RETIREMENT STRATEGIES

Wolters Kluwer

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One of the most important financial issues that impacts your life is planning for your retirement. Life expectancy and retirement periods for Americans have lengthened significantly in recent years. Based on recent data, for example, a woman age 65 could expect to live nearly 20 more years; a man the same age could expect to live an additional 17. With this increased risk of outliving your assets, you must implement strategies to ensure that you have enough money saved to live comfortably and feel secure during your retirement years. Fortunately, there are a variety of tax-friendly vehicles to help you save for retirement. And new regulatory developments on the horizon may make it even easier to provide a steady income for yourself in old age.

> ***Comment.*** Many individuals' retirement plans have struggled to recover since the great financial crisis. Some 401(k)s and other retirement plans have lost significant amounts of value. Many individuals are faced with the challenge of rebuilding their portfolios and looking for ways to diversify their investments to plan for retirement.

WHAT IS A RETIREMENT PLAN?

Although it may seem superfluous explaining to most individuals what exactly a retirement plan is, many people who are just beginning to fashion a plan may not truly understand its purpose or benefits.

A retirement plan is an arrangement under which compensation, or assets, are set aside by or on behalf of an individual, or group of individuals, in order to provide income during retirement. Generally, these arrangements are designed to ensure that tax benefits are achieved. Compensation used to fund retirement plans is not taxed in many instances (such as contributions to a traditional IRA) until you are eligible to withdraw the money from the account.

However, the form of the arrangement determines whether you can take an immediate deduction for amounts contributed to the plan as well as whether, and when, earnings accumulated in the plan are taxed. Many types of retirement plans (qualified plans) are specifically given preferential tax treatment under the Tax Code in order to encourage retirement savings.

Once you retire, retirement planning does not come to a halt; it changes. Generally, you have a fixed amount of assets at that point that won't grow over and above its investment potential even if you follow the growing trend and continue to work part-time. You may not be able to count on that extra income if your health changes, however, which makes the strategic allocation of assets into growth, income-producing, and secure investments even more critical. Equally imperative is how you plan when, and in what amount, to draw down from both your taxable and non-taxable retirement savings.

WHERE TO BEGIN

Creating a retirement strategy starts by looking into your future to determine:

- What your monthly expenses will be after retirement; and
- How much money you'll have after retirement to pay these expenses.

Once you have a ballpark estimate, you can come up with a plan for saving and investing today to ensure that you'll have enough to meet your expenses after retirement.

It can be helpful to use a pie chart when thinking about your retirement savings. The four pieces of the pie are:

- Social Security;
- A traditional retirement plan sponsored by your employer (or sponsored by you as the employer);
- Savings and investments you accumulate on your own, through stocks, bonds, mutual funds, IRAs, CDs, Treasury notes, and the like; and
- Real estate you own, including your residence, vacation homes and rental property.

Status of retirement plans today

Traditionally, the sources of retirement income have been described metaphorically as three legs of a stool: employer-funded pension plan payments, Social Security benefits, and personal savings.

Employer-funded pension plans, especially of the defined benefit variety, were taken for granted a generation ago. That is no longer the case. Many employers are terminating their plans for cost reasons. Under-funding of defined benefit plans has been a chronic problem for years, and has remained so despite recently tightened rules (fortunately, vested benefits are guaranteed by the federal government). Companies hit hard by the last recession cut back on profit sharing contributions to employee 401(k) plans, and it seems that in the recovery the reduced amounts have become the new normal.

Social Security, the second leg, has the advantage of being inflation adjusted. However, there has been talk in Washington of changing the adjustment mechanism to provide less generous cost of living adjustments even for current retirees. This is in response to concerns that Social Security will lack the resources (income plus trust fund reserves) to fully meet its obligations after 2027 if Congress does not make funding or benefit changes by that time (according to the Social Security Trustees Report for 2013).

The third leg is personal savings. This is one area where opportunities have grown as Congress has provided a wide array of tax favored vehicles for retirement savings, such as employer-sponsored 401(k)s and personal IRAs. The risks to retirement savings are well known: wild market swings, inflation, and the generally dismal rate of return offered by safe investments to name just a few. But of the three legs of the stool, this is the one most of us have the most control over, and saving more is always better than saving less.

