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Timely Retirement Plan Strategies

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Retirement plans, including traditional and Roth IRAs and qualified plans provided by employers, are often a key component of an individual's portfolio of assets. This edition of our periodic newsletter offers some planning opportunities and some tips regarding these assets focusing on (i) wealth transfer opportunities with Roth IRAs; (ii) rollover opportunities for nonspouse beneficiaries; (iii) the option to make a tax-free distribution from your IRA to charity; and (iv) estate planning and beneficiary designations with retirement plans. The discussion below is in general terms and is intended to be "food for thought" as you consider your own situation with your investment advisor.

Retirement plan benefits for children or grandchildren? Consider a Roth.

If you are focused on wealth transfer opportunities with your qualified plan, as opposed to your own retirement needs, you may wish to consider converting to a Roth IRA. Most types of IRAs can be converted to a Roth, except for an IRA inherited from someone other than your spouse. For the rest of this year and in 2009, there is an income limitation on making the conversion. If you as a single taxpayer or you and your spouse filing jointly have more than \$100,000 in adjusted gross income, you cannot make this switch. However, in 2010, there will no longer be this income limitation.

The advantage to a Roth account is that after paying the income taxes attributable to the conversion, future earnings in the Roth can compound free of tax.

In addition, unlike a traditional IRA, you are not required to start taking minimum required distributions (MRDs) from your Roth account when turn 70 ½. Roth IRAs have no required beginning and the participant is never compelled to take distributions from his or her Roth. Accordingly, the in the account are able to

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grow tax-free, perhaps exponentially over a period of years. After the participant's death, the Roth IRA beneficiary will be required to take the MRDs beginning no later than December 31 of the year after the year of the participant's death but the withdrawals, typically paid out over the beneficiary's life expectancy, will be tax-free.

As added benefits, if you stand to have a taxable estate, the payment of income taxes on the conversion will serve to reduce the estate by the amount of tax you have to pay to convert. Alternately, if you want to minimize the impact of the tax hit on the conversion in 2010, you will have the option of splitting the tax equally between years 2011 and 2012.

There are, of course, many issues to consider when deciding to convert, most of which are not covered in this feature. When you convert your regular IRA to a Roth, you will have to pay income tax on the entire value of the account, net of any non tax-deductible contributions to it. Ideally, you should have sufficient assets outside of the account to pay the taxes. If you need to tap your IRA account and if you have not yet reached age 59 ½, you will likely owe a 10% penalty on that portion of the IRA you have to withdraw to cover the taxes. Moreover, that portion of the IRA that is spent on taxes related to the conversion will not be part of the tax-free growth in the new Roth account.

With these caveats in mind, provided you do not need the funds in your IRA account to meet your own retirement needs, you are interested in moving this wealth down to the next generation, and you have the wherewithal outside of your IRA to pay the conversion tax, you may be a candidate for a conversion to a Roth. Again, for the vast majority of Welch & Forbes clients this is food for thought between now and 2010.

Non-spouse rollovers from inherited IRAs

Another relatively recent opportunity with respect to qualified retirement plans is the ability for nonspouse beneficiaries to roll over an inherited IRA. An option formerly available to spouses, a rollover is an opportunity to defer taxation. The new law applies to post-2006 distributions from IRAs and employer-provided qualified retirement plans.

Before 2007, inherited retirement plan benefits could not be rolled over to an IRA on a tax-free basis if the deceased participant's beneficiary was anyone other than a spouse. Without a nonspouse rollover, inherited benefits are often paid out by the plan shortly after the participant's death, with the beneficiary paying substantial income taxes on the inherited amount. The amount of the benefit payout can push the beneficiary into a higher tax bracket further increasing the tax due. Today, if the plan permits, any nonspouse beneficiary, including a child, parent, sibling, domestic partner, can roll over inherited retirement benefits to an "inherited IRA" newly created for that purpose. For tax-free treatment, the inherited retirement benefits must be rolled over directly from the plan or IRA to the new rollover inherited IRA and cannot be paid out to the beneficiary first.

With nonspouse rollovers, the new IRA will have the same owner (the deceased) and beneficiary. The nonspouse rollover allows beneficiaries to have some level of control over how they want to invest and receive the retirement benefits that have been left to them.

There are, of course, differences in spousal versus nonspouse rollovers. When the surviving spouse of a deceased IRA participant rolls over inherited benefits to the spouse's own retirement plan, the spouse becomes the owner/participant with regard to those benefits under the rules pertaining to MRDs. As such, the spouse gets significant deferral advantages compared with taking the benefits as beneficiary.

