example, the spouse may wish to gradually withdraw the inherited retirement account money over a number of years to pay living expenses. One adult child may wish to immediately use all of his/her money to purchase a home. The other adult child may wish to preserve the retirement account's tax advantages as long as possible.

When each beneficiary inherits a separate account, each beneficiary is free to do whatever he/she wants with the money without affecting any of the other heirs who also inherit retirement account money.

In contrast, when all of the beneficiaries inherit percentage interests in the same account, one beneficiary cannot withdraw money without the others being given their percentage shares at the same time. This can mean unwanted tax liabilities for beneficiaries who would otherwise be content to leave their money in the tax-advantaged account. The beneficiaries may also have widely different investment objectives for any inherited retirement account money. Obviously, this can cause friction when each beneficiary's share is "trapped" in a single account.

Finally, as explained in Chapter 7, "Planning for Inherited Accounts," setting up separate accounts ensures more flexibility from a federal income tax standpoint under the required minimum distribution rules for inherited tax-advantaged retirement accounts.

As long as the retirement accounts in question are IRA or SEP accounts, the client is free to set up separate accounts (see Example 6-4) for each beneficiary via tax-free rollover transactions.

Example 6-4

Assume the client has $500,000 in a single IRA, which was originally set up to receive a rollover of all of her qualified retirement plan money when she retired. The client wishes to leave 50% of the IRA money to her husband and 25% to each of her two adult children. Assume these three individuals have widely varying plans for any IRA money they may inherit.

The client should be advised to create two new IRAs and transfer 25% of the existing balance to each new account via tax-free rollover transactions (also called trustee-to-trustee transfers). Each adult child can be named as the sole primary beneficiary of each of the new accounts. (Beneficiary designations are made by filling out the required form and turning it into the IRA trustee.) At the same time, the client can designate her husband as the sole primary beneficiary of the original account, which now has 50% of the client's total IRA money remaining in it.

This procedure will give each beneficiary complete freedom to do as he/she pleases with the inherited IRA money without affecting the other beneficiaries.

Key Point. For the reasons just explained, multiple accounts with sole designated beneficiaries are generally preferred to a single account with multiple beneficiaries.

Warning. As explained in the preceding section, retirement account beneficiaries are determined by beneficiary designation forms turned into the retirement plan administrator or IRA trustee. These designations override any contrary provisions in the client's will.

Required Minimum Distribution Rules for Original Retirement Account Owners

If your client is over age 70½ and owns an IRA or simplified employee pension (SEP) account, the federal income tax laws say he/she must start taking mandatory payouts each year. Of course, that means getting stuck with the resulting income tax bills. In fact, the whole reason Congress enacted these so-called required minimum distribution rules (RMDs) was to force people who would otherwise leave their IRAs untouched to hand over the government's share sooner rather than later.

If the account owner fails to take at least the required minimum distribution amount each year, he/she will be assessed a 50% penalty on the shortfall (IRC §4974). Of course, the account owner can always withdraw more than the minimum and pay the resulting extra income taxes.

Here is the good news. In early 2001, a set of IRA required minimum distribution rules was released in the form of *proposed regulations*. They replaced the former set of proposed regulations, which were issued way back in 1987. [See Prop. Reg. §§1.401(a)(9)-1 through -8, 1.408-8, and 54.4974-2.]

Then in April 2002, the IRS released *final regulations* on the subject. [See Reg. §§1.401(a)(9)-1 through -5; 1.401(a)(9)-7 through -9; 1.408-8; and 54.4974-2.]

With the preceding background in mind, the rest of this section is devoted to explaining how the new rules (meaning the 2002 final regulations) work for original IRA owners.

Note 1. The IRA required minimum distribution rules apply equally to SEP and SIMPLE IRA accounts, because they are considered IRAs for this purpose. The required minimum distribution rules for defined-contribution qualified retirement plan original account owners are also essentially the same as the IRA rules explained in this section. So the rules covered herein will apply to the original owners of most tax-deferred retirement accounts (for example, Keogh profit-sharing plan accounts and 401(k) plan accounts). Roth IRAs, on the other hand, are exempt from the required minimum distribution rules as long as the original account owner remains alive.

Note 2. In the discussion that follows, we will refer to mandatory IRA payouts as "required minimum withdrawals" rather than "required minimum distributions." The word "distribution" seems to imply payouts that occur automatically without the account owner's intervention. In contrast, the word "withdrawal" seems to imply something that must be arranged for. The fact is, IRA owners must affirmatively arrange for withdrawals to take place in order to avoid the 50% penalty under IRC §4974.

Required Minimum Withdrawal Basics

By April 1 of the year after the original account owner turns 70½, he must take his first IRA required minimum withdrawal.

Alternatively, the account owner can choose to take the initial required minimum withdrawal during the year he turns 70½.

This first required minimum withdrawal relates to the calendar year the account owner turns 70½. Then for each subsequent calendar year, he must take at least the required minimum withdrawal by December 31 of that year.

Key Point. If the account owner does not take his initial minimum withdrawal during the year he turns 70½, he must take two — and pay the resulting double dip of taxes — the following year (see Example 6-5).

Example 6-5

Assume your client turns 70½ in 2005 and does *not* take his initial required minimum withdrawal in that year. He is therefore in the double-dip mode for 2006 with withdrawal deadlines of April 1, 2006, and December 31, 2006. Falling into the double-dip mode can mean getting pushed into much higher tax brackets when the account owner has substantial IRA balances. In addition, the client may be adversely affected by various AGI-sensitive tax rules. For instance, more of the client's Social Security benefits may be taxable, and the client's personal exemption and itemized deduction write-offs may be diminished under the phase-out rules for those breaks. For these reasons, it is often best for the client to take his initial required minimum withdrawal in the year he turns 70½, even though this necessarily means giving up some tax-deferral advantages.

The amount of the required minimum withdrawal for a particular calendar year depends on the account owner's IRA balance at the end of the previous year divided by a joint life expectancy figure found in IRS tables.

The younger the account owner is, the longer the joint life expectancy figure. The longer the joint life expectancy figure, the bigger the divisor. The bigger the divisor, the lower the minimum withdrawal amount. Of course, lower minimum withdrawals mean lower taxes — which is good.

Key Point. With one exception (explained below), the new required minimum withdrawal rules automatically assume the account owner has designated a person 10 years her junior as the IRA beneficiary. This is generally a taxpayer-friendly assumption, because the designated beneficiary is usually older than the assumed age.

In fact, it generally does not matter if the account owner has actually designated a beneficiary or not. The "automatic-10-years-younger-beneficiary" assumption means longer life expectancy figures than if the account owner's single life expectancy figures are used, which in turn means lower minimum withdrawal amounts and lower taxes. A partial version of the new "automatic-10-years-younger-beneficiary" joint life expectancy table is presented immediately below.

Joint Life Expectancy Table

Explanation. Use the table below to find the account owner's joint life expectancy divisor. To find the proper divisor, use the account owner's age as of the end of the calendar year for which the minimum withdrawal is being calculated. For example, say your client will be 73 at the end of 2005. You can see that the divisor for his 2005 minimum withdrawal calculation is 24.7. Divide the client's December 31, 2004, IRA balance by 24.7. The result is the client's 2005 required minimum withdrawal amount.

Warning. You may *not* want to use this table if the account owner's spouse is designated as the sole beneficiary of the IRA and the spouse is *more than 10 years* younger than the account owner. In that case, to calculate the lowest possible minimum withdrawal, use the joint life expectancy divisor from the table in Reg. §1.401(a)(9)-9, Q&A-3, or Table II in Appendix C of IRS Publication 590. To find the proper divisor, use the account owner's age and the spouse's age as of the end of the calendar year for which the minimum withdrawal is being calculated. Then proceed as explained in Scenario 7 later in this chapter. Alternatively, the client can choose to use the divisor from the following table to calculate his minimum withdrawal (the "standard procedure"). Following the standard procedure will result in a somewhat higher minimum withdrawal, and somewhat higher taxes. But either way is all right with the IRS.

IRA Owner's Age at Year-End	Use Divisor of
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9
76	22.0
77	21.2
78	20.3
79	19.5
80	18.7
81	17.9
82	17.1
83	16.3
84	15.5
85	14.8
86	14.1
87	13.4
88	12.7
89	12.0
90	11.4
91	10.8
92	10.2
93	9.6
94	9.1
95	8.6
96	8.1
97	7.6
98	7.1
99	6.7
100	6.3

(**Note:** For the complete table, see Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590.)

Under the new rules, the *only* exception to the "automatic-10-years-younger-beneficiary rule" is when the account owner's spouse is designated as the sole IRA beneficiary and she is *actually* more than 10 years younger. In this somewhat unusual circumstance, minimum withdrawals can be calculated using the longer joint life expectancy figures based on the actual ages of the account owner and spouse (see Scenario 7 below).

In summary, the new rules make taxpayer-friendly life expectancy assumptions. Most original IRA owners are better off under the new rules.

The following nine scenarios illustrate how the new rules work in specific client situations.

Scenario 1: Turns 70½ This Year; Takes First Minimum Withdrawal This Year

Here is how to calculate the original account owner's initial required minimum withdrawal if she turns 70½ in 2005 and chooses to take her initial minimum withdrawal before the end of 2005, rather than in 2006 by April 1 of that year.

Key Point. Regardless of whether the account owner takes her initial required minimum withdrawal in 2005 or 2006, the required withdrawal is considered to be for calendar year 2005, because that is the year the account owner turns 70½. [See Reg. §1.401(a)(9)-5, Q&A-1.]

Say the account owner will still be 70 at December 31, 2005. In this case, take her December 31, 2004, IRA balance — say it is $200,000 — and divide by 27.4 (the joint life expectancy figure for an account owner who is age 70, from the table presented earlier in this section). The result is $7,299 ($200,000 ÷ 27.4). If the account owner takes out at least that amount by December 31, 2005, she will have fulfilled her initial minimum withdrawal requirement during 2005.

Now let us change the facts slightly by assuming the account owner will be 71 at December 31, 2005. In this case, the proper divisor is 26.5 years (from the table presented earlier). Her minimum withdrawal number is $7,547 ($200,000 ÷ 26.5). She should take out that amount (at least) on or before December 31, 2005.

There is only one exception to the preceding arithmetic. This is when the account owner's spouse is designated as the sole beneficiary of her IRA and the spouse is more than 10 years younger. In this case, tax savings can be gained by using the divisor from the joint life expectancy table found in Reg. §1.401(a)(9)-9, Q&A-3, or Table II in Appendix C of IRS Publication 590, based on the account owner's age and her spouse's age as of December 31, 2005. This results in a lower minimum withdrawal amount than under the "standard procedure" explained immediately above. Lower is good if the client wants to minimize her 2005 taxes. Alternatively, the account owner can choose to use the standard procedure to calculate her 2005 minimum withdrawal. Following the standard procedure will produce a somewhat higher minimum withdrawal amount and somewhat higher taxes, but it is simpler. In either case, the account owner should take out the calculated amount (at least) on or before December 31, 2005.

In 2006, the account owner must take her second minimum withdrawal by December 31, 2006. Under the standard procedure, that amount will equal her December 31, 2005, IRA balance divided by the joint life expectancy figure (from the table presented earlier) based on her age at the end of 2006. (If the account owner's spouse is more than 10 years younger and is named as the sole account beneficiary, the alternative procedure explained in the immediately preceding paragraph can also be used.)

Scenario 2: Turns 70½ This Year; Takes First Minimum Withdrawal Next Year

If this is really what the client wants to do, the answer is easy. He can defer his initial required minimum withdrawal for 2005 until April 1, 2006. For 2005 (the year he turns 70½), he need not take any withdrawal.

Remember, however, if the client goes this route, he must also take his second required minimum withdrawal by December 31, 2006 (as explained near the beginning of this section). That means two tax hits in 2006. If he has a big IRA balance, this double dip could easily push him into a higher tax bracket and have other adverse tax effects. Not good. So the client may want to reconsider and take his first minimum withdrawal by the end of 2005, as explained in Scenario 1.

Scenario 3: Turned 70½ Last Year; Took First Minimum Withdrawal Last Year

Say the account owner turned 70½ in 2004. Here is how to calculate the original account owner's required minimum withdrawal for 2005. Simply take her IRA account balance as of the end of 2004 and divide that number by the joint life expectancy figure (from the table presented earlier in this section) based on her age as of the end of 2005.

For example, say the account owner's December 31, 2004, account balance was $190,000 and she will be 72 on December 31, 2005. Divide $190,000 by the applicable divisor of 25.6. The answer is $7,422 ($190,000 ÷ 25.6). That is the amount she must withdraw (at least) on or before December 31, 2005.

However, if the account owner's spouse is the sole designated beneficiary and the spouse is more than 10 years younger, tax savings can be gained by using the divisor found in the joint life expectancy table from Reg. §1.401(a)(9)-9, Q&A-3, or Table II in Appendix C of IRS Publication 590, based on the account owner's age and the spouse's age as of December 31, 2005. The calculated required minimum withdrawal amount will be lower than the result from following the "standard procedure" just explained. This is good if the account owner wants to minimize her 2005 taxes. Alternatively, the account owner can use the standard procedure to calculate her 2005 minimum withdrawal. Following the standard procedure will produce a somewhat higher minimum withdrawal amount and somewhat higher taxes, but it is simpler. In either case, the account owner should take out the calculated amount (at least) on or before December 31, 2005.

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. Under the standard procedure, that amount will equal her December 31, 2005, IRA balance divided by the joint life expectancy figure based on her age at the end of 2006 (from the preceding table). (If the account owner's spouse is more than 10 years younger and is named as the sole account beneficiary, the alternative procedure explained in the immediately preceding paragraph can also be used.)

Scenario 4: Turned 70½ Last Year; Did Not Take First Minimum Withdrawal Last Year

This is the most complicated situation. Here is the deal. Say the account owner turned 70½ in 2004. The original account owner's initial required minimum withdrawal — which is actually considered to be for calendar year 2004 — must have been taken by April 1, 2005. That amount was calculated using his December 31, 2003 (*not* 2004), account balance and a joint life expectancy divisor based on his age as of December 31, 2004.

The account owner must then take his second required minimum withdrawal — for calendar year 2005 — by December 31, 2005. Under the new rules, the amount for calendar year 2005 is calculated using the divisor based on his age as of December 31, 2005 (from the table presented earlier in this section), and his account balance as of December 31, 2004. For example, say the account owner's December 31, 2004, balance was $250,000 and that he will be 71 as of December 31, 2005. The joint life expectancy divisor for his second minimum withdrawal is 26.5 (from the table presented earlier). His second minimum withdrawal is therefore $9,434 ($250,000 ÷ 26.5). He must withdraw that amount (at least) by December 31, 2005.

The account owner might *not* want to follow the just-explained "standard procedure" for his second minimum withdrawal when his spouse is designated as the sole beneficiary of his IRA and she is more than 10 years younger. In that case, the account owner can choose to use the joint life expectancy divisor found in Reg. §1.401(a)(9)-9, Q&A-3, or Table II in Appendix C of IRS Publication 590, based on the account owner's age and his spouse's age as of December 31, 2005. He will calculate a somewhat lower minimum withdrawal amount than under the standard procedure, which is good if he wants to minimize his 2005 taxes. Alternatively, the standard procedure can be used to calculate his second minimum withdrawal. Following the standard procedure will produce a somewhat higher minimum withdrawal amount and somewhat higher taxes, but it is simpler. In either case, the account owner should take out the calculated amount (at least) on or before December 31, 2005.

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. Under the standard procedure, that amount will equal his December 31, 2005, IRA balance divided by the joint life expectancy figure based on his age at the end of 2006 (from the table presented earlier in this section). (If the account owner's spouse is more than 10 years younger and is named as the sole account beneficiary, the alternative procedure explained in the immediately preceding paragraph can also be used.)

Scenario 5: Well over 70½; No Designated Beneficiary

Say the account owner will be 73 as of the end of 2005. At the end of 2004, her IRA balance was \$250,000. Her minimum withdrawal for 2005 equals \$250,000 divided by the joint life expectancy figure of 24.7 for someone 73 years old (from the joint life expectancy table presented earlier in this section). So her magic number is \$10,121 (\$250,000 ÷ 24.7). She must withdraw that amount (at least) by December 31, 2005.

Note that the minimum withdrawal calculations under the new rules assume the account owner has named an IRA beneficiary who is 10 years her junior — even though she has not actually named anyone.

Key Point. Does the preceding paragraph mean account owners no longer need to bother with designating account beneficiaries? No! Naming a beneficiary is still the only way for the account owner to be certain her IRA money will go to the intended person after the account owner is deceased. When there is no designated beneficiary, the account owner's will controls who gets her IRA. But wills can be unclear, and they are often contested. When there is no will, the laws of the account owner's state decide who gets her IRA. Bottom line: It is still critically important for account owners to turn in beneficiary designation forms to their IRA trustees. (See the two immediately preceding sections of this chapter for additional discussion of this issue.)

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. Under the standard procedure, that amount will equal her December 31, 2005, IRA balance divided by the joint life expectancy figure based on her age at the end of next year (from the table presented earlier). (If the account owner's spouse is more than 10 years younger and has now been named as the sole account beneficiary, the alternative procedure explained earlier in this section can also be used.)

Scenario 6: Well over 70½ with Spouse as Designated Beneficiary

Now let us assume the original account owner has designated his spouse, who is five years younger, as his IRA beneficiary.

For instance, say he will be 73 as of December 31, 2005, and his spouse will be 68 as of that date. The IRA balance as of December 31, 2004, was $250,000. The account owner's 2005 minimum withdrawal equals $250,000 divided by the joint life expectancy figure of 24.7 for someone 73 years old (from the table presented earlier in this section). The answer is $10,121 ($250,000 ÷ 24.7). He must withdraw that amount (at least) by December 31, 2005.

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. That amount will equal his December 31, 2005, IRA balance divided by the joint life expectancy figure based on his age at the end of next year (from the table presented earlier).

Note. See Scenario 7 below if the account owner's spouse is more than 10 years younger.

Scenario 7: Well over 70½ with Much-Younger Spouse as Designated Beneficiary

When the original account owner's spouse is more than 10 years younger and that spouse is designated as the sole beneficiary of the IRA, a special taxpayer-friendly set of rules can be used to calculate required minimum withdrawals.

For example, assume the account owner will be 73 at the end of 2005. Her spouse will be 61 on that date. The account balance as of December 31, 2004, was $250,000. Under the special rules, the account owner's 2005 minimum withdrawal equals $250,000 divided by a joint life expectancy divisor of 26.1 from the table found in Reg. §1.401(a)(9)-9, Q&A-3, or Table II in Appendix C of IRS Publication 590. This divisor is based on the account owner's age and her spouse's age as of December 31, 2005. The answer is $9,579 ($250,000 ÷ 26.1). The account owner must take out that amount (at least) by December 31, 2005.

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. Her 2006 minimum withdrawal amount will equal the account owner's December 31, 2005, IRA balance divided by the joint life expectancy figure from Reg. §1.401(a)(9)-9, Q&A-3, based on her age and her spouse's age as of the end of next year.

Alternative. Even with a much younger spouse, the account owner can always choose to follow the "standard procedure" explained in the earlier scenarios to calculate required minimum withdrawals for this and future years. Following the standard procedure will produce somewhat higher minimum withdrawal amounts and somewhat higher taxes, but it is easier. There is no need to dig through

IRS Publication 590 to find the appropriate joint life expectancy divisor for each year. Instead, the life expectancy divisors from the table presented earlier can be used.

Scenario 8: Non-Spouse Is Designated Beneficiary

Say the original account owner has designated a non-spouse (sibling, child, grandchild, companion, next-door neighbor, whomever) as his IRA beneficiary. Under the new rules, it does not matter how old the beneficiary is. The account owner's required minimum withdrawal calculation generally depends only on his age as of the end of the calendar year for which the required minimum withdrawal is being calculated and his IRA balance as of the end of the previous year.

For example, say the account owner will be 73 at the end of 2005 and that his IRA balance was \$250,000 as of the end of 2004. His 2005 minimum withdrawal equals \$250,000 divided by the joint life expectancy divisor of 24.7 for an IRA owner who is 73 years old (from the table presented earlier in this section). The answer is \$10,121 (\$250,000 ÷ 24.7). The account owner must withdraw that amount (at least) by December 31, 2005.

In 2006, the account owner must take another minimum withdrawal by December 31, 2006. That amount will equal his December 31, 2005, IRA balance divided by the joint life expectancy figure based on his age at the end of next year (from the table presented earlier).

Scenario 9: Multiple IRAs

When the original account owner has more than one IRA, the account balances must be aggregated to calculate the required minimum withdrawal amount for each year. However, the account owner need not take minimum withdrawals from each account. Instead, the account owner can choose to take the entire minimum withdrawal amount from one account, or from selected accounts, while leaving other accounts untouched. If the account owner's spouse also owns one or more IRAs, the spouse makes separate minimum withdrawal calculations for his/her IRAs.

Key Point. Do not forget to include SEP account and SIMPLE IRA balances in the aggregate IRA balance for required minimum withdrawal calculation purposes.

Tax Planning for Lump-Sum Distributions

All taxpayers are entitled to choose between the following two options for lump-sum distributions (LSDs) paid from qualified retirement plans:

1. Report the entire taxable portion of the LSD as ordinary income in the year of receipt.

2. Roll over all or part of the LSD tax-free into an IRA or other qualified plan account. Any taxable portion not rolled over must be reported as ordinary income in the year of receipt.

As explained later in this section, taxpayers born *before 1936* potentially have the additional option of using a special 10-year averaging rule to compute the federal income tax bill on LSDs.

Key Point. As explained in Chapter 3, "Planning for Employer Stock Held in Qualified Retirement Accounts," a special rule applies to employer stock received in an LSD. As a result, the issue of whether or not a retirement account distribution qualifies as an LSD can be important even for clients who were born *after 1935*.

What Qualifies as a Lump-Sum Distribution?

A lump-sum distribution is a distribution, or several distributions, that result in the employee receiving his/her entire balance from a qualified pension plan, profit-sharing plan, or stock bonus plan (or several such plans) within a single year. For purposes of this "entire-balance rule," the following "aggregation rules" apply:

- All pension plans maintained by the employer are treated as a single pension plan. This includes target benefit and money purchase pension plans as well as defined-benefit pension plans.

- All profit-sharing plans maintained by the employer are treated as a single profit-sharing plan.

- All stock bonus plans maintained by the employer are treated as a single stock bonus plan.

Basically, the preceding rules mean that a distribution will qualify as an LSD if the employee receives in the same year his/her entire balance from all plans of the same type in which he/she participates. (Multiple payments are permitted as long as they are all received in the same year.)

For example, if the employee receives his/her entire balance from all pension plans in Year 1, the pension plan payout(s) qualify as an LSD even if the employee did not receive his/her entire balance from the employer's profit-sharing plan(s) until Year 2.

In order for a distribution to be an LSD, it must be received because of the employee's (1) death, (2) attainment of age 59½, or (3) separation from service [IRC §402(e)(4)(D)]. An employee aged 59½ or older can receive an LSD without separating from service if the plan(s) permit such distributions. (See PLRs 8852034 and 8952010.) "Separation from service" means leaving one's job due to retirement, quitting, being laid off, being fired, etc.

Distributions from a self-employed taxpayer's qualified retirement plan (usually a Keogh plan) can qualify for LSD treatment if received due to (1) death, (2) attainment of age 59½, or (3) becoming permanently disabled. [See former IRC §402(d)(4)(A).] Unlike "regular" employees, a self-employed person cannot receive an LSD upon separation from service. Instead, one of the preceding three standards must be met.

Note. Distributions from IRAs, SEP accounts, and SIMPLE IRAs will never qualify as LSDs because such accounts are not considered qualified retirement plan accounts for purposes of the LSD rules (see Example 6-6).

Example 6-6

Assume your client retired from his job on March 15, 2005. His employer sponsored both a money purchase pension plan and a defined-benefit pension plan. In April of 2005, the client received part of his balance from the money purchase plan, with the remainder received in July of 2005. The client received his entire balance from the defined-benefit plan in November of 2005. For purposes of the "entire-balance rule," all pension plans in which the client participated are aggregated. Since he received 100% of his balances in calendar year 2005 from all pension plans in which he participated as a result of separating from service, the pension plan distributions comprise an LSD.

Variation 1. Assume the same facts as the preceding example, except this time assume the client did not receive his entire balance from the defined-benefit plan until 2006. In this case, none of the distributions qualifies as an LSD because he did not receive his entire balance from all pension plans in a single year.

Variation 2. Assume the same facts as the main part of this example, except this time assume the client also participated in a 401(k) profit-sharing plan and received his entire balance from that plan in 2006. In this case, the distributions received in 2005 (from all pension plans) qualify as an LSD and so does the distribution received in 2006 (from all profit-sharing plans).

When the 10-year averaging privilege is unavailable for any reason or is not taken advantage of for any reason, the taxable portion of the LSD (to the extent not rolled over into an IRA or another qualified retirement plan account) is simply treated as ordinary income reported on page 1 of Form 1040. This may result in the client being pushed into higher tax brackets and partial or total loss of various AGI-sensitive tax breaks (such as the education tax credits, the dependent child tax credit, itemized deductions, and personal exemptions).

In addition, LSDs received upon separation from service before age 55 and not rolled over will generally be subject to the 10% premature-distribution penalty tax under IRC §72(t).

Special 10-Year Averaging Rule for Taxpayers Born before 1936

Taxpayers born before 1936 may be eligible to use a special 10-year averaging rule to compute the federal income tax due on LSDs.

Only LSDs as defined above will qualify for the special 10-year averaging privilege. However, 10-year averaging is unavailable if any of the circumstances listed below apply:

- Any part of an otherwise qualifying LSD is rolled over into an IRA or another qualified plan [former IRC §402(d)(4)(K)].

- An otherwise qualifying LSD is received before the employee has participated in the plan for at least five years before the year the LSD is received [former IRC §402(d)(4)(F)]. However, this five-year rule is inapplicable to LSDs paid out due to the employee's death.

- The participant made a post-1986 LSD election to use five-year averaging, 10-year averaging, or the 20% capital gains method in an earlier year. (Five-year averaging was repealed for LSDs received after 1999; the 20% capital gains method is explained later in this section.)

- Any prior-year distributions from the plan paying out the LSD (or from another plan required to be aggregated with that plan) were rolled over into an IRA or another qualified plan.

Note. The preceding restrictions are explained in the instructions to Form 4972 (Tax on Lump-Sum Distributions), which is used to compute the LSD tax under the 10-year averaging rules.

Under the 10-year averaging method, the tax on the LSD is computed as if the LSD was received in equal annual installments over 10 years. The tax is calculated using the 1986 tax rate schedule for single taxpayers. The 1986 rate schedule is included in the instructions to Form 4972. [See §1122(h) of the Tax Reform Act of 1986, as amended by §1011A(b) of the Technical and Miscellaneous Revenue Act of 1988.] While the tax calculation itself assumes a 10-year spread period, the entire LSD tax bill is actually due with the return for the year the LSD is received.