The federal government has taken tentative steps to increase the number and availability of retirement payout options for individuals who survive into advanced age (i.e. age 80 to 85). But these new rules, which are still in development, are mainly being designed to enhance the payout options for the deferred contribution savings that you voluntarily set aside largely of your own initiative.

There is one more thing to consider which is, what job will you take in retirement? This might come to be known as the fourth leg of the retirement income stool. Delaying Social Security benefits until age 70 dramatically increases your monthly payments (just as starting them just as soon as you can dramatically reduces them). Continued employment gives you the chance to top off your 401(k) with catch-up contributions or delay taking IRA withdrawals. For many, this may mean taking a job at a reduced rate of pay compared to their previous job. But anything that helps delay the draw-down of retirement resources is a significant benefit.

Social Security

The following table shows how the age at which you can retire and receive full Social Security benefits increases depending on your year of birth. You can start Social Security retirement benefits as early as age 62 or as late as age 70. If you retire before your full retirement age, your benefits will be lower based on your age. By the same token, if you retire after your normal retirement age your benefits will be higher.

DATE OF BIRTH*	FULL BENEFIT AT AGE
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943—1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 + 10 months
1960 and later	67**

Requesting an estimate of benefits. You don't have to guess what your benefits will be. The Social Security Administration (SSA) will send you an estimate of your future benefits if you complete and file Form SSA-7004, Personal Earnings and Benefits Estimate Statement.

You can get a copy of Form SSA-7004 at your local Social Security office or by calling 1-800-772-1213. You can also go online at *www.ssa.gov*.

Obtaining the SSA estimate of your benefits helps you in two ways. It gives you a better idea of how much you'll need from other sources to fund the lifestyle you want to have during retirement. It allows you to check whether SSA is giving you proper credit for all of the years you worked.

Taxation of benefits. Often, Social Security benefits are taxable, at least in part. The tax is based on other amounts of income you earn in addition to Social Security benefits. The maximum amount of benefits that can be taxed is 85 percent.

This calculation is not quite as complicated as it sounds. To make it a bit simpler, use the worksheet in the instructions to Form 1040.

PRIVATE RETIREMENT PLANS

There are three types of private retirement plans:

(1) Employer funded plans;
(2) Employer and/or worker funded plans; and
(3) Worker funded accounts.

Employer funded plans. An employer funded plan is exclusively funded through employer contributions. You generally do not have any control over the funds until

they are distributed to you. Employer funded plans include defined benefit and defined contribution plans.

Employer and/or worker funded plans. The second type of plan allows you to exercise some control over how much money you can save for retirement. For example, you can choose to make elective or salary reduction contributions, such as to a 401(k) plan.

Worker funded accounts. The third type is the individual retirement account (IRA). Except for SIMPLE IRAs and SEPs, which can be set up by employers, IRAs are exclusively employee funded.

EMPLOYER FUNDED RETIREMENT PLANS

There are two types of employer funded plans: defined benefit plans and defined contribution plans. These qualified plans provide tax advantages if established and maintained properly. Specifically, participants are generally taxed only when they receive payments from their retirement plan while earnings grow tax free.

Additionally, many retirees' income tax brackets will be lower at the time their benefits are received. Moreover, Social Security taxes are not paid on either employer contributions to qualified retirement plans or on distributions to participants.

Defined benefit plans

Defined benefit plans are funded with employer contributions, the amount of which is determined under a formula based on a number of factors, such as the participant's age, average compensation, years of service, as well as actuarial assumptions about life expectancy and investment performance. Defined benefit plans are required to provide employees with definitely determinable benefits payable at retirement.

The annual benefit for a participant under a defined benefit plan may not be more than the smaller of:

(1) $210,000 for 2014; or
(2) 100% of the participant's average compensation for his or her highest three consecutive years.

Employers that maintain a defined benefit plan bear the risks of investment performance.

Under a defined benefit plan, retirement planning generally becomes more straightforward. You can add your monthly benefit to your monthly Social Security payment to determine the additional monthly income you will need to meet your monthly expenses during retirement.

Although the benefit under this type of plan is usually expressed in terms of a monthly benefit amount, when you are ready to retire your employer may

distribute your benefits in a lump sum rather than monthly payments. A lump sum payment offers you more flexibility to manage your retirement assets, but it also increases your risk of outliving them. Proposals now before the IRS call for allowing employers to more easily offer a combination of a partial lump sum and a stream of annuity payments. As more of the U.S. population ages, additional proposals to find solutions to building a balanced retirement nest egg are likely, too, so re-evaluating a retirement strategy every few years is recommended not only because of changing needs but also changing law.

