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Retirement Plan Contributions and Withdrawals

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WHAT APPEARS OBVIOUS MAY NOT BE THE BEST WAY TO GO.

RETIREMENT PLAN

CONTRIBUTIONS AND WITHDRAWALS

IN BRIEF Work the Numbers

Qualified retirement plans provide for tax deferral but they are also subject to a 15% excise tax on excess distributions or accumulations, potentially higher marginal income tax rates on plan withdrawals, mandatory contributions for employers, estate taxes at death, and possible substantial income tax liability for plan beneficiaries.

The 15% excise tax applies to distributions from a qualified retirement plan in excess of the greater of $112,500 indexed for inflation, (1997 amount is $160,000), or $150,000. The 15% excise tax on accumulations is based on the excess of the value of the accumulated plan assets in all qualified employer plans and IRAs over the present value of a single life annuity with annual payments equal to the base amount, (1997 amount is $160,000). Under the Small Business Job Pro section Act, excise tax on excess plan distributions has been suspended for a three-year period.

Three possible planning strategies to optimize return on funds available for contributions to a qualified plan include investment in alternative assets, lifetime gifts, and accelerated plan withdrawals. While the three-year suspension of the excess tax may favor plan withdrawals, in certain situations participants are often best served by leaving the full amount in the plan to take advantage of the tax deferrals.

Investments in qualified retirement plans are generally an excellent means to accumulate retirement funds on a tax-deferred basis. Plan contributions are tax deductible (with in limits) by contributors and tax deferred to participants, thus allowing for accelerated build-up of retirement benefits. However, qualified retirement plans possess certain disadvantages, including--

a 15% excise tax on excess distributions or accumulations under IRC section 4980A,

potentially higher marginal income tax rates on plan withdrawals, and

mandatory contribution requirements for employers.

In addition, qualified plan assets are subject to estate taxes at death. Moreover, since they are items of income in respect of a decedent, no basis step-up is permitted. Consequently, substantial income tax liability may be incurred by plan beneficiaries.

The Problems

To illustrate the impact of excise, income, and estate taxes at the death of a qualified plan owner, consider the case of an individual age 65, who is single and the owner of a current qualified retirement plan. The plan has a balance of $3 million to which he contributes $30,000 annually and earns a return of seven percent before-tax. Assume he contributes $30,000 at the beginning of the plan year and dies at the end of such year. If marginal income and estate tax rates are 31% and 55%, respectively, the taxes paid relative to the last $30,000 contribution plus the $2,100 it would have earned in the last year would be as follows:

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Excise tax (15% of $32,100)    $4,815
Estate tax (55% of $27,285)      15,007
Income tax (to beneficiaries)
(31% of $17,093)                  5,299
Total taxes paid                $25,121
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Therefore, the plan beneficiaries would realize only $6,979 (23%) from the last plan contribution. Clearly this is an unfortunate result, caused by the failure to consider all future tax consequences. Using proper tax planning techniques, excise and estate taxes can be reduced, resulting in significant overall tax savings.

The Excise Tax

IRC section 4980A was added by TRA 86 to limit tax-deferred build-up of retirement plans in excess of an amount deemed required to adequately provide for retirement. By enacting this section, Congress sought to limit the ability of taxpayers to accumulate "excess" retirement benefits through multiple retirement plans, e.g., maintenance of plans through more than one company or use of IRAs in combination with other qualified plans. The IRC section 4980A excise tax is generally effective for distributions and accumulations occurring after 1986.

Tax on Distributions. The 15% excise tax under IRC section 4980A applies to lifetime distributions from a qualified retirement plan in excess of the greater of $112,500 indexed for inflation (the 1997 indexed amount is $160,000), or $150,000, defined as the base amount. If a lump-sum distribution is received from a retirement plan before 1999, the plan owner may use five-year forward averaging to calculate the tax, and the excess amount used is five times the normal base amount ($800,000 in 1997). As defined in IRC section 4980A, distributions do not include those made after an individual's death, distributions rolled over into a separate retirement plan, and distributions from an IRC section 72(f) annuity contract, among others. In addition, if the spouse of an individual is the sole beneficiary of the plan assets, he or she may elect to defer the application of IRC section 4980A.