There is another special rule for the pre-1974 capital gain portion (if any) of an LSD eligible for 10-year averaging. Under this rule, the taxpayer can elect to have the entire pre-1974 portion of the capital gain inherent in the LSD taxed at a flat 20% rate [per §1122(h)(3)(B)(ii) of the Tax Reform Act of 1986]. The election is made and the tax computed on Part II of Form 4972. If the election is made, the capital gain is not reported on Schedule D and thus cannot be offset by the taxpayer's capital losses. When the taxpayer chooses to use the 20% capital gain method, the remaining part of the LSD (the ordinary income part) is still eligible for 10-year averaging. Note that the 20% rate was *not* changed by the Job and Growth Tax Relief and Reconciliation Act of 2003.

Taxpayers who are eligible for 10-year averaging can mix and match the tax treatment of their LSDs as follows:

- The entire taxable amount of the LSD can simply be reported on page 1 of Form 1040 (i.e., no special tax treatment).

- The 10-year averaging method can be used for the entire taxable amount with the LSD tax bill computed on Part III of Form 4972.

- The 20% capital gain method can be used for the capital gain component (if any) of the LSD (with the tax bill for that part computed on Part II of Form 4972) while the 10-year averaging method is used for the ordinary income component of the LSD (with the tax bill for that part computed on Part III of Form 4972).

- The ordinary income component of the LSD can be reported on page 1 of Form 1040 (i.e., no special tax treatment) while the 20% capital gain method is used for the capital gain component of the LSD (with the tax bill for that part computed on Part II of Form 4972).

Key Point 1. To the extent the tax on an LSD is computed on Form 4972 (under either the 10-year averaging method or the 20% capital gain method, or both), that amount of the LSD is *not* included in the taxpayer's adjusted gross income. Therefore when the taxpayer would have a current-year NOL or excess deductions in the absence of the LSD or has an NOL carryover, it may be beneficial to report all or part of the LSD on page 1 of Form 1040 so it can be offset by the taxpayer's NOL or excess deductions. In other cases, it will generally be beneficial to compute the LSD tax on Form 4972 and thereby avoid including the LSD in the taxpayer's adjusted gross income. Lower adjusted gross income (AGI) means less chance the taxpayer will be adversely affected by all of those AGI-sensitive phaseout rules.

Key Point 2. A post-1986 LSD election to use the 10-year averaging method or the 20% capital gain method precludes the plan participant from using either of these methods in any subsequent year [former IRC §402(d)(4)(B)]. Thus, these methods are basically a privilege that can be used only once. This should be considered if the participant expects to receive additional LSDs in future years. However, electing to use the 10-year averaging method or the 20% capital gain method will apparently not preclude the participant's spouse from later taking advantage of these methods for LSDs received from plans in which the spouse participates, even if joint returns are filed.

Key Point 3. As mentioned earlier, when the 10-year averaging privilege is unavailable for any reason or is not taken advantage of for any reason, the taxable portion of the LSD (to the extent not rolled over into an IRA or another qualified retirement plan account) is simply treated as ordinary income and reported on page 1 of Form 1040. LSDs received upon separation from service before age 55 and not rolled over will generally be subject to the 10% premature-distribution tax under IRC §72(t).

Rolling Over Qualified Retirement Account Distributions into an IRA

In many cases, retiring clients will be unable to take advantage of the 10-year averaging privilege for lump-sum distributions. In this case, rolling over his/her qualified retirement account funds into an IRA will generally be the preferred option. A rollover allows the client to continue to take advantage of tax deferral, because he/she will not owe any income taxes until funds are actually withdrawn from the rollover IRA. In addition, the client gains full control over investing his/her retirement account dollars, which is not true when money is left in an employer-sponsored plan account.

If the client has an immediate need for some of the qualified retirement account money, he/she can decide to keep whatever is required and roll over the rest tax-free into the IRA. Of course, income taxes will be due on amounts not rolled over. Also, the 10% premature-withdrawal penalty tax will generally be due if the client separates from service before age 55. However, since this chapter is supposed to be about older clients, the 10% penalty tax should not be a factor here. ("Separation from service" means leaving one's job due to retirement, quitting, being laid off or fired, etc.)

"Direct" Rollovers Are Best

Here is a very important thing to know, even for older clients. There are two types of rollovers: "direct" and "indirect."

A client who wants to do a rollover should be sure to arrange for a "direct" rollover (also called a "trustee-to-trustee" transfer) of his/her qualified retirement plan account assets into the rollover IRA. This involves very little work on the client's part. He/she simply instructs the trustee or plan administrator of the company plan to make out a check payable to the trustee of the new rollover IRA account set up on the client's behalf. The employee-benefits department should have all of the forms necessary to arrange for a direct rollover. The client must then deposit the check in the rollover IRA within 60 days. (The client may also be able to arrange for an instantaneous wire transfer of the qualified retirement plan account funds into the rollover IRA.)

If the client fails to arrange for a direct rollover, he/she will receive a check from the company retirement plan payable to the client personally. Here is the problem with that. When the client examines the check, he/she will discover 20% of the taxable amount has been withheld for federal income taxes. If the client intends to make a totally tax-free rollover, he/she must then come up with the "missing 20%" and deposit it along with the rest of the retirement account distribution money into the rollover IRA within 60 days. Otherwise the client will owe income taxes on the amount withheld for taxes (and possibly the 10% premature-withdrawal penalty tax as well). Of course, if the client manages to come up with the "missing 20%" and thereby succeeds in making a totally tax-free "indirect" rollover, the client will be entitled to a refund of the 20% income tax withholding. However, that refund will not be collected until after filing Form 1040 for the year the withholding occurs. Depending on the timing, the client might have to wait many months to get the cash back. So advise your clients to be smart and prevent the 20% withholding from happening in the first place by arranging for a direct rollover.

Avoiding the 10% Penalty Tax on Amounts Not Rolled Over

Here is another very important thing to know about IRA rollovers if your client is retiring at a relatively early age (and you are nevertheless reading this chapter about older clients). Once the client's qualified retirement plan money is deposited into the rollover IRA, it generally cannot be taken out before age 59½ without triggering the 10% premature-withdrawal penalty tax (on top of the income taxes due on the withdrawal).

For example, say the client retires on the day she turns 55 and rolls all of her company qualified retirement plan money into an IRA. In this case, she should not plan on withdrawing any money from the IRA for at least 4½ years. At that point, she will be 59½ and, therefore, exempt from the 10% premature-withdrawal penalty tax.

In other words, she should keep any cash she knows she will need in the relatively near future outside her rollover IRA. Of course, she will have to pay income taxes on the amount not rolled over, but at least she will avoid the 10% penalty tax, assuming she is at least age 55 upon separation from service. ("Separation from service" means leaving one's job due to retirement, quitting, being laid off or fired, etc.)

Now, there are a few exceptions that allow clients to withdraw money from their IRAs before age 59½ without getting socked with the 10% premature-withdrawal penalty tax:

- The client can take "annuity-like withdrawals" from the IRA. The way this works is that for at least five years or until the client turns 59½ (whichever is longer), the client must take out withdrawals (at least annually) based on his/her life expectancy. (See Chapter 4, "Planning for Early Retirees and Early Retirement Account Withdrawals," for full coverage of these annuity-like withdrawals.)

- Withdrawals can be taken after becoming disabled or dying.

- Withdrawals can be taken to pay for uninsured medical expenses that exceed 7.5% of adjusted gross income.

- Withdrawals can be taken to pay for a qualifying home purchase by the client or certain family members ($10,000 lifetime limit).

- Withdrawals can be taken to pay certain college expenses for the client or certain family members.

- Withdrawals can be taken to pay health insurance premiums during certain periods of unemployment.

Rolling Over After-Tax Contributions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) liberalized the rules for tax-free rollovers between tax-deferred retirement accounts. Before EGTRRA, after-tax contributions to employer-sponsored qualified retirement plans could not be rolled over into IRAs. So when an individual retired, his after-tax dollars had to be reinvested in a taxable account or spent. In either case, the tax deferral advantage was lost.

That was then. This is now. The updated rules allow rollovers of after-tax contributions into IRAs [IRC Sec. 402(c)(2)]. This favorable change allows clients to continue investing those dollars in a tax-deferred fashion, which is great news for folks who have made significant after-tax contributions.

Estate Planning and Retirement Accounts

Assuming the federal estate tax will continue to exist, here are a few retirement account estate-tax-planning considerations to keep in mind.

First, tax-deferred retirement accounts and Roth IRAs are *lousy* candidates for funding bypass trusts (also known as credit shelter trusts). These trusts are used by married couples as an estate tax avoidance tool. The main advantage of a bypass trust is that the value of assets used to fund the trust is not included in either spouse's taxable estate.

Typically, the bypass trust is funded with assets having a value equal to no more than the current federal estate tax exemption amount ($1.5 million for 2004 and 2005). Funding of the bypass trust occurs when the first spouse passes away.

Since the objective is to "bypass" the taxable estates of both spouses, the best assets to fund bypass trusts are those expected to appreciate. That way, any future appreciation will not be hit with estate taxes even after the death of the second spouse.

However, tax-deferred retirement accounts and Roth IRAs that name a bypass trust as the account beneficiary generally must be liquidated under the required minimum distribution rules over the oldest bypass trust beneficiary's life expectancy. [See Reg. §1.401(a)(9)-4, Q&A-5 and -6.]

What if the retirement account owner's estate is named as the beneficiary of the tax-deferred retirement account or Roth IRA, and the account then passes into a bypass trust under the terms of the account owner's will? In this case, the account must be liquidated over an even shorter period under the required minimum distribution rules. In fact, the account must be completely liquidated by the end of the fifth year after the year of the account owner's death if he/she dies before April 1 of the year after turning 70½. This is because the required minimum distribution rules treat the account as having no designated beneficiary when the account owner's estate is named as the beneficiary. [See Reg. §1.401(a)(9)-3, Q&A-4]

Key Point. Because of the required minimum distribution rules, tax-deferred retirement accounts and Roth IRAs are basically depreciating assets, which makes them a sub-optimal choice for funding bypass trusts. Instead, bypass trusts should generally be funded with assets expected to appreciate whenever possible.

On the other hand, taxable retirement-savings accounts that contain assets expected to appreciate, such as stocks and equity mutual fund shares, are *good* candidates for funding bypass trusts.

There are two reasons. First, funding the bypass trust with appreciating assets is smart because the future appreciation will escape being included in the taxable estate of either spouse. In addition, the tax basis (for income tax purposes) of capital gain assets used to fund a bypass trust will be stepped up to fair market value as of the date of the account owner's death under IRC §1014(a). So the bypass trust will have a stepped-up tax basis in the assets, which will reduce or eliminate any capital gains tax when they are later sold.

Key Point. Taxable retirement-savings accounts that are loaded with stocks and equity mutual funds are good candidates for funding bypass trusts. Taxable accounts that are loaded with cash equivalents and fixed income assets are only so-so candidates (however, they are better than tax-deferred retirement accounts and Roth IRAs).

Using the Roth IRA Conversion Privilege as an Estate-Planning Tool

The "garden variety" reason for converting a traditional IRA into a Roth account is to earn tax-free income that will be withdrawn after age 59½ to help finance the account owner's retirement years.

But if the account owner does not really need the money, there is another less publicized advantage to converting. If the account owner intends to pass along as much as possible to his/her heirs, a Roth conversion transaction can be a great estate-planning technique.

Do not misunderstand: Roth IRAs are not exempt from the federal estate tax (nor are traditional IRAs). However, by paying the upfront Roth conversion tax bill, the account owner effectively prepays his/her heirs' future income tax bills while reducing his/her taxable estate at the same time.

And this prepayment does not result in any gift tax or use up any of the account owner's valuable $1 million federal gift tax exemption or $1.5 million federal estate tax exemption (for 2004 and 2005).

Now here is where it gets really interesting. A big advantage for Roth accounts is they are *not* subject to the required minimum distribution rules that apply to traditional IRAs (as explained earlier in this chapter). These rules force the account owner to begin liquidating the IRA the year after turning 70½. Of course, this means Uncle Sam gets his cut, and the state tax collector as well. When the account owner does not need the money, being forced to take these required minimum distributions and pay the resulting income taxes is pretty darn frustrating.

But converting a traditional IRA into a Roth account stops this nonsense in its tracks. Now the account owner is free to leave the account balance untouched and accumulate as many tax-free dollars as possible to pass along to his/her heirs.

Unfortunately, the required minimum distribution exemption ends when the Roth account owner dies. At that point, the account falls under the same minimum distribution rules that apply to inherited traditional IRAs (as explained in Chapter 7). However, if the account owner's heir is disciplined enough to take only the required minimum distributions from the inherited Roth IRA, that liquidation process can be strung out for many years, as the following example illustrates.

Example 6-7

Assume Husband is age 65 when he converts his traditional IRA into a Roth account. He lives for eight more years and never takes any withdrawals. Wife, age 70 when Husband dies, inherits the Roth IRA because she is the named beneficiary of the account. According to IRS tables [found in Reg. 1.401(a)(9)-9, Q&A-1, or Table I in Appendix C of IRS Publication 590], Wife is expected to live another 17 years. Under the rules explained in Chapter 7, she can treat the inherited Roth account as her own, so she is not required to take any minimum distributions during her lifetime. Assume she does not take out a dime. At age 87, she dies and leaves the Roth IRA to Sonny Boy, who was designated as the beneficiary when Wife took over the account.

Sonny Boy is 55, and the IRS life expectancy tables say he should live for another 29.6 years. He must start taking required minimum distributions and gradually liquidate the inherited Roth IRA over that 29.6-year period (as explained in Chapter 7). But all of Sonny Boy's withdrawals will be federal-income-tax-free. (Husband effectively prepaid the federal income tax bill when he converted his traditional IRA into a Roth account years earlier.)

Assume Sonny Boy is smart enough to take *only* the required minimum distribution amount for each year. In this case, he will preserve the inherited Roth IRA's tax-free earning power as long as possible (29.6 years in this case). So in this scenario, the Roth IRA is allowed to "live" and earn tax-free income for a total of 54.6 years: eight years with Husband, 17 years with Wife, and 29.6 years with Sonny Boy. That is pretty good mileage when you consider Husband was a well-worn 65 years old when he converted his traditional IRA into a Roth account in the first place.

What really happened here? In effect, Husband and Wife used the Roth IRA tax rules to set up a long-term *federal-income-tax-free annuity* for Sonny Boy.

Key Point. For this planning technique to work as advertised, Husband must designate Wife as the Roth IRA beneficiary before he dies. Wife must then treat the account as her own by retitling the Roth IRA in her name and naming Sonny Boy as the new account beneficiary. Finally, Sonny Boy must begin taking required minimum distributions by December 31 of the year following Wife's death. Otherwise he will have to liquidate the Roth IRA after only five years, which would end the tax-free income game prematurely.

Before leaving this topic, let us review the key assumptions that seem to make using the Roth IRA conversion privilege as an estate-planning tool so attractive.

First, we must believe Congress will leave the current Roth IRA tax rules in place, at least for a good long while.

Second, the Roth IRA owner does not need money from the account to pay for his/her own retirement.

Third, the account owner must believe his/her heirs will keep their hands out of the inherited Roth IRA till, except to take required minimum distributions.

Fourth, we must assume the Roth account can be invested at a respectable rate of return, which makes paying the upfront conversion tax a wise move in the first place.

Summary

This chapter identifies and makes recommendations regarding basic financial-planning issues faced by older clients with respect to their retirement-savings accounts (whether taxable or tax-advantaged).

From a tax-planning perspective, special emphasis was placed on dealing with the new required minimum distribution rules that apply to IRAs, SEP accounts, and defined-contribution qualified retirement plan accounts after the client has reached age 70½.

Tax-planning considerations for lump-sum distributions and rollovers of qualified retirement plan distributions were also covered, along with some basic estate-planning considerations for retirement accounts.

Chapter 7

Planning for Inherited Accounts

Objectives

After completing this chapter, you should be able to help clients who inherit retirement-savings accounts — whether tax-advantaged accounts or taxable accounts — plan for the related tax issues.

Introduction

With increasing participation in tax-deferred qualified retirement plan accounts and traditional and Roth IRAs, it is inevitable that more and more people will inherit such accounts when their original owners pass on. And these inherited accounts may often have very substantial balances. Tricky tax rules apply to inherited tax-advantaged accounts, but careful planning can result in significant tax savings for the heirs.

In addition, important tax considerations apply to inherited taxable accounts that were used by deceased individuals for accumulating retirement savings.

This chapter covers tax considerations for the most commonly encountered client situations.

When a Spouse's Tax-Advantaged Retirement Account Is Inherited: Calculating the Surviving Spouse's Required Minimum Distributions

Say your client inherits his/her deceased spouse's tax-advantaged retirement account. What happens tax-wise? Good question. It turns out the surviving spouse must now follow the required minimum distribution rules that apply specifically to inherited accounts. The only time these rules *do not* apply is when the deceased spouse's Roth IRA is inherited and the surviving spouse then chooses to treat the Roth IRA as his/her own Roth account. (This will be covered in more detail later.)

In April 2002, the IRS issued new final required minimum distribution regulations. [See Reg. §§ 1.401(a)(9)-1 through -5; 1.401(a)(9)-7 through -9; 1.408-8, and 54.4974-2.] The new final regulations — which are referred to as the "new rules" for purposes of this chapter — replaced proposed regulations issued in early 2001. [See Prop. Reg. §§1.401(a)(9)-1 through -8, 1.408-8, and 54.4974-2.] In turn, the 2001 proposed regulations had replaced an earlier set of proposed regulations issued way back in 1987. While the new rules are substantially simpler than the old ones, they are still pretty tricky. Clients who inherit tax-advantaged retirement accounts from their spouses will still need your help to avoid unexpected (and generally unfavorable) tax outcomes.

The one thing clients cannot afford to do is ignore the whole issue of required minimum distributions. If the client fails to withdraw at least the required minimum amount from the inherited account, he/she can be charged a penalty equal to 50% of the shortfall under IRC §4974. That is one of the harshest penalties in our beloved Tax Code.

Note 1. The required minimum distribution rules for spousal inheritors of IRAs apply equally to spousal inheritors of simplified employee pension (SEP) accounts and SIMPLE IRA accounts, because they are considered IRAs for this purpose.

Note 2. With the exception of the special rule that allows a spousal inheritor of an IRA to treat the account as his/her own, the required minimum distribution rules for inherited tax-deferred defined-contribution qualified retirement plan accounts [401(k)s, Keoghs, etc.] are basically the same as the IRA guidelines explained in this section.

Note 3. In the discussion that follows, we will refer to mandatory account payouts as "required minimum withdrawals" rather than as "required minimum distributions." The word "distribution" seems to imply payouts that occur automatically without the taxpayer's intervention. In contrast, the word "withdrawal" seems to imply something that must be arranged for. The fact is, taxpayers must affirmatively arrange for withdrawals (or take other steps explained in this section) in order to avoid the 50% penalty under IRC §4974.

With that background behind us, the remainder of this section explains the new required minimum withdrawal rules for spousal inheritors of IRAs and how to avoid the dreaded 50% penalty.

Scenario 1: Spouse Dies *Before* April 1 of Year After Turning 70½ (or on Any Earlier Date)

The following analysis assumes the surviving spouse is the sole beneficiary of the IRA in question. For this purpose, "sole beneficiary" means the surviving spouse is the only primary account beneficiary and that he/she has an unlimited right to take withdrawals from the account. This rule cannot be met when the account beneficiary is a trust, even if the trust's sole beneficiary is the surviving spouse (Reg. §1.408-8, Q&A-5). Note that the surviving spouse is still considered to be the sole beneficiary even when there are one or more designated contingent or successor beneficiaries who would become entitled to funds from the account if – and only if – the surviving spouse dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

Assume the surviving spouse is named as the sole designated beneficiary of the deceased spouse's traditional IRA. When the account owner dies *before* April 1 of the year after he/she turns 70½, or at any earlier time, the surviving spouse who inherits the account generally has *three different options* to choose from. They are explained below in order of "tax efficiency."

Option No. 1: Treat Inherited IRA as Surviving Spouse's Own Account

Under this option, the surviving spouse can choose to treat the inherited traditional IRA as owned by the surviving spouse. (We will talk about inherited Roth IRAs later.) When this option is chosen, the surviving spouse is considered to be the original account owner [Reg. §1.408-8, Q&A-5(a)]. As you will see, this is almost always the tax-smart way to go.

Say the surviving spouse is under age 70½. In this case, treating the traditional IRA as owned by the surviving spouse means he/she will not have to take any required minimum withdrawals until *after* turning 70½. So when the surviving spouse is well under that magic age, making this choice yields years of continued tax-deferral advantages, as illustrated in Example 7-1.

Example 7-1

Assume your client's husband passes away at age 67. The client is 65 and is the sole designated beneficiary of her husband's traditional IRA. For maximum tax-deferral advantages, she should choose to treat the inherited account as her own. The easiest way to do this is by retitling the account to show her as the account owner (as opposed to the account beneficiary). [See Reg. §1.408-8, Q&A-5(b).]

Treating the account as the surviving spouse's own means no minimum withdrawals are required until after she turns 70½. So the account's tax-deferral advantages are allowed to continue unabated until then.

After turning 70½, the client must start taking required minimum withdrawals, but the amounts will be calculated using the taxpayer-friendly rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

However, if the surviving spouse is under age 59½ and needs access to some of the inherited IRA money before that age, he/she should put off retitling the inherited IRA, as explained in Example 7-2.

Example 7-2

Assume the same basic facts as in Example 7-1, except now the surviving spouse is only 45 and needs to get her hands on some of the inherited IRA money. In this scenario, the surviving spouse should *not* retitle the IRA in her own name. At least not for a while. Why? If she does, she will owe the 10% premature-withdrawal penalty tax (in addition to federal and state income taxes) on amounts withdrawn from the IRA. (The 10% penalty tax generally applies to IRA withdrawals taken from one's own IRA before age 59½.) However, the 10% penalty tax does *not* apply to withdrawals taken by a beneficiary from a deceased account owner's IRA [IRC §72(t)(2)(A)(ii)]. Therefore, the surviving spouse should leave the IRA in her husband's name for a while (possibly until she reaches age 59½). This allows her to withdraw the cash she needs without owing the 10% premature-withdrawal penalty tax. (As explained under Option No. 2 below, the surviving spouse may have to take some required minimum withdrawals during the period the IRA is left in the deceased spouse's name.) After the needed cash has been withdrawn or the surviving spouse reaches age 59½, she should generally retitle the inherited IRA in her own name for the reasons explained in Example 7-1. (Ltr. Rul. 200110033 explicitly allows this strategy.)

Even if the surviving spouse is over 70½, he/she will still come out way ahead by treating the inherited IRA as the surviving spouse's own account. This is illustrated in Example 7-3 below.

Example 7-3

Assume the client is 72 when her 66-year-old husband passes away. She is the sole designated beneficiary of her husband's traditional IRA. Here is the tax-saving strategy for this situation: Leave the account in the deceased husband's name until the year he would have turned 70½. Why? Because that way, no required minimum withdrawals are required during this period, meaning continued tax-deferral advantages for the surviving spouse. Then in the year the husband would have turned 70½, the surviving spouse should treat the IRA as her own (by retitling it to show her as the account owner, rather than the account beneficiary). Then the surviving spouse should take her initial required minimum withdrawal by December 31 of that year. The amount of that initial minimum withdrawal and minimum withdrawal amounts for subsequent years are calculated using the taxpayer-friendly rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

Technical Analysis. See Reg. §1.401(a)(9)-3, Q&A-3(b), for the deadline for the first required minimum withdrawal when the surviving spouse is the sole IRA beneficiary but has not elected to treat the account as the surviving spouse's own. The deadline is the *later* of (1) December 31 of the year after the year of the deceased spouse's death or (2) December 31 of the year the deceased spouse would have turned 70½. So in this example, no minimum withdrawal is required before December 31 of the year the deceased spouse would have turned 70½, provided the account is left in the deceased spouse's name. Next, see Reg. §1.408-8, Q&A-5(a), which says the surviving spouse can elect to treat the account as her own at any time after the deceased spouse's date of death. So in this example, the surviving spouse can wait until the year the deceased spouse would have turned 70½, claim the account as her own in that year, and then start taking required minimum withdrawals under the more favorable rules for original account owners. If the surviving spouse does this, the initial minimum withdrawal from the account must be taken by December 31 of that year.

Now assume the deceased account owner had turned 70½ before dying (or would have turned 70½ in the year of death). In this case, watch out! If the surviving spouse elects to treat the account as her own within the year of the account owner's death, a required minimum withdrawal must be taken by December 31 of that year. (This assumes the deceased account owner had not already withdrawn the required amount before death.) The amount of that required minimum withdrawal is calculated as if the deceased account owner were still alive at the end of the year of death. [See Reg. §1.408-8, Q&A-5(a) and paragraph 52 of the preamble to the final regulations (TD 8987).] However, if the surviving spouse waits until the year *after* the account owner's death to treat the account as the surviving spouse's own, there is apparently *no* requirement to take any minimum withdrawal until later. [See Reg. §1.401(a)(9)-3, Q&A-3(b).] This situation is illustrated in Example 7-4.

Example 7-4

Say your client's wife died this year. She turned 70½ this year (or would have had she lived until year-end). Your client (in this example, the husband) is the sole designated beneficiary of his deceased wife's traditional IRA account.

To take advantage of the taxpayer-friendly required minimum withdrawal rules for original account owners, your client should treat the inherited IRA as his own.

However, if he takes that action this year (the year of his wife's death), he must take out a minimum withdrawal for this year. (The amount is calculated as if his wife were still alive at year-end using the favorable rules for original account owners.) Your client must withdraw the calculated amount by December 31 of this year. [See Reg. §1.408-8, Q&A-5(a) and paragraph 52 of the preamble to the final regulations (TD 8987).]

If the husband is under 70½, he will not be required to take any further minimum withdrawals from the account (which is now treated as his account) until after reaching that age.

If the husband is already over 70½, the next required minimum withdrawal from the account (which is now treated as his) generally must be taken by December 31 of next year. The husband calculates the amount of that minimum withdrawal and required withdrawals for subsequent years using the more favorable rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

Recommendation. In this example, the surviving spouse should wait until the year *after* the year of his wife's death and *then* treat the account as his own in that later year (i.e., next year). By following this procedure, the surviving spouse apparently avoids any requirement to take a minimum withdrawal during the year of his wife's death (i.e., this year). [Per Reg. §1.401(a)(9)-3, Q&A-3(b), there is apparently no requirement to take a minimum withdrawal from a deceased person's account during the year of death, provided the account is still in the deceased person's name at the end of that year.] If the surviving spouse is under 70½, he will not be required to take any minimum withdrawals from the account (now treated as his account) until after reaching that age. If he is already over 70½, he generally must take a minimum withdrawal from the account (now treated as his) by December 31 of next year and by December 31 of each subsequent year, using the taxpayer-friendly rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

Option No. 2: Leave Inherited IRA in Deceased Spouse's Name

Under Option No. 2, a surviving spouse named as the sole beneficiary of the deceased spouse's IRA can simply leave the account in the deceased spouse's name and begins taking minimum withdrawals when required under the rules explained below. This option is generally not the most tax-efficient way to handle the inherited account, but it is the easiest way.