Other benefits. In general, defined benefit plans can only provide retirement benefits. They can provide other benefits only if they are subordinate to the retirement benefits. Other types of allowable benefits include death, disability, and supplemental benefits, as well as medical benefits.

Except for spousal benefits, benefits can be forfeited upon the participant's death.

Defined contribution plans

A defined contribution plan is a retirement plan that provides each participant with an individual account to which amounts are contributed by the employer. Defined contribution plans include money purchase pension plans, profit-sharing plans, and qualified stock bonus plans.

There are limits on annual contributions to a participant's account, overall limits on contributions for any one participant under a combination of plans sponsored by one employer, as well as limits on the deduction an employer can take for the contributions.

For 2014, contributions to a defined contribution plan cannot exceed the smaller of:

(1) $52,000; or
(2) 100% of the participant's compensation.

Money purchase plans. Under a money purchase plan an employer contributes a specified amount of cash to the employee's retirement account each year, generally based upon a percentage of the employee's wages or salary. A participant's eventual retirement benefits under a money purchase plan are determined by their particular vested account balances at retirement. Contributions to money purchase plans are not discretionary,

like with profit-sharing plans, and an employer's failure to make required contributions subjects the employer to an excise tax on underfunded plans. Once in common usage, employers in recent years have largely stopped contributing to money purchase plans, which are attached to burdensome requirements.

Profit-sharing plans. The basic profit-sharing plan is designed to encourage employees to share in the profits of the employer. Qualified profit-sharing plans also provide a specific formula for allocating employer contributions among participants' accounts. A stock bonus plan is one type of profit-sharing plan in which your employer's securities are contributed and distributed from the plan in lieu of cash amounts.

Such plans usually provide for payment of benefits not only at retirement, but upon the occurrence of specific events such as termination of employment, disability, attainment of a specific age, after the passage of a certain number of years or the participant's death.

Self-employed retirement plans

If you are both the employer and the employee, you can establish a defined benefit or defined contribution plan for yourself (these are sometimes called "Keogh" plans). Self-employed individuals may have any kind of retirement plan that larger employers may have, but special rules apply.

You don't have to carry on a full-time business in order to be considered self-employed. If you work for a salary during the day and conduct a business from your home in the evenings, the earnings from your home business are considered self-employment income.

Your plan must provide that contributions or benefits cannot exceed certain limits. The limits differ depending on whether your plan is a defined contribution plan or a defined benefit plan (these limits factor in inflation, so they rise a few dollars each year). The same annual contribution limits that apply to defined benefit and defined contribution plans apply in the self-employment setting.

EMPLOYER AND EMPLOYEE FUNDED ACCOUNTS

In addition to plans funded with employer contributions, you may be able to elect to defer certain amounts of your salary and invest that money in your employer's retirement plan, thereby enabling you to accumulate additional amounts toward retirement. Some employer-sponsored plans permit employees to earmark six to 15 percent of their salary to invest in the plan.

This type of contribution, generally made to a 401(k) plan, is referred to as a salary reduction contribution or elective contribution. For 2014, you can generally contribute up to $17,500 in elective contributions to 401(k), 403(b), and certain 457 plans (and, if you are age 50 or older this year, you may also be able to make additional catch-up contributions of $5,500 for 2014).

If you are thinking of making elective contributions, you should be aware that the rules are complicated. For tax planning purposes, you should know:

- How the plan operates and the limits on the amounts you may contribute;
- If the employer is also making a contribution and how your employer's contribution is computed;
- If you may direct the investment of your money;
- If you have the option of either receiving the employer's contribution in cash when it is made or letting money go into the plan;
- If you can borrow from the plan; and
- How and when you can begin withdrawing your contributions from the plan.

In-plan rollovers. Plans may permit participants in 401(k), 403(b), and 457 governmental plans to roll over otherwise qualified distributions, including in-service distributions, into a designated Roth account set up by their employers within those plans. The taxable amount of the rollover is generally includible in gross income for the year received, with an exception for any after-tax contributions. Plan may allow for such rollovers even if the participant is not severing employment or over age 59½.