Example. Assume a qualified plan owner makes a current withdrawal of $450,000. The potential excise tax imposed thereon would be as follows:

```
Annual withdrawal     $ 450,000
Less: base amount      (160,000)
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Excess withdrawal	290,000
Excise tax rate	15%
Excise tax	$ 43,500

Tax on Excess Plan Accumulations. The section 4980A excise tax also applies to excess plan accumulations at death. This excess amount is defined as the date of death value of the accumulated plan assets in all qualified employer plans and IRAs in excess of the present value of a single life annuity with annual payments equal to the base amount. This present value is calculated using 120% of the Federal midterm rate applicable for the month of valuation and mortality estimates, based on age of the taxpayer at death.

The level of plan accumulations at which the excise tax will apply is illustrated below. These amounts are based on current mortality estimates used by the IRS, a discount rate of eight percent, and an annual base amount of $160,000.

At the date of death, qualified plan balances in excess of the "floor" amounts indicated would be subject to excise tax on excess accumulations. For example, an individual age 50 at death with a qualified plan balance in excess of $1,646,064 would be subject to the excise tax. Note that the floor amount declines as age at death increases.

Qualified Plan Benefits Subject to Excise Tax

Age at Death	Floor Amount
50	$1,646,064
55	1,547,984
60	1,432,416
65	1,301,760
70	1,115,040

Example. To illustrate determination of the excise tax on excess accumulations, assume an unmarried individual, age 55, dies with accumulated plan assets of $3 million. Using a Federal midterm rate of eight percent, the appropriate annuity factor for an individual age 55 is 9.6749. This individual would be subject to the excise tax since accumulated plan assets at the date of death exceed $1,547,984 ($160,000 x 9.6749). The excise tax on the excess accumulations would be as follows:

Accumulated plan assets $3,000,000 Less: base amount (9.6749 x $160,000) (1,547,984) Excess retirement accumulation 1,452,016 Excise tax rate 15% Excise tax $ 217,802

The excise tax is deductible in the plan owner's Federal estate tax computation, and thus the effective tax rate on the retirement assets is lower than the statutory rate of 15%. Assuming a marginal estate tax rate of 55%, the after-tax cost of the excise tax in this example would be $98,011.

In this example, the estate tax payment on the plan assets would be ($3,000,000 - $217,802) x 55% = $1,530,209. Since this estate tax is an itemized deduction on the beneficiary's income tax return [IRC section 691 (c)(l)(A)], the income tax paid on the $3 million of income in respect of a decedent would be ($3,000,000 $1,530,209) x 31% = $455,635, which represents an effective income tax rate of 15.2%.

The 1996 Small Business Tax Act

Under the provisions of the recently enacted Small Business Job Protection Act, the excise tax on excess plan distributions has been temporarily suspended. It will not apply to distributions made in 1997, 1998, or 1999. The excise tax will be restored when the repeal of the overall limit on annual contributions made for the benefit of an employee who participates in both a defined contribution and defined benefit qualified plan sponsored by

the same employer becomes effective. The suspension of the excise tax provides some taxpayers with a possible window of opportunity within which to realize tax savings by receiving excess plan distributions.

Planning Strategies
The primary planning objective is to maximize after-tax return to the family unit from funds available for contribution to a qualified plan, within the constraint of acceptable investment risk to the plan owner. Although qualified plan earnings accumulate on a tax-deferred basis, the disadvantages of the excise tax, estate tax, and mandatory contribution requirements for the owner's employees require a careful analysis of future tax exposure before each plan contribution is made.

Three possible planning strategies that may be used to optimize return on funds available for contribution to a qualified retirement plan are discussed.