Key Point. When Option No. 2 is chosen and the surviving spouse dies, the remaining account balance will be inherited by whomever the first spouse (the deceased account owner) named as the contingent or successor account beneficiary. In other words, the only way the surviving spouse can gain control over who inherits the account after the surviving spouse dies is to treat the account as the surviving spouse's own (i.e., choose to follow Option No. 1) and then name a new account beneficiary.

When the surviving spouse nevertheless chooses Option No. 2, the first required minimum withdrawal must be taken by the *later* of

- December 31 of the year the deceased spouse (the account owner) would have turned 70½, or

- December 31 of the year following the year the deceased spouse dies. [See Reg. §1.401(a)(9)-3, Q&A-3(b).]

For instance, say your client's husband dies this year. Your client – the surviving wife and sole account beneficiary – leaves the account in her deceased husband's name. As explained immediately above, the earliest possible date for a required minimum withdrawal is December 31 of next year. Minimum withdrawal amounts will be based on the wife's single life expectancy, as explained in Example 7-5 below.

Example 7-5

Your client's husband passed away in 2005. He turned 70½ this year (or would have had he lived until year-end). Your client is the sole beneficiary of her husband's traditional IRA. She chooses to leave the account in her husband's name. Under the rules just explained, your client (the surviving spouse) must take the initial required minimum withdrawal by the end of 2006. To calculate the proper amount, one must first determine the appropriate life expectancy divisor to use. This depends on your client's age as of the end of the calendar year for which the required minimum withdrawal is being calculated.

Let us say she will be 68 as of December 31, 2006. To calculate the required minimum withdrawal for 2006, find the single life expectancy divisor for a 68-year-old person from the table in Reg. §1.401(a)(9)-9, Q&A-1. The answer is 18.6 years. Now divide the December 31, 2005, account balance, say $250,000, by the aforementioned 18.6. The answer is $13,441 ($250,000/18.6). Your client must take out that amount (at least) by December 31, 2006, in order to avoid the 50% penalty for failure to comply with the required minimum withdrawal rules.

The next required minimum withdrawal must be taken by December 31, 2007. The amount will equal the December 31, 2006, account balance divided by 17.8 (the single life expectancy figure for a 69-year-old person, because your client is a year older). And so on and so forth for each subsequent year until your client dies or the IRA is completely liquidated. [See Reg. §§1.401(a)(9)-3, Q&A-1(b), and 1.401(a)(9)-5, Q&A-5(b) and (c)(2).]

There is only one problem with choosing Option No. 2, your client's annual minimum withdrawal calculations are made using her single life expectancy figure as the divisor. In contrast, if she chooses Option No. 1, she can use the more favorable rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

Key Point. The surviving spouse can switch over to Option No. 1, and thereby be treated as the original account owner, at any time after the account owner's date of death. [See Reg. §1.408-8, Q&A-5(a).] After switching over, the surviving spouse can then follow the more taxpayer-friendly required minimum withdrawal rules for original account owners.

Option No. 3: Follow the "Five-Year Rule"

This is the *least* tax-smart choice for a surviving spouse who is named as the sole beneficiary of his/her deceased spouse's IRA. If the surviving spouse chooses Option No. 3, the account is left in the deceased account owner's name. The surviving spouse can then do whatever he/she wants with the account until December 31 of the fifth year after the year of the account owner's death. In fact, the surviving spouse can leave the account completely untouched until that date.

However, by the end of that fifth year, the surviving spouse must completely drain the account (which means paying any resulting taxes) in order to avoid the dreaded 50% penalty for failure to follow the required minimum withdrawal rules. Note that IRAs are not required to offer the five-year rule option. [See Reg. §1.401(a)(9)-3, Q&A-1, -2, and -4.]

As explained earlier, Options No. 1 and No. 2 will almost always allow the surviving spouse to keep an inherited IRA open longer than five years (usually much longer), which means more tax-deferral benefits for the surviving spouse. For this reason, Options No. 1 and No. 2 are almost always preferable to the five-year rule from a tax-planning perspective. In some cases, however, the five-year rule may be mandatory, because the IRA's terms so specify or because the account owner so specified before he/she died. Really, about the only good thing about following the five-year rule is it avoids the dreaded 50% penalty [Reg. §54.4974, Q&A-7(b)].

Scenario 2: Spouse Dies on or After April 1 of Year After Turning 70½

The following analysis assumes the surviving spouse is the sole beneficiary of the IRA in question. For this purpose, "sole beneficiary" means the surviving spouse is the only primary account beneficiary and that he/she has an unlimited right to take withdrawals from the account. This rule cannot be met when the account beneficiary is a trust, even if the trust's sole beneficiary is the surviving spouse (Reg. §1.408-8, Q&A-5). Note that the surviving spouse is still considered to be the sole beneficiary even when there are one or more designated contingent or successor beneficiaries who would become entitled to funds from the account if— and only if— the surviving spouse dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

The following two options are available to a surviving spouse who is named as the sole designated beneficiary of his/her deceased spouse's traditional IRA when the deceased spouse dies on or after April 1 of the year after turning 70½, or any later date.

Option No. 1: Treat Inherited IRA as Surviving Spouse's Own

Under this option, the surviving spouse chooses to treat the inherited IRA as though it is the surviving spouse's own account. As you will see, this is almost always the tax-smart way to go.

For optimal tax results, the choice should be made by no later than the end of the year following the year of the deceased spouse's death, but it can also be made in the year of death. In either case, the deceased spouse's required minimum withdrawal for the year of death must be taken out of the account by the end of that year (if it was not already taken earlier). [See Reg. §§ 1.401(a)(9)-5, Q&A-4(a), and 1.408-8, Q&A-5(a).]

Example 7-6

Say your client's husband died this year at age 73. The client is the sole designated beneficiary of the husband's traditional IRA. The client (the surviving spouse) should treat the inherited account as her own in order to take advantage of the more favorable rules for original account owners. Whether she does or not, however, the required minimum withdrawal for this year (the year of her husband's death) must be taken out of the account by the end of this year. The amount of that minimum withdrawal is calculated as if the husband were still alive at year-end using the taxpayer-friendly rules for original account owners. [See Reg. §1.401(a)(9)-5, Q&A-4(a).] Your client should withdraw the calculated amount (at least) by December 31 of this year.

As soon as possible after her husband's death (but not later than December 31 of next year), your client should designate the account as her own by retitling it to show her as the account owner rather than the account beneficiary [Reg. §1.408-8, Q&A-5(b)]. If she is under 70½, she will not be required to take any further minimum withdrawals until after reaching that age. If she is already over 70½, the next minimum withdrawal must be taken by December 31 of the year after the year of the original account owner's death (i.e., December 31 of next year). The amount of that minimum withdrawal and the minimum withdrawals for subsequent years are calculated using the taxpayer-friendly rules for original account owners.

In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

Option No. 2: Leave Inherited IRA in Deceased Spouse's Name

Under this Option No. 2, the surviving spouse can simply leave the traditional IRA account in the deceased spouse's name. This is generally not the most tax-efficient way to handle the inherited IRA, but it is the easiest way.

Key Point. When Option No. 2 is chosen and the surviving spouse dies, the remaining account balance will be inherited by whomever the first spouse (the deceased account owner) named as the contingent or successor account beneficiary. In other words, the only way the surviving spouse can gain control over who inherits the account after the surviving spouse dies is to treat the account as the surviving spouse's own (i.e., choose to follow Option No. 1) and then name a new account beneficiary.

When Option No. 2 is nevertheless chosen, the first order of business is calculating the required minimum withdrawal amount for the year of the original account owner's death. This withdrawal must be taken by December 31 of that year (to the extent the required amount had not already been withdrawn by the original account owner before he/she died). The required amount for the year of death is calculated as if the account owner were still alive, using the more favorable rules for original account owners. [See Reg. §1.401(a)(9)-5, Q&A-4(a).]

For subsequent years, minimum withdrawals are calculated based on the *longer* of (1) the deceased account owner's remaining single life expectancy, based on the deceased account owner's age as of his/her birthday in the year of death, or (2) the surviving spouse's single life expectancy. [See Reg. §1.401(a)(9)-5, Q&A-5(a)(1) and (c)(2).] This rule is illustrated in Examples 7-7 and 7-8 below.

Example 7-7

Assume your client's husband passed away in 2005. Had he lived, he would have been 73 at year-end. Your client (the surviving spouse) is the sole designated beneficiary of her husband's traditional IRA. Under the rules just explained, a minimum withdrawal must be taken by December 31, 2005. (This assumes nothing was withdrawn by the husband in 2005 before he died.) To calculate the required minimum withdrawal amount for the year of death, follow the more favorable rules for original account owners just as if the husband were still alive at year-end [Reg. §1.401(a)(9)-5, Q&A-4(a)].

By December 31 of 2006, another minimum withdrawal must be taken. To calculate the proper amount, the appropriate life expectancy divisor must be determined. This depends on the surviving spouse's age as of the end of 2006. Let us say your client will be 68 at that time. Use the table found in Reg. §1.401(a)(9)-9, Q&A-1, or Table I in Appendix C of IRS Publication 590, to find the single life expectancy divisor for a 68-year-old person. It is 18.6 years. Now divide the December 31, 2005, account balance, say $250,000, by the aforementioned 18.6 to come up with the 2006 minimum withdrawal amount of $13,441. Your client should take out that amount (at least) by the end of 2006 to avoid the 50% penalty.

The 2007 minimum withdrawal must be taken by December 31, 2007. The amount of that withdrawal will equal the December 31, 2006, account balance divided by 17.8 [the life expectancy divisor for a 69-year-old person from the table in Reg. §1.401(a)(9)-9, Q&A-1]. And so on and so forth for each subsequent year until your client dies or the IRA is completely liquidated. [See Reg. §1.401(a)(9)-5, Q&A-5(a)(1) and (c)(2).]

Example 7-8

Assume the same basic facts as in Example 7-7, except this time your client (the surviving spouse) is age 80 when her husband (the original account owner) dies in 2005. The same procedure described in Example 7-7 is used to calculate the required minimum withdrawal for the year of death (2005).

However, since the surviving spouse in this example is considerably older than her deceased husband, minimum withdrawals for subsequent years will be lower if the deceased account owner's remaining life expectancy is used (instead of the surviving spouse's) as the divisor for minimum withdrawal calculation purposes. Here is how that works.

The deceased account owner would have been 73 at the end of 2005 had he lived. The single life expectancy figure for a 73-year-old person is 14.8 [per the life expectancy table found in Reg. §1.401(a)(9)-9, Q&A-1, or Table I in Appendix C of IRS Publication 590]. To use the deceased account owner's remaining life expectancy to calculate the 2006 required minimum withdrawal to be taken by the surviving spouse, divide the December 31, 2005, account balance of $250,000 by 13.8 (the 14.8 figure for 2005 reduced by 1.0, because the calculation is being made for 2006, which is a year later). Therefore, the 2006 required minimum withdrawal is $18,116 ($250,000 ÷ 13.8). Your client should take out that amount (at least) by December 31, 2006. For 2007, the required minimum withdrawal will equal the December 31, 2006, account balance divided by 12.8. And so on for subsequent years. [See Reg. §1.401(a)(9)-5, Q&A-5(a)(1) and (c)(3).]

Key Point. There is only one problem with choosing Option No. 2. For years after the original account owner's death, the minimum withdrawal calculations are made using a single life expectancy figure as the divisor (either the surviving spouse's, as in Example 7-7, or the deceased account owner's, as in Example 7-8). In contrast, when the surviving spouse chooses Option No. 1, he/she can use the longer joint life expectancy figures allowed for original account owners. That means bigger divisors, lower minimum withdrawal amounts, and lower taxes. So Option No. 1 is better if minimizing taxes is the surviving spouse's goal. Note that a surviving spouse can switch over to Option No. 1 at any time after the date of the original account owner's death. [See Reg. §1.408-8, Q&A-5(a).]

Key Point. The five-year rule does not apply in Scenario 2. It can only apply when the account owner dies *before* the April 1 magic date.

Scenario 3: Surviving Spouse Wants to Disclaim the Inherited Account

Under the new required minimum withdrawal rules, the ultimate designated beneficiary for an IRA can be decided as late as September 30 of the year after the year of the account owner's death. That means a surviving spouse who is named as the sole account beneficiary has until that date to disclaim (give up his/her legal right to) the account in favor of another person who was designated as co-beneficiary or as a contingent or successor beneficiary. Then the account will go to the other beneficiary (often the surviving spouse's child), and required minimum withdrawals will be calculated under the rules for non-spousal beneficiaries as explained in the next section. However, for this to work for purposes of calculating required minimum withdrawals, the other person must actually be a designated beneficiary as of the date of the account owner's death. [See Reg. §1.401(a)(9)-4, Q&A-4; see Reg. §1.401(a)(9)-5, Q&A-7(b) and (c) for who constitutes a contingent or successor beneficiary.]

Why would the surviving spouse ever want to disclaim an inherited account? The typical reason is the surviving spouse simply does not need the money, and having it would just worsen his/her estate tax situation. In this scenario, it may be better for all concerned tax-wise if the account goes directly to the next person in line. Then that person will have to start taking minimum withdrawals under a separate set of rules for non-spousal inheritors (covered in the next section of this chapter).

Key Point. For a disclaimer to work for required minimum withdrawal calculation purposes, it must satisfy the provisions of IRC §2518 [Reg. §1.401(a)(9)-4, Q&A-4(a)].

Scenario 4: Deceased Spouse's Estate Is Account Beneficiary

What happens when the designated beneficiary for the deceased account owner's IRA is his/her estate, and the surviving spouse is the estate's sole beneficiary? Good question.

In general, naming the account owner's estate as the IRA beneficiary is the same as naming no beneficiary for purposes of calculating required minimum withdrawals for years after the account owner's death. [See Reg. §1.401(a)(9)-4, Q&A-3.] That can result in relatively unfavorable required minimum withdrawal rules for the surviving spouse, who effectively inherits the account.

However, when the surviving spouse is the sole beneficiary of the deceased account owner's estate, the old minimum withdrawal rules were interpreted as allowing a surviving spouse to roll over the funds in the deceased spouse's account into a new account set up in the surviving spouse's own name. (See Ltr. Ruls. 9545010 and 9831032.) Then the surviving spouse could follow the taxpayer-friendly minimum withdrawal rules for original account owners. In a nutshell, these rules allow the surviving spouse to calculate required minimum withdrawals using joint life expectancy figures [from the table found in Reg. §1.401(a)(9)-9, Q&A-2, or Table III in Appendix C of IRS Publication 590]. This results in lower required minimum withdrawals and maximum tax-deferral advantages for the surviving spouse.

It is not entirely clear whether this spousal rollover trick is still allowed under the new rules. Reg. §1.408-8, Q&A-7 seems to imply it is (although without much certainty). If not, required minimum withdrawals from the deceased person's account must be calculated under the less favorable set of rules that apply to accounts without designated beneficiaries. [For that set of rules, see Reg. §§1.401(a)(9)-5, Q&A-5(a)(2), (b), and (c)(3); and 1.401(a)(9)-3, Q&A-4(a)(2).]

Scenario 5: Roth IRA Inherited by Surviving Spouse

What if the surviving spouse is the sole beneficiary of the deceased account owner's Roth IRA?

Key Point. For this purpose, "sole beneficiary" means the surviving spouse is the only primary account beneficiary and that he/she has an unlimited right to take withdrawals from the Roth IRA. This rule cannot be met when the Roth IRA beneficiary is a trust, even if the trust's sole beneficiary is the surviving spouse (Reg. §1.408-8, Q&A-5). Note that the surviving spouse is still considered to be the sole beneficiary even when there are one or more designated contingent or successor beneficiaries who would become entitled to funds from the Roth account if — and only if — the surviving spouse dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

Now to answer the question: It is almost always a good idea to treat an inherited Roth IRA as the surviving spouse's own account (i.e., Option No. 1, as explained earlier) if the surviving spouse wants to stretch out the Roth IRA's tax advantages for as long as possible.

The surviving spouse is not required to take *any* minimum withdrawals from a Roth IRA that is treated as his/her own account as long as the surviving spouse lives. Nor is the surviving spouse required to take any minimum withdrawal on behalf of the deceased spouse (the deceased account owner) in the year of that person's death.

Bottom line: By treating the inherited Roth IRA as the surviving spouse's own account, the surviving spouse can leave the entire account balance untouched as long as he/she wishes. Of course, leaving the account untouched will maximize the tax-free earnings power that makes Roth IRAs such a great deal.

The author recommends designating the Roth account as the surviving spouse's own (by retitling it to show the surviving spouse as the account owner, rather than the account beneficiary) as soon as possible after the original account owner's death, but in no event later than December 31 of the year after death. (See Reg. §1.408-8, Q&A-5.)

Key Point. Another important advantage to treating the inherited Roth IRA as the surviving spouse's own account is that it gives the surviving spouse the opportunity to designate his/her own beneficiary to inherit the Roth IRA after the surviving spouse is gone.

Planning for Tax-Advantaged Retirement Accounts Inherited by Non-Spouses

Say your client inherits a tax-advantaged retirement account from someone other than the client's deceased spouse. What happens tax-wise? Another good question. Here is the answer: Your client must now follow the required minimum distribution rules that apply specifically to inherited accounts.

In April 2002, the IRS issued new final required minimum distribution regulations. [See Reg. §§1.401(a)(9)-1 through -5; 1.401(a)(9)-7 through -9; 1.408-8; and 54.4974-2.] The new final regulations — which are referred to as the "new rules" for purposes of this chapter — replaced proposed regulations issued in early 2001. [See Prop. Reg. §§1.401(a)(9)-1 through –8; 1.408-8; and 54.4974-2.] In turn, the 2001 proposed regulations had replaced an earlier set of proposed regulations issued way back in 1987. While the new rules are substantially simpler than the old ones, they are still pretty tricky. Clients who inherit tax-advantaged retirement accounts will still need your help to avoid unexpected (and generally unfavorable) tax outcomes.

The one thing the client cannot afford to do is ignore the whole issue of required minimum distributions. Why? Because if the client fails to withdraw at least the required minimum amount from the inherited account, he/she can be charged a penalty equal to 50% of the shortfall under IRC §4974.

Note 1. The required minimum distribution rules for non-spousal inheritors of IRAs apply equally to non-spousal inheritors of simplified employee pension (SEP) accounts and SIMPLE IRA accounts, because they are considered IRAs for this purpose.

And these very same rules apply to non-spousal inheritors of *Roth IRAs*. Finally, the required minimum distribution rules for non-spousal inheritors of tax-deferred defined-contribution qualified retirement plan accounts [401(k)s, Keoghs, etc.] are generally the same as the IRA guidelines explained in this section. However, the discussion in Scenario 3 on the following pages regarding an IRA treated as the surviving spouse's own account applies only to IRAs (including Roth IRAs, SEP accounts, and SIMPLE IRAs).

Note 2. In the discussion that follows, we will refer to mandatory account payouts as "required minimum withdrawals" rather than "required minimum distributions." The word "distribution" seems to imply payouts that occur automatically without the taxpayer's intervention. In contrast, the word "withdrawal" seems to imply something that must be arranged for. The fact is, taxpayers must affirmatively arrange for withdrawals (or take other steps explained in this section) in order to avoid the 50% penalty under IRC §4974.

With that background behind us, here is what you need to know if your client inherits her uncle's (or aunt's or next-door neighbor's) IRA.

Scenario 1: Account Owner Dies Before April 1 of Year After Turning 70½ (or Any Earlier Date)

Under the new rules, a non-spousal individual who is named as the sole account beneficiary in Scenario 1 generally must take required minimum withdrawals over the beneficiary's life expectancy. The first withdrawal must occur by December 31 of the year following the year the original account owner dies. In subsequent years, additional required minimum withdrawals must be taken by each December 31.

So if your client is the beneficiary, he/she must take these minimum withdrawals to avoid the 50% penalty. To calculate how much to withdraw each year, divide the account balance at the end of the previous year by the beneficiary's single life expectancy figure, as illustrated in Example 7-9.

Example 7-9

Say your client's beloved Uncle Bob passes away at age 68 in 2005, and your client is the sole designated beneficiary of his traditional IRA. She must take her initial minimum withdrawal by the end of 2006. Until then, your client can leave the account untouched, which is the tax-smart thing to do. To calculate the minimum withdrawal amount for 2006, we must first determine the appropriate life expectancy divisor to use. That depends on your client's age as of December 31, 2006. Let us assume she will be 48 on that date. Use the table found in Reg. §1.401(a)(9)-9, Q&A-1, or Table I in Appendix C of IRS Publication 590, to find the single life expectancy divisor for a 48-year-old person. The answer is 36.0 years. Now divide the December 31, 2005, account balance, say $250,000, by 36.0 to come up with the 2006 required minimum withdrawal amount of $6,944. Your client must take out that amount (at least) by December 31, 2006, to avoid the 50% penalty. (She can always take out more, but that would raise her tax bill.) The 2007 minimum withdrawal must be taken by December 31, 2007. The amount will equal the December 31, 2006, account balance divided by 35.0 (the single life expectancy figure for someone age 48 minus 1.0, since your client is now a year older) — and so on and so forth for each subsequent year until your client dies or the account is completely liquidated. [See Reg. §§1.401(a)(9)-3, Q&A-1 and -3(a), and 1.401(a)(9)-5, Q&A-5(b) and (c)(1).]

Key Point. The following analysis assumes there is a sole beneficiary of the IRA in question. For this purpose, "sole beneficiary" means one person is the only primary account beneficiary. Note that a sole beneficiary is still considered to exist when one or more other persons are designated as contingent or successor beneficiaries who would become entitled to funds from the account if — and only if — the primary beneficiary dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

In Scenario 1, there is one other possible required minimum withdrawal outcome: the so-called five-year rule. In some cases, the five-year rule may be mandatory because the IRA's terms so specify or because the deceased account owner so specified before he/she died. In other cases, the IRA's terms may allow the beneficiary to choose to follow the five-year rule (see Example 7-10). In any of these cases, the five-year rule simply requires the beneficiary to completely liquidate the inherited account by no later than December 31 of the fifth year after the year the original account owner dies in order to avoid the dreaded 50% penalty for failure to comply with the required minimum withdrawal rules. Note that IRAs are not required to offer the five-year rule option. [See Reg. §§1.401(a)(9)-3, Q&A-1, -2, and –4; and 54.4974, Q&A-7(b).]

Example 7-10

Assume the same basic facts as in Example 7-9. After Uncle Bob dies in 2005, your client chooses to follow the five-year rule. She therefore has until December 31, 2010, to liquidate the account and pay the resulting tax hit. However, following the five-year rule is not the tax-smart choice. Why?

Because your client would forgo the many additional years of tax-deferral advantages allowed if she instead chose to gradually liquidate the inherited account over her life expectancy (as illustrated in Example 7-9). However, as explained above, she may not have that option. Really, the only good thing about following the five-year rule is that it allows your client to avoid the 50% penalty.

Key Point. In Scenario 1, the exact same drills apply if your client inherits a Roth IRA.

Scenario 2: Original Account Owner Dies on or After April 1 of Year After Turning 70½

The following analysis assumes there is a sole beneficiary of the IRA in question. For this purpose, "sole beneficiary" means one person is the only primary account beneficiary. Note that a sole beneficiary is still considered to exist when one or more other persons are designated as contingent or successor beneficiaries who would become entitled to funds from the account if — and only if — the primary beneficiary dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

In Scenario 2, the first order of business is calculating the required minimum withdrawal amount for the year of the original account owner's death. To the extent it was not already taken by the deceased account owner before he/she died, this amount must be withdrawn by the beneficiary by December 31 of the year of death in order to avoid the 50% penalty for failure to follow the required minimum withdrawal rules. The amount of the minimum withdrawal for the year of death is calculated just as if the deceased account owner were still alive as of year-end, using the more favorable rules for original account owners.

For subsequent years, minimum withdrawals are calculated based on the *longer* of (1) the deceased account owner's remaining single life expectancy, based on the deceased account owner's age as of his/her birthday in the year of death, or (2) the beneficiary's single life expectancy. Examples 7-11 and 7-12 illustrate this rule.

Example 7-11

Assume your client's beloved Uncle Bob passed away in 2005. Had he lived, he would have been 73 at year-end. Your client is the sole designated beneficiary of Uncle Bob's traditional IRA. Under the rules just explained, she must take a minimum withdrawal by December 31 of the year of death. (This assumes Uncle Bob had not withdrawn anything during 2005 before he died.) To calculate the required minimum withdrawal amount for the year of death, follow the more favorable rules for original account owners, just as if Uncle Bob were still alive at year-end [Reg. §1.401(a)(9)-5, Q&A-4(a)].

By December 31 of 2006, another minimum withdrawal must be taken. To calculate the proper amount, the appropriate life expectancy divisor must be determined. This depends on your client's age as of the end of 2006. Let us say your client will be 48 at that time. Use the table found in Reg. §1.401(a)(9)-9, Q&A-1, to find the single life expectancy divisor for a 48-year-old person. It is 36.0. Now divide the December 31, 2005, account balance, say $250,000, by the aforementioned 36.0 to come up with the 2006 minimum withdrawal amount of $6,944. Your client should take out that amount (at least) by the end of 2006 to avoid the 50% penalty. (She can always take out more, but that would raise her tax bill.) The 2007 minimum withdrawal must be taken by December 31, 2007. The amount will equal the December 31, 2006, account balance divided by 35.0 (the single life expectancy figure for someone age 48 minus 1.0, because your client is now a year older). And so on and so forth for each subsequent year until your client dies or the account is completely liquidated. [See Reg. §1.401(a)(9)-5, Q&A-5(a)(1) and (c)(1).]

Example 7-12

Assume the same basic facts as in Example 7-11, except this time assume your client is age 80 when her brother dies in 2005. Your client is the sole beneficiary of her brother's traditional IRA. The same procedure described in Example 7-11 above is used to calculate the required minimum withdrawal for the year of death. (This assumes the deceased account owner had not withdrawn anything during 2005 before he died.)

Since the beneficiary in this example is considerably older than the deceased account owner, minimum withdrawals for subsequent years will be lower if the deceased account owner's remaining life expectancy is used (instead of the older beneficiary's) as the divisor for minimum withdrawal calculation purposes. Here is how that works.