INDIVIDUAL RETIREMENT ACCOUNTS

Individual retirement accounts (IRAs) are investment accounts or annuities established to provide retirement savings for a particular individual. They include traditional IRAs and Roth IRAs.

IRAs are trust or custodial accounts established for the exclusive benefit of an individual and/or his or her beneficiaries. They are offered by most financial institutions, including banks, mutual funds, and stock brokers.

Most IRAs are set up by individuals, but employers can establish and contribute to IRAs under SEP and SIMPLE plans. Establishing an IRA – either a traditional IRA or a Roth IRA – is an excellent way to save at least part of the funds that you'll need during retirement.

Traditional IRAs

For 2014, the annual contribution limit for a traditional IRA (as well as a Roth IRA) is $5,500. You can contribute up to the lesser of your compensation or the applicable dollar amount limit ($5,500). And, in general, your contributions are deductible.

Individuals who will be at least age 50 by the end of the year can make additional catch-up contributions of $1,000 in 2014 to their traditional IRA (or Roth IRA).

Eligibility. An individual can establish and contribute to a traditional IRA if he or she has received taxable compensation for the year and has not reached age 70½ by the end of the year.

Investments. Depending on the institution, IRAs offer a virtually unlimited number of investment choices. However, IRA assets cannot be invested in collectibles, and they cannot be used to buy property for personal use, to buy property from the owner or his family, or used as collateral for a loan.

Deductions for contributions. Contributions to a traditional IRA are deductible on your federal income tax return, subject to certain exceptions. Individuals under age 70½ in 2014 may be able to deduct IRA contributions up to the lesser of $5,500 or 100 percent of their compensation ($6,500 for persons age 50 or older).

However, the deduction is phased out if:

- You are an active participant in an employer's retirement plan for any part of a year; and
- Your modified adjusted gross income (MAGI) exceeds a specific amount (for 2014, phase-out begins at MAGI of $60,000 for single individuals and $96,000 for joint filers who are both also covered by a workplace plan).

The applicable MAGI limit depends on your filing status and the limits will be increased annually over the next few years.

Married couples. If both spouses are active individuals in an employer's retirement, their modified AGI may limit or restrict their ability to claim a deduction for a contribution to a traditional IRA. However, an individual is not considered an active participant in an employer's

retirement plan merely because his or her spouse is treated as an active participant. In this case, the modified AGI phaseout start limit is increased to $181,000 for joint filers. This allows more married couples to take a full deduction for a contribution to an IRA.

> ***Example.*** Arturo and Jacinta are married. Arturo participates in his employer's retirement plan; Jacinta does not work outside the home. They file a joint return for 2014 with a modified AGI of $100,000. Jacinta may make a deductible contribution to a traditional IRA for the year because she is not an active participant in an employer-sponsored retirement plan and the couple's modified AGI is below the phase-out amount.

You can still make nondeductible contributions to your IRA even if your deduction is otherwise limited.

Distributions. Distributions from a traditional IRA are taxed as ordinary income. Once you reach age 59½, distributions from your IRA can be made without any penalty. However, if you don't need to take distributions, you can leave your IRA assets in the account and continue to earn income.

Required distributions. Once you reach age 70½, contributions to your IRA must stop and you must begin receiving required minimum distributions (RMDs). More on RMDs later.

> ***Comment.*** The Treasury recently proposed carving out an exception for these rules for plan participants who have purchased a deferred longevity annuity where payouts are scheduled to commence when the participant reaches an advanced age, such as 80 or 85.

Premature distributions. If you withdraw or use traditional IRA assets before reaching age 59½, you will be subject to an additional 10 percent tax imposed on the amounts withdrawn or used. There are certain exceptions for qualified premature distributions, such as:

- Distributions for qualified medical expenses, up to a certain dollar amount;
- Distributions to a disabled owner;
- Distributions for qualified higher education expenses, up to a certain amount; or
- Distributions used to buy, build or rebuild a first home.

> *Distributions for charitable purposes.* At the end of 2012, Congress renewed through 2013 the temporary incentive for distributions of IRA proceeds to charity. (In 2010 and 2011 individuals age 70 ½ or over were able to exclude from gross income up to $100,000 paid directly from their IRAs to a qualified charitable organization.)