Investment in Alternative Assets. As an alternative to qualified plan contributions, superior returns may be gained through investment in other assets, such as individual stocks, mutual funds, or tax-free municipal bonds. The advantage is reduced exposure to the excise tax, since investments are made outside the plan. However, earnings from such investments are not tax deferred, which may result in lower total after-tax returns. In the case of tax-exempt bonds, earnings would be tax free, but the rate of return would be lower than taxable investments. However, in certain cases, particularly for older investors approaching retirement, alternative investments, both taxable and tax exempt, may produce a higher after-tax return, due to the high present value of the excise tax.

Lifetime Gifts. A program of lifetime gift giving in lieu of contributions to a qualified plan is another alternative. This method not only reduces future exposure to the excise tax but also removes assets from the gross estate of the plan owner. Additional advantages include the opportunity to test donees' management abilities and level of maturity and the intrinsic reward gained from observing the donees' current enjoyment of the property.

Donors can reduce the dollar amount of their estate, and avoid the gift tax, by making gifts that qualify for the gift tax annual exclusion of $10,000 per donee per year. For married donors, if a gift-splitting election is made, one-half of each gift is attributed to the donor's spouse. This permits a married donor to make gifts of up to $20,000 per year per donee with out incurring gift tax consequences. The annual exclusion cannot be claimed retroactively. As each year passes, any unused exclusion is lost forever.

To qualify for the exclusion, the gift must be one of a "present interest;" the donee must have the immediate and unrestricted right to use and enjoy the gift property itself or the income from the property. Gifts made in trust for the benefit of minors and those made to a trust that employs a "Crummey" power type provision will also qualify as present interests if certain requirements are met.

Accelerated Plan Withdrawals. Under IRC section 4980A, plan owners are permitted to withdraw a base amount each year without penalty, assuming the individual is at least age 59 1/2. In 1997, the base amount is $160,000. As mentioned earlier, the excise tax has been suspended for the years 1997, 1998, and 1999. Therefore, one possible method of reducing the impact of the excise tax is to cease contributions and initiate immediate withdrawals. Although accelerated withdrawals would also accelerate the payment of income taxes, this would be a prudent strategy if excise tax savings exceed the value of the income tax deferral. In this regard, if a single lump-sum distribution is made, income tax savings may result from electing five-year income averaging. Alternatively, individuals who turned age 50 prior to January 1, 1986, have the option of electing 10-year averaging to reduce their tax liability. In addition, estate tax savings would result if withdrawals are removed from the gross estate through gifts or consumption by the plan owner. The actual payment of income taxes on plan withdrawals would also reduce the estate tax liability.

Should Plan Withdrawals Be Accelerated?
Some taxpayers may feel the three-year suspension of excess distribution excise taxes is a windfall and should be utilized. However, taxpayers should use caution before taking lump-sum distributions of their balances. The following examples provide a comparison of the results at ages 55, 60, and 65. The after tax results are shown in Tables 1, 2, and 3, respectively.

Age 55. Example 1: John Smith has a pension account balance of $1.5 million when he separates from the service of his employer in a corporate downsizing in 1997. John is age 55 He decides to take a lump sum distribution of his account balance. Assume that John's pre-tax rate of return is eight percent on investments, his after-tax rate of return is 5.1 12%, his marginal tax rate for the distributions is 43%, and his marginal tax rate for capital gains is 32%. John does not qualify for five-year averaging since he is not yet age 59 1/2.

