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# RETIREMENT STRATEGIES

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## RETIREMENT STRATEGIES

One of the most important financial issues that impacts your life is planning for your retirement. You need to implement strategies to ensure that you have enough money saved to live comfortably and feel secure during your retirement years.

**Comment.** Most individuals' retirement plans have been battered by the market over the last few years. Many 401(k)s and other retirement plans have lost half, if not more, of the value of their account balances. The market's volatility has left many faced with the challenge of rebuilding their portfolios and looking for ways to diversify their investments in order 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 continue to work part-time, which is a growing trend. You may not be able to count on that extra income if your health changes. Allocation of assets into growth, income-producing and secure investments becomes critical. So does planning



when, and in what amount, you must 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*

Today, it is hard to believe that Congress had originally intended for Social

Security to make up the largest part of a retiree's income. That was true 70 years ago, but as we know now, the same is not true today.

By some estimates, Social Security will start running a deficit by 2016, which means that the program will begin paying out more money in benefits than it makes through taxes. Social Security is now projected to provide for only about 20 percent, if that, of the average individual's retirement income needs.

At the same time, the percentage of an average individual's retirement income that is derived from employer-funded retirement plans has declined. This is part of a growing trend, as more and more employers either freeze, modify or altogether eliminate pension plans. As a consequence of the troubled economy, employers are also eliminating their matching programs for 401(k)s.

If you are lucky enough to still have a traditional pension plan, relying too much on such plans to fund your retirement should be cautioned. The overall long-term health and stability of traditional pension plans is becoming increasingly questionable.

Just as you would want to diversify your investment portfolio to manage risk, so too should you want to diversify your retirement "portfolio." For example, the fact that Social Security and private

pension plans will likely make up much less of your total retirement dollars means that you need to rely more on your savings and investments. It has become strategically more advantageous from a tax perspective to have a large portion of your savings and investments in tax-friendly retirement vehicles.

### **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 receive Social Security retirement benefits as early as age 62, but if you retire before your full retirement age, your benefits will be permanently reduced, based on your age.

DATE OF BIRTH*	FULL BENEFIT AT AGE
1/1/38 or earlier	65
1938	65 + 2 months
1939	65 + 4 months
1940	65 + 6 months
1941	65 + 8 months
1942	65 + 10 months
1943—1/1/55	66
1955	66 + 2 months
1956	66 + 4 months
1957	66 + 6 months
1958	66 + 8 months
1959	66 + 10 months
1960 and later	67**

\* Month and date are January 2 unless otherwise shown.

\*\* Experts fully expect the retirement age to continue to rise in future years.

**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](http://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. 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, 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 exceed the lesser of:

- (1) \$195,000 for 2010; 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, you may be able to receive your benefits in a lump sum rather than monthly payments.

**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 2010, contributions to a defined contribution plan cannot exceed the lesser of:

- (1) \$49,000; or
- (2) 100% of the participant's compensation.

**Money purchase plans.** A participant's 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.

***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. "Keogh" plans are a special type of retirement plan for self-employed people. These types of plans generally provide for the same tax benefits as other qualified plans.

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 Keogh 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 2010, you can generally

contribute up to \$16,500 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 2010).

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.

## 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 2010, the annual contribution limit for a traditional IRA (as well as a Roth IRA) is \$5,000. You can contribute up to the lesser of your compensation or the applicable dollar amount limit (\$5,000). 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 2010 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 2010 may be able to deduct IRA contributions up to the lesser of \$5,000 or 100 percent of their compensation (\$6,000 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 2010, phase-out begins at MAGI of \$56,000 for single individuals and \$89,000 for joint filers).

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

If your spouse is an active participant in an employer-sponsored plan for any part of a plan year, the MAGI limit is increased to \$167,000 for joint filers. This allows more people to take a full deduction for a contribution to an IRA, even if their spouse is covered under a retirement plan at work.

You can still make nondeductible contributions to your IRA even if your deduction is otherwise limited because you or your spouse are participating in your employer's retirement plan.

***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.*** RMDs were suspended for 2009 under the *Worker, Retiree, and Employer Recovery Act of 2008*. In 2010, however, RMDs must begin again as Congress did not extend this benefit after 2009.

***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.*** Congress has yet to pass a package of extenders – popular, temporary tax incentives, including tax-free distributions from IRAs for charitable purposes. This incentive, like many others, expired at the end of 2009. A bill pending in Congress would retroactively extend these incentives through 2010.

### **Roth IRAs**

Although contributions to a Roth IRA are never deductible, interest, dividends and appreciation accrue in a Roth IRA tax-free, making them incredibly popular.

***Contribution limits.*** For 2010, the maximum contribution you can make to a Roth IRA is \$5,000 (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 2010, as well).

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 2010, the amount you can contribute to a Roth IRA phases out as your adjusted gross income (AGI) rises. For 2010, the AGI phase-out range for Roth IRA contributions is \$167,000 for joint filers, and \$105,000 for all other taxpayers (other than married taxpayers filing separate returns).

***No income limit on conversions in 2010.*** Effective January 1, 2010, rollovers from a traditional IRA to a Roth IRA (also known as a conversion) will no longer be subject to income and filing status limitations. Any individual, no matter what their AGI, will be able to convert a traditional IRA to a Roth IRA. More information on how to prepare for this change if you have a traditional IRA you'd like to convert to a Roth IRA in 2010, later.

***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.

### **Rollovers from traditional IRAs to Roth IRAs**

You may roll over funds from a traditional IRA into a Roth IRA. The reason for making a rollover is to convert money from a tax-deferred account into an account that is potentially tax-free. However, the rollover is taxable. The total taxable amount is included in your income in the year the rollover takes place. Penalties will not be applied if the requirements are met.