Nonspouse rollovers. The employee who receives a distribution from a qualified plan is entitled to make a rollover. An employee's surviving spouse can roll over a

distribution attributable to the employee and paid to the spouse on account of the employee's death. A nonspouse beneficiary may also roll over, in a direct-trustee-to-trustee transfer, distributions from an eligible retirement plan of a deceased employee to an IRA (account or annuity) established for the purpose of receiving such distribution. The transfer is treated as an eligible rollover distribution and the transferee's IRA treated as an inherited account.

Roth IRAs

Although contributions to a Roth IRA are never deductible, interest, dividends and appreciation accrue in a Roth IRA tax-free, making them very popular. The rules for Roth IRAs are similar to the rules for traditional IRAs but with some important differences.

Contribution limits. For 2014, the maximum contribution you can make to a Roth IRA is $5,500 (and if you are age 50 or older by the end of the year, you can make catch-up contributions up to $1,000 in 2014, as well). Contributions can be made even if you participate in an employer-sponsored qualified plan. However, your maximum contribution is reduced by any amount you contribute to a traditional IRA.

Unlike traditional IRAs, you may make contributions to a Roth IRA even after you reach 70½. Furthermore, you are not required to take minimum distributions from Roth IRA funds during your lifetime, as with traditional IRAs.

Income phaseouts. For 2014, as in past years, the amount you can contribute to a Roth IRA phases out as your adjusted gross income (AGI) rises. For 2014, the AGI phase-out range for Roth IRA contributions is $181,000 for joint filers, and $114,000 for all other taxpayers (other than married taxpayers filing separate returns).

Five-year holding period. In order to receive the tax-free advantages that a Roth IRA has to offer, you generally must keep your money in the account for five years. Moreover, Roth IRAs are subject to premature withdrawal penalties, like traditional IRAs. If you withdraw or use Roth IRA assets before you reach age 59½, the amount you withdraw is taxed as ordinary income and subject to an additional 10 percent penalty tax, unless the withdrawal is made for a qualified purpose.

Savings in a Roth IRA can be accessed tax- and penalty-free:

- After you reach age 59½;
- If made to a beneficiary on or after your death;
- Because of disability;
- To pay for certain higher education expenses, or
- To pay for first-time home buying expenses.

Converting a traditional IRA to a Roth IRA

Converting from a traditional IRA to a Roth account has many advantages. One of the key factors to consider when deciding whether to convert involves determining whether you anticipate being in a higher or lower tax bracket after retirement. The tax deferral rules applicable to traditional IRAs work well for individuals who will fall into a lower tax bracket during retirement. However, higher income taxpayers often end up in the same, or a higher bracket.

Moreover, converting to a Roth gives you the ability to continue making contributions after reaching age 70½, or becoming an active participant in an employer-sponsored qualified plan. Moreover, Roth IRA owners are not subject to the required minimum distribution rules.

■ ***Planning Tip.*** Taxpayers should also, consider the effect of conversion on their heirs. Heirs of an inherited IRA are taxed just as the owner was. Thus, if you have a traditional IRA that outlasts you, your beneficiaries will have to pay tax on account distributions just as you did. On the other hand, since Roth IRA distributions are not taxable to you as the owner, they are also not taxable to your heirs.

Generally, amounts converted are included in gross income in the tax year in which the amount is distributed.

Roth 401(k) plans

A Roth 401(k) (or a Roth 403(b)) plan allows employees to designate some, or all, of their elective contributions as designated Roth contributions (which are included in gross income), rather than traditional, pre-tax elective contributions to a traditional 401(k).

IRA recharacterizations

An individual who has made a contribution to a Roth IRA or a traditional IRA may later determine that he or she should have contributed the money to the other type of account. For example, maybe you contributed to your Roth IRA but later realized it would have been more advantageous to have contributed that amount to your traditional IRA.

■ ***Planning Tip.*** Individuals can contribute to both a designated Roth account and a traditional, pre-tax account in the same year in any proportion you choose.

Recharacterizing an IRA contribution involves transferring amounts previously contributed to a traditional

or Roth IRA (plus any resulting net income, or minus any resulting net loss) to another IRA of the opposite type and electing to have the amounts treated as having been transferred to the second IRA at the time they actually were contributed to the first IRA.

