**STRATEGIC TAX PLANNING FOR RETIREMENT PLAN ROLLOVERS**

As people retire, they will often have a choice of leaving funds with their previous employer or rolling over the funds to an individual retirement account (IRA). An IRA is somewhat like a pension or profit sharing plan, in that it allows the funds to be held tax-deferred until later withdrawn. Although there are differences, in general, from a distribution perspective, IRAs and profit sharing plans share many commonalities. From an asset protection standpoint, however, ERISA plans (i.e., profit sharing and pension plans) generally provide enhanced asset protection. (discussed below)

The key question one faces after retirement is the determination of whether or not funds should be moved from an ERISA-governed plan to an IRA. The primary answer to this question will be based on asset protection, while the secondary answer will largely be governed by federal tax law.

In certain circumstances, an employee who plans to separate from service (or has already separated from service) after age 55, but who is not already age 59½, may be well-advised to leave funds in an ERISA-governed qualified plan until he reaches age 59½. This can be beneficial because distributions from qualified plans are not subject to the ten-percent additional tax on early distributions if the plan participant is over the age of 55 at the time of separation, while distributions from IRAs are subject to such penalty unless the IRA owner has reached age 59½.

Lump Sum Distributions

For certain older taxpayers, special tax breaks exist for qualified retirement plan (e.g., 401(k), profit sharing, pension, or stock bonus) distributions which are taken pursuant to a lump sum distribution. In general terms, a lump sum distribution is simply a distribution of the entire qualified retirement plan balance to the taxpayer within one tax year.

However, in order to obtain special tax treatment under the lump sum distribution rules, the following must occur:

1.    The distribution must be taken from an exempt trust (i.e., 401(k), profit sharing plan, etc.);

2.    The entire plan balance must be paid to the retiree (i.e., plan participant);

3.    The entire distribution must take place within one tax year (i.e., by December 31); and

4.    The qualified plan balance must be payable to the taxpayer “on account of” (upon) one of the following triggering events:

a.    Death

b.    Attainment of age 59½

c.    Separation of employee from service, or

d.    Disability.

Notably, in order for the lump sum distribution rules to apply, the distribution must be from an employer retirement plan; a distribution from an IRA is never eligible for lump sum distribution rule treatment.

Net Unrealized Appreciation (NUA)

In the area of retirement distribution planning, one of the most often overlooked hidden gems in the tax law is net unrealized appreciation (NUA). In short, when a retiree opts to take a lump sum distribution of employer stock from his employer's qualified retirement plan, he is afforded special capital gains tax treatment. That special treatment is available on the difference between the fair market value (FMV) of the employer stock at the time of rollout and the cost basis of that stock. In essence, the retiree is converting what would otherwise be ordinary income into long-term capital gains.

Under IRC Section 402(e)(4)(D), whenever a retiree takes a lump sum distribution from his employer qualified retirement plan that contains employer stock, he is only required to pay income tax on that portion of the distribution that constitutes (a) the cost basis of the employer stock plus (b) the FMV of any other assets (e.g., cash, mutual funds, etc.) that have been distributed to the taxpayer and not subsequently rolled over into another qualified retirement plan or IRA within a specified period of time. The NUA component (i.e., the amount equal to the excess of the FMV over the cost basis), on the other hand, is not taxable at the time of distribution, but rather it is taxed at a later time when the stock is disposed of in a taxable transaction.

*Example:* In 2009, John, age 60, took a lump sum distribution of 5,000 shares of Blackacre Corp stock (employer stock) from his employer qualified retirement plan. The qualified plan trustee’s cost basis in the stock was $10 per share and the FMV of the stock at the time of rollout was $100. In this case, John would pay income tax, at ordinary income tax rates, on the $50,000 cost basis (5,000 shares x $10/share) of the employer stock in the year of distribution. The $450,000 of NUA on the employer stock [($100 FMV - $10 cost basis) x 5,000 shares], however, is not taxed until John sells the stock at a later period in time. When it is ultimately sold, the NUA gain of $450,000 will be taxed at long-term capital gains rates.

While very few will, or should, take a 100-percent distribution of employer stock from a qualified retirement plan, to not take any employer stock out of the plan may be imprudent. As such, the ultimate decision will often lie somewhere between 0-percent and 100-percent.

Along with the above considerations, one of the key issues to address in determining whether to take employer stock from a qualified retirement plan is whether it makes sense topay an immediate income tax on the cost basis of the employer stock rolled out of the plan versus deferring the income tax by rolling the stock over to an IRA. From a pure tax perspective, the decision whether to roll out employer stock will largely depend on: (1) the cost basis of the stock as a percentage of FMV, (2) the income tax rate differential between ordinary and capital gain income, and (3) the client's time horizon over which he will be selling the stock or taking IRA distributions.

Investment risk in a rollover situation can be mitigated by choosing to sell the stock immediately after the distribution from the employer retirement plan. However, if this is accomplished with a NUA distribution, it will potentially result in a significant immediate income tax liability – one that may have been significantly deferred if the retiree had instead rolled the funds into an IRA, diversified out of the stock without a tax liability (due to the tax deferral of the IRA), and postponed withdrawals for many years (or even decades) until the funds were needed.