As stated in Example 7-11, the deceased account owner would have been 73 at the end of 2005 had he lived. The single life expectancy figure for a 73-year-old person is 14.8 [per the life expectancy table found in Reg. §1.401(a)(9)-9, Q&A-1]. To use the deceased account owner's remaining life expectancy to calculate the 2006 required minimum withdrawal to be taken by your client, divide the December 31, 2005, account balance of $250,000 by 13.8 (the 14.8 figure for 2005 reduced by 1.0, because the calculation is being made for 2006, which is a year later). Therefore, the 2006 required minimum withdrawal is $18,116 ($250,000 ÷ 13.8). Your client should take out that amount (at least) by December 31, 2006. For 2007, the required minimum withdrawal will equal the December 31, 2006, account balance divided by 12.8. And so on for subsequent years. [See Reg. §1.401(a)(9)-5, Q&A-5(a)(1) and (c)(3).]

Key Point. For an inherited Roth IRA, follow the Scenario 1 rules even when the original account owner dies on or after the April 1 magic date.

Note: The five-year rule does not apply in this scenario. It can only apply when the account owner dies *before* the April 1 magic date.

Scenario 3: Beneficiary Inherits Account From Original Account Owner's Spouse

The following analysis assumes there is a sole beneficiary of the IRA in question. For this purpose, "sole beneficiary" means one person is the only primary account beneficiary. Note that a sole beneficiary is still considered to exist when one or more other persons are designated as contingent or successor beneficiaries who would become entitled to funds from the account if — and only if — the primary beneficiary dies. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

What happens if the original account owner's surviving spouse inherited the IRA and treated it *as his/her own* account and your client then inherits the same account (as the sole designated beneficiary) after the surviving spouse dies? In this case, the surviving spouse is treated as the original account owner. Therefore, your client's required minimum withdrawals fall under the non-spousal beneficiary guidelines for either Scenario 1 or Scenario 2 above, depending on whether the surviving spouse died before or on or after the April 1 magic date.

Now let us say the original account owner's surviving spouse was the sole designated beneficiary and did *not* treat the IRA as his/her own account. Your client then inherits the same account (as the sole successor beneficiary following the surviving spouse) *before* any minimum withdrawals were required to be taken by the surviving spouse. In other words, the surviving spouse dies before the *later* of (1) December 31 of the year the original account owner (the first spouse) would have turned 70½ had the original account owner continued to live, or (2) December 31 of the year following the year the original account owner died. Here the rules explained in Scenario 1 above apply, using the surviving spouse's date of death. That means your client's initial required minimum withdrawal must be taken by December 31 of the year after the year the surviving spouse dies (assuming the five-year rule does not apply). The client's single life expectancy [from the table in Reg. §1.401(a)(9)-9, Q&A-1] is used as the divisor to calculate annual required minimum withdrawal amounts. Alternatively, the five-year rule may apply if the IRA document so specifies or if the beneficiary (your client) so chooses. [See Reg. §1.401(a)(9)-3, Q&A-5 and -6.]

Finally, what happens when (1) the original account owner's surviving spouse was the sole beneficiary, (2) the surviving spouse did *not* treat the account as his/her own, and (3) your client then inherits the account (as the sole successor beneficiary following the surviving spouse) *after* the deadline for the surviving spouse to begin taking required minimum withdrawals? In other words, the surviving spouse dies on or after the *later* of (1) December 31 of the year the original account owner (the first spouse) would have turned 70½ had the original account owner continued to live, or (2) December 31 of the year following the year the original account owner died. Example 7-13 explains the procedure in this case.

Example 7-13

Say your client's beloved Aunt Gertrude died in 2005. Had she lived, she would have been age 73 as of year-end. She was the sole beneficiary of an IRA owned by her deceased husband, Uncle Bob. She did *not* treat the account as her own. Under the rules for such cases (as explained earlier in this chapter), Aunt Gertrude had begun taking required minimum withdrawals before she died. Your client then inherits the IRA, because he was the sole successor beneficiary after Aunt Gertrude's death.

The first order of business is calculating the minimum withdrawal required to be taken by December 31 of 2005, the year of Aunt Gertrude's death. Assume she had not withdrawn anything in 2005 before passing on. Your client must take a minimum withdrawal by December 31 of 2005. The amount is calculated just as if Aunt Gertrude were still alive as of year-end. (See the earlier discussion in this chapter.) Your client must take another required minimum withdrawal by December 31, 2006, and additional withdrawals by the end of each succeeding year. The amounts are calculated based on Aunt Gertrude's remaining single life expectancy as of the end of the year in which she died (2005) reduced by 1.0 for each subsequent year.

To find the appropriate life expectancy figure, use the table in Reg. §1.401(a)(9)-9, Q&A-1. For a 73-year-old person (the age Aunt Gertrude would have been at the end of the year of her death), the number is 14.8. Therefore, your client's 2006 required minimum withdrawal amount equals the December 31, 2005, account balance divided by 13.8 (14.8 – 1.0). To calculate your client's minimum withdrawals for later years, the life expectancy divisor is reduced by 1.0 for each passing year. So the divisors used to calculate the 2007 and 2008 minimum withdrawals would be 12.8 and 11.8, respectively. [See Reg. §1.401(a)(9)-5, Q&A-5(c)(2).]

Key Point. In Scenario 3, essentially the same drills apply if your client inherits a Roth IRA. However, no minimum withdrawal is required in the year of the Roth account owner's death, regardless of his/her age.

Planning for Tax-Advantaged Retirement Accounts Inherited by Multiple Beneficiaries

What happens when the deceased account owner's IRA has multiple beneficiaries? Yet another good question. As you probably suspect, the required minimum distribution rules come into play here, too.

Key Point. For this purpose, "multiple beneficiaries" means several persons are designated as primary account beneficiaries. For example: Person A gets 25%, Person B gets 25%, and Person C gets 50%. When one or more other persons are designated as contingent or successor beneficiaries who would become entitled to funds from the account if — and only if — a primary beneficiary dies, these contingent or successor beneficiaries are not considered for purposes of calculating required minimum distributions. [See Reg. §1.401(a)(9)-5, Q&A-7(b) and (c).]

In April 2002, the IRS issued new final required minimum distribution regulations. [See Reg. §§1.401(a)(9)-1 through -5; 1.401(a)(9)-7 through -9; 1.408-8; and 54.4974-2.] The new final regulations — which are referred to as the "new rules" for purposes of this chapter — replaced proposed regulations issued in early 2001. [See Prop. Reg. §§1.401(a)(9)-1 through -8, 1.408-8, and 54.4974-2.] In turn, the 2001 proposed regulations had replaced an earlier set of proposed regulations issued way back in 1987. While the new rules are substantially simpler than the old ones, they are still pretty tricky. Clients who inherit tax-advantaged retirement accounts will still need your help to avoid unexpected (and generally unfavorable) tax outcomes.

The one thing clients cannot afford to do is ignore the whole issue of required minimum distributions. If the required minimum amount is not withdrawn from the inherited account, the IRS can charge a penalty equal to 50% of the shortfall under IRC §4974.

Note 1. The required minimum distribution rules for multiple inheritors of IRAs apply equally to multiple inheritors of simplified employee pension (SEP) accounts and SIMPLE IRA accounts, because they are considered IRAs for this purpose.

And these very same rules apply to multiple inheritors of Roth IRAs. Finally, the required minimum distribution rules for multiple inheritors of tax-deferred defined contribution qualified retirement plan accounts [401(k)s, Keoghs, etc.] are generally the same as the IRA guidelines explained in this section. However, any discussion regarding an account inherited by a surviving spouse and treated as the surviving spouse's own account applies only to IRAs.

Note 2. In this section, we will refer to mandatory account payouts as "required minimum withdrawals" rather than "required minimum distributions." The word "distribution" seems to imply payouts that occur automatically without the taxpayer's intervention. In contrast, the word "withdrawal" seems to imply something that must be arranged for. The fact is, taxpayers must affirmatively arrange for withdrawals (or take other steps explained in this section) in order to avoid the 50% penalty under IRC §4974.

With that background in mind, here is what you need to know if your client is among several people who inherit her uncle's (or aunt's or cousin's or next-door neighbor's) IRA.

When an account is inherited by multiple designated beneficiaries who are all individuals, the general rule says required minimum withdrawal amounts must be calculated using the single life expectancy of the oldest beneficiary [Reg. §1.401(a)(9)-5, Q&A-7(a)(1)]. The amounts are then calculated using the guidelines for non-spousal inheritors, as explained in Scenarios 1, 2, and 3 in the immediately preceding section. In Scenarios 1 and 3, the five-year rule may also apply in the circumstances explained in those scenarios. [See Reg. §§1.401(a)(9)-3, Q&A-4; and 1.401(a)(9)-5, Q&A-7.]

Example 7-14

Say your 29-year-old client's beloved Uncle Fred passes away in 2005 at age 68. The client is one of four individuals named as equal designated beneficiaries of Uncle Fred's traditional IRA. Specifically, she inherits 25% of Uncle Fred's account. Unless the five-year rule applies, the initial required minimum withdrawal from Uncle Fred's account must be taken by the end of 2006. Until then the account can be left untouched, which is the tax-smart thing to do. To calculate the minimum withdrawal amount for 2006, we must first determine the appropriate life expectancy divisor to use. That depends on the oldest beneficiary's age as of December 31, 2006. Let us assume the oldest beneficiary (who is not your client) will be 48 on that date. Use the table in Reg. §1.401(a)(9)-9, Q&A-1, to find the single life expectancy for a 48-year-old person. It is 36.0 years. Now divide the December 31, 2005, account balance, say $250,000, by 36.0 to come up with the 2006 required minimum withdrawal amount of $6,944. That amount must be taken out (at least) by December 31, 2006, to avoid the 50% penalty. Your client would receive 25% of the $6,944, or $1,736. The same $1,736 amount would also be received by the other three beneficiaries. (Of course, more than the required minimum can be taken out, but that would raise the beneficiaries' tax bills.) The 2007 minimum withdrawal must be taken by December 31, 2007. The amount will equal the December 31, 2006, account balance divided by 35.0 (the single life expectancy figure for someone age 48 minus 1.0, since the oldest beneficiary is now a year older). And so on and so forth for each subsequent year. [See Reg. §1.401(a)(9)-5, Q&A-5(c)(1) and Q&A-7(a)(1).]

Key Point. As you can see, your client's age in Example 7-14 is completely irrelevant in calculating required minimum withdrawals from the inherited IRA. See below for a planning suggestion.

Note. The same drill would apply if Uncle Fred's account were a Roth IRA.

In Example 7-14, Uncle Fred could have given his heirs much more flexibility, while he was still alive, by splitting up his IRA (via tax-free rollovers) into several IRAs with each account having only one primary designated beneficiary.

For instance, he could have put 25% of his IRA money into an IRA set up with your 29-year-old client as the sole beneficiary. Then your client could have calculated her required minimum withdrawals using her longer single life expectancy (as explained in the immediately preceding section), which would mean greater tax-deferral advantages for her. The same goes for other beneficiaries who are younger than the oldest beneficiary.

Setting up separate IRAs for each beneficiary has the added advantage of giving each beneficiary the freedom to manage and invest his/her inherited IRA money as he/she chooses, without having to consider the wishes of the other beneficiaries.

And if one beneficiary wants to withdraw most or all of his/her inherited IRA money, that will not affect other beneficiaries who may wish to keep as much as possible in their IRAs so they can continue reaping tax-deferral benefits.

So if you are Uncle Fred's tax adviser, please tell him to set up separate accounts for his heirs, especially if they are the sorts who would wish to maximize the tax benefits of their inherited IRA money. Of course, this is a moot point if Uncle Fred's heirs can be expected to loot the inherited IRA money as soon as humanly possible.

Key Point. The new required minimum withdrawal rules permit a postmortem solution in the preceding scenario. Specifically, Uncle Fred's IRA can still be divided up into four new IRAs, one for each beneficiary, via tax-free rollover transactions after Uncle Fred is dead and gone. The now-deceased Uncle Fred will still be named as the owner of each of the four new accounts resulting from the rollover transactions. These rollovers must be done by September 30 of the year after the year Uncle Fred dies. Then, as illustrated in Example 7-15 below, each beneficiary must take required minimum withdrawals from his/her separate account. Because each person is now the sole beneficiary of his/her separate account, each can use his/her own single life expectancy figure [from the table in Reg. §1.401(a)(9)-9, Q&A-1] to compute required minimum withdrawals. [See Reg. §1.401(a)(9)-4, Q&A-4, which says the beneficiary for required minimum withdrawal calculation purposes is deemed to be the designated beneficiary as of September 30 of the year after the year the deceased account owner dies.]

Example 7-15

Assume the same basic facts as in Example 7-14. However, this time assume deceased Uncle Fred's IRA is divided up into four new IRAs, one for each 25% beneficiary, before September 30, 2006 (September 30 of the year after Uncle Fred dies). By December 31, 2006, your client must take her initial required minimum withdrawal from the inherited account (unless she follows the five-year rule, which is *not* the tax-smart thing to do). Until then, the account can be left untouched (which *is* the tax-smart thing to do). To calculate the minimum withdrawal amount for 2006, we must first determine the appropriate life expectancy divisor to use. That depends on your client's age as of December 31, 2006. Let us assume she will be 30 on that date. Use the table in Reg. §1.401(a)(9)-9, Q&A-1, to find the single life expectancy for a 30-year-old person. It is 53.3 years. Now divide your client's share of Uncle Fred's account balance as of December 31, 2005, say $62,500, by 53.3 to come up with the 2006 required minimum withdrawal amount of $1,173. That amount must be taken out (at least) by December 31, 2006, to avoid the 50% penalty. (Of course, more than the required minimum can be taken out, but that would raise your client's tax bill.) The 2007 minimum withdrawal must be taken by December 31, 2007. The amount will equal the December 31, 2006, account balance divided by 52.3 (the single life expectancy figure for a 30-year-old minus 1.0, because your client is now a year older). And so on and so forth for each subsequent year until the account is completely liquidated. As you can see, your client's age in this example *is* relevant when calculating required minimum withdrawals from the inherited IRA. Compare this result to the less favorable result for your client in Example 7-14 above.

Key Point. It is still preferable to have Uncle Fred split up his IRA into separate IRAs for each beneficiary *before* he dies. The postmortem solution explained in this example requires (1) timely action to split up the account after Uncle Fred's death and (2) cooperation among the beneficiaries to get that done. Having Uncle Fred himself split up the account before he dies is a much more foolproof method to achieve the same, more-favorable results for his beneficiaries.

Note. The same drill would apply if Uncle Fred's account were a Roth IRA.

Example 7-16

Assume the same basic facts as in Example 7-14, except this time assume Uncle Fred is age 73 when he dies in 2005 and had thus already begun taking required minimum withdrawals from his IRA. In this example, a minimum withdrawal must be taken by December 31 of the year of death (2005). The amount is calculated as if Uncle Fred were still alive as of December 31, 2005, using the favorable rules for original account owners. [See Reg. §1.401(a)(9)-5, Q&A-4(a).] The minimum withdrawal amount must then be divided into four equal pieces (25% for each beneficiary). For required minimum withdrawals in 2006 and beyond, follow the advice in Example 7-14 or 7-15, whichever applies.

Note. This example assumes Uncle Fred had not withdrawn anything from his account in 2005 before he died. If he did, the remaining required minimum withdrawal amount for 2005 is reduced or eliminated accordingly. For required minimum withdrawals in 2006 and beyond, follow the advice in Example 7-14 or 7-15, whichever applies.

Key Point. Essentially the same drill would apply if Uncle Fred's account were a Roth IRA. However, with a Roth IRA, no minimum withdrawal is required for the year of the account owner's death, regardless of his/her age.

Required Minimum Withdrawals for Accounts with No Designated Beneficiary

Say the owner of a tax-advantaged retirement account dies without having designated an account beneficiary. This is not uncommon. The account owner may have been unmarried without any children or favored relatives, or he may simply have failed to fill out the required paperwork, or whatever.

Also, when the deceased account owner's *estate* is a designated account beneficiary, it's considered the same as having *no* beneficiary for purposes of calculating required minimum withdrawals (even when one or more individuals are named as co-beneficiaries).

Similarly, when any designated account beneficiary is *not an individual* (i.e., not a natural person), the account is considered to have no beneficiary for purposes of calculating required minimum withdrawals. This is true even when there are one or more other account beneficiaries who *are* individuals (natural persons). Probably the most common example of a non-individual beneficiary is a charity.

However, when a *trust* is designated as an account beneficiary, the individual trust beneficiaries *can* be considered individual (natural person) account beneficiaries, provided certain requirements are met. [See Reg. 1.401(a)(9)-4, Q&A-3 and Q&A-5.]

Key Point: As you will soon see, required minimum withdrawals must still be taken from accounts that have no beneficiaries and from accounts that are considered to have none under the rules explained in the preceding paragraphs. The existence or lack of beneficiaries only affects how required minimum withdrawal *amounts* are calculated. Specifically, the calculation procedure depends on when the account owner died. Required minimum withdrawals will be received by either the deceased account owner's estate or by whoever winds up inheriting the account.

When the account owner dies *before* April 1^{st} of the year after the year he turned 70½ (or on any earlier date), the five-year rule applies. Under the five-year rule, the account must be completely liquidated by December 31^{st} of the fifth year following the year of the account owner's death [Reg. 1.401(a)(9)-3, Q&A-4(b)]. This rule is illustrated by Example 7-17 below.

Example 7-17

Bernie died in 2005, at age 66, without designating a beneficiary for his IRA. Bernie's estate, or whoever ultimately ends up inheriting the IRA, has until December 31, 2010, to completely liquidate the account in order to avoid the 50% penalty for failure to comply with the required minimum withdrawal rules.

Example 7-18

Same basic facts as Example 7-17, except now assume Bernie's designated his estate as the account beneficiary. For required minimum withdrawal purpose, this is the same as having no beneficiary. Thus, the five-year rule applies. Bernie's estate, or whoever ultimately ends up inheriting the IRA, has until December 31, 2010, to completely liquidate the account in order to avoid the 50% penalty.

When the account owner dies *on or after* April 1^{st} of the year after the year he turned 70½, the first order of business is calculating the year-of-death required minimum withdrawal. For this, follow the taxpayer-friendly rules for original account owners, as if the account owner were still alive. [See Reg. 1.401(a)(9)-5, Q&A-4(a).] The year-of-death required minimum withdrawal that must be taken by December 31st of that year (to the extent the account owner had not already withdrawn that amount before death).

Required minimum withdrawals for subsequent years are calculated based on the deceased account owner's remaining single life expectancy. Use the life expectancy divisor based on the account owner's age on the birthday occurring during the year of death, and reduce that divisor by 1.0 for each subsequent year. [See Reg. 1.401(a)(9)-5, Q&A-5(a)(2) and (c)(3).] Examples 7-19 and 7-20 below illustrate how these rules work.

Example 7-19

Orlando died at age 75 in 2005 without designating a beneficiary for his IRA. The year-of-death required minimum withdrawal is to be taken by December 31, 2005 (this assumes Orlando did not withdraw anything in 2005 before he died). To calculate the amount, we must first determine the proper life expectancy divisor to use. This depends on the age Orlando would have attained as of December 31, 2005, had he continued to live. Say he would have been 76. Find the joint life expectancy divisor for a 76-year-old from the table in Reg. 1.401(a)(9)-9, Q&A-2. (The same information can be found in Table III of Appendix C of IRS Publication 590.) The divisor is 22.0.

Next, divide the December 31, 2004, account balance, say $400,000, by 22.0. The answer is: $18,182 ($400,000/22.0). This is the 2005 required minimum withdrawal amount. Orlando's estate, or whoever ends up inheriting the IRA, must withdraw that amount (at least) by December 31, 2005, in order to avoid the 50% penalty for failure to comply with the required minimum withdrawal rules.

In 2006, another required minimum withdrawal must be taken by December 31, 2006. To calculate the amount, use the single life expectancy divisor based on Orlando's age as of December 31, 2005, reduced by 1.0 (because this calculation is for 2006, the year after the year Orlando died). Find the single life expectancy divisor for a 76-year-old from the table in Reg. 1.401(a)(9)-9, Q&A-1. (The same information can be found in Table I of Appendix C of IRS Publication 590.) The divisor is 12.7. The 2006 required minimum withdrawal will equal the December 31, 2005, account balance divided by 11.7 (12.7 minus 1.0). The 2007 required minimum withdrawal will equal the December 31, 2006, account balance divided by 10.7 (12.7 minus 2.0). And so on for subsequent years.

Example 7-20

Same basic facts as Example 7-19, except now assume Orlando's estate is designated as the IRA beneficiary. The results will be exactly the same as in Example 7-19. This is because naming one's estate as the account beneficiary is the same as having no beneficiary for purposes of calculating required minimum withdrawals.

Removing a Non-Individual Beneficiary

As explained earlier, designating a beneficiary that is not an individual (i.e., not a natural person — for example, a charity) generally means the account is considered to have *no* beneficiary for required minimum withdrawal calculation purposes after the account owner's death. This can result in higher required minimum withdrawals (and higher taxes) for other co-beneficiaries who *are* individuals.

Key Point: This situation can be cured by *removing* the non-individual beneficiary by no later than September 30 of the year after the year the account owner dies. If this strategy is employed, subsequent required minimum withdrawals are calculated as if the non-individual beneficiary never existed. [See Reg. 1.401(a)(9)-4, Q&A-4.] Example 7-21 below illustrates the point.

Example 7-21

Daryl, age 32, is your client. His 66-year-old mother dies in 2005. Daryl is an equal 50% co-beneficiary of his mother's IRA. The other co-beneficiary is a charity. Therefore, the mother's account is considered to have *no* beneficiary for required minimum withdrawal purposes. As explained earlier, the dreaded five-year rule will apply in this circumstance, which means minimal tax deferral for Daryl. (The charity does not care a bit about tax deferral, because it is tax-exempt.)

The strategy in this situation is to distribute 50% of the IRA balance to the charity by no later than September 30, 2006. This removes the charity as a beneficiary for required minimum withdrawal calculation purposes.

Assume the account balance as of March 1, 2006, is $350,000. On that date, Daryl arranges for the charity to receive $175,000 (50% of $350,000), which cashes out the charity's interest in the IRA. Since the charity is tax-exempt, it has absolutely no problem with receiving all this money at once. Daryl is now the sole beneficiary of the IRA, which has a remaining balance of $175,000.

Daryl can now calculate required minimum withdrawals based on his relatively long single life expectancy (remember, he is only 32 years old). The calculations are made as explained in the earlier discussion of accounts inherited by non-spouses.

Planning for Inherited Capital Assets Held by a Decedent in Taxable Accounts

The general rule for an inherited capital asset held by a decedent in a taxable account is that the inheritor's tax basis in the asset is adjusted to its date-of-death fair market value [IRC §1014(a)].

Alternatively, the executor can elect to value the decedent's assets as of six months after the date of death. This is the so-called alternate valuation date.

If the alternate valuation date is elected, that date must be used to value all assets included in the decedent's gross estate. The value of capital assets held in taxable accounts as of the alternate valuation date will then be the relevant figure for both estate-tax- and income-tax-basis purposes. However, assets that are sold, distributed to heirs, or otherwise disposed of before the six-month period has elapsed are valued — for both estate-tax- and income-tax-basis purposes — as of the date they are sold, distributed, or otherwise disposed of [IRC §2032(a)].

This means heirs generally receive a stepped-up tax basis in inherited appreciated capital assets, such as stocks and mutual fund shares, that were held by the decedent in taxable accounts.

Key Point. When the decedent has a significant amount of publicly traded capital assets held in taxable accounts, electing the alternate valuation date can be beneficial for estate tax purposes when these assets decline in value after the decedent's death. However, the lower value as of the alternate valuation date will result in lower tax bases for the heirs who inherit these assets. When heirs sell inherited capital assets, the practitioner should verify whether the date of death or alternate valuation date was used for valuation purposes.

Contrary to what many clients believe, there is *no* tax-basis step-up for appreciated capital assets that were held in the decedent's tax-advantaged accounts [traditional or Roth IRA, SEP account, Keogh account, 401(k) account, variable life insurance account, etc.]. This is because the income in respect of a decedent rule discussed on the following pages applies to assets held in such accounts.

There is also no tax-basis step-up for the amount of net unrealized appreciation (NUA) in employer stock received by the decedent as part of a lump-sum distribution from a qualified retirement plan and then held by the decedent in a taxable account. The NUA is the difference between the retirement plan's cost basis in the employer shares (generally FMV when they were acquired by the plan) and the FMV of the shares on the date they were distributed by the retirement plan to the decedent. When the shares are later inherited by the decedent's heirs, the NUA represents an item of income in respect of a decedent (Rev. Rul. 75-125). So the heirs will owe capital gains tax on the NUA when the shares are ultimately sold (assuming they are sold for at least their FMV as of the date they were distributed to the decedent). Note that the heirs *do* receive a basis step-up for any appreciation that occurs between when the employer shares were distributed to the decedent and the decedent's date of death (or the alternate valuation date if so elected).

No Basis Step-Up for Income in Respect of Decedent (IRD) Items

When an individual dies, some of his/her retirement account assets may be taxed twice: once for federal estate tax purposes and then again for federal income tax purposes (and possibly state and local income taxes as well).

Specifically, this double-taxation concept applies to so-called income-in-respect-of-a-decedent items (IRD items), because these items constitute taxable gross income when received by the decedent's estate, heir, or beneficiary. (See IRC §691.)

IRD items are gross income items the decedent was entitled to at the time of his/her death but that were not included in the final 1040 because they had not yet been received. Put another way, IRD items are economically earned before the decedent's death, but are not received by any taxpayer until after the decedent's death.

As mentioned earlier in this section, IRD items generally do *not* include unrealized capital gains from the decedent's investment assets held in taxable accounts. Instead, the tax bases of these assets are generally stepped up to FMV as of the date of death (or the alternate valuation date) pursuant to IRC §1014(a) (or IRC §2032).

Commonly Encountered IRD Items

Commonly encountered IRD items include the following:

- **Accrued interest** from investments held in taxable accounts that are received after the decedent's death.
- **Annuity payments** received after the decedent's death.
- **Taxable income and gains** deferred under the installment sale rules until after the decedent's death. There is no basis step-up under IRC §1014(a) for deferred installment gains, even if the deferred gains are capital in nature [IRC §691(a)(4)].
- **Distributions** from qualified retirement plan, IRA, SEP, and SIMPLE IRA accounts that occur after the decedent's death.
- As explained earlier in this section, the **net unrealized appreciation** (NUA) in employer shares received by the decedent in a lump-sum distribution from a qualified retirement plan and then held by the decedent in a taxable account.

In effect, all of the preceding items are taxed to the recipient (the decedent's estate, heir, or beneficiary) because there is no date-of-death-basis step-up for assets to the extent they include IRD items [IRC §1014(c)]. In other words, the decedent has a zero tax basis in IRD items, and that zero tax basis carries over to whichever taxpayer ultimately collects the IRD items.

Good News: Income Tax Deduction for Estate Tax Attributable to IRD Items

So much for the bad news on IRD items. The only good news is that there is a federal income tax deduction for the amount of federal estate tax attributable to IRD items [under IRC §691(c)]. This deduction offsets at least some of the double taxation of IRD items.

The deduction is allowed to the taxpayer who receives and is taxed on the IRD items. This may be the decedent's estate, or it may be the heir or beneficiary who ultimately inherits the IRD asset. The deduction is allowed in the year the IRD item is included in taxable income.