■ ***Planning Tip.*** Recharacterizing contributions may make significant financial sense, especially for those whose level of income has changed or who have modified their investment strategies and goals.

Timing. The election to recharacterize or the transfer of assets from one IRA to the other must both take place on or before the due date (including extensions) of your federal income tax return for the year in which the contribution was made for the first IRA.

An election to recharacterize is generally irrevocable, and once made cannot be undone. However, the amount may be converted at a later date in certain situations (this is referred to as a reconversion).

DECIDING WHEN TO RETIRE

The decision of when to retire encompasses many factors. One of the factors to consider is how your monthly Social Security income will be affected at the age at which you retire. Another factor to consider is whether you want to continue working in your current job, business, or occupation. As you approach your ideal retirement age, you must review your major sources of income to see if the actual income you will be receiving will meet your retirement needs, goals, and objectives.

Social Security benefits

Hopefully, you already requested and received a projection from the Social Security Administration of what your benefits will be. Some general rules to consider are that if you are under age 62 and not disabled, you cannot collect Social Security benefits. If you elect to commence receiving benefits at age 62, then you will receive substantially reduced benefits. If you can hold off until after normal retirement age, benefits are substantially increased depending on age (up to age 70).

Wild cards

Situations arise that can result in a "wild card" being thrown into your planning. For example, you inherit a substantial amount of money, your employer offers you a sweetened early retirement package, or your stock market portfolio suddenly drops dramatically. Health care costs also remain problematic, not only in terms of the health condition of the retiree but also in assessing what portion Medicare and future health care reform mandates will or will not cover. To determine how to handle these

circumstances, the most telling analysis will be when you "do the math."

Inflation. Inflation itself is perhaps the greatest wildcard in retirement planning.

Fortunately, your retirement savings keep earning interest, dividends, and capital appreciation that will hopefully be at least a few points above inflation each year. If inflation is less, your earnings will be less, but presumably so will your expenses after retirement.

To protect the full amount of your retirement earnings each year – and therefore the amount you are left with after retirement – it is very important to use the tax law to your advantage.

If earnings are taxed instead of tax-deferred each year, the magic of compounding does not work nearly as well over the course of 10, 20 or 30 years. The principal benefit to be gained from saving for retirement in a qualified retirement savings vehicle, whether it is a qualified defined benefit or contribution plan, a 401(k), an IRA, or a combination of these, is tax-deferral of contributions and earnings (or tax-exemption of earnings in the case of a Roth IRA).

Another benefit is that you will simply be more likely to save for retirement in a special account that is separately set aside for your retirement.

Cost of living. While your retirement savings are growing, remember that the cost of living after you retire is also growing. Think back to what a typical one-bedroom apartment rented for 30 years ago – maybe around $200? The same apartment now rents for $2,000. Sure, you may forecast that you will have a million dollars when you retire 10 years from now, but how will inflation have lowered its true value?

Retirees must also keep in mind that inflation does not stop on the day of retirement. If they should live for 20 or 30 years more, prices are likely to triple, at least, during that time. Only by carefully timing the withdrawal of retirement savings and skillfully using inflation, investment acumen and tax deferral, can you come out ahead.

POST-RETIREMENT DECISIONS

Retirees often have a wide variety of options on how to receive benefits from their retirement plans: periodic

payments, annuities, lump-sum distributions, or combinations of these. Each has its own tax consequences.

Taxation of retirement plan distributions

Distributions from employer-sponsored retirement plans and from traditional IRAs are taxed as ordinary income when received, and are thus subject to income tax at whatever tax bracket your total taxable income falls.

> ***Comment.*** There is an exception to this rule for amounts distributed from Roth IRAs. These amounts were taxed before they were invested in the Roth IRA and therefore are not subject to tax when distributed.

Since most of these distributions are taxed immediately (except in the case of Roth IRAs), you may be financially better off leaving the funds in the plans until you need them to meet immediate living expenses.

However, certain rules require you to begin taking minimum distributions from employer-sponsored plans and traditional IRAs once you attain age 70½.

Required minimum distribution rules

By April 1 of the year following the date you turn 70½, you are required to begin taking minimum distributions from any tax-deferred retirement savings account.

These include plans sponsored by your employer, such as 401(k) and 403(b) plans, qualified plans, government plans, and traditional IRAs. The IRS imposes a 50 percent excise tax to the extent a RMD in the proper amount is not made.