Example 2: Same facts as in Example 1 except that John decides to leave the $1.5 million balance in the account and begins receiving minimum distributions in the year following the year in which he reaches age 70 1/2.

Example 3. Same facts as in Example 1 except John takes a partial withdrawal or distribution of $1 million to avoid the IRC section 4980A excess distribution excise tax. He leaves the remaining balance in the plan and begins receiving minimum distributions in the year foe lowing the year in which he reaches age 70 1/2. John invests the $1 million withdrawn in 1997 to earn an eight percent rate of return.

When considering the three examples in terms of the optimal action/inaction for John, the most economic tax position is for John to leave the amount invested in the plan (Example 2), followed by taking a partial distribution to avoid the excise tax (Example 3), and taking a lump-sum distribution (Example 1). In 2012 (the year John reaches age 70 1/2), the after-tax amount $2,472,370 associated with leaving the funds in the plan is $242,151 in excess of $2,230,219 achieved by taking a partial distribution to avoid the excise tax (See Table 1). Furthermore, leaving the amount in the plan is $669,877 more than taking a lump sum distribution. Thus, income tax deferral far exceeds the potential tax savings in avoiding the excess distribution excise tax by taking a lump-sum distribution.

To allow the taxpayer in Example 1 to qualify for five-year averaging and to see if his optimal strategy has changed, the facts should be changed to reflect ages 60 or 65 for 1997.

Age 60. Example 4: Bill Perkins retires in 1997 when his retirement plan balance is $1.5 million. He decides to have the balance distributed in a lump sum in 1997 when he is age 60. Bill qualifies for the five-year averaging method. Assume Bill's pre-tax rate of return is eight percent while his after-tax rate for the distributions is 43% (Federal and state tax), and his tax rate for capital gains is 32%.

Example 5: Same facts as in Example 4 except that Bill decides to leave the $1.5 million balance in the account and begins receiving minimum distributions in the year following the year in which he reaches age 70 1/2.

Example 6. Same facts as in Example 4 except Bill takes a partial withdrawal or distribution of $1 million to avoid the IRC section 4980A excess distribution excise tax. He leaves the remaining balance in the plan and begins receiving distributions in the year following the year in which he reaches age 70 1/2. John invests the $1 million withdrawn in 1997 to earn an eight percent rate of return.

The results in Table 2 show that a lump sum distribution in 1997 combined with five-year averaging (Example 4) is the worst alternative for 2007 when John reaches age 70 1/2. Table 2 shows that leaving the funds in the plan (Example 5) produces the largest after-tax amounts ($1,723,403) in 2007 by a small margin. However,

note that Example 4 (the lump sum distribution) produces the largest amounts through the first nine years of the calculations shown in Table 2. Example 6 (the partial distribution that avoids the excise tax) never produces the largest amount in any year but produces the second best alternative in all years except the eighth through the tenth (years 2004 through 2006).

Age 65. Example 7: Kevin McCloud retires at age 65 in 1997. He decides to take his $1.5 million IRC section 401(K) plan balance in a lump sum in 1997. Kevin qualifies for the five-year averaging method. Assume Kevin's pre-tax rate of return is eight percent while his after-tax rate of return is 5.12%. His marginal tax rate for the distributions is 43% (Federal and state tax) while his tax rate for capital gains is 32%.

Example 8: Same facts as in Example 7 except that Kevin decides to leave the $1.5 million balance in the account and begins receiving minimum distributions in the year following the year in which he reaches age 70 1/2.

Example 9: Same facts as in Example 7 except that Kevin takes a partial withdrawal or distribution of $1 million to avoid the IRC section 4980A excess distribution excise tax. He leaves the remaining balance in the plan and begins receiving minimum distributions in the year following the year in which he reaches age 70 1/2. Kevin invests the $1 million withdrawn in 1997 to earn an 8% rate of return.

