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Making the Most of Your Retirement Benefits

Although years ago, a company pension was the largest source of income for retirees, today it is becoming more common for seniors to rely more heavily on retirement accounts such as 401(k)s and individual retirement accounts for a significant amount of their retirement income. In many instances, this is the primary asset in the senior's estate. As such, planning for these assets is important.

Following are the basic rules governing taking minimum distributions from retirement plans and a few pointers for getting the most out of them.

Calculating Your Minimum Distribution

Withdrawals (with limited exceptions) before age 59½ are subject to a 10 percent excise tax. The plan participant must begin taking distributions by the April 1 occurring after he or she reaches age 70½ (known as the required beginning date), or pay a whopping 50 percent excise tax on the amount that should have been distributed but was not.

In general, the advantage of retirement plans is that the participant may save income before taxes during his or her working career and continue to have such savings grow without paying taxes until the funds are withdrawn. This permits the retirement savings to grow at a much faster rate than other savings and investments. However, this interest-free loan from the federal government ends abruptly when assets are withdrawn. As a result, it usually makes sense to postpone withdrawals for as long as possible.

The amount the participant must withdraw after reaching age 70 ½ is based on his or her own life expectancy as set forth in tables in the IRS regulations. There are exceptions for these tables (for example, if a retiree is married to someone significantly younger), but most plan participants will be use these tables. Fortunately, the table is based on the life expectancy of the participant, and the IRS assumes that the life expectancy is recalculated every year, so the participant will never, during his or her lifetime, have to withdraw 100 percent of these funds.

If your spouse is the named beneficiary, when the plan participant dies, the spouse can rollover these funds into her own IRA and use the same tables (based on the survivor's life expectancy) as the participant used. If the spouse is then under 70 ½ , she need not take any distributions until that time—even if the participant was taking distributions prior to his death.

If the spouse is not the primary beneficiary, the distributions are based on the life expectancy of the beneficiary, and payments must be made annually from the account at a fixed rate, regardless of the age of the beneficiary. For example, if the non-spouse beneficiary has a 15-year life expectancy when the participant dies, he must take 1/15th of the assets in the trust each year for the next 15 years. This means that the non-spouse beneficiary will eventually (assuming he lives to his full life expectancy) deplete all the assets in the plan.

Estate Planning

The simplest form of planning would be to name primary and secondary beneficiaries. Each plan has designation of beneficiary forms and some attorneys draft specialized beneficiary designations to control the distribution of these assets. However, the matter is more complicated if the participant has a taxable estate.

The Roth IRA

As if the rules described above were not complicated enough, as part of the Taxpayer Relief Act of 1997 Congress created two new planning vehicles: the Roth IRA, named after Senator William V. Roth (R-Del.), and the Education IRA. The Roth IRA, in effect, turns a traditional IRA on its head. While traditional IRAs permit the taxpayer to shelter pre-tax earnings but taxes them upon withdrawal, the Roth IRA is for after-tax savings, but both the original deposits and the earnings on them are not taxed on withdrawal. In addition, unlike traditional IRAs, Roth IRAs are available to taxpayers already contributing to a plan at work and to taxpayers who continue to work after age 70 ½. Finally, there is no minimum distribution requirement upon reaching that age.

Eligibility for the Roth IRA is limited to taxpayers with an adjusted gross income of under $110,000 if single and $160,000 if married (to be adjusted for inflation after 1998). The contribution is limited to $2,000 a year, with smaller limits for taxpayers with income of between $95,000 and $110,000 if single and between $150,000 and $160,000 if married and filing a joint return. During 1998, taxpayers who qualify may change their old IRA to a Roth IRA, but will have to pay taxes on the total amount they have deposited to date. If your income is less than $100,000, you can average this out over four years, but either way you have to pay the taxes with funds outside of your IRA. In addition, you have to leave the funds in the Roth IRA for at least five years.

Financial experts calculate that for many Americans a Roth IRA will save more money than a traditional IRA. This is because the future value of the interest earned, which will never be taxed, often far outweighs the value of deferring taxes on the investment itself. Remember, traditional IRAs may be converted to Roth IRAs this year only! Consult with your financial advisor to help decide if a Roth IRA makes sense for you.

The Education IRA

Similar to the Roth IRA, the new Education IRA permits individuals to save up to $500 annually with the earnings accumulating tax-free. This may be of special interest to parents and grandparents who can contribute this amount annually to accounts owned by their children and grandchildren. Although $500 a year is not a lot of money given the size of college tuition, over time it can make a difference. It is only available to taxpayers whose adjusted gross income is under $110,000 for single taxpayers and $160,000 for married taxpayers filing a joint return, with limits on contributions for taxpayers with income between $95,000 and $110,000 and between $150,000 and $160,000, respectively (all numbers to be adjusted for inflation after 1998). If the parents' income exceeds these levels, grandparents and others with lower taxable incomes can contribute to the accounts. Only $500 can be added per child per year.

Funds can only be added to the accounts while the child is under age 18 and must be withdrawn by the time he or she reaches age 30 or turned over into an account for another family member. An advantage with these accounts over most accounts created for children is that the funds do not have to be turned over to the child at age 18. But a word of caution: if you expect that your child or grandchild will apply for financial assistance for college, it may be wiser to invest the money in your own name. The financial aid application process for college has become increasingly complex, but, in general, colleges treat assets held by the family—especially a grandparent—differently from assets held by the student. Only a portion of family assets are expected to be used for a specific student's education, while all of the child's assets are expected to be used before the student draws on financial aid.

Conclusion

While the rules regarding retirement plans are complicated (and the summary above only brushes the surface), the most important lesson is to always name a designated beneficiary and to make sure that you name individuals only. (You can also name a trust that meets certain requirements beyond the scope of this article.) The second lesson is to consult with a qualified professional advisor when you reach 70 ½, if not before.