**Factors involved in making this decision.** Deciding whether to convert a traditional IRA into a Roth IRA should

only be made after a careful evaluation of all the various tax and investment factors. Among these factors are:

- (1) The total income tax you will pay because of the conversion;
- (2) The costs you will incur because of the conversion (transaction fees and sales charges);
- (3) Your anticipated tax bracket when you would receive distributions from the traditional IRA;
- (4) The anticipated return from the Roth and traditional IRA;
- (5) Your age at the time of conversion; and
- (6) The length of time it will take you to recoup the tax and other expenses caused by the conversion.

### **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).

You can contribute to both a designated Roth account and a traditional, pre-tax account in the same year in any proportion you choose.

**Contribution limits.** However, there are limits on the combined amount you can contribute in any one year to all designated Roth IRAs and traditional,

pre-tax accounts. For 2010, the limit is \$16,500, plus an additional \$5,500 in catch-up contributions if the employee is age 50 or older at the end of the year.

Individuals can also make the maximum contributions, including catch-up contributions, to both a designated Roth 401(k) (or 403(b) account) and a Roth IRA in the same year. An individual age 50 or older can make a contribution of up to \$22,000 in 2010 to the 401(k) or 403(b) plan (\$16,500 in regular contributions plus \$5,500 in catch-up contributions) and \$6,000 to a Roth IRA (\$5,000 in regular contributions and \$1,000 in catch-up contributions) for a total of \$28,000 for 2010.

### **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.

Or, perhaps you contributed to a traditional IRA, and experienced such a significant increase in income that the contribution to the account is nondeductible, thereby making a contribution to a Roth IRA more advantageous since in both cases the contribution is

nondeductible. However, with the Roth, your earnings will grow tax-free and you will not pay income taxes on any qualified distributions during retirement.

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. In effect, recharacterization allows you to solve the problem of, “If I only knew then what I know now...”.

**Why switch?** 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. For example, perhaps you contributed to a Roth IRA (or converted from a traditional IRA to a Roth IRA and paid a hefty tax bill for the conversion) only to thereafter suffer significant losses amid the current market turmoil.

**Timing.** The election to recharacterize and 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 for 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).

### **IRA conversions**

A traditional IRA may be converted into a Roth IRA. However, a Roth IRA cannot be converted into a traditional IRA. For tax years beginning after 2009, you can convert a traditional IRA into a Roth IRA without regard to your adjusted gross income (AGI), and without regard to your filing status.

**Comment.** Roth IRAs become open to taxpayers of all income tax brackets in 2010. In 2009, the ability to contribute to a Roth IRA was limited by your AGI and filing status. You could not contribute to a Roth IRA if your AGI exceeded \$100,000, and/or your filing status was married filing separately. This all changes in 2010, however.

If you convert your IRA in 2010, you will recognize the conversion amount ratably in AGI in 2011 and 2012, unless you elect to recognize it all in 2010.

**Example.** David has a traditional IRA with a value of \$10,000, consisting of deductible contributions and earnings. He does not have a Roth IRA. In 2010, he converts his traditional IRA into a Roth and, as a result of the conversion, has \$10,000 in gross income. Unless he elects otherwise, \$5,000 of the amount is included in his income in 2011, and \$5,000 is included in come in 2012.

**Why convert?** 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, high-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 the required minimum distribution rules.

Also, consider the effect of conversion on your 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.

**Reconversions.** A reconversion is a conversion from a traditional IRA to a Roth IRA of an amount that was previously recharacterized as a contribution to traditional IRA after having been earlier converted to a Roth IRA. To benefit from this tax strategy, certain

requirements must be met, including timing of the reconversion.

A reconversion may be beneficial, for example, if you converted a traditional IRA into a Roth IRA in a year when market values were higher, therefore paying higher taxes on the conversion. You may want to consider reconverting the Roth IRA back to traditional IRA, and then back into a Roth IRA in a later year, in order to take advantage of lower market values.

**“At risk” requirement.** Taxpayers who recharacterize must be “at risk” in the market for a minimum of 30 days. This means that, in general, an individual who converts amounts from a traditional to a Roth IRA, and then wants to transfer the amount back to the traditional IRA by means of a recharacterization, cannot reconvert the amount from the traditional IRA to the Roth IRA before the end of a 30-day period. The period generally begins on the day on which the IRA owner transfers the amount from the Roth IRA back to the traditional IRA.

## 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 reduced benefits.

### *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. 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.

**Comment.** RMDs were suspended for 2009 only, in addition to the waiver of the 50 percent excise tax. However, Congress did not extend this benefit into 2010. Individuals must resume taking their RMDs in 2010. As well, the 50 percent excise tax on underpayments becomes effective again for 2010 as well. Congress has not extended this benefit

**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.

### ***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.

***High-income taxpayers.*** If you are a high-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.

**Nonqualified use.** Gain from the sale of a principal residence will no longer be excluded from gross income under Code Sec. 121 for periods that the home was not used as a principal residence (i.e. "nonqualified use"). This new income inclusion rule, courtesy of the *2008 Housing Assistance Tax Act*, prevents use of Code Sec. 121's exclusion of gain from the sale of a principal residence of up to \$250,000 (\$500,000 for joint filers) for appreciation attributable to periods after 2008 during which the residence was used as a vacation home

or as a rental property before its use as a principal residence.

The new rule applies to home sales after December 31, 2008 and, under a transition rule, is based on nonqualified use periods that begin on or after January 1, 2009.

**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. 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.