CEO FINANCE

The Tax Man Cometh

Although we began this series with a focus on the Net Investment Income Tax (NIIT) which began in 2013 as a consequence of the Affordable Care Act (ACA), the strategies we have written about will seek a positive impact in reducing income tax burdens in addition to the NIIT. In our first article, we focused on moves that could be made in 2015 that could still reduce taxes in 2014. If you were employed and were allowed a deductible IRA or SEP-IRA, or, for some business owners who had adopted a 401(k), profit sharing plan and/ or defined benefit plan prior to the end of 2014, the information we provided may have been especially meaningful. Subsequently, we discussed the benefits and tax-advantages of saving for college through a state-sponsored 529 Plan, these savings could be for anyone, family member, friend, etc. This was especially timely, since these plans were under review relative to revoking a number of the tax-advantages they produce as a means of the federal government's initiative to raise tax revenues. For now, there are no changes in the tax treatment of these plans, hopefully, increasing their attraction and assets.

Today, I want to switch to another topic and focus on those that are closing in on their required mandatory distribution (RMD) of their retirement savings. Although we spoke of retirement savings in our first article, our perspective was relative to those still in the work force and on the contribution and savings end of the spectrum. Today, we will be speaking to those nearing the magic age of 70 ½ or as this feature suggests the critical age of 69 ½. Although there may be opportunity to continue deferral of distributions for those still employed and covered by a 401(k), 403(b), 457(b) or government Thrift Savings Plan beyond the age of 70 ½; for the majority of retirees, their retirement savings are in an IRA and, therefore, governed by the mandatory distribution rules. Or, at least, that was the popular consensus, which I will address and somewhat dispel thanks to both recent legislation and strategies that can be completed prior to age 70½.

Let's begin by saying that the year in which you turn 69 ½, is actually more critical for instituting a number of strategies to defer or eliminate the required mandatory distribution, as follows:

1) If you are still working, this is the final year that a traditional IRA contribution may be made to reduce your ordinary incomes taxes for that contribution year.
2) Assuming you are still working and have a qualified retirement plan at work, such as a 401(k) or 403(b), you may roll your traditional IRA into that plan which may allow for continued deferrals of required mandatory distributions while still working provided that you don't own more than 5% of the business that sponsors the plan. * (*The plan must accept IRA rollovers, most but not all do. The plan must also permit the later commencement of RMD's until the retirement of the participant even if beyond age 70 ½.)
3) Another method, which creates tax burden before it relieves it, is the conversion of traditional IRA assets to a Roth IRA. Roth IRA's have no minimum distribution requirements. However, the conversion will be taxed as ordinary income in the year of distribution. The major impetus for converting to a Roth IRA is based on one or both of these assumptions: 1) longevity: conversion makes little sense if the owner does not live long enough to mitigate the initial tax bite. 2) the possibility of tax rates rising in subsequent distribution years means that accelerating the tax liability through a Roth conversion may make sense in the long run.
4) On July 1, 2014 the Treasury Department released final regulations for Qualifying Longevity Annuity Contracts (QLACs). Although the rules are somewhat complex, what makes this option compelling is that the value of a QLAC is excluded from your RMD calculation and distributions from a QLAC don't have to begin until you reach age 85! Regulations do limit the amount of money you can invest in a QLAC in two ways; 1) a percentage limit; and 2) an overall limit. Relative to these, you may not invest more than 25 percent of retirement account funds with a limit of $125,000 on total QLAC purchases. The limit needs no further explanation but the 25 percent is calculated in different ways for non-Roth IRA's (including SEP and SIMPLE IRA's) then it is for 401(k)'s and similar plans. For the specifics on these rules, I suggest you consult your tax advisor or look for Internal Revenue Bulletin: 2014-30 dated July 21, 2014 on the IRS.gov site. Also bear in mind that although QLAC regulations are in effect already, insurance carriers are just now beginning to launch products that will comply with the rules but these products are very scarce as of this writing. There are possible residual benefits to "carving out" a portion of your 401(k) plan or IRA and investing it in a QLAC as follows:
   a) The length of retirement assets may be extended: by reducing the RMD required on your entire retirement account by having the ability to place up to $125,000 into a QLAC which can earn and compound interest until a mandatory beginning distribution age of 85, the value of these assets have a much greater opportunity to increase.
   b) The length of nonretirement assets may be extended: if the amount of RMD's are reduced there may be a "ripple" effect in the reduction of adjusted gross income. This reduction may benefit allowable deductions, personal exemptions and reductions or elimination of the NIIT. It is also possible that reduced RMD's may result in reduced taxation of Social Security benefits. This overall reduction in taxes may extend the life of your nonretirement assets.
   c) Sustainable lifetime income: by shifting some assets to a QLAC which is a fixed income product, not subject to market risk and may be contractually guaranteed to pay for life, this portion of your retirement offers guaranteed predictability.
   d) Providing a death benefit: a QLAC is permitted to have a return of premium feature, or death benefit. The legislation allows insurance companies to provide for a lump sum death benefit. The "trick" would be in making sure that the insurance carrier you choose offers this benefit and that you elect the appropriate income choice for this feature.

Thank you for your continued interest and although taxes are a boring subject they are nonetheless a critical part of our lives so I am hopeful that this series will offer some value to you. See you in the next edition!

(***We are not in the business of giving tax advice. The information set forth herein was obtained from sources which we believe reliable but we do not guarantee its accuracy. Please check with your tax advisor regarding your particular situation.***)

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