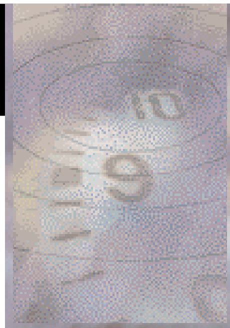

legal matters

The Ins and Outs of Retirement Plans, Part II of II

When your number is up to withdraw money from your retirement plan, it's best to go ahead and take it. And be sure you have named the appropriate beneficiaries to those accounts.

BY JOHN ALLEVATO

If you do nothing else to shore up your financial and retirement planning matters this year, pay particular attention to the persons (or trusts) you have named as beneficiaries for your retirement plans and when and how you are going to take money out of your plans. By retirement plans, I'm referring to IRAs, qualified plans such as profit-sharing or pension plans, and 401(k) plans. And in case you hadn't heard, now is a good time to have your estate plan reviewed to make adjustments after this year's tax law changes.

In following up my article in the September/October issue, "The Ins and Outs of Retirement Plans, Part I," we now must discuss the rules surrounding distributions from qualified retirement plans. The most important thing is to make sure the beneficiaries you have named and your retirement planning choices are appropriate for your circumstances.

While the tax changes passed in early summer have captured most of the press lately, earlier in the year the IRS promulgated revised regulations dealing with distributions from qualified retirement plans. These new regulations are mostly taxpayer friendly in that they simplified distribution choices and did so in ways beneficial to plan participants and their beneficiaries. Coupled with the tax changes, all participants in retirement plans should now rethink choices which they may have made years ago, and make sure those choices mesh with their current situation.

Your personal circumstances will ultimately dictate which alternatives are best for you. Your retirement planning adviser can help you with specific choices.

Distribution rules

As you surely know, there are significant tax advantages to establishing a qualified retirement plan, whether it be a profit-sharing plan, an IRA, or a plan which offers the features of a Section 401(k)—also known as a salary deferral plan. Generally, contributions to these plans are deductible for tax purposes when made by or on behalf of participants, and the earnings in the plans grow tax-free until withdrawn from the plan.

This "double whammy" benefit—tax deductible contributions, tax-free growth—makes retirement plans a powerful tool in retirement and personal financial planning. But it also means that the IRS wants the double whammy to eventually end. Not only does the IRS want to collect the taxes on the funds it has allowed you to save for retirement, it also wants the tax-free growth to stop. The law accomplishes this by essentially "forcing" or "strongly encouraging" you to withdraw funds from these tax-favored plans. This is consistent with the policy objective of encouraging savings for retirement.

Since they are retirement

Continued from previous page

plans, funds must be withdrawn in minimum amounts (you can always withdraw more) each year beginning when you reach a certain age. Although not everyone retires at the same age, withdrawals from qualified retirement plans (including IRAs) must begin on the date known as the required beginning date, or RBD. The RBD is the same for everyone—age 70 1/2. To avoid a penalty of 50 percent of the amount you should have withdrawn, you are required to make a withdrawal by April 1st of the year following the year in which you turn age 70 1/2. Most people, however, should make their first withdrawal during the year in which they turn age 70 1/2, since if you wait until April 1st of the next year to do it, you must also then make a withdrawal for that tax year—thus, you would have to take two withdrawals in that tax year.

This is the rule whether you are retired or continue to work, be it on the job for which a retirement plan was established or another job. (I'm oversimplifying a bit here. Suffice it to say this is the rule for the vast majority of people.)

Beneficiaries in question

It gets a little more complicated when you die. If you die before your RBD, your beneficiary must withdraw all the funds from the qualified plan (and incur all the income taxes, since amounts withdrawn are income to whoever makes the withdrawal) within the five-year period beginning with the year in which the plan participant died. If you stopped reading here, you would miss the most important point—the ubiquitous exception which, as is often the case, is more important than the general rule. The exception is unless your beneficiary is a "designated beneficiary," in which case she can withdraw the plan assets over her remaining life expectancy—potentially a huge tax-deferral opportunity.