The deduction is treated as a miscellaneous itemized deduction that is *not* subject to the 2%-of-AGI limit that applies to most other miscellaneous itemized deductions. (The deduction is also allowed for AMT purposes.)

If the IRD is capital gain in nature (most commonly from NUA in employer stock or deferred installment gains), the taxable amount of gain is reduced by the deduction for federal estate tax attributable to the gain per IRS Publication 559 (Survivors, Executors, and Administrators).

To calculate the deduction for estate tax paid, the amount of estate tax that qualifies for the deduction must be determined, and the IRD recipient's share of said estate tax must be determined.

The estate tax qualifying for the deduction is the tax attributable to the *net value* of all IRD items included in the decedent's taxable estate (i.e., the excess of the IRD items over any related items of expense in respect of the decedent).

The deductible estate tax is the difference between the actual estate tax liability and the estate tax that would be due without including the net value of the IRD items (i.e., a "with-and-without" calculation is made).

A particular heir's or beneficiary's proportionate share of the deductible estate tax amount is calculated by dividing the estate tax value of the IRD items included in the heir's or beneficiary's gross income by the total value of all IRD items included in the decedent's taxable estate.

Example 7-22

Assume the client's deceased parent was entitled at the time of his death to receive $12,000 of accrued taxable bond interest plus $8,000 of declared but not yet received stock dividends. The $20,000 of income is reported in the parent's estate tax return with no offsetting expenses. Therefore, the *net value* of the IRD items is $20,000. Assume the tax on the parent's estate is $10,000 after applying the estate tax credit. The estate tax determined *without* including the $20,000 net value of IRD items would have been only $5,000. Therefore, the amount of estate tax qualifying as an income tax deduction is $5,000 ($10,000 – $5,000). Assume your client inherits and collects the $12,000 of taxable bond interest (a sibling inherits the dividends). The client includes the $12,000 in his gross income for the tax year it is collected. For that same year, your client is entitled to claim a $3,000 miscellaneous itemized deduction calculated as follows: ($12,000 ÷ $20,000) × $5,000 = $3,000.

Summary

This chapter identifies tax issues relevant to heirs who inherit tax-advantaged retirement accounts and assets that were held in taxable accounts by the decedent.

Special emphasis was placed on dealing with the new required minimum distribution rules that apply to inherited tax-advantaged retirement accounts.

The impact of the income in respect of a decedent rule on heirs was also discussed.

Chapter 8

Pulling It All Together and Making Specific Client Recommendations

Objectives

After completing this chapter you should be able to

- *Calculate whether clients are saving enough for retirement and make appropriate recommendations if they are not.*
- *Identify and recommend appropriate retirement-planning strategies, as explained in earlier chapters of this book.*

Introduction

Earlier chapters explained various strategies clients can use to accumulate more wealth before reaching retirement age and to stretch out their money during retirement. These ideas are all well and good. But we have yet to examine a couple of basic questions that apply to almost all clients who are still in the pre-retirement phase of life. First, has the client saved enough to meet his/her retirement-age financial needs? Second, if the answer is "no" (as it often is), how much is the shortfall and what can be done to make it up? This discussion presents a worksheet methodology that you can employ to help clients answer these critically important questions. (See Appendix 8A for a sample set of completed worksheets.)

The remainder of this section is devoted to two checklists you can use to identify and recommend specific retirement-planning strategies that are appropriate for the particular client under consideration. The first checklist is for pre-retirement-age clients; the second one is for those who are already in retirement.

Estimating the Client's Retirement-Age Financial Needs and Required Additional Savings Between Now and Then

Depending on exactly what the client's vision of retirement is, the client will probably need to save additional money and invest it wisely during his/her remaining working years. So about how much should the client have accumulated by age 60, 62, or 65? And what does that translate into in terms of required monthly savings? Good questions. Let us start figuring out the answers.

Until fairly recently, "conventional wisdom" said a retired client could get by fairly comfortably on around 60% of his/her pre-retirement income. Lately that figure has come under fire as perhaps being too low in many cases. It is probably safer to assume the client's living costs during retirement will actually be more like 70% to 80% of the pre-retirement level. Here is why.

While the mortgage payment and certain other expenses may vanish by the time the client hits retirement age, other expenses will inevitably kick in or increase. For instance, he/she can count on paying more for medical insurance, uninsured medical costs, long-term care insurance, repairs on an aging home, property taxes on an increasingly valuable home, etc. The client may also want to travel more, provide occasional financial assistance to adult children, or help out with a grandchild's college expenses.

With the preceding thoughts in mind, let us use Worksheet No. 1 to put together a projection of the client's retirement-age income, based solely on the retirement savings he/she has already accumulated plus existing sources of retirement-age income (like Social Security). This is step 1 of our attempt to determine whether the client is currently saving enough to finance a comfortable retirement. (See the Appendix for a filled-out version of Worksheet No. 1.)

Worksheet No. 1: Projected Income from Current Retirement Savings Plus Pension and Social Security Benefits

Explanation: Use this worksheet to estimate the retirement-age income the client can expect from his/her current level of retirement savings, plus defined benefit pension plan payments (if applicable), plus Social Security benefits. When asked to enter expected rates of return below, be sure to enter rates before any adjustments for inflation or taxes.

Tax-Deferred Retirement Accounts

1a. Enter the current value of retirement savings in client's tax-deferred accounts [401(k), Keogh, SEP, traditional IRA, etc.]. $________

1b. Enter the factor from Table 1 below, based on years to retirement and expected rate of return on tax-deferred accounts between now and retirement age. ____.____

1c. The expected value of client's tax-deferred accounts at retirement age is **(Line 1a x Line 1b)**: $________

1d. Enter the factor from Table 2 below, based on number of years expected to be spent in retirement and expected rate of return on tax-deferred accounts during those years. ________

1e. The expected annual before-tax income during retirement generated by client's tax-deferred accounts is **(Line 1c x Line 1d)**: $________

1f. Enter as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. ____.____

1g. Subtract Line 1f from 1.00 and enter result here. ____.____

1h. The expected annual after-tax income during retirement generated by the client's tax-deferred accounts is **(Line 1e x Line 1g)**: $________

Key Point: The amount on Line 1h assumes the client's tax-deferred retirement accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Taxable Retirement Savings Accounts

2a.	Enter the current value of retirement savings in client's taxable accounts.	$ ________
2b.	Enter as a percent the pre-tax rate of return expected to be earned on these accounts between now and retirement.	________ %
2c.	Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts between now and retirement (taking into account preferential rates on long-term capital gain).	____ . ____
2d.	Subtract Line 2c from 1.00 and enter result here.	____ . ____
2e.	The expected after-tax rate of return is **(Line 2b x Line 2d)**:	________ %
2f.	Enter the factor from Table 1 below, based on years to retirement and expected after-tax rate of return on taxable accounts between now and then. (In Table 1, use the closest rate of return to the percentage calculated on Line 2e.)	____ . ____
2g.	The expected after-tax value of client's taxable accounts at retirement age is **(Line 2a x Line 2f)**:	$ ________
2h.	Enter as a percent the pre-tax rate of return expected to be earned on client's taxable accounts during retirement.	________ %
2i.	Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts during retirement (taking into account preferential rates on long-term capital gains).	____ . ____
2j.	Subtract Line 2i from 1.00 and enter result here.	____ . ____
2k.	The expected after-tax rate of return is **(Line 2h x Line 2j)**:	________ %
2l.	Enter the factor from Table 2 below, based on the number of years expected to be spent in retirement and expected rate of return on taxable accounts during those years. (In Table 2, use the closest rate of return to the percentage calculated on Line 2k.)	____ . ____
2m.	The expected annual after-tax income during retirement generated by client's taxable accounts is **(Line 2g x Line 2l)**:	$ ________

Note: The amount on Line 2m assumes the client's taxable accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Tax-Free Roth IRA Accounts

3a. Enter the current value of client's retirement savings in Roth IRAs. $__________

3b. Enter the factor from Table 1 below, based on years to retirement and expected rate of return on Roth IRAs between now and then. _____._____

3c. The expected value of client's Roth IRAs at retirement age is **(Line 3a x Line 3b)**: $__________

3d. Enter the factor from Table 2 below, based on the number of years expected to be spent in retirement and expected rate of return on client's Roth IRAs during those years. _____._____

3e. The expected annual after-tax income during retirement generated by the client's Roth IRAs is **(Line 3c x Line 3d)**: $__________

Note. The amount on Line 3e assumes the client's Roth IRAs will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Note. The amount on Line 3e assumes the client's Roth IRA withdrawals occur after age 59½ and after the account has been open at least five years. If these two conditions are met, the withdrawals will be federal-income-tax-free.

Pension Benefits

4a. If client is covered by a defined benefit pension plan, enter the annual benefit expected at the retirement age assumed throughout this worksheet. $__________

4b1. If client's pension benefits are not adjusted for inflation between now and retirement age, enter inflation discount factor #1 based on expected years to retirement. Enter the factor for the closest number of years to retirement. For 5 years inflation discount factor #1 is .86; for 10 years it is .74; for 15 years it is .64; for 20 years it is .55; for 25 years it is .48; for 30 years it is .41; for 35 years it is .36; for 40 years it is .31. If client's pension benefits are adjusted for inflation between now and retirement age, enter 1.00 on this line. _____._____

4b2. If client's pension benefits are not adjusted for inflation during retirement, enter inflation discount factor #2 based the number of years expected in retirement. For 15 years inflation discount factor #2 is .80; for 20 years it is .74; for 25 it is .70; for 30 years it is .65; for 35 years it is .61; for 40 years it is .58; for 45 years it is .54; for 50 years it is .51. If client's pension benefits are adjusted for inflation during retirement, enter 1.00 on this line. _____._____

Note. The inflation discount factors for Lines 4b1 and 4b2 are based on an assumed annual inflation rate of 3%.

4c. Enter as a decimal the average tax rate (federal and state combined) client expects to pay or ordinary income during retirement. (This should be the same as the rate entered on Line 1f.) _____._____

4d. Subtract Line 4c from 1.00 and enter result here. _____._____

4e. The expected annual after-tax income during retirement from client's pension benefits is **(Line 4a x Line 4b1 x Line 4b2 x Line 4d)**: $__________

Social Security Benefits

5a. Enter client's expected annual Social Security benefits at the retirement age that has been assumed throughout this worksheet. $__________

Note. The amount on Line 5a can be obtained from the annual statement sent to the client by the Social Security Administration. It's assumed that benefits will continue to be adjusted to keep pace with inflation.

5b. Enter as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. (This should be the same as the rate entered on Line 1f.) _____._____

5c. Multiply the number on Line 5b by either .50 or .85 (or other percentage if appropriate) and enter the result here. _____._____

Note. Under current tax law, most individuals are taxed on 50% of their Social Security benefits. Higher-income individuals can be taxed on as much as 85% of their benefits. For purposes of filling out Line 5c, use your best guess for the taxable percentage (expressed as a decimal) that will apply to the client's Social Security benefits.

5d. Subtract Line 5c from 1.00 and enter result here. _____._____

5e. The expected annual after-tax income during retirement from client's Social Security benefits is **(Line 5a x Line 5d):** $__________

Total Expected Retirement-Age Income from Existing Sources

6. Based on the client's current level of retirement savings, projected pension benefits (if any), and Social Security benefits, the client's total annual income during retirement in today's after-tax dollars is projected to be **(Line 1h + Line 2m + Line 3e + Line 4e + Line 5e):** $__________

Key Point. As you completed Worksheet No. 1, you probably noticed that the amount of income the client can expect during his/her retirement years depends largely on how much has been saved by retirement age and the rate of return earned on retirement savings (both before and during retirement). You might want to try completing the worksheet a few more times using different assumed rates of return. You will clearly see how important the rate of return factor really is. See Chapter 6 for more on the rate of return factor, investment risk, and asset allocation.

Now that we know roughly the level of income the client can expect from his/her current retirement savings (plus any pension benefits, plus Social Security, plus any income from other existing sources), the next step is to find out about how much the client's desired retirement-age lifestyle will cost.

Here we need to think of expenses in terms of "monthly" and "annual" in order to budget for both regularly recurring expenses as well as "once-in-a-while" costs the client will still need to be prepared for.

So let us complete another worksheet (Worksheet No. 2) to project the client's annual retirement-age cost of living. Remember, this worksheet should include any outlays necessary to fulfill the client's retirement vision. So if he/she plans on joining the country club, be sure to include that expense.

Key Point. The Appendix has a sample filled-out Worksheet No. 2.

Worksheet No. 2: Projected Retirement-Age Living Costs

Explanation: Use this worksheet to project the client's retirement-age living costs. All amounts entered below should be in today's dollars (without any adjustment for inflation).

Anticipated Monthly Expenses During Retirement

1.	Home mortgage principal and interest or rent.	$ ________
2.	Utilities and garbage pickup.	________
3.	Food and personal care items.	________
4.	Auto or transportation costs.	________
5.	Clothing.	________
6.	Entertainment, gifts, subscriptions, etc.	________
7.	Debt payments other than mortgage.	________
8.	Other items not listed above.	________
9.	Total monthly expenses **(Sum of Lines 1-8)**:	________
10.	Annualized monthly expenses **(Line 9 x 12)**:	$ ________

Other Anticipated Expenses During Retirement

11.	Annual spending on vacations and memberships.	$ ________
12.	Annual premiums for health and LTC coverage.	________
13.	Annual uninsured medical costs.	________
14.	Annual amount for other insurance premiums.	________
15.	Annual repair and maintenance expenses.	________
16.	Annual property taxes.	________
17.	Annual amount for emergencies or other unexpected items (i.e., contingencies).	________
18.	Annual amount for any other expense items.	________
19.	Total other expenses **(Sum of Lines 11-18)**:	$ ________
20.	Projected annual retirement-age living expenses **(Line 10 + Line 19):**	$ ________

Basically, the client will need to somehow generate a retirement-age "salary" at least equal to the annual living expense figure we just estimated using Worksheet No. 2. Part of that salary will be funded by assets the client has already accumulated and earmarked for retirement. Part will presumably be paid by the federal government via Social Security benefits. If the client is lucky, part will be covered by his/her employer via defined-benefit pension payments.

Key Point. The Appendix has a sample filled-out Worksheet No. 2.

The final step is to determine if the client is on track to pay him/herself the needed salary (from Worksheet No. 2) with retirement savings that have already been accumulated and/or with other existing resources already accounted for (in Worksheet No. 1). More likely, there is a shortfall. In most cases, that shortfall can only be made up by accumulating additional savings between now and when the client retires.

So, let us fill out one more worksheet (Worksheet No. 3) to complete our analysis.

Worksheet No. 3: Is Client Financially Set for Retirement or (More Likely) Are Additional Savings Required?

Explanation: Use this worksheet to estimate if the client has already accumulated enough to finance his/her retirement or (more likely) not.

1. Enter client's expected annual income from existing sources during retirement from Worksheet No. 1, Line 6. $ ________

2. Enter client's expected annual retirement-age living costs from Worksheet No. 2, Line 20. $ ________

3. Subtract Line 1 from Line 2. This is the projected annual after-tax retirement-age income shortfall that must be made up via additional savings between now and when the client retires: $ ________

Explanation: If Line 1 equals or exceeds Line 2, you can stop right here, because it appears the client has already accumulated enough to see him/her through retirement (at least based on the assumptions used in this analysis). However it never hurts to have more money than appears to be required in case the client: (1) lives longer than expected, (2) has higher-than-expected expenses during retirement, (3) earns a lower-than-expected rate of return on retirement savings, or (4) any combination of the above. Of course, if the client is in the more typical scenario where Line 2 exceeds Line 1, he/she will need to save more money between now and retirement. In the latter case, please complete this worksheet.

4. Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in tax-deferred retirement accounts between now and retirement age. (If none, enter zero here.) $ ________

5. Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in taxable accounts between now and retirement age. (If none, enter zero here.) $ ________

6. Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in Roth IRAs. (If none, enter zero here.) $ ________

Note. The amounts on Lines 4, 5, and 6 should total up to the annual shortfall amount quantified on Line 3 of this worksheet.

Required Additional Savings in Tax-Deferred Retirement Accounts

7a. If an amount was entered on Line 4, enter here as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. (This should be the same as the rate entered on Worksheet No. 1, Line 1f.) ______.______

7b. Subtract Line 7a from 1.00; enter result here. ______.______

7c. Divide amount on Line 4 by Line 7b and enter the result here. $__________

7d. Enter the factor from Table 3 below, based on the number of years expected to be spent in retirement and the expected rate of return on tax-deferred accounts during those years. ______.______

7e. The additional amount the client needs to accumulate in tax-deferred accounts by retirement age (before taxes) is **(Line 7c x Line 7d)**: $__________

7f. Enter the factor from Table 4 below, based on expected years to retirement and rate of return on tax-deferred accounts between now and then. ______.______

7g. The additional annual amount the client needs to save in tax-deferred accounts between now and retirement is projected to be **(Line 7e x Line 7f)**: $__________

Note. The amount on Line 7g cannot exceed the client's annual limit on contributions to tax-deferred retirement accounts. If it does, the amount entered on Line 4 is too large and must be scaled back accordingly.

Note. The amount on Line 7g assumes the client's tax-deferred accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Required Additional Savings in Taxable Accounts

8a. If an amount was entered on Line 5, enter here the pre-tax rate of return the client expects to earn on taxable accounts during retirement. (This should be the same as the rate of return entered on Worksheet No. 1, Line 2h.) __________%

8b. Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts during retirement (taking into account preferential rates on long-term capital gains). (This should be the same as the rate entered on Worksheet No. 1, Line 2i.) ______.______

8c. Subtract Line 8b from 1.00; enter result here. ______.______

8d. The after-tax rate of return on client's taxable accounts during retirement is expected to be **(Line 8a x Line 8c)**: ______%

8e. Enter the factor from Table 3 below, based on number of years expected to be spent in retirement and the expected after-tax rate of return on taxable accounts during those years. (In Table 3, use the rate of return closest to the percentage calculated on Line 8d.) ______.______

8f. The additional amount the client needs to accumulate in taxable accounts by retirement age (after taxes) is **(Line 5 x Line 8e)**: $______

8g. Enter the pre-tax rate of return expected to be earned on additional savings in client's taxable accounts between now and retirement. (This should be the same rate of return as on Worksheet No. 1, Line 2b.) ______%

8h. Enter as a decimal the tax rate (combined federal and state) client expects to pay on earnings from taxable accounts between now and retirement (taking into account preferential rates on long-term capital gains). (This should be the same rate as on Worksheet No. 1, Line 2c.) ______.______

8i. Subtract Line 8h from 1.00; enter result here. ______.______

8j. The after-tax rate of return on client's taxable accounts between now and retirement is expected to be **(Line 8g x Line 8i)**: ______%

8k. Enter the factor from Table 4 below, based on expected years to retirement and expected after-tax rate of return on additional savings in client's taxable accounts between now and then. (In Table 4, use the rate of return closest to the percentage calculated on Line 8j.) ______.______

8l. The additional annual amount client needs to save in taxable accounts between now and retirement age is projected to be **(Line 8f x Line 8k)**: $______

Note. The amount on Line 8l assumes the client's taxable accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Required Additional Savings in Roth IRAs

9a. If an amount was entered on Line 6, enter here the factor from Table 3 below, based on number of years expected to be spent in retirement and expected rate of return on the client's Roth IRAs during those years. ______.______

9b. The additional amount the client needs to accumulate in Roth IRAs by retirement age is projected to be **(Line 6 x Line 9a)**: $________

9c. Enter the factor from Table 4 below, based on expected years to retirement and expected rate of return on additional savings in client's Roth IRAs between now and then. ____.____

9d. The additional annual amount client needs to save in Roth IRAs between now and retirement age is projected to be **(Line 9b x Line 9c)**: $________

Note. The amount on Line 9d cannot exceed the client's annual limit on Roth IRA contributions. If it does, the amount entered on Line 6 is too large and must be scaled back accordingly.

Note. The amount on Line 9d assumes the client's Roth IRAs will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Note. The amount on Line 9d assumes Roth IRA withdrawals occur after age 59½ and after the account has been open at least five years. If these two conditions are met, the withdrawals will be federal-income-tax-free.

Total Required Additional Annual Savings

10. The total additional annual amount the client needs to save between now and retirement age is projected to be **(Line 7g + Line 8l + Line 9d)**: $________

Summary: According to this analysis, the client can cover his/her projected retirement-age shortfall by: (1) saving the additional annual amount estimated on **Line 7g** in tax-deferred retirement accounts, (2) saving the additional annual amount estimated on **Line 8l** in taxable accounts, and (3) saving the additional annual amount estimated on **Line 9d** in Roth IRAs. So you now have a specific retirement savings program to get the client to where he/she wants to be at retirement age.

Key Point: After appropriate worksheet adjustments, the results on Line 10 above constitute a recommended retirement savings program that is projected to get the client to where he/she wants to be at retirement age (subject to the assumptions made in this analysis).

Key Point: The Appendix has a sample filled-out Worksheet No. 3.

Table 1: Future Value Factors Based on Years to Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (before Inflation)

Years to Retirement	4%	6%	8%	10%
5	1.05	1.15	1.27	1.39
10	1.10	1.33	1.61	1.93
15	1.16	1.54	2.04	2.68
20	1.21	1.78	2.58	3.72
25	1.27	2.05	3.27	5.17
30	1.34	2.37	4.15	7.19
35	1.40	2.73	5.25	10.00
40	1.47	3.15	6.66	13.87

Table 2: Annuity Payment Factors Based on Years in Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (before Inflation)

Years in Retirement	4%	6%	8%	10%
15	0.0720	0.0832	0.0954	0.1084
20	0.0553	0.0667	0.0793	0.0929
25	0.0452	0.0569	0.0699	0.0842
30	0.0386	0.0504	0.0640	0.0789

Years in Retirement	**4%**	**6%**	**8%**	**10%**
35	0.0338	0.0460	0.0600	0.0755
40	0.0303	0.0427	0.0571	0.0732
45	0.0275	0.0402	0.0551	0.0717
50	0.0253	0.0382	0.0535	0.0706

Table 3: Present Value Factors to Fund Annuity Based on Years in Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (before Inflation)

Years in Retirement	**4%**	**6%**	**8%**	**10%**
15	13.90	12.01	10.48	9.23
20	18.10	15.00	12.62	10.76
25	22.10	17.58	14.30	11.87
30	25.92	19.82	15.63	12.67
35	29.55	21.76	16.68	13.24
40	33.02	23.44	17.51	13.65
45	36.32	24.90	18.16	13.95
50	39.46	26.16	18.68	14.17

Table 4: Annual Savings Factors to Fund Future Amount Based on Years to Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (before Inflation)

Years to Retirement	**4%**	**6%**	**8%**	**10%**
5	0.2141	0.2057	0.1976	0.1900
10	0.1119	0.1020	0.0928	0.0843
15	0.0778	0.0669	0.0574	0.0490
20	0.0607	0.0491	0.0395	0.0315
25	0.0503	0.0382	0.0286	0.0213
30	0.0433	0.0307	0.0214	0.0148
35	0.0382	0.0253	0.0163	0.0104
40	0.0343	0.0211	0.0126	0.0074

After completing Worksheet No. 3, we now know a lot more than when we started this process. For instance, we know whether or not the client has already accumulated enough to finance his/her retirement. If not, we have calculated about how much more the client should be saving annually in tax-deferred retirement accounts, taxable accounts, and Roth IRAs.

If the amount the client needs to save looks impossibly large, there is no need to panic. However, the client will need to make some adjustments. For example, he/she can bite the bullet and decide to work a few years longer, all the while contributing more to retirement savings and taking advantage of the extra years of compounded growth. Or the client can adjust his/her retirement vision somewhat. Maybe the client can scrape by without a vacation home and survive with just one car instead of two. In any case, the client should do everything possible to contribute more to tax-advantaged retirement accounts. A few extra dollars a month carved out of spending and instead contributed to these tax-favored accounts could make a surprisingly large difference in the size of the client's retirement stash down the road.

Finally, the client may want to consider investing a bit more aggressively with the expectation of earning a higher return. Usually the best way to do this is by allocating more retirement savings to growth-oriented investments such as stock funds. Of course, investing in stocks involves more risk than investing in fixed-income vehicles like bond and money market funds. (See Chapter 6 for more on this subject.)

Or the client can do all of the above to some extent. Then you can redo Worksheets No. 2 and No. 3 to see how the client fares under revised assumptions.

Key Point. The Appendix has a sample filled-out Worksheet No. 3.

Checklist 1: Retirement-Planning Strategies for Pre-Retirement-Age Clients

From Chapter 1, "The New Retirement-Planning Environment and Data Gathering to Identify and Implement Tax-Smart Strategies"

1. Is client "maxing out" on contributions to tax-advantaged retirement accounts?

   Response and Notes:

2. If client is eligible to make additional "catch-up contributions" to salary-deferral retirement accounts and/or IRAs, are these additional contributions being made?

   Response and Notes:

3. If client is not "maxing out," is he/she a candidate for basic financial-planning advice from you regarding budgeting and managing cash flow?

   Response and Notes:

4. If client is a small business owner, has he/she set up a tax-advantaged retirement plan? If not, have you offered your services regarding setting up a plan? If the client already has a plan, is it the best one for the client's situation?

   Response and Notes:

5. List here all action items you have identified based on the material covered in Chapter 1:

From Chapter 2, "Allocating Investments to Retirement-Savings Accounts and Answering the Roth IRA Conversion Question"

1. Is the client making optimal allocations of investments to his/her retirement-savings accounts?

   Response and Notes:

2. If the client's modified AGI permits, would a Roth IRA conversion transaction be advisable? (See also Chapter 6 regarding using a Roth conversion as an estate-planning strategy.)

   Response and Notes:

3. If the client decides to do a Roth IRA conversion, have you carefully estimated the overall tax impact and whether the client would benefit from "spreading out" the conversion over several years?

   Response and Notes:

4. If the client decides to do a Roth IRA conversion, have you ascertained that he/she can raise the cash to pay the resulting tax hit without taking money out of the IRA or borrowing?

   Response and Notes:

5. If the client decides to do a Roth IRA conversion, have you advised the client to extend his/her return for the year of the conversion?

   Response and Notes:

6. If the client did a Roth IRA conversion earlier this year or last year and the account value subsequently dropped, has the client considered "unconverting"?

   Response and Notes:

7. List here all action items you have identified based on the material covered in Chapter 2:

From Chapter 3, "Planning for Employer Stock Held in Qualified Retirement Plan Accounts"

1. If the client will receive (or has very recently received) a lump-sum distribution that includes shares of employer stock, would it be advisable to *not* roll the shares over into an IRA?

   Response and Notes:

2. If "yes" to the previous question, have you determined with certainty that the client did in fact receive a lump-sum distribution?