With nonspouse rollovers, the new IRA will have the same owner (the deceased) and beneficiary. The nonspouse rollover allows beneficiaries to have some level of control over how they want to invest and receive the retirement benefits that have been left to them. By rolling over an inherited plan into an “inherited IRA” the beneficiary can take advantage of a deferred “stretch” payout of the benefits over his or her own life expectancy, as opposed to receiving these benefits in a lump sum payout or over a five-year span. Unlike the spouse, however, the non-spouse beneficiary must still begin taking the MRDs immediately, regardless of his/her own age.

In sum, the nonspouse rollover option provides a nonspouse beneficiary of an eligible IRA or qualified retirement plan an opportunity like that previously held by spouses alone; that is the opportunity for tax deferral and some added control over this inherited asset.

IRA Distributions to Charity

Individuals who are charitably inclined and who do not need their MRDs for their own expenses may be able to take advantage of the opportunity to make a tax-free distribution to charity of up to \$100,000 per year from their traditional or Roth IRA, now that the bill that was extended by Congress has just been signed into law. Under the Pension Protection Act of 2006, P.L. 109-280, that had been in effect until January 1 of this year and is now in effect through December 31, 2009, up to \$100,000 from a traditional IRA or a Roth IRA can be excluded from gross income if distributed to a qualified charity. To qualify, the charitable distribution must be made by an IRA owner who was at least age 70 ½ years of age and the IRA distribution must be made directly by the IRA administrator to the charity. A distribution will be treated as a qualified charitable distribution only to the extent that the distribution is includible in gross income.

This opportunity allows an individual over 70 ½ who is required to take a minimum distribution from his or her IRA but who does not need the income to direct it to charity instead. In so doing, he or she will not be taxed on the income.

If you are eligible, have not yet taken your MRD for 2008 or are already thinking about your distribution for 2009, and can afford to dedicate it to charity instead of receiving it yourself, consider utilizing this opportunity to dedicate up to \$100,000 per year tax free to the charity of your choice.

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Basic estate planning and beneficiary designation considerations

Finally, as a reminder, ideally you should leave your retirement plan assets out of your core estate planning trusts due to the unique tax treatment of such assets. As a quick overview, for married individuals estate tax can be avoided in the wake of the first death and minimized at the second death through the use of both spouses' individual exemptions from estate tax. Under federal law, the current exemption amount is \$2,000,000 per person, which is scheduled to increase to \$3,500,000 per person in 2009. Regardless of the outcome of the Presidential election, the estate tax exemption amount is likely to stay at \$3.5 million at the least and may be increased.

Typically clients carry out this credit shelter/marital deduction planning via revocable trusts created by them during life that implement the planning in the wake of the first decedent's death. Property in the trust up to the first decedent's then available exemption amount is held in such a way that it is sheltered from estate tax and thus not subject to estate tax either in that first estate or in the survivor's estate. The property in excess of that exempt amount is typically for the sole benefit of the surviving spouse and held in such a fashion that it is eligible for the marital deduction from estate tax. As a result, no tax is due in that first estate. Further, at the survivor's death, the only property from the first estate that will be includable in the survivor's taxable estate is that marital deduction property. The exempt/sheltered property remains sheltered. The marital deduction property (at its then value) coupled with the survivor's own property will be subject to estate tax only to the extent that it exceeds his/her then applicable exemption amount.

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For clients who need to do estate tax planning and who have sufficient assets outside of their retirement plan accounts, we recommend against using retirement plan assets as part of the trust, particularly as part of the credit shelter component. The MRDs coupled with the income tax due on said distributions will diminish the trust value, which is contrary to the goal of sheltering an ongoing trust that is growing in value from estate tax.

Instead, we recommend naming an individual or individuals as the designated beneficiary. For married people, usually the spouse is named as the primary beneficiary and issue as the contingent beneficiary. The spouse's interest in the plan qualifies for the marital deduction from estate tax. For all beneficiaries, again provided the plan permits, there should be the opportunity for a rollover. Thus, to be able to receive the optimal tax treatment of retirement plans, it is best to have individual designated beneficiaries. So long as your portfolio of assets permits you to do your trust estate tax planning with assets other than your retirement plans, keep them out of your trust!

We hope that this discussion of certain issues related to retirement plans is helpful to you when discussing your own specific situation with your Welch & Forbes LLC portfolio manager.

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