Who is a "designated beneficiary"? Basically, it is the person you name on your plan's beneficiary designation forms. The only difference is that after your death, your personal representative is now given the flexibility, within limits, to "designate" as your beneficiary the individual who may fall into the best age category for estate planning. This post-mortem desgnation is taxpayer-friendly in that it allows your beneficiary to be "designated" after your death, providing flexibility in tax planning for your estate and heirs. It should not be a substitute for you naming a beneficiary in your plan forms. Now is the time to review your beneficiary designations with your adviser to make sure they reflect your desires.

There is another important exception for your heirs. Assume the sole beneficiary of the plan is the spouse of the deceased plan owner. Whether or not the RBD has occurred, the spouse is permitted to "roll over" the plan assets into a new IRA—his own IRA. Why do this? Because the surviving spouse/beneficiary can then wait until his own RBD before beginning withdrawals thereby obtaining additional tax deferral and tax-free build up of assets.

Let's now assume you die after your RBD, and your spouse is not your sole beneficiary or elects not to roll over the funds from your account. In this case, the rules are different. Here, the withdrawals must continue at least as rapidly as you, the plan participant, were withdrawing them. But the new regulations finalized by the IRS earlier this year provide a huge benefit to the "at least as rapidly" rule by stating that if the beneficiary is a designated beneficiary, then that beneficiary can use her life expectancy to determine the minimum distributions. This allows the continued tax-free build-up of funds inside the qualified plan by delaying the distributions to beneficiaries if, of course, that is desirable under the circumstances. What it most certainly does is provide more flexibility for your survivors.

Amount of withdrawals

Now that we've discussed when the withdrawals must begin and what might happen after your death, let's review how much of a distribution you must take at your RBD and thereafter.

Beginning with the RBD, and continuing each year thereafter, the law dictates how much of a distribution must be taken. These required amounts are known as required minimum distributions, or RMD.

The new regulations probably made their best impact relative to taxpayers in the area of required minimum distributions. There is now one universal table to determine how much of a distribution from a retirement plan must be taken in any one year. This table is more taxpayer friendly than the previous tables in that the RMD is less in just about every instance than it used to be.

Let's look at an example to illustrate how the RMD works. Assume Dr. Susan Jones retired a number of years ago, and this year attained age 70 1/2. In her qualified retirement plan and IRA, she has a total of $1 million. She has not taken a distribution yet this year from either plan. By April 1st of 2002, she must withdraw an aggregate of $38,168 from the plans to avoid the harsh 50 percent penalty. For tax planning purposes, she is advised to withdraw that amount this tax year to avoid having to take two distributions next year, which may throw her into a higher tax bracket.

Dr. Jones can always take out more than her RMD. And she doesn't have to wait until she is age 70 1/2 to begin taking distributions—she may begin taking distributions at age 59 1/2. (If she takes one before that, with few exceptions, she will incur a 10 percent penalty of the amount withdrawn.)

Continued from previous page

Summary of Recommendations

From determining if a certain retirement plan is right for you to deciding on a distribution plan, you will face many options and alternatives. A list of my recommendations boils down to this:

- Review your beneficiary designations as you have your retirement plan reviewed in the near future.
- Try to maximize contributions to your plans without jeopardizing needed cash flow for living expenses.
- If you don't need to (or are not required by law to) withdraw funds from a retirement plan, allow the funds to continue to grow, tax-free.
- Have your retirement plan reviewed, along with your other financial resources, to determine if you should stop contributing to your plan (if that is an option).
- And, (just to see if you've been paying attention) don't forget to take your RMD at your RBD.

Qualified retirement plans, while providing significant tax benefits, are also one of the most difficult parts of your economic picture. As I have always said, do not attempt to navigate your way through the retirement planning maze without good, competent advice from well-trained professionals. The benefits are worth the effort. ■

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