   Response and Notes:

3. List here all action items you have identified based on the material covered in Chapter 3:

From Chapter 4, "Planning for Early Retirees and Early Retirement Account Withdrawals"

1. If the client intends to retire before age 59½ (or has already done so very recently), have you done the work necessary to properly advise him/her regarding how much of any money distributed from company qualified retirement plan accounts should be rolled over tax-free into an IRA?

   Response and Notes:

2. For qualified retirement plan distribution amounts the client intends to roll over into an IRA, have you advised the client to arrange for a “direct” or “trustee-to-trustee” transfer?

   Response and Notes:

3. If the client is self-employed and needs to withdraw money from his/her Keogh or SEP account before age 59½, have you advised him/her regarding the 10% premature-withdrawal penalty tax and ways to avoid it?

   Response and Notes:

4. If the client thinks he/she needs to withdraw money from tax-advantaged retirement accounts before age 59½, have you discussed alternative tax-smart ways to increase cash flow?

   Response and Notes:

5. List here all action items you have identified based on the material covered in Chapter 4:

From Chapter 5, "Planning for Divorcing Clients" (for Divorcing Clients Only)

1. Have you advised your divorcing client regarding the tax implications of any transfers to the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

2. Have you advised your divorcing client regarding the tax implications of receiving from the other party any retirement-savings investments held in taxable accounts?

   Response and Notes:

3. Is the divorcing client's property settlement agreement based on "net-of-tax" values?

   Response and Notes:

4. Have you advised your divorcing client regarding the tax implications of any post-divorce transfers to the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

5. Have you advised your divorcing client regarding the tax implications of any post-divorce receipt from the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

6. If your divorcing client will be transferring all or part of his/her interests in qualified retirement plan accounts to the other party, has the client been protected tax-wise by including proper QDRO language in the divorce papers?

   Response and Notes:

7. If your divorcing client will be receiving all or part of the other party's interests in qualified retirement plan accounts pursuant to a QDRO, does the client understand that he/she will be responsible for the taxes on subsequent account withdrawals?

   Response and Notes:

8. Has your divorcing client been advised against transferring any IRA funds to the other party unless required to do so by a "divorce or separation instrument"?

   Response and Notes:

9. If your divorcing client will be transferring all or part of his/her interests in IRAs or SEP accounts to the other party, has the client been protected tax-wise by including "fail-safe language" (as recommended in Chapter 5) in the divorce or separation instrument?

   Response and Notes:

10. If your divorcing client will be transferring all or part of his/her interests in IRAs or SEP accounts to the other party, has the client been advised regarding the specifics of arranging for the transfer(s) such that the tax results will be as expected?

    Response and Notes:

11. If your divorcing client will be receiving all or part of the other party's interests in IRAs or SEP accounts pursuant to the divorce or separation instrument, does the client understand that he/she will be responsible for the taxes on subsequent account withdrawals?

    Response and Notes:

12. List here all action items you have identified based on the material covered in Chapter 5:

From Chapter 6, "Planning for Older Clients"

1. Even though Chapter 6 is intended primarily for older clients, have you nevertheless considered the discussion regarding investment approach and asset allocation for your younger client's retirement-savings dollars?

   Response and Notes:

2. List here all action items you have identified based on the material covered in Chapter 6:

From Chapter 7, "Planning for Inherited Accounts"

1. If your client has inherited one or more tax-advantaged retirement accounts, is he/she properly calculating required minimum distributions and withdrawing them on time?

   Response and Notes:

2. If your client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, has the client been advised of the potential advantages of treating the account as his/her own account?

   Response and Notes:

3. If your client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, has the client considered disclaiming the account in favor of other account beneficiaries?

   Response and Notes:

4. If your client is one of several designated beneficiaries of an inherited tax-advantaged retirement account, are required minimum distributions being properly calculated and withdrawn on time?

   Response and Notes:

5. If your client has inherited retirement-savings investments held by the deceased in taxable accounts, have you advised the client regarding the basis rules for inherited capital assets and the IRD rules for inherited ordinary income assets?

   Response and Notes:

6. If your client has inherited IRD items, have you determined if he/she is entitled to an income tax deduction for the federal estate tax attributable to the IRD items?

   Response and Notes:

7. List here all action items you have identified based on the material covered in Chapter 7:

From Chapter 8, "Putting It All Together and Making Specific Client Recommendations"

1. Have you assessed whether the client is saving enough money for retirement? (Consider using the worksheet methodology explained earlier in this chapter and illustrated in Appendix 8A at the end of this chapter.)

   Response and Notes:

2. List here all action items you have identified based on the material covered in this Chapter 8:

Checklist 2: Retirement-Planning Strategies for Already-Retired Clients (and Very-Soon-to-Be-Retired Clients)

From Chapter 2, "Allocating Investments to Retirement-Savings Accounts and Answering the Roth IRA Conversion Question"

1. Is the client making optimal allocations of investments to his/her retirement-savings accounts?

   Response and Notes:

2. If the client's modified AGI permits, would a Roth IRA conversion transaction be advisable?

   Response and Notes:

3. If the client decides to do a Roth IRA conversion, have you carefully estimated the overall tax impact and whether the client would benefit from "spreading out" the conversion over several years?

   Response and Notes:

4. If the client decides to do a Roth IRA conversion, have you ascertained that he/she can raise the cash to pay the resulting tax hit without taking money out of the IRA or borrowing?

   Response and Notes:

5. If the client decides to do a Roth IRA conversion, have you advised the client to extend his/her return for the year of the conversion?

   Response and Notes:

6. If the client did a Roth IRA conversion earlier this year or last year and the account value subsequently dropped, has the client considered "unconverting"?

   Response and Notes:

7. List here all action items you have identified based on the material covered in Chapter 2:

From Chapter 3, "Planning for Employer Stock Held in Qualified Retirement Plan Accounts"

1. If the client will receive (or has very recently received) a lump-sum distribution that includes shares of employer stock, would it be advisable to *not* roll the shares over into an IRA?

   Response and Notes:

2. If "yes" to the previous question, have you determined with certainty that the client did in fact receive a lump-sum distribution?

   Response and Notes:

3. List here all action items you have identified based on the material covered in Chapter 3:

From Chapter 4, "Planning for Early Retirees and Early Retirement Account Withdrawals" (If Client Is Under Age 59½)

1. If the client intends to retire before age 59½ (or has already done so very recently), have you done the work necessary to properly advise him/her regarding how much of any money distributed from company qualified retirement plan accounts should be rolled over tax-free into an IRA?

   Response and Notes:

2. For qualified retirement plan distribution amounts the client intends to roll over into an IRA, have you advised the client to arrange for a "direct" or "trustee-to-trustee" transfer?

   Response and Notes:

3. If the client is self-employed and needs to withdraw money from his/her Keogh or SEP account before age 59½, have you advised him/her regarding the 10% premature-withdrawal penalty tax and ways to avoid it?

   Response and Notes:

4. If the client thinks he/she needs to withdraw money from tax-advantaged retirement accounts before age 59½, have you discussed alternative tax-smart ways to increase cash flow?

   Response and Notes:

5. List here all action items you have identified based on the material covered in Chapter 4:

From Chapter 5 "Planning for Divorcing Clients" (for Divorcing Clients Only)

1. Have you advised your divorcing client regarding the tax implications of any transfers to the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

2. Have you advised your divorcing client regarding the tax implications of receiving from the other party any retirement-savings investments held in taxable accounts?

   Response and Notes:

3. Is the divorcing client's property settlement agreement based on "net-of-tax" values?

   Response and Notes:

4. Have you advised your divorcing client regarding the tax implications of any post-divorce transfers to the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

5. Have you advised your divorcing client regarding the tax implications of any post-divorce receipt from the other party of retirement-savings investments held in taxable accounts?

   Response and Notes:

6. If your divorcing client will be transferring all or part of his/her interests in qualified retirement plan accounts to the other party, has the client been protected tax-wise by including proper QDRO language in the divorce papers?

   Response and Notes:

7. If your divorcing client will be receiving all or part of the other party's interests in qualified retirement plan accounts pursuant to a QDRO, does the client understand that he/she will be responsible for the taxes on subsequent account withdrawals?

   Response and Notes:

8. Has your divorcing client been advised against transferring any IRA funds to the other party unless required to do so by a "divorce or separation instrument"?

   Response and Notes:

9. If your divorcing client will be transferring all or part of his/her interests in IRAs or SEP accounts to the other party, has the client been protected tax-wise by including "fail-safe language" (as recommended in Chapter 5) in the divorce or separation instrument?

   Response and Notes:

10. If your divorcing client will be transferring all or part of his/her interests in IRAs or SEP accounts to the other party, has the client been advised regarding the specifics of arranging for the transfer(s) such that the tax results will be as expected?

    Response and Notes:

11. If your divorcing client will be receiving all or part of the other party's interests in IRAs or SEP accounts pursuant to the divorce or separation instrument, does the client understand that he/she will be responsible for the taxes on subsequent account withdrawals?

    Response and Notes:

12. List here all action items you have identified based on the material covered in Chapter 5:

From Chapter 6, "Planning for Older Clients"

1. Have you assessed the client's current asset allocation scheme and explained any changes that you feel are advisable?

   Response and Notes:

2. Have you advised the client regarding the importance of properly completed and filed beneficiary designations for all of his/her tax-advantaged retirement accounts?

   Response and Notes:

3. Have you advised the client to obtain copies of current beneficiary designation forms for all of his/her tax-advantaged retirement accounts?

   Response and Notes:

4. If your client intends multiple beneficiaries for money in his/her IRAs, have you advised the client to set up separate IRAs for each intended beneficiary?

   Response and Notes:

5. If your client is approaching age 70½, have you gathered the necessary account information and advised the client regarding the required minimum distribution rules and their implications for his/her future tax situation?

   Response and Notes:

6. If your client is approaching age 70½, have you considered tax-planning strategies to offset the additional taxable income the client must recognize when he/she starts taking required minimum distributions?

   Response and Notes:

7. If your client has already turned 70½, has he/she already taken the initial required minimum distribution(s) from his/her traditional IRA(s) and any other tax-deferred retirement account(s)? If not, would it be advisable to take the initial required minimum distribution(s) during the year the client turns 70½ instead of during the following year?

   Response and Notes:

8. If your client has already turned 70½, are his/her required minimum distributions being properly calculated and withdrawn on time?

   Response and Notes:

9. If your client has already turned 70½, have you considered tax-planning strategies to offset the additional taxable income he/she must recognize from required minimum distributions?

   Response and Notes:

10. If your client intends to retire soon (or has already done so very recently), have you done the work necessary to properly advise him/her regarding how much of any money distributed from company qualified retirement plan accounts should be rolled over tax-free into an IRA?

    Response and Notes:

11. For qualified retirement plan distribution amounts the client intends to roll over into an IRA, have you advised the client to arrange for a "direct" or "trustee-to-trustee" transfer?

    Response and Notes:

12. Is your client eligible for favorable tax treatment of qualified retirement plan lump-sum distributions? If so, is it advisable to pay the tax instead of doing an IRA rollover?

    Response and Notes:

13. If "yes" to the previous question, have you determined with certainty that the client did in fact receive a lump-sum distribution and is in fact eligible for the favorable tax treatment accorded lump-sum distributions?

    Response and Notes:

14. Does your client have a bypass trust arrangement set up via his/her will or living trust document? If so, have you advised the client that tax-advantaged retirement accounts are lousy assets for funding bypass trusts? If possible, advise the client regarding which other assets would be more appropriate for this purpose.

    Response and Notes:

15. Is your client eligible for and interested in making a Roth IRA conversion for estate-planning reasons? If so, see the Chapter 2 checklist earlier in this chapter for additional Roth conversion considerations.

    Response and Notes:

16. List here all action items you have identified based on the material covered in Chapter 6:

From Chapter 7, "Planning for Inherited Accounts"

1. If your client has inherited one or more tax-advantaged retirement accounts, is he/she properly calculating required minimum distributions and withdrawing them on time?

   Response and Notes:

2. If your client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, has the client been advised of the potential advantages of treating the account as his/her own account?

   Response and Notes:

3. If your client is a surviving spouse who has inherited a tax-advantaged retirement account from his/her deceased spouse, has the client considered disclaiming the account in favor of other account beneficiaries?

   Response and Notes:

4. If your client is one of several designated beneficiaries of an inherited tax-advantaged retirement account, are required minimum distributions being properly calculated and withdrawn on time?

   Response and Notes:

5. If your client has inherited retirement-savings investments held by the deceased in taxable accounts, have you advised the client regarding the basic rules for inherited capital assets and the IRD rules for inherited ordinary income assets?

   Response and Notes:

6. If your client has inherited IRD items, have you determined if he/she is entitled to an income tax deduction for the federal estate tax attributable to the IRD items?

   Response and Notes:

7. List here all action items you have identified based on the material covered in Chapter 7:

Summary

By completing the three worksheets provided in this chapter, you can develop a tentative savings program to meet your client's retirement-age financial needs. In effect, the savings program identified in Worksheet No. 3 can become the client's basic financial plan for the period between now and retirement. If Worksheet No. 3 shows that an impossibly large amount of additional savings is required, the client should be encouraged to revise his/her assumptions accordingly until a workable savings program can be developed. This may take several iterations. (See the Appendix for sample filled-out worksheets.)

The two checklists (that follow the worksheets) can be used to identify specific retirement-planning strategies to recommend to the client under consideration. You can then follow up to see if the recommendations have been implemented and if the client is making satisfactory progress. If not, the same or additional actions can be recommended. And so on and so forth until you have successfully guided your client to and through retirement.

Chapter 8 Appendix

Filled-Out Retirement-Planning Worksheets

Worksheet No. 1: Projected Income from Current Retirement Savings Plus Pension and Social Security Benefits

Explanation: Use this worksheet to estimate the retirement-age income the client can expect from his/her current level of retirement savings, plus defined benefit pension plan payments (if applicable), plus Social Security benefits. When asked to enter expected rates of return below, be sure to enter rates before any adjustments for inflation or taxes.

Tax-Deferred Retirement Accounts

1a.	Enter the current value of retirement savings in client's tax-deferred accounts [401(k), Keogh, SEP, traditional IRA, etc.]. **Assume $150,000**	$ 150,000
1b.	Enter the factor from Table 1 below, based on years to retirement and expected rate of return on tax-deferred accounts between now and retirement age. **Assume 20 years; 8%**	2.58
1c.	The expected value of client's tax-deferred accounts at retirement age is **(Line 1a x Line 1b)**:	$ 387,000
1d.	Enter the factor from Table 2 below, based on number of years expected to be spent in retirement and expected rate of return on tax-deferred accounts during those years. **Assume 25 years; 6%**	.0569
1e.	The expected annual before-tax income during retirement generated by client's tax-deferred accounts is **(Line 1c x Line 1d)**:	$ 22,020
1f.	Enter as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. **Assume .25**	.25

1g.	Subtract Line 1f from 1.00 and enter result here.	.75
1h.	The expected annual after-tax income during retirement generated by the client's tax-deferred accounts is **(Line 1e x Line 1g)**:	$ 16,515

Key Point. The amount on Line 1h assumes the client's tax-deferred retirement accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Taxable Retirement Savings Accounts

2a.	Enter the current value of retirement savings in client's taxable accounts. **Assume $50,000**	$ 50,000
2b.	Enter as a percent the pre-tax rate of return expected to be earned on these accounts between now and retirement. **Assume 8%**	8.00%
2c.	Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts between now and retirement (taking into account preferential rates on long-term capital gain). **Assume .22**	.22
2d.	Subtract Line 2c from 1.00 and enter result here.	.78
2e.	The expected after-tax rate of return is **(Line 2b x Line 2d)**:	6.24%
2f.	Enter the factor from Table 1 below, based on years to retirement and expected after-tax rate of return on taxable accounts between now and then. (In Table 1, use the closest rate of return to the percentage calculated on Line 2e.) **Assume 20 years; use 6% rate**	1.78
2g.	The expected after-tax value of client's taxable accounts at retirement age is **(Line 2a x Line 2f)**:	$ 89,000
2h.	Enter as a percent the pre-tax rate of return expected to be earned on client's taxable accounts during retirement. **Assume 7%**	7.00%
2i.	Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts during retirement (taking into account preferential rates on long-term capital gains). **Assume .20**	.20
2j.	Subtract Line 2i from 1.00 and enter result here.	.80

2k.	The expected after-tax rate of return is **(Line 2h x Line 2j)**:	5.60%
2l.	Enter the factor from Table 2 below, based on the number of years expected to be spent in retirement and expected rate of return on taxable accounts during those years. (In Table 2, use the closest rate of return to the percentage calculated on Line 2k.) **Assume 25 years; use 6% rate**	.0569
2m.	The expected annual after-tax income during retirement generated by client's taxable accounts is **(Line 2g x Line 2l)**:	\$ 5,064

Note. The amount on Line 2m assumes the client's taxable accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Tax-Free Roth IRA Accounts

3a.	Enter the current value of client's retirement savings in Roth IRAs.	\$ 30,000
3b.	Enter the factor from Table 1 below, based on years to retirement and expected rate of return on Roth IRAs between now and then. **Assume 20 years; 8%**	2.58
3c.	The expected value of client's Roth IRAs at retirement age is **(Line 3a x Line 3b)**:	\$ 77,400
3d.	Enter the factor from Table 2 below, based on the number of years expected to be spent in retirement and expected rate of return on client's Roth IRAs during those years. **Assume 25 years; 6%**	.0569
3e.	The expected annual after-tax income during retirement generated by the client's Roth IRAs is **(Line 3c x Line 3d)**:	\$ 4,404

Note. The amount on Line 3e assumes the client's Roth IRAs will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Note. The amount on Line 3e assumes the client's Roth IRA withdrawals occur after age 59½ and after the account has been open at least five years. If these two conditions are met, the withdrawals will be federal-income-tax-free.

Pension Benefits

4a.	If client is covered by a defined benefit pension plan, enter the annual benefit amount expected at the retirement age assumed throughout this worksheet. **Assume $22,000**	$ 22,000
4b1.	If client's pension benefits are not adjusted for inflation between now and retirement age, enter inflation discount factor #1 based on expected years to retirement. Enter the factor for the closest number of years to retirement. For 5 years inflation discount factor #1 is .86; for 10 years it is .74; for 15 years it is .64; for 20 years it is .55; for 25 years it is .48; for 30 years it is .41; for 35 years it is .36; for 40 years it is .31. If client's pension benefits are adjusted for inflation between now and retirement age, enter 1.00 on this line. **Assume no adjustment; 20 years**	.55
4b2.	If client's pension benefits are not adjusted for inflation during retirement, enter inflation discount factor #2 based the number of years expected in retirement. For 15 years inflation discount factor #2 is .80; for 20 years it is .74; for 25 it is .70; for 30 years it is .65; for 35 years it is .61; for 40 years it is .58; for 45 years it is .54; for 50 years it is .51. If client's pension benefits are adjusted for inflation during retirement, enter 1.00 on this line. **Assume no adjustment; 25 years**	.70

Note. The inflation discount factors for Lines 4b1 and 4b2 are based on an assumed annual inflation rate of 3%.

4c.	Enter as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. (This should be the same as the rate entered on Line 1f.)	.25
4d.	Subtract Line 4c from 1.00 and enter result here.	.75
4e.	The expected annual after-tax income during retirement from client's pension benefits is **(Line 4a x Line 4b1 x Line 4b2 x Line 4d)**:	$ 6,352

Social Security Benefits

5a.	Enter client's expected annual Social Security benefits at the retirement age that has been assumed throughout this worksheet. **Assume $21,000**	$ 21,000

Note. The amount on Line 5a can be obtained from the annual statement sent to the client by the Social Security Administration. It is assumed that benefits will continue to be adjusted to keep pace with inflation.

5b.	Enter as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. (This should be the same as the rate entered on Line 1f.)	.25
5c.	Multiply the number on Line 5b by either .50 or .85 (or other percentage if appropriate) and enter the result here. **Assume .50 is appropriate**	.125

Note. Under current tax law, most individuals are taxed on 50% of their Social Security benefits. Higher-income individuals can be taxed on as much as 85% of their benefits. For purposes of filling out Line 5c, use your best guess for the taxable percentage (expressed as a decimal) that will apply to the client's Social Security benefits.

5d.	Subtract Line 5c from 1.00 and enter result here.	.875
5e.	The expected annual after-tax income during retirement from client's Social Security benefits is **(Line 5a x Line 5d)**:	$ 18,375

Total Expected Retirement-Age Income from Existing Sources

6.	Based on the client's current level of retirement savings, projected pension benefits (if any), and Social Security benefits, the client's total annual income during retirement in today's after-tax dollars is projected to be (Line 1h + Line 2m + Line 3e + Line 4e + Line 5e):	**$ 50,710**

Worksheet No. 2: Projected Retirement-Age Living Costs

Explanation: Use this worksheet to project the client's retirement-age living costs. All amounts entered below should be in today's dollars (without any adjustment for inflation).

Anticipated Monthly Expenses during Retirement

1. Home mortgage principal and interest or rent.	$ 2,000
2. Utilities and garbage pickup.	275
3. Food and personal care items.	500
4. Auto or transportation costs.	350
5. Clothing.	225
6. Entertainment, gifts, subscriptions, etc.	700
7. Debt payments other than mortgage.	0
8. Other items not listed above.	200
9. Total monthly expenses **(Sum of Lines 1-8)**:	4,250
10. Annualized monthly expenses **(Line 9 x 12)**:	$ 51,000

Other Anticipated Expenses during Retirement

11. Annual spending on vacations and memberships.	$ 4,000
12. Annual premiums for health and LTC coverage.	7,000
13. Annual uninsured medical costs.	5,000
14. Annual amount for other insurance premiums.	2,250
15. Annual repair and maintenance expenses.	3,000
16. Annual property taxes.	2,750
17. Annual amount for emergencies or other unexpected items (i.e., contingencies).	2,000
18. Annual amount for any other expense items.	1,650
19. Total other expenses **(Sum of Lines 11-18)**:	$ 27,650
20. **Projected annual retirement-age living expenses (Line 10 + Line 19)**:	$ 78,650

Worksheet No. 3: Is Client Financially Set for Retirement or (More Likely) Are Additional Savings Required?

Explanation: Use this worksheet to estimate if the client has already accumulated enough to finance his/her retirement or (more likely) not.

1.	Enter client's expected annual income from existing sources during retirement from Worksheet No. 1, Line 6.	$ 50,710
2.	Enter client's expected annual retirement-age living costs from Worksheet No. 2, Line 20.	$ 78,650
3.	Subtract Line 1 from Line 2. This is the projected annual after-tax retirement-age income shortfall that must be made up via additional savings between now and when the client retires:	$ 27,940

Explanation: If Line 1 equals or exceeds Line 2, you can stop right here, because it appears the client has already accumulated enough to see him/her through retirement (at least based on the assumptions used in this analysis). However, it never hurts to have more money than appears to be required in case the client: (1) lives longer than expected, (2) has higher-than-expected expenses during retirement, (3) earns a lower-than-expected rate of return on retirement savings, or (4) any combination of the above. Of course, if the client is in the more typical scenario where Line 2 exceeds Line 1, he/she will need to save more money between now and retirement. In the latter case, please complete this worksheet.

4.	Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in tax-deferred retirement accounts between now and retirement age. (If none, enter zero here.) **Assume $15,000**	$ 15,000
5.	Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in taxable accounts between now and retirement age. (If none, enter zero here.) **Assume $6,940**	$ 6,940
6.	Of the annual shortfall amount shown on Line 3, enter here the amount the client expects will come from additional money that will be saved in Roth IRAs. (If none, enter zero here.) **Assume $6,000**	$ 6,000

Note: The amounts on Lines 4, 5, and 6 should total up to the annual shortfall amount quantified on Line 3 of this worksheet.

Required Additional Savings in Tax-Deferred Retirement Accounts

7a.	If an amount was entered on Line 4, enter here as a decimal the average tax rate (federal and state combined) client expects to pay on ordinary income during retirement. (This should be the same as the rate entered on Worksheet No. 1, Line 1f.)	.25
7b.	Subtract Line 7a from 1.00; enter result here.	.75
7c.	Divide amount on Line 4 by Line 7b and enter the result here.	$ 20,000
7d.	Enter the factor from Table 3 below, based on the number of years expected to be spent in retirement and the expected rate of return on tax-deferred accounts during those years. **Assume 25 years, 6%**	17.58
7e.	The additional amount the client needs to accumulate in tax-deferred accounts by retirement age (before taxes) is **(Line 7c x Line 7d)**:	$ 351,600
7f.	Enter the factor from Table 4 below, based on expected years to retirement and rate of return on tax-deferred accounts between now and then. **Assume 20 years; 8%**	.0395
7g.	The additional annual amount the client needs to save in tax-deferred accounts between now and retirement is projected to be **(Line 7e x Line 7f)**:	$ 13,888

Note: The amount on Line 7g cannot exceed the client's annual limit on contributions to tax-deferred retirement accounts. If it does, the amount entered on Line 4 is too large and must be scaled back accordingly.

Note: The amount on Line 7g assumes the client's tax-deferred accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Required Additional Savings in Taxable Accounts

8a.	If an amount was entered on Line 5, enter here the pre-tax rate of return the client expects to earn on taxable accounts during retirement. (This should be the same as the rate of return entered on Worksheet No. 1, Line 2h.)	7.00%
8b.	Enter as a decimal the tax rate (federal and state combined) client expects to pay on earnings from taxable accounts during retirement (taking into account preferential rates on long-term capital gains). (This should be the same as the rate entered on Worksheet No. 1, Line 2i.)	.20

8c.	Subtract Line 8b from 1.00; enter result here.	.80
8d.	The after-tax rate of return on client's taxable accounts during retirement is expected to be **(Line 8a x Line 8c)**:	5.60%
8e.	Enter the factor from Table 3 below, based on number of years expected to be spent in retirement and the expected after-tax rate of return on taxable accounts during those years. (In Table 3, use the rate of return closest to the percentage calculated on Line 8d.) **Assume 25 years; use 6% rate**	17.58
8f.	The additional amount the client needs to accumulate in taxable accounts by retirement age (after taxes) is projected to be **(Line 5 x Line 8e)**:	$ 122,005
8g.	Enter the pre-tax rate of return expected to be earned on additional savings in client's taxable accounts between now and retirement. (This should be the same rate of return as on Worksheet No. 1, Line 2b.)	8.00%
8h.	Enter as a decimal the tax rate (combined federal and state) client expects to pay on earnings from taxable accounts between now and retirement (taking into account preferential rates on long-term capital gains). (This should be the same rate as on Worksheet No. 1, Line 2c.)	.22
8i.	Subtract Line 8h from 1.00; enter result here.	.78
8j.	The after-tax rate of return on client's taxable accounts between now and retirement is expected to be **(Line 8g x Line 8i)**:	6.24%
8k.	Enter the factor from Table 4 below, based on expected years to retirement and expected after-tax rate of return on additional savings in client's taxable accounts between now and then. (In Table 4, use the rate of return closest to the percentage calculated on Line 8j.) **Assume 20 years; use 6% rate**	.0491
8l.	The additional annual amount client needs to save in taxable accounts between now and retirement age is projected to be **(Line 8f x Line 8k)**:	$ 5,990

Note. The amount on Line 8l assumes the client's taxable accounts will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Required Additional Savings in Roth IRAs

9a.	If an amount was entered on Line 6, enter here the factor from Table 3 below, based on number of years expected to be spent in retirement and expected rate of return on the client's Roth IRAs during those years. **Assume 25 years; 6%**	17.58
9b.	The additional amount the client needs to accumulate in Roth IRAs by retirement age is projected to be **(Line 6 x Line 9a)**:	$ 105,480
9c.	Enter the factor from Table 4 below, based on expected years to retirement and expected rate of return on additional savings in client's Roth IRAs between now and then. **Assume 20 years; 8%**	.0395
9d.	The additional annual amount the client needs to save in Roth IRAs between now and retirement age is projected to be:	$ 4,166

Note. The amount on Line 9d cannot exceed the client's annual limit on Roth IRA contributions. If it does, the amount entered on Line 6 is too large and must be scaled back accordingly.