> ***Comment.*** Since there is no tax collected when Roth IRA distributions are made, the government does not require minimum distributions from these accounts.

Calculating RMDs. RMDs are calculated based on the account's balance as of the last business day (December 31) of the year prior to the year for which the RMD must be made.

Lump sum distribution

You may be able to take a lump sum distribution from your retirement savings account in lieu of distributions. Distributions up to the full value of your account are allowed at any time, without penalty. For example, you may withdraw your entire IRA balance in a single year, if you desire.

However, the usual recognition of ordinary income on the taxable amount withdrawn remains. The entire value of the amount withdrawn will be included in your taxable income as ordinary income in the year of withdrawal. For many, the recognition of ordinary

income on the lump sum (likely to be a large payment) distribution creates a financial disincentive to go this route; a larger distribution means more taxable income, and a larger tax bill.

Your tax advisor can help you determine the minimum amount that you must start withdrawing annually from these plans. A calculation must be made to determine this amount, which is based on life-expectancy tables provided by the IRS.

Deferred Annuity

A recent development for retirement plan payouts involve the modification of RMD rules to facilitate the purchase of longevity annuities. Under this proposal, deferred contribution plan participants can use a portion of their retirement account balances to purchase an annuity (if their employer offers one) that would provide a specified income payout when they reach an advanced age, for example age 80 or 85. They would not be subject to the RMD rules.

Withholding on distributions

If you receive a lump-sum distribution from an employer-sponsored retirement plan, you generally will be subject to a 20 percent withholding tax. The withholding tax can be avoided only if the distribution is transferred directly to another retirement plan or IRA. This 20

percent withholding applies even if you meet the 60-day requirement for traditional rollovers. This means that you will have to come up with funds from another source if you want to roll over the full amount of the distribution. However, you will recover the 20 percent that was withheld when you file your return for the year of the distribution, either as a refund or as a payment toward your total income tax liability.

For any distribution that does not qualify as a lump-sum distribution, having taxes withheld is optional. You decide at the time of the distribution. So as not to get a big surprise at tax time, it may be advisable to opt to have taxes withheld from all retirement plan distributions, with the exception of Roth IRA distributions.

Estimated tax liability

In order to avoid any penalty for underpayment of estimated tax, you must consider the impact of any large one-time payment on your tax liability in

the year of retirement. One-time payments can include severance payments or retirement benefits paid in a lump sum and not rolled over into an IRA.

To determine whether any estimated tax penalties apply, withholding is treated as having been made in the amount of 25 percent of your estimated tax liability in each of the quarterly tax periods even if actually withheld later in the year. Also, you can rely on a safe harbor provision and pay 100 percent of your prior year's tax liability to avoid any penalty…unless you fall into the "high-income" category of taxpayer.

Higher-income taxpayers. If you are a higher-income taxpayer, an individual with an adjusted gross income in excess of $150,000 ($75,000 for a married individual filing separately)), you can avoid the penalty by paying 110 percent of the amount of tax shown on the prior year's return if the prior year was a full calendar year.

LIQUIDATING ASSETS

After you retire, you may have certain assets that are not necessarily producing any income for you. As such, you may want to consider whether converting nonproductive assets to productive investments could provide sufficient cash flow to meet your income needs. Generally, the most valuable asset you have is your personal residence. There are several methods for producing income from this asset. You can sell your home and (1) rent or (2) purchase a less expensive home. Under current tax law, up to $250,000 in gain from a principal residence can escape tax entirely ($500,000 for joint filers).

Reverse mortgages. As an alternative to selling your home, you may want to consider remaining in your home and obtaining a reverse mortgage that will provide a monthly payment to you based on the amount of your equity. Care should be taken, however, in evaluating a reverse mortgage not only from the income stream it produces, but how much equity you have to give up in addition to points and other fees.

CONCLUSION

The key to successful retirement planning is starting early. It's easier to save five percent of your income when you're beginning to work than a higher percentage later in life. It's also important to diversify your savings to maximize your tax savings when you retire. There are a great variety of tax-friendly retirement savings vehicles. While this guide has reviewed some retirement planning strategies, your tax advisor can craft a plan incorporating these and other vehicles to best match your situation.