Table 3 shows that Example 7 Jump sum distribution) produces the largest amount ($ 1,350,494) in 2002--the year in which Kevin reaches age 70 1/2. The partial distribution to avoid the excess tax of Example 9 produces the next best results. The worst alternative for year 2002 is to leave the balance in the plan and start taking minimum distributions in 2003. However, note that by 2006 the decision to leave the balance in the plan produces the best results and the advantage of this alternative (Example 8) at age 74 continues to increase in later years (2007 and thereafter).

Work the Numbers

While it appears the three-year suspension of the excise tax may provide a windfall for those subject to the excise tax, the above examples show the plan participants are often best served by leaving the full amount in the plan to take full advantage of the tax deferral. The only way to find out is to work the numbers.

TABLE 1 AFTER TAX RESULTS AGE 55

Year	Example 1	Example 2	Example 3
1997	923,400	912,597	923,400
1998	965,507	970,932	977,566
1999	1,009,534	1,040,353	1,035,167
2000	1,055,569	1,106,986	1,096,436
2001	1,103,703	1,178,357	1,161,625
2002	1,154,032	1,261,595	1,231,001
2003	1,206,656	1,343,586	1,304,853
2004	1,261,680	1,438,120	1,383,490
2005	1,319,213	1,538,978	1,467,245
2006	1,379,369	1,646,697	1,556,471
2007	1,442,268	1,755,727	1,651,552
2008	1,508,035	1,879,014	1,752,897
2009	1,576,801	2,011,001	1,860,947
2010	1,648,703	2,152,428	1,976,172
2011	1,723,884	2,309,676	2,099,082
2012	1,802,493	2,472,370	2,230,219

2013	1,884,687	2,692,192	2,370,171
2014	1,970,629	2,920,656	2,516,000
2015	2,060,490	3,158,174	2,669,501
2016	2,154,448	3,415,554	2,830,961
2017	2,252,691	3,683,728	3,000,665
2018	2,355,414	3,972,936	3,178,896
2019	2,462,821	4,278,788	3,365,930
2020	2,575,126	4,601,226	3,562,052
2021	2,692,552	4,945,180	3,767,527
2022	2,815,332	6,302,291	3,982,626
2023	2,943,711	6,677,401	4,207,616
2024	2,077,944	6,075,397	4,442,750
2025	2,218,298	6,493,070	4,688,305
2026	2,365,052	6,930,899	4,944,516

TABLE 2 AFTER TAX RESULTS AGE 60

Year	Example 4	Example 5	Example 6
1997	1,080,600	895,263	923,400
1998	1,129,875	952,530	979,919
1999	1,181,397	1,020,314	1,040,168
2000	1,235,269	1,085,876	1,104,410
2001	1,291,597	1,156,182	1,172,926
2002	1,350,494	1,237,708	1,246,018
2003	1,412,077	1,318,540	1,324,012
2004	1,476,468	1,411,199	1,407,256
2005	1,543,795	1,510,086	1,496,127
2006	1,614,192	1,615,759	1,591,026
2007	1,687,799	1,723,403	1,692,386
2008	1,764,763	1,881,413	1,800,673
2009	1,845,236	2,035,773	1,913,487
2010	1,929,379	2,199,693	2,032,278
2011	2,017,359	2,378,475	2,157,266
2012	2,109,351	2,562,809	2,288,672
2013	2,205,537	2,758,171	2,426,709
2014	2,306,109	2,969,222	2,571,591
2015	2,411,268	3,187,906	2,723,535
2016	2,521,222	3,423,097	2,882,740
2017	2,636,190	3,667,133	3,049,413
2018	2,756,400	3,928,561	3,223,752
2019	2,882,092	4,203,461	3,405,947
2020	3,013,515	4,492,865	3,596,205
2021	3,150,931	4,799,934	3,794,699
2022	3,294,613	5,118,374	4,001,621
2023	3,444,847	5,451,389	4,217,161
2024	3,601,932	5,803,074	4,441,541
2025	3,766,180	6,169,746	4,674,946
2026	3,937,918	6,551,432	4,917,604

TABLE 3 AFTER TAX RESULTS AGE 65

Year	Example 7	Example 8	Example 9
1997	1,080,600	875,664	923,400
1998	1,129,875	931,867	983,056
1999	1,181,397	997,880	1,046,836
2000	1,235,269	1,062,237	1,115,041
2001	1,291,597	1,131,297	1,187,993
2002	1,350,494	1,210,886	1,266,041
2003	1,412,077	1,320,496	1,349,559
2004	1,476,468	1,428,080	1,436,544
2005	1,543,795	1,541,979	1,528,185
2006	1,614,192	1,662,512	1,624,653
2007	1,687,799	1,785,335	1,726,114
2008	1,764,763	1,920,281	1,832,732
2009	1,845,236	2,062,730	1,944,667
2010	1,929,379	2,213,241	2,062,084
2011	2,017,359	2,376,081	2,185,130
2012	2,109,351	2,543,415	2,313,959
2013	2,205,537	2,719,886	2,448,719
2014	2,306,109	2,909,152	2,589,545
2015	2,411,268	3,104,641	2,736,590
2016	2,521,222	3,313,263	2,889,976
2017	2,636,190	3,528,603	3,049,840
2018	2,756,400	3,756,921	3,216,316
2019	2,882,092	3,995,843	3,389,564
2020	3,013,515	4,244,981	3,569,712
2021	3,150,931	4,506,921	3,756,922
2022	3,294,613	4,775,753	3,951,367
2023	3,444,847	5,054,474	4,153,271
2024	3,601,932	5,345,714	4,362,877
2025	3,766,180	5,647,299	4,580,450
2026	3,937,918	5,958,740	4,806,278

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