Note. The amount on Line 9d assumes the client's Roth IRAs will be completely drained over the number of years he/she expects to spend in retirement. If the client lives longer than expected, no money from these accounts will be available for those extra years.

Note. The amount on Line 9d assumes Roth IRA withdrawals occur after age 59½ and after the account has been open at least five years. If these two conditions are met, the withdrawals will be federal-income-tax-free.

Total Required Additional Annual Savings

10.	The total additional annual amount the client needs to save between now and retirement age is projected to be (Line 7g + Line 8l + Line 9d):	**$ 24,044**

Summary: According to this analysis, the client can cover his/her projected retirement-age shortfall by: (1) saving the additional annual amount estimated on **Line 7g** ($13,888) in tax-deferred retirement accounts, (2) saving the additional annual amount estimated on **Line 8l** ($5,990) in taxable accounts, and (3) saving the additional annual amount estimated on **Line 9d** ($4,166) in Roth IRAs. As you can see, this client needs to do a whole lot of saving between now and retirement! Realistically, this client may also need to sharply scale back spending during his/her retirement years (as projected on Worksheet No. 2). In other words, expecting to live a fairly luxurious post-retirement lifestyle may not realistically be in the cards.

Key Point: After appropriate worksheet adjustments, the results on Line 10 above constitute a recommended retirement savings program that is projected to get the client to where he/she wants to be at retirement age (subject to the assumptions made in this analysis).

Table 1: Future Value Factors Based on Years to Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (Before Inflation)

Years to Retirement	4%	6%	8%	10%
5	1.05	1.15	1.27	1.39
10	1.10	1.33	1.61	1.93
15	1.16	1.54	2.04	2.68
20	1.21	1.78	2.58	3.72
25	1.27	2.05	3.27	5.17
30	1.34	2.37	4.15	7.19
35	1.40	2.73	5.25	10.00
40	1.47	3.15	6.66	13.87

Table 2: Annuity Payment Factors Based on Years in Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (Before Inflation)

Years in Retirement	4%	6%	8%	10%
15	0.0720	0.0832	0.0954	0.1084
20	0.0553	0.0667	0.0793	0.0929
25	0.0452	0.0569	0.0699	0.0842
30	0.0386	0.0504	0.0640	0.0789
35	0.0338	0.0460	0.0600	0.0755
40	0.0303	0.0427	0.0571	0.0732
45	0.0275	0.0402	0.0551	0.0717
50	0.0253	0.0382	0.0535	0.0706

Table 3: Present Value Factors to Fund Annuity Based on Years in Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (Before Inflation)

Years in Retirement	4%	6%	8%	10%
15	13.90	12.01	10.48	9.23
20	18.10	15.00	12.62	10.76
25	22.10	17.58	14.30	11.87
30	25.92	19.82	15.63	12.67
35	29.55	21.76	16.68	13.24
40	33.02	23.44	17.51	13.65
45	36.32	24.90	18.16	13.95
50	39.46	26.16	18.68	14.17

Table 4: Annual Savings Factors to Fund Future Amount Based on Years to Retirement

The factors in this table are already adjusted to reflect an assumed annual inflation rate of 3%. For example, the numbers shown below in the 8% column actually equate to an inflation-adjusted return of 4.854% [(1.08 ÷ 1.03) – 1 = 0.04854].

Expected Annual Rate of Return (Before Inflation)

Years to Retirement	4%	6%	8%	10%
5	0.2141	0.2057	0.1976	0.1900
10	0.1119	0.1020	0.0928	0.0843
15	0.0778	0.0669	0.0574	0.0490
20	0.0607	0.0491	0.0395	0.0315
25	0.0503	0.0382	0.0286	0.0213
30	0.0433	0.0307	0.0214	0.0148
35	0.0382	0.0253	0.0163	0.0104
40	0.0343	0.0211	0.0126	0.0074

Chapter 9

Legislative Developments

Throughout this book, we have attempted to identify the key changes in the retirement arena and their implications for retirement-planning professionals and their clients. As we have mentioned, among the most notable recent changes, are a host of retirement-savings tax incentives made available by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), and the reduced individual income tax rates granted by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA).

Although many of the changes made by the American Jobs Creation Act of 2004 (AJCA) and the Working Families Tax Relief Act of 2004 (WFTRA) do not directly affect the plans we have discussed in the book, we nevertheless believe that these two pieces of legislation will so affect this area for years to come, that they warranted a special mention. Thus, we have summarized some of the highlights of this important legislation below, with special emphasis on the expanded opportunities for small-business owners.*

The Working Families Tax Relief Act of 2004

President Bush signed P.L. 108-311 (H.R. 1308), the Working Families Tax Relief Act of 2004 (WFTRA) into law on October 4, 2004. The law, which extended a series of expiring tax benefits for individuals and businesses, also contains a number of technical corrections substantively affecting pension and benefit plans, and extends the mental health parity provisions of ERISA and the IRC. In general, the WFTRA:

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* These Legislative Developments have been adapted, by the editors, from a Tax Section E-ALERT, *American Jobs Creation Act of 2004*, sent to members of the AICPA Tax Section. For information on Section membership, please contact AICPA at 888-777-7077 or visit *www.cpa2biz.com*. Please note: The summaries presented here are not to be viewed as a comprehensive analysis of the laws. To more fully research planning opportunities and potential pitfalls that may affect your clients and your practice, we recommend that you refer to the *legislative text* for each of these laws, or visit *www.cpa2biz.com* for other products that cover these topics.

A side-by-side chart comparing the AJCA's deferred compensation provisions to prior law, prepared for the Council by the Benefits Group of Davis & Harman, follows. The chart is provided courtesy of the American Benefits Council (http://www.americanbenefitscouncil.org/) and the Benefits Group of Davis & Harman LLP© (www.davis-harman.com).

Extends family tax relief provisions through 2010—

- Marriage penalty relief is extended.
- The expanded 10-percent income tax bracket is extended.
- The $1,000 child tax credit is extended, and the higher 15-percent refundability rate is accelerated to the beginning of 2004.

Provides assistance to military families in combat zones—

- Increases the child credit for military families by allowing them to include tax-free combat pay when calculating their refundable child credit.
- Increases the Earned Income Credit (EIC) for military families in 2004 and 2005 by giving them the option to include combat pay when calculating the EIC.

Extends relief from the Alternative Minimum Tax (AMT) through 2005—

- The $58,000 AMT exemption amount for married couples is extended for one year (through 2005). Without action, it would drop to $45,000.
- The $40,250 AMT exemption amount for single individuals is extended for one year (through 2005). Without action, it would drop to $33,750.

Creates a uniform definition of a child for tax purposes—

The Act simplifies the Code by adopting a uniform definition of a child for the dependency exemption, the child credit, the EIC, the dependent care credit, and head-of-household filing status.

Extends annual expiring tax provisions through 2005—

The Act extends Code provisions that expired in 2003 (without modification). These provisions are routinely extended on an annual basis. They include:

- Research and development tax credit
- Work Opportunity Tax Credit (WOTC) and the Welfare-to-Work tax credit
- $250 deduction for teacher classroom expenses
- Allowing nonrefundable tax credits against the AMT
- Tax credit for electricity produced from renewable sources

- Tax credit for electric vehicles
- Deduction for clean-fuel vehicles
- Archer MSAs
- Disclosures relating to terrorist activities

WFTRA also includes several technical corrections to current-law provisions.

American Jobs Creation Act of 2004

On October 22, 2004, President Bush signed into law, the American Jobs Creation Act of 2004 (AJCA), P.L. 108-357 (H.R. 4520). Despite its title, the moving force behind the AJCA was the repeal of the extraterritorial income exclusion (known as ETI), which ran afoul of world trade agreements, and subjected U.S. exporters to trade sanctions imposed by the European Union.

As it wound its way through Congress, however, the bill morphed into arguably the most significant corporate tax reform bill in decades. It made some important changes, including those affecting businesses—especially manufacturers, and those with foreign income.

The AJCA provides domestic manufacturing and other business tax relief, including energy-related tax credits; allows for itemized deduction of State and local sales taxes; provides for reform of tobacco subsidies; includes international tax reform and simplification provisions; and includes various revenue-raising provisions. The ETI exclusion is repealed over a number of years subject to a transition rule.

In addition to its centerpiece—tax relief for manufacturers—the bill contains numerous provisions that apply to specialized industries and taxpayers, including agriculture, RICs, REITs, tobacco producers, tax-motivated expatriates, fuel tax evaders, NASCAR tracks, and Alaskan Native subsistence whalers, to name only a few. The AJCA:

- **Ends Sanctions on American Products** – Repeals export tax subsidy known as FSC-ETI – thereby ending escalating tariffs on American manufacturers and farmers.
- **Reduces Corporate Tax Rates, Benefits Small Businesses** – Effectively reduces the tax rate from 35 percent to 32 for domestic manufacturers, large and small. It also provides tax incentives for small businesses and farmers.
- **Simplifies International Tax Law and Enhances U.S. Competitiveness** – Reduces double taxation of U.S. businesses engaged in the worldwide market and simplifies complex international tax law.

- **Creates American Jobs** – Reducing taxes for manufacturing done in the United States, ending sanctions and encouraging business investment will generate American job growth. U.S. businesses will have more resources available to create new jobs and keep existing workers.

New Requirements for Nonqualified Deferred Compensation Plans

The AJCA provides dramatic changes in the tax rules applicable to "nonqualified deferred compensation." The Act adds Section 409A to the Internal Revenue Code, which will have a significant impact on the design and operation of such plans. Section 409A is effective January 1, 2005, and affects all employers, whether public, private or tax-exempt. These changes will affect how most companies provide compensation to their executive groups.

The downside of violating these new rules is considerable—affected participants in plans not in compliance with the Act would be immediately taxed on deferred compensation, subject to a *20 percent penalty,* plus underpayment interest on the tax due will be charged at a one percent higher rate.

Plans must *operate* in conformity with the rules beginning in 2005, although a transition period is available after the effective date, to modify plans.

We expect that these rules will be interpreted very broadly, affecting far more than just traditional nonqualified deferred compensation. CPAs should review all equity plans, other than qualified stock options, as well as arrangements with independent contractors and directors.

S Corporation Simplifications

S corporation simplifications include: (1) All members of a family (up to six generations) are treated as one shareholder; (2) the number of shareholders permitted increases from 75 to 100; (3) IRAs may be shareholders of bank S corporations; (4) unexercised powers of appointment will be disregarded for determining the potential current beneficiaries of ESBTs; and the IRS may waive inadvertent invalid qualified subchapter S subsidiary elections and terminations.

Also, suspended losses or deductions with respect to stock transferred incident to divorce are treated as incurred by the corporation with respect to the transferee in the subsequent tax year. A beneficiary of a qualified subchapter S trust (QSST) may deduct suspended losses under the at-risk rules and the passive loss rules when the trust disposes of the S corp stock.

S Corporations and ESOPs

ESOPs maintained by S corporations would not be treated as violating qualification requirements or as engaging in prohibited transactions merely because, under plan provisions, a distribution of qualifying employer securities held by the ESOP is used to make payments on a loan used to acquire the securities, whether or not allocated to participants, with some limitations. Effective for distributions made after December 31, 1997.

Incentive Stock Options and Employee Stock Purchase Plan Options

FICA and FUTA taxes would not apply upon exercising a statutory stock option. Federal income tax withholding would not be required on disqualifying dispositions, nor when compensation is recognized in connection with an employee stock purchase plan discount. Also, remuneration for stock transferred pursuant to exercising an incentive stock option, under an employee stock purchase plan, or any disposition of such stock will not be taken into account for determining Social Security benefits. Effective for stock acquired pursuant to options exercised after October 22, 2004.

Changes with the Potential to Affect Your Practice

Although these provisions of the AJCA do not directly affect retirement plans or retirement planning, they do affect you as a practitioner—and your interaction with your clients.

Tax Shelter Exception to Confidentiality. Taxpayer communications with tax practitioners regarding *all* tax shelters—whether entered into by corporations, individuals, partnerships, exempt organizations, or any other entity—are no longer protected by the Code's confidentiality provision effective for communications made on or after the date of enactment.

"Material Advisor" Disclosure of Reportable Transactions. Each "material advisor" involved with any reportable or listed transaction must timely file an information return or incur a $50,000 or greater penalty—which cannot be waived except for rare circumstances for reportable, but not listed transactions. "Material advisor" includes any person who provides material aid, assistance, or advice with respect to insuring any reportable transaction and who derives gross income for such assistance or advice in excess of $250,000 ($50,000 for advice to individuals). Penalties will apply to transactions for which material aid, assistance or advice is provided after the date of enactment.

Expanded Sanctions for Practitioners before IRS. Censure and monetary penalties have been added as sanctions that may be imposed on practitioners for actions taken after the date of enactment (October 22, 2004). Monetary penalties may be imposed separately on both practitioners and their employers in addition to, or in lieu of, any suspension, disbarment, or censure of an individual.

For More Information

For more detailed information on, and statutory language of, these new tax laws, please see:

American Jobs Creation Act of 2004 (H.R.4520)

- *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h4520enr.txt.pdf.*

- For a summary of the Act, Committee Reports, Resource Kits and more, visit: *http://waysandmeans.house.gov/Links.asp?section=1559.*

Working Families Tax Relief Act of 2004 (H.R.1308)

- *http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:h1308enr.txt.pdf.*

- For a summary of the Act, Committee Reports, Resource Kits and more, visit: *http://waysandmeans.house.gov/Links.asp?section=343.*

You may also visit *http://thomas.loc.gov/* and search by Bill number or name for more information on each of the Acts, including full text of the Bill, summary of the Bill, references in the Congressional Record and more.

Chapter 9 Appendix

Overview of Nonqualified Deferred Compensation Provisions Contained in the American Jobs Creation Act of 2004†

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation ("NQDC")	Current law provides no single definition. Treas. Reg. §1.404(b)-1T defines deferred compensation as any payment made more than 2½ months after the tax year in which the relevant services were rendered. Regulations under §31.3121(v)(2)- 1(b) impose a special timing rule for employment taxes on deferred compensation plans that	New Code section 409A applies to any "plan," "agreement," or "arrangement" that provides for deferral of compensation, other than tax-qualified plans and tax-deferred annuities, IRAs, SEPs, SIMPLEs, 457(b) plans, and plans providing for vacation, sick leave, disability, compensatory time, and death payments. Code section	Nonqualified deferred compensation is not defined in section 409A or its legislative history and the scope of the bill is somewhat unclear. As a result, any compensatory payment or transfer made in a subsequent calendar year and more than 2-1/2 months after the relevant services are performed could be NQDC subject to

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† This overview is provided courtesy of the American Benefits Council (http://www.americanbenefitscouncil.org/) and the Benefits Group of Davis & Harman LLP© (*www.davis-harman.com*). Reprinted with permission.
The Provisions on nonqualified deferred compensation discussed in this chart are included in the Conference Agreement on the American Jobs Creation Act of 2004 (H.R. 4520) amending the Internal Revenue Code to address international taxation and the World Trade Organization's rulings on the FSC/ETI benefits. H.R. 4520 was introduced by House Ways and Means Committee Chairman Thomas (R-CA), and was passed by the House on June 17, 2004. S. 1637 was introduced by Senate Finance Committee Chairman Grassley (R-IA), and was included as a substitute amendment to H.R. 4520, which was passed by the Senate on May 11, 2004. The Conference Agreement on H.R. 4520 was passed by the House on October 7, 2004, and by the Senate on October 11, 2004, and is expected to be signed by the President. [Editor's Note: The Act was subsequently signed by President Bush on October 22, 2004.]

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation *(continued)*	meet certain regulatory requirements (excluding welfare, stock plans, death benefits, and disability benefits).	409A is not limited to elective arrangements. Code section 409A does not apply to stock options provided that the exercise price is not less than the fair market value of the shares on the date of grant and the option does not include a deferral feature beyond the right to exercise in the future. The provisions apply to supplemental nonelective pensions (SERPs), but the conference agreement gives Treasury the authority to issue regulations relating to changes in benefits forms under SERPs. The conference report states that short term deferrals will not be treated as NQDC. For example, Code section 409A is not intended to apply to annual bonuses or other amounts payable within 2½ months after the close of the taxable year in which the relevant services were performed.	§409A. Presumably, deferred amounts that are not includable in income (e.g., health benefits provided to retirees) are not NQDC. Questions arise with respect to a number of specific types of compensation, as discussed below. **Stock Options.** Although there is no exception in section 409A for compensatory transfers subject to Code section 83, the conference report indicates that the grant of a stock option with an exercise price no less than the fair market value of the stock on the date of grant (so-called "fair market value options") is not NQDC. In contrast, discounted options (except those issued under a section 423(b) employee stock purchase plan) would be treated as NQDC. **SARs**. During the course of the legislation, questions arose on the application of §409A to stock appreciation rights ("SARs") granted at fair market value. Because SARs are economically equivalent to a fair

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation *(continued)*			market value option exercised in a cashless exercise transaction, many have argued that SARs, like fair market value options, should not be treated as NQDC. The conference report acknowledges that Treasury has authority to write rules with respect to SARs but does not indicate whether relief should or should not be provided. At this date, however, it appears that Treasury intends to treat SARs as NQDC. **Restricted Stock**. A grant of restricted stock is generally treated as a current transfer for tax purposes (with deferred taxation) and Treasury has informally indicated that it does not intend to treat a grant of restricted stock as NQDC. **Stock Units.** A stock unit plan, under which a promise is made to transfer stock in the future, is treated as NQDC. If the plan provides for stock to be transferred on a date certain, the application of §409A would have no apparent effect. If, however, the plan provides additional

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation *(continued)*			deferral elections with respect to the stock delivery date, then those elections would be required to satisfy the election timing rules of §409A. **Vesting.** Treasury has informally indicated that it is leaning towards treating an amount as deferred only if a payment is delayed beyond the period in which an amount is fully earned and vested. If this position is taken, amounts that are paid when they vest would not be subject to §409A, *e.g.*, restricted stock units that are paid upon the attainment of a performance goal. **Severance**. Severance arrangements are not excluded from the definition of NQDC. Query whether Treasury will provide regulatory exceptions. Under DOL Regulation §2510.3-2(b), a severance arrangement that is limited to "2X pay" and distributed over no more than 24 months generally is not treated as a deferred compensation arrangement. Treasury

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation *(continued)*			regulations under §3121(v)(2) also exclude severance arrangements. **Commissions.** Commissions are not excluded from the definition of NQDC. Query whether commissions with a trail over a number of years (typically paid in the insurance industry) are NQDC. **Negotiated Releases.** No statutory exception is provided for negotiated settlements with employees or releases of claims under which part of the total payments are intended to release the employer from liability under deferred compensation arrangements, such as supplemental pensions. **Perqs.** No statutory exception is provided for taxable fringe benefits provided after termination of employment (other than an exception for death benefits), such as use of a corporate plane or country club membership.

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Definition of Nonqualified Deferred Compensation *(continued)*			**Miscellaneous.** It is unclear whether deferred compensation that has been taxed (e.g., compensatory annuity contracts or vested 457(f) plans) is subject to §409A. There are also questions about less common NQDC arrangements, such as LOSAPs under §457(e)(11)(A)(ii).
Timing of Deferrals and New Rules for "Performance-Based" Compensation	Case law interpreting the doctrine of "constructive receipt" supports an election to defer compensation that occurs any time prior to the date that amounts are due and payable. The IRS ruling position generally requires that deferral elections be made prior to the period in which the underlying services are performed, but this position was not a legal determination by the IRS and reflected only the conservative fact pattern on which the IRS would provide an individual ruling.	The timing of all deferral elections must continue to satisfy the rules of constructive receipt. In addition, Code section 409A generally requires deferral elections to be made prior to the taxable year in which the services are performed or as provided in regulations. A special 30-day grace period is provided for new participants in deferred compensation plans. For "performance-based compensation" where the performance period is 12 months or more, elections to defer may be made up to 6 months prior to the end of the services period. The conference report states it is intended that the term "performance-based compensation" will be defined by Treasury to include	**Performance-based compensation**. During consideration of the legislation, many requested more flexible timing for deferral elections with respect to annual bonuses and long-term incentive arrangements. Ultimately, the conference agreement addressed these comments through the exception for "performance-based" compensation, which is already defined under Code section 162(m) for purposes of the $1 million deduction limit for the top-five officers of publicly-held companies. This exception appeared late in the process and had not been part of either the House or Senate versions of H.R. 4520. There are many questions as to how this exception will apply and

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Timing of Deferrals and New Rules for "Performance-Based" Compensation *(continued)*		compensation to the extent that an amount is (i) "variable and contingent on the satisfaction of pre-established organizational or individual performance criteria" and (ii) "not readily ascertainable" at the time of the election.	just how many of the §162(m) requirements will be imported under section 409A. Initially, Treasury has informally noted that the description of the performance-based standard in the conference report does not include the §162(m) requirement that all performance standards be "objective." Thus, it appears that subjective and non-mechanical standards should be allowed for purposes of §409A. Query whether Treasury will require that under §409A the maximum dollar amount of bonuses be fixed in advance, which is one of the requirements under §162(m) but would be a significant departure from the typical design of many bonus arrangements for other than the top five officers. Note also that there is a significant transition issue for annual bonuses for 2005 payable in 2006 because if those bonus arrangements are not performance-based, then deferral elections with respect to such bonus must be made prior to December 31, 2004.

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Timing of Deferrals and New Rules for "Performance-Based" Compensation *(continued)*			**Vesting.** Section 162(m) indicates that compensation is not performance-based solely because it is conditioned on the future performance of services. To the extent that an amount is subject to service-based vesting, e.g., 5 years of service, it appears that the deferral election will be required before the start of the performance of services. If vesting is based, in whole or in part, on performance standards, it appears that the 6-month election period rule would apply. **Determining the 6-month election period.** To the extent that an amount is performance-based and eligible for the 6-month election window, note that the election is required six months before the end of the relevant services period. Thus, if an employee eligible to receive an annual bonus for 2005 is required to work until the payment date of March 15, 2006, in order to receive the bonus, then it may be that the 6-month election window ends on September 15, 2005. This may depend on the

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Timing of Deferrals and New Rules for "Performance-Based" Compensation *(continued)*			design of the bonus arrangement, including whether the performance goal extends past the end of the year. Query whether the 6-month election window is available for bonuses payable after the end of the year based on quarterly performance goals. **Issues for Defined Contribution SERPs.** If an employee's ability to change his or her §401(k) deferral election during the course of the year affects the extent to which amounts accrue under the SERP, that may violate the timing of election rules since changes to deferral elections could occur during the calendar year of services.
Substantial Risk of Forfeiture	Sections 83, 457 and 3121(v)(2) all use the term "substantial risk of forfeiture." The §83 regulations include a detailed definition of "substantial risk of forfeiture," which is generally thought to apply for all three sections.	Code section 409A defines the term in a manner that is almost indistinguishable from the definitions in §§ 83, 457, and 3121(v)(2). Section 409A provides that Treasury consider regulations as to what events otherwise constituting a "substantial risk of forfeiture" should be disregarded.	Treasury has informally indicated that it is considering a narrower definition of substantial risk of forfeiture for purposes of §409A. This suggests that NQDC may not be vested for purposes of §§83, 457, or 3121(v)(2), but may be vested for §409A purposes. It is possible that Treasury might utilize this authority to treat certain practices

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
"Rabbi" Trusts	No current taxation if an employee is a general creditor with respect to an unfunded promise to pay compensation in the future. Compensation is "unfunded" even if amounts are irrevocably transferred to a trust as long as creditors may access the funds upon insolvency. Foreign trusts and arrangements are subject to the same standards as domestic trusts. Foreign rabbi trusts are specifically exempted from Treasury regulations governing U.S. persons who are beneficiaries of foreign trusts. See Treas. Reg. §1.672(f)-1.	Code section 409A provides that a transfer to a rabbi trust or similar arrangement will be treated as a transfer of property under Code section 83 and employees will be subject to current taxation on benefits (plus the penalties and interest imposed under section 409A discussed below) if (i) transfers are made to a trust or similar arrangement where the assets are located outside of the United States or (ii) benefits become restricted or transfers could be made under the terms of a plan to a trust in connection with a "change in the employer's financial health." An amount is treated as restricted even if it is available to satisfy the claims of general creditors. The conference report states that this provision will apply in the case of a plan that provides that a rabbi trust will become effective upon a change in the employer's financial health even if the rabbi trust remains available to creditors. An exception is provided for foreign	under current law (*e.g.*, "rolling" risks of forfeiture) as not satisfying section 409A. Multinational companies that maintain foreign trusts for employees working abroad may not be able to utilize the exception provided, however, because the trust often is maintained in a jurisdiction other than the one in which services are performed (*i.e.*, one foreign trust may be maintained for all expatriate employees). Domestic "rabbi trusts" generally will be able to operate as under current law with the exception of transfers on a change in the financial health of the employer. While the conference report provides some comfort that the rule should not be applied where a transfer to a rabbi trust is made on a change in control or at a time that coincidentally follows a change in financial health, the IRS's application of the rule with the benefit of hindsight may give employers pause. It is hoped that Treasury will clarify that the penalty

