RETIREMENT PLAN TAX TREATMENT

When it comes time to collect retirement plan benefits, many will be faced with a number of options and a bewildering array of tax consequences. Avoid costly mistakes by learning the tax rules now, well before being eligible for a payout from an employer’s plan.

PAYOUT POSSIBILITIES

Most plans let people take benefits either as an annuity or in a lump sum. The annuity is usually a fixed monthly amount paid out for the remainder or life. Many plans, however, allow joint and survivor annuities. These pay lower monthly amounts, but continue as long as either the retiree or his or her spouse is alive. Estimate the value in today’s dollars of the total annuity payments expected to receive. Compare that figure with the value of the lump sum available if eligible. Consider:

- The state of health
- Estimated investment return on the lump sum

The help of a tax advisor who has expertise in retirement planning and access to computer programs to analyze the options may be required. Then, compare the tax consequences of each payout option.

LUMP SUM TAX BREAKS

When they are received, lump sum distributions may be taxed under special tax saving rules if certain conditions are met. One may defer tax on the distribution by rolling it over (by making a transfer) into another tax sheltered retirement plan.

Special rules for lump sum distributions to taxpayers that were born before January 1, 1936 (ten-year averaging and the five-year forward averaging, have been phased out).

CONDITIONS FOR LUMP SUM TAX TREATMENT

For a retirement plan payout to be treated under the favorable lump sum tax rules, the following conditions must be met:

- You must receive everything in the plan in one tax year

If the company covered the person under more than one plan of the same type (pension or profit sharing), the accounts in each plan must be received in the same year.

- Plan participation five years before distribution
- At payout time, specific requirements must be met

The participant must be totally disabled, separated from service with your company or older than 59 ½.
TAX FREE ROLLOVERS

A lump sum payout is not subject to tax if, within 60 days, it rolled into another qualified retirement plan, such as a company plan, a Keogh plan or an IRA.

Effective in 1998, taxpayers could roll a taxable IRA into a Roth IRA that would trigger tax changes. The amount withdrawn would be subject to tax (with no penalty if re-invested), but taxes would have to be paid. The tax payments could be spread over four years if rolled over in 1998. The new Roth IRA would continue to grow tax-deferred. If removed more than five years later, the proceeds would then be tax free - as opposed to the taxable income from the traditional IRA.

Rollovers made directly into a corporate plan or Keogh plan avoids this problem.

Suggestion: As you near retirement, look for a way to earn some self-employment income. Set up a Keogh plan and roll the company lump sum distribution into the Keogh plan.

TAX PITFALLS AND PENALTIES

A 10% penalty tax is imposed on distributions made before the account owner reaches age 59 ½, with the following exceptions: death, disability, medical expenses in excess of 7.5% of AGI, up to $10,000 (lifetime max) toward the purchase of a new home, or for higher education. The tax is waived for any part of the distribution that is made as an annuity, to cover medical expenses or to an employee age 55 or older who has separated from service and satisfied his or her company’s plan requirements for early retirement.

HOW TO PAY LOWEST TAX ON IRA/KEOGH DISTRIBUTION

The primary rule: Most money (except for medical purposes - over 7.5% AGI, first time home buyer - capped at $10,000 lifetime and higher education) taken out before reaching age 59 ½ is subject to a 10% penalty tax. For that reason, it is best to take out only as much as needed. Any large distribution can put someone in a high tax bracket, and cause the loss of the benefit of tax-free earnings whenever money is taken out of the fund.

Keogh plan distributions may, if age 50 before January 1, 1986, qualify for the 10 year averaging method applicable to lump sum pension distributions. This method does result in large savings.

Distributions after a taxpayer’s death are also taxable, and there may be an estate tax.

WHEN IS A DISTRIBUTION REQUIRED?

In a traditional IRA, one must begin distribution from all qualified retirement plan accounts (other than Roth IRAs) no later than April 1 of the calendar year, following the year
reaching age 70 ½, unless still employed. Withdrawal of the whole account in a lump sum may be made, but is not necessary. One must, however, make a minimal withdrawal each year, calculated on the basis of life expectancy (or that of retiree or beneficiary).

For example, if your life expectancy (or that of you and your beneficiary) were 14 years, you would have to withdraw 1/14 of your account that year. If your life expectancy were 12.2 years, you would have to withdraw 1/12.2 of your account and so forth.

If withdrawal is less than the minimum distribution, there is a 50% penalty on the difference. If withdrawal is only $2,000 in a year when the minimum required is $8,000, the penalty is $3,000 (50% of the $6,000 difference).

WITHDRAWAL TAX TECHNIQUES

All participants do, however, get a tax break. The minimum requirement is figured as of the first of the year, but it does not have to be taken out until December 31. The account’s earnings for the year are tax-free and remain in the account.

Example: The account is $100,000, invested at 8%. In a particular year, it is required to withdraw 1/10. By December 31, the account will have grown to $108,000, but $10,000 will be the required minimum withdrawal.

Each year, go back to the life expectancy table and calculate the minimum withdrawal on the basis of the new life expectancy figure. The effect is to reduce the required payments and spread them out over a longer period. In addition, in certain limited situations, one may wait until after age 70 ½ to withdraw from an account.

USE OF IRS LIFE EXPECTANCY TABLES

Most people want to keep IRA accounts intact for as long as possible, accumulating tax deferred interest. They want their beneficiary to get maximum benefits from the account. However, the tax law requires quick distribution of an IRA account after the death of the owner. The general rule is that the entire account must be paid out within five years of the owner’s death or the death of the surviving spouse, whichever comes later.

Exception: If the owner or beneficiary started to receive payments from the account before death, the account balance may be paid out over the life expectancy of the surviving spouse.

To preserve this benefit, begin to take token distributions from the IRA after reaching age 59 ½. Leave the bulk of the account intact. The required distribution is calculated based on joint life expectancy when distributions begin. When starting nominal distributions, however, payments do not have to be the minimum required under that life expectancy.