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
"Rabbi" Trusts *(continued)*		situs trusts if employees perform services in the jurisdiction where the trust is located.	for transfers after a change in financial health will be interpreted narrowly. Moreover, the rationale for this provision is a bit unclear given that the assets of a rabbi trust remain subject to the claims of general creditors.
Fixed Payout Terms Including "Second Elections" and Other Changes	No current taxation until receipt of payments to the extent that the employee's right to payment may be accelerated upon certain events not in the employee's control or subject to substantial limitations, such as a financial hardship, a termination of employment, a change in control, or disability (as defined by the deferred compensation plan). Changes in the deferral period or changes in the form of payment (*e.g.*, from lump sum to installment) may be made prior to the time that payments are due and payable. [Many employers rely on favorable case law to allow changes in deferral and payout elections while an employee is still employed and in the tax year prior to the year	Distributions are allowed under Code section 409A only upon separation from service (as determined by Treasury), death, disability, a specified time or pursuant to a fixed schedule, a change in control (to the extent provided by Treasury), or the occurrence of an unforeseeable financial emergency. Aggregation rules apply; for example, a distribution event will not occur if a participant separates from service from one member of a controlled group, but continues employment with another member of the same controlled group. No accelerations are permitted except as provided in Treasury regulations. Plans may provide that minimal amounts may be automatically distributed upon a permissible distribution	**Relationship of the acceleration rules to vesting**. Query whether the rules precluding acceleration of payments except on specified events also preclude an acceleration of vesting where payments coincide with vesting. As mentioned above, Treasury has informally indicated that it is inclined to the view that an amount is deferred only if it is both earned and vested. If a contrary position is taken, an amount that is paid upon vesting could run afoul of section 409A. For example, if a stock unit plan requires delivery of stock upon vesting, is it a violation of §409A if the employer accelerates vesting in its discretion or upon an event not otherwise specified under §409A? It would be surprising, however, if Treasury went so far;

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Fixed Payout Terms Including "Second Elections" and Other Changes *(continued)*	that payments are scheduled to be made. As discussed above, the IRS ruling position historically has been more restrictive.]	event for administrative convenience. Code section 409A allows a "second election" to delay, or change the form of, a payout provided that the "second election" is made at least 12 months prior to the scheduled payout date, does not take effect until 12 months after the date of the election, and results in an additional deferral of at least five years (except in the case of death, disability, or unforeseeable emergency). There is no requirement that the second election be made prior to a termination of employment. It is expected that Treasury will issue regulations regarding the extent to which changes in a stream of payments are permissible. In addition, any "key employee" of a publicly held company generally would be required to wait 6 months for the commencement of any payment triggered by a separation from service. For these purposes, a key employee is defined under Code section 416(i) as a top-50 officer with	such a rule might preclude vesting and payment upon the attainment of a performance goal, which seemingly would not be consistent with the exception for performance-based compensation provided elsewhere in the statute. **Payouts linked to performance goals.** Presumably, Treasury will interpret §409A to preclude a payment based upon the attainment of a performance goal. **Structured payouts.** The conference report notes that deferrals may satisfy §409A even if there are multiple payment dates specified. For example, a deferral may be payable in installments on a date certain but be payable in a lump sum if prior to that date the participant terminates employment, dies, or becomes disabled. The ability to structure multiple payout dates suggests more planning flexibility than some had originally believed might be available under §409A. There is,

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Fixed Payout Terms Including "Second Elections" and Other Changes *(continued)*		compensation in excess of $130,000 (indexed), a 5-percent owner, or a 1-percent owner with compensation in excess of $150,000. This definition likely encompasses a broader group of officers than the definition of a Rule 16 insider for purposes of the Securities Exchange Act.	however, a question whether the exception provided for separation from service will continue to apply if a participant has elected to extend the deferral for five years or more. **Same desk rule?** The "separation from service" standard has raised concerns because this was a term of art under prior pension law. Although that term was substantially liberalized, it provided that an employee who continued performing services for the same unit in certain business transactions, such as an outsourcing, had not "separated from service." It is possible the exception for distributions upon change in control will apply to permit distributions in most or all cases where the separation from service rule would not. **Application to SERPs**. The restrictions on payouts causes significant problems for many SERPs that key the commencement and form of benefits to the participant's election in an underlying qualified plan. Without

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Fixed Payout Terms Including "Second Elections" and Other Changes *(continued)*			administrative relief from Treasury, such a design would not satisfy the new rules under §409A because the benefit commencement date would not be fixed (if the participant could affect the commencement date through his or her election in the qualified plan) or because the form of payment is not fixed. One design option is to create a default payment under the terms of the SERP. If, however, the SERP provides for a lump sum and the participant desires to change to an annuity, for example, this election would be a "re-deferral" subject to the requirement that the commencement of the benefit be delayed for five years. In the opposite case, where the plan provides for an annuity or installment but the participant desires a lump sum, such an election would create an impermissible acceleration under section 409A. Treasury informally has indicated an intention to allow changes in SERP elections between different types of actuarially equivalent annuity options, but it

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Fixed Payout Terms Including "Second Elections" and Other Changes *(continued)*			appears that Treasury may not be inclined to provide broader election relief (*e.g.*, participants with a lump sum election in effect could not elect an annuity). **Termination of plans or unilateral payouts**. The statute provides no exception for an employer to unilaterally pay out NQDC or terminate the plan. Treasury has regulatory authority to provide exceptions for accelerated payments. **Payouts upon a section 409A event**. Technically, the statute does not allow an acceleration of payment to the extent that taxation is imposed under section 409A. **6-month delay for key employees**. As drafted, the statutory language in §409A imposing a 6-month delay in payment upon separation from service applies to "employees" who are key employees and, thus, technically should not apply to outside directors who are not employees. Query whether Treasury might

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Fixed Payout Terms Including "Second Elections" and Other Changes *(continued)*			provide administrative relief from the 6-month distribution rule for key employees who receive payouts that are made in stock if the stock is not transferable for 6 months, which would assist some employers with certain securities law rules for determining beneficial ownership of stock that must be transferred within 60 days of termination of employment.
"Haircuts," Penalty Withdrawals and Change in Control Payments	Regulations under section 451 are relied upon to avoid constructive receipt if elective withdrawal rights are subject to a penalty or "haircut" that is a substantial limitation on the employee's ability to withdraw funds. The IRS allows plans to include a withdrawal right upon an unforeseen financial emergency without triggering constructive receipt and current taxation for all participants.	Code section 409A precludes "haircut" and other penalty withdrawal rights. Change in control payments and payments upon an unforeseeable financial emergency are permitted as discussed above. Note that the conference agreement directs Treasury to issue guidance defining "change in control" within 90 days after the date of enactment. It is intended that the definition will be similar, but more restrictive, than the definition used under Code section 280G.	Treasury has informally indicated that they will be considering whether a change in control with respect to certain businesses in a controlled group should be treated as a change in control for the entire controlled group.
Timing and Amount of Tax Imposed	Taxpayers on the cash method of accounting pay income tax at the ordinary income tax rates in the tax year in	If Code section 409A is not satisfied, affected participants are immediately taxed on the amount deferred and	There are significant valuation questions with respect to NQDC that does not satisfy §409A. If, for example, a SAR

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Timing and Amount of Tax Imposed *(continued)*	which amounts are actually or constructively received.	are subject to a 20 percent penalty and interest at the underpayment rate plus 1 percent as if the deferred compensation had been included in the participant's income on the earliest date that the employee was vested in the benefit. The penalty and interest on underpayments applies to amounts that become taxable because of a foreign trust or transfers that are contingent on the employer's financial health.	that does not satisfy §409A is "underwater" what is its value for tax purposes and on what date during a year is the value determined?
Deductions	Current law generally provides that the employer is entitled to a deduction when NQDC is includible in the gross income of the service provider.	The conference report indicates that §409A does not affect the rules regarding the timing of an employer's deduction.	Presumably this means that the employer is entitled to a deduction when the service provider has income. The IRS, however, has been reluctant to acknowledge an employer's right to a deduction when an employee has taxable income due to constructive receipt. Query whether this reluctance will be imported into §409A.
Persons Affected	Current law applies to all employees and independent contractors on the cash method of accounting. Special limitations apply to deferred compensation arrangements sponsored by governments and	Code section 409A applies to any person receiving nonqualified deferred compensation for the performance of services, except that special distribution rules apply to "key employees" of publicly-	**Non-compensatory arrangements**. Presumably, deferrals of payments that are not compensation for personal services (*e.g.*, licenses and royalties) are not subject to §409A.

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Persons Affected *(continued)*	tax-exempt organizations under Code section 457.	held companies within the meaning of Code section 416(i) as discussed above. Note that there is no specific carve-out for non-employees (*i.e.*, outside directors, consultants, and independent agents are covered).	**Tax-exempts**. It is not clear how §409A applies to arrangements of tax-exempt employers (other than §457(b) arrangements that are excluded by statute). Under §457(f), deferred compensation for employees and service-providers of tax-exempt organizations is taxed when there is no longer a substantial risk of forfeiture. If §409A applies once an amount is earned and vested but §457(f) results in immediate taxation upon vesting, is there a "deferral" for purposes of §409A?
Effective Date	N/A	Amounts deferred (and earnings thereon) after December 31, 2004, are subject to §409A. Amounts deferred prior to January 1, 2005 are grandfathered subject to certain restrictions (see Grandfather Rules below). An amount is considered deferred before January 1, 2005, if it is earned and vested before that date, provided that there is no material modification to the arrangement after October 3, 2004. This means that if (1) the bonus is subject to the employer's discretion, or (2) an employee has	

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Effective Date *(continued)*		to continue working until 2005 in order to receive a bonus that he or she deferred through an election filed in 2004, that bonus is not earned and vested and is subject to §409A as of January 1, 2005. Unless the terms of the deferral and underlying plan happen to satisfy §409A, those amounts are in violation of the rules as of January 1, 2005. Treasury is required to issue transition guidance providing relief in these situations. (See Regulatory Authority below.)	
Grandfather Rules	N/A	Present law will continue to apply to amounts deferred prior to January 1, 2005, unless there is a material modification to the arrangement after October 3, 2004. The grandfather is broad. For example, a plan that has a "haircut" penalty withdrawal may continue to allow such a provision on a going forward basis with respect to pre-January 1, 2005 amounts deferred (and earnings on those deferrals) even though such a provision would violate Code section 409A on amounts deferred after	**Scope of grandfather**. It is critical to determine what amounts are grandfathered since those accruals and earnings may continue to operate under current law and existing plan terms. Treasury has informally indicated that even if the earnings rate under a grandfathered arrangement is not a market-based rate, the "earnings" under such rate will continue to be grandfathered provided that there is no material modification.

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Grandfather Rules *(continued)*		December 31, 2004. A plan that does not have a "haircut," for example, could not be amended to add such a provision because of the material modification rule.	**Material modification.** Even though grandfathered deferrals may continue to operate under current law and current plan terms, exercising the discretionary right under a plan to vest deferrals prior to December 31, 2004, is a material modification to the arrangement that eliminates the grandfather protection. While this rule may be viewed as an "anti-stuffing" provision, the inability to vest employees in prior awards means that outstanding and unvested equity grants (*e.g.*, SARs, discounted options) are subject to Code §409A and in all but rare cases will fail to meet these provisions and will become immediately taxable (and subject to penalties) except as provided in administrative relief from Treasury. Note, however, that the material modification rule appears to have relevance only with respect to a grandfathered amount. If an employer makes a material modification to an amount that is fully

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Grandfather Rules *(continued)*			paid out before January 1, 2005, there should be no application of §409A because no amount is deferred after December 31, 2004. The grandfather provision may also require valuing the amount deferred as of December 31, 2004, which will present valuation issues.
Regulatory Authority	In 1978, the IRS and Treasury issued a proposed regulation, 1.61-16, which would tax currently any amount that an employee voluntarily deferred from salary or bonuses (other than qualified plans). Under the proposed regulation, the assignment of income doctrine would apply at the time that the employee made the election to defer. In section 132 of the Revenue Act of 1978, Congress directed Treasury and IRS to tax deferred compensation arrangements under the principles in place on February 1, 1978 (just prior to the issuance of the proposed regulation). Treasury has stated that it would not finalize the regulation if given authority to write	Code section 409A does not explicitly repeal section 132 of the Revenue Act of 1978, but the moratorium is effectively eliminated. Treasury has authority to prescribe regulations necessary to carry out the proposal, including specific authority to write rules (i) valuing the amount deferred under a non-elective, defined benefit-type arrangement; (ii) defining change in control; (iii) exempting arrangements from the offshore trust rules if they do not result in an "improper deferral"; (iv) defining "financial health" of the employer; and (v) disregarding any substantial risk of forfeiture where necessary to carry out the purposes of the legislation. With respect to this latter item, the	**Transition Relief**. It is expected that Treasury will issue immediate guidance (within the 60-day statutory window) waiving the timing of election rules for elections filed on or before December 31, 2004, with respect to NQDC that is earned and vested on or before December 31, 2005. This waiver will provide relief for 2004 bonus elections that may have been made either before or after the enactment of §409A but that do not meet the timing rules for elections. As noted above, if Treasury does not provide immediate guidance on the standards for performance-based compensation or provide that employers may rely on a "reasonable, good faith" interpretation of such

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Regulatory Authority *(continued)*	regulations in the future. Section 132 has not precluded the IRS from continuing to develop its own ruling positions (*e.g.*, Rev. Proc. 92-64 (setting forth a ruling position on rabbi trusts); Rev. Proc 92-65 (modifying the rulings position on the timing of deferral elections)).	conference report states that it is intended that substantial risks of forfeiture may not be used to manipulate the timing of income inclusion and that illusory risks should be disregarded. Treasury also has authority to write regulations addressing issues relating to SARs and SERPs. Treasury also is instructed to write rules within 60 days providing a limited period of time during which a plan adopted prior to December 31, 2004, may be amended to provide that a participant may terminate participation or cancel a deferral election with respect to amounts deferred after December 31, 2004, if the amounts being deferred would be subject to taxation under the statutory provisions.	standard, then many employers may need to obtain deferral elections prior to January 1, 2005, with respect to bonus plans for services that will be performed beginning in 2005; otherwise, if Treasury provides later guidance with respect to the performance-based standard that does not cover an employer's existing arrangement, it will be too late to obtain deferral elections in a time frame that satisfies section 409A. **Issues with respect to "curing" amendments.** Treasury is expected to provide guidance allowing for potentially up to one year for employers to adopt new plan designs and agreements that satisfy section 409A. Note that the need to "cure" arrangements that violate section 409A will not be limited to amounts that were electively deferred in 2004. Under some plan designs, employees may have been participating in the plan for many years but because of the strict definition of "earned and vested" that is utilized for the

Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Regulatory Authority *(continued)*			effective date and grandfather rule, little if any of the employee's accruals are protected under old law. This situation might occur, for example, in a supplemental pension plan that provides payments only if the employee terminates employment after retirement age and, thus, nothing is "vested" prior to January 1, 2005, for purposes of section 409A. Unless Treasury provides relief for such an arrangement, an employee may have many years' of accruals and expectations under the terms of the old plan that cannot be satisfied under the new law. Particular concerns also are raised with respect to outstanding but unvested SARs or discounted options that are treated as NQDC. Typically, such grants cannot be amended without the consent of the holder. While employees presumably would agree to amendments designed to protect them from the penalties of section 409A, there may not be easy agreement as to how such grants should be amended and

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Item	Current Law	American Jobs Creation Act Of 2004 (H.R. 4520)	Issues and Comments
Regulatory Authority *(continued)*			whether they must be amended in the same manner for all similarly situated employees.
Annual Reporting	No tax reporting of deferred compensation prior to inclusion in an employee's income other than deferrals subject to early inclusion for employment taxes under Code section 3121(v). Note that the Department of Labor has authority to require reporting of such arrangements.	Code section 409A requires annual reporting to the IRS of "amounts deferred" on the Form W-2 even if amounts are not currently includable in income. Treasury is authorized to write rules governing the extent to which the IRS reporting requirement will not apply to small deferral amounts and amounts that are not reasonably ascertainable.	

Glossary of Terms

401(k) plan — A qualified retirement plan to which contributions from salary are made from pre-tax dollars.

Accelerated depreciation — Computation of depreciation to provide greater deductions in earlier years of equipment and other business or investment property.

Accounting method — Rules applied in determining when and how to report income and expenses on tax returns.

Accrual method — Method of accounting that reports income when it is earned, disregarding when it may be received, and expense when incurred, disregarding when it is actually paid.

Acquisition debt — Mortgage taken to buy, hold or substantially improve main or second home that serves as security.

Active participation — Rental real estate activity involving property management at a level that permits deduction of losses.

Adjusted basis — Basis in property increased by some expenses (e.g., by capital improvements) or decreased by some tax benefit (e.g., by depreciation).

Adjusted gross income (AGI) — Gross income minus above-the-line deductions (i.e., deductions other than itemized deductions, the standard deduction, and personal and dependency exemptions).

Alimony — Payments for the support or maintenance of one's spouse pursuant to a judicial decree or written agreement related to divorce or separation.

Alternative minimum tax (AMT) — System comparing the tax results with and without the benefit of tax preference items for the purpose of preventing tax avoidance.

Amortization — Write-off of an intangible asset's cost over a number of years.

Applicable federal rate (AFR) — An interest rate determined by reference to the average market yield on U.S. government obligations. Used in Sec. 7872 to determine the treatment of loans with below-market interest rates.

At-risk rules — Limits on tax losses to business activities in which an individual taxpayer has an economic stake.

Backup withholding — Withholding at a rate of 31% on interest or dividend payments by a payor that has not received required taxpayer identification number (TIN) information.

Bad debt — Uncollectible debt deductible as an ordinary loss if associated with a business and otherwise deductible as short-term capital loss.

Basis — Amount determined by a taxpayer's investment in property for purposes of determining gain or loss on the sale of property or in computing depreciation.

Cafeteria plan — Written plan allowing employees to choose among two or more benefits (consisting of cash and qualified benefits) and to pay for the benefits with pretax dollars. Must conform to Sec. 125 requirements.

Capital asset — Investments (e.g., stocks, bonds, and mutual funds) and personal property (e.g., home).

Capital gain/loss — Profit (net of losses) on the sale or exchange of a capital asset or Sec. 1231 property, subject to favorable tax rates, and loss on such sales or exchanges (net of gains) deductible against $3,000 of ordinary income.

Capitalization – Addition of cost or expense to the basis of property.

Carryovers (carryforwards) and carrybacks — Tax deductions and credits not fully used in one year and chargeable against prior or future tax years.

Conservation Reserve Program (CRP) — A voluntary program for soil, water, and wildlife conservation, wetland establishment and restoration and reforestation, administered by the U.S. Department of Agriculture.

Credit — Amount subtracted from income tax liability.

Deduction — Expense subtracted in computing adjusted gross income.

Defined benefit plan — Qualified retirement plan basing annual contributions on targeted benefit amounts.

Defined contribution plan — Qualified retirement plan with annual contributions based on a percentage of compensation.

Depletion — Deduction for the extent a natural resource is used.

Depreciation — Proportionate deduction based on the cost of business or investment property with a useful life (or recovery period) greater than one year.

Earned income — Wages, bonuses, vacation pay and other remuneration, including self-employment income, for services rendered.

Earned income credit — Refundable credit available to low-income individuals.

Employee stock ownership plan (ESOP) — Defined contribution plan that is a stock bonus plan or a combined stock bonus and money purchase plan designed to invest primarily in qualifying employer securities.

Estimated tax — Quarterly payments of income tax liability by individuals, corporations, trusts and estates.

Exemption — A deduction against net income based on taxpayer status (i.e., single, head of household, married filing jointly or separately, trusts, and estates).

Fair market value — The price that would be agreed upon by a willing seller and willing buyer, established by markets for publicly-traded stocks, or determined by appraisal.

Fiscal year — A 12-month taxable period ending on any date other than December 31.

Foreign tax — Income tax paid to a foreign country and deductible or creditable, at the taxpayer's election, against U.S. income tax.

Gift — Transfer of money or property without expectation of anything in return, and excludable from income by the recipient. A gift may still be affected by the unified estate and gift transfer tax applicable to the gift's maker.

Goodwill — A business asset, intangible in nature, adding a value beyond the business's tangible assets.

Gross income — Income from any and all sources, after any exclusions and before any deductions are taken into consideration.

Half-year convention — A depreciation rule assuming property other than real estate is placed in service in the middle of the tax year.

Head-of-household — An unmarried individual who provides and maintains a household for a qualifying dependent and therefore subject to distinct tax rates.

Health savings account (HSA) — Tax-exempt trust or custodial account established exclusively to pay qualified medical expenses of the account beneficiary who, for the months for which contributions are made to an HSA, is covered under a high-deductible health plan.

Holding period — The period of time a taxpayer holds onto property, therefore affecting tax treatment on its disposition.

Imputed interest — Income deemed attributable to deferred-payment transfers, such as below-market loans, for which no interest or unrealistically low interest is charged.

Incentive stock option (ISO) —An option to purchase stock in connection with an individual's employment, which defers tax liability until the stock acquired by means of the option is sold or exchanged.

Income in respect of a decedent (IRD) — Income earned by a person but not paid until after his or her death.

Independent contractor — A self-employed individual whose work method or time is not controlled by an employer.

Indexing — Adjustments in deductions, credits, exemptions and exclusions, plan contributions, AGI limits, etc., to reflect annual inflation figures.

Individual retirement account (IRA) — Tax-exempt trust created or organized in the U.S. for the exclusive benefit of an individual or the individual's beneficiaries.

Information returns — Statements of income and other items recognizable for tax purposes provided to the IRS and the taxpayer. Form W-2 and forms in the 1099 series, as well as Schedules K-1, are the prominent examples.

Installment method — Tax accounting method for reporting gain on a sale over the period of tax years during which payments are made, i.e., over the payment period specified in an installment sale agreement.

Intangible property — Items such as patents, copyrights, and goodwill.

Inventory — Goods held for sale to customers, including materials used in the production of those goods.

Involuntary conversion — A forced disposition (e.g., casualty, theft, condemnation) for which deferral of gain may be available.

Jeopardy — For tax purposes, a determination that payment of a tax deficiency may be assessed immediately as the most viable means of ensuring its payment.

Keogh plan — A qualified retirement plan available to self-employed persons.

Key employee — Officers, employees, and officers defined by the Internal Revenue Code for purposes of determining whether a plan is "top heavy."

Kiddie tax — Application of parents' maximum tax rate to unearned income of their child under age 14.

Lien — A charge upon property after a tax assessment has been made and until tax liability is satisfied.

Like-kind exchange —Tax-free exchange of business or investment property for property that is similar or related in service or use.

Listed property — Items subject to special restrictions on depreciation (e.g., cars, computers, cell phones).

Lump-sum distribution — Distribution of an individual's entire interest in a qualified retirement plan within one tax year.

Marginal tax rate — The highest tax bracket applicable to an individual's income.

Material participation — The measurement of an individual's involvement in business operations for purposes of the passive activity loss rules.

Medical savings account (MSA) — A savings plan providing for deduction of contributions, tax-deferred earnings, and exclusion of tax on any monies withdrawn for medical purposes.

Mid-month convention —Assumption, for purposes of computing depreciation, that all real property is placed in service in the middle of the month.

Mid-quarter convention — Assumption, for purposes of computing depreciation, that all property other than real property is placed in service in the middle of the quarter, when the bases of property placed in service in the final quarter exceeds a statutory percentage of the bases of all property placed in service during the year.

Minimum distribution —A retirement plan distribution, based on life expectancies, that an individual must take after age 70 ½ in order to avoid tax penalties.

Minimum funding requirements — Associated with defined benefit plans and certain other plans, such as money purchase plans, assuring the plan has enough assets to satisfy its current and anticipated liabilities.

Miscellaneous itemized deduction — Deductions for certain expenses (e.g., unreimbursed employee expenses) limited to only the amount by which they exceed 2% of adjusted gross income.

Money purchase plan — Defined contribution plan in which the contributions by the employer are mandatory and established other than by reference to the employer's profits.

Net operating loss (NOL) — A business or casualty loss for which amounts exceeding the allowable deduction in the current tax year may be carried back 2 years to reduce previous tax liability and forward 20 years to cover any remaining unused loss deduction.

Nonresident alien — An individual who is neither a citizen nor a resident of the United States and who is taxed on income effectively connected with a U.S. trade or business.

Original issue discount (OID) — The excess of face value over issue price set by a purchase agreement.

Passive activity loss (PAL) — Losses allowable only to the extent of income derived each year (i.e., by means of carryover) from rental property or business activities in which the taxpayer does not materially participate.

Pass-through entities — Partnerships, LLCs, LLPs, S corporations, and trusts and estates whose income or loss is reported by the partner, member, shareholder, or beneficiary.

Personal holding company (PHC) — A corporation, usually closely-held, that exists to hold investments such as stocks, bonds, personal service contracts and to time distributions of income in a manner that limits the owner(s) tax liability.

Qualified subchapter S trust (QSST) — A trust that qualifies specific requirements for eligibility as an S corporation shareholder.

Real estate investment trust (REIT) — A form of investment in which a trust holds real estate or mortgages and distributes income, in whole or in part, to the beneficiaries (i.e., investors).

Real estate mortgage investment conduit (REMIC) — Treated as a partnership, investors purchase interests in this entity which holds a fixed pool of mortgages.

Realized gain or loss — The difference between property's basis and the amount received upon its sale or exchange.

Recapture — The amount of a prior deduction or credit recognized as income or affecting its characterization (capital gain v. ordinary income) when the property giving rise to the deduction or credit is disposed of.

Recognized gain or loss — The amount of realized gain or loss that must be included in taxable income.

Regulated investment company (RIC) — A corporation serving as a mutual fund that acts as investment agents for shareholders and customarily dealing in government and corporate securities.

Reorganization — Restructuring of corporations under specific Internal Revenue Code rules so as to result in nonrecognition of gain.

Resident alien — An individual who is a permanent resident, has substantial presence, or, under specific election rules, is taxed as a U.S. citizen.

Roth IRA — Form of individual retirement account that produces, subject to holding period requirements, nontaxable earnings.

S corporation — A corporation that, upon satisfying requirements concerning its ownership, may elect to act as a pass-through entity.

Saver's credit — Term commonly used to describe Sec. 25B credit for qualified contributions to a retirement plan or via elective deferrals.

Sec. 1231 property — Depreciable business property eligible for capital gains treatment.

Sec. 1244 stock — Closely held stock whose sale may produce an ordinary, rather than capital, loss (subject to caps).

Split-dollar life insurance — Arrangement between an employer and employee under which the life insurance policy benefits are contractually split, and the costs (premiums) are also split.

Statutory employee — An insurance agent or other specified worker who is subject to social security taxes on wages but eligible to claim deductions available to the self-employed.

Stock bonus plan — A plan established and maintained to provide benefits similar to those of a profit-sharing plan, except the benefits must be distributable in stock of the employer company.

Tax preference items — Tax benefits deemed includable for purposes of the alternative minimum tax.

Tax shelter — A tax-favored investment, typically in the form of a partnership or joint venture, that is subject to scrutiny as a tax-avoidance device.

Tentative tax — Income tax liability before taking into account certain credits, and AMT liability reduced regular tax liability.

Transportation expense — The cost of transportation from one point to another.

Travel expense — Transportation, meals, and lodging costs incurred away from home and for trade or business purposes.

Unearned income — Income from investments (i.e., interest, dividends, and capital gains).

Uniform capitalization rules (UNICAP) — Rules requiring capitalization of property used in a business or income-producing activity (e.g., items used in producing inventory) and to certain property acquired for resale.

Unrelated business income (UBIT) — Exempt organization income produced by activities beyond the organization's exempt purposes and therefore taxable.

Wash sale — Sale of securities preceded or followed within 30 days by a purchase of substantially identical securities. Recognition of any loss on the sale is disallowed.

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