*Example:* Jane, age 56, currently has $1,250,000 in her qualified retirement plan, of which 80-percent consists of employer stock. In addition to her qualified retirement plan, Jane has $50,000 in a traditional IRA and $200,000 in a taxable investment account, both of which are highly diversified. In this situation, it would not be advisable, from a diversifiable risk standpoint, for Jane to take all of the employer stock out of the qualified plan in that over two-thirds of her retirement investment portfolio consists of a single stock, unless she is prepared to sell most or all of the stock immediately and incur the associated tax liability.

*Example:* Assume the same facts as above, except that Jane has $750,000 in her traditional IRA and $1,000,000 in her taxable investment account, both of which are highly diversified. In addition, Jane is to receive a $5,000 monthly pension for the rest of her life. In this case, Jane could take a 100-percent distribution of employer stock from her qualified retirement plan in that only one-third of her total investment portfolio would consist of a single-stock position and she has a pension for life. Although this may still be an uncomfortably concentrated portfolio by some measures, the ability to diversify out of the position over time will allow Jane to enjoy a greater tax benefit by deferring her capital gains tax liability on the stock until it is sold.

Alternatively, the retiree can also manage the investment risk by choosing to roll over a portion of the stock for immediate sale, and retain the result in a taxable account under the NUA rules for subsequent sale at preferential capital gains tax rates.

It is notable, though, that the NUA election is only available for a distribution from a qualified plan. If a taxpayer rolls over the employer stock into an IRA, the NUA election cannot be made for a distribution from the IRA, and the NUA election is permanently lost.

Qualified Plan to IRA Rollovers

At retirement, one will often roll over funds from one’s qualified retirement plan into an IRA. This is done partly for income tax purposes and sometimes for additional investment choices and diversification. Also, many individuals have transferred funds from their qualified retirement plans to IRAs in order to assure a “stretch-out” of payments and defer income tax after their deaths. In most circumstances, qualified plans do not allow non-spouse beneficiaries (e.g., children, grandchildren, siblings, etc.) to retain funds within the plan and take distributions spread out over their life expectancy. However, under PPA 2006, a non-spouse beneficiary is now allowed (if the plan permits it) to transfer, via trustee-to-trustee transfer, funds from the decedent's qualified retirement plan into an IRA in the name of the decedent.

*Example:* On October 23, 2007, Jacqueline Roberts, age 69, passes away, naming her daughter Marianne as sole beneficiary of her 401(k). The 401(k) mandates a 5-year payment. On December 1, 2007, Marianne transfers her mother's 401(k) to an inherited IRA for her benefit via a trustee-to-trustee transfer. Under PPA 2006, Marianne is permitted to make this post-mortem transfer to an inherited IRA for her benefit. The value of the account is $500,000 on December 31, 2007. Marianne attains age 38 in 2008, the year after death, when distributions must begin from the IRA if distributions are to be made over her life expectancy, rather than within five years of death.

From a strategic perspective, when one combines certain income tax provisions (see above) with asset protection provisions (see below), there is little doubt that certain clients should leave their funds within the environment of an ERISA-protected employer retirement plan. In analyzing whether to roll over funds from a qualified plan to an IRA, one also must be cognizant of the differences in the 72(t) 10% early withdrawal penalty rules for qualified plans versus IRAs (see below).

However, many clients will still seek to roll over funds from their pension plan to an IRA. This is generally best accomplished in a trustee-to-trustee transfer and not in a traditional rollover. A traditional rollover from a qualified plan to an IRA is accomplished by taking a distribution of the amount, and rolling it over by re-depositing it within 60 days to an IRA. By utilizing the trustee-to-trustee transfer option, one never encounters the 60 day rule and reduces the opportunity for a mistake along the way. Unlike the lump sum distribution rules (see above), there are no special requirements for an IRA rollover. One must simply instruct the trustee of their ERISA-governed plan to move the funds to an IRA with a new custodian.

IRC Section 72(t) 10% Early Withdrawal Penalty

Under IRC Section 72(t), a 10% penalty will be assessed to any early withdrawals from IRAs and qualified retirement plans taken prior to the plan participant reaching age 59½. However, among the various exceptions to this penalty, are two exceptions which are especially relevant in retirement rollover planning strategies.

The first exception to the penalty, referred to as the “early retirement” exception, applies for all distributions made to an employee from a qualified retirement plan after separation from service after attainment of age 55. Basically, this means that when an employee retires in the year the employee turns 55 or a later year, withdrawals after retirement from the employee’s qualified retirement plan are not subject to the 10% early withdrawal penalty. The Pension Protection Act of 2006 reduced the age for this exception from 55 to 50 for early withdrawals made by public safety officers, such as firemen, policemen, and emergency medical personnel.

Therefore, as a planning point, an employee who is retiring at age 55 or older (50 for public safety officers), but before age 59½, may want to refrain from rolling over their qualified retirement plan to an IRA because of this early retirement exception. By maintaining their funds in the qualified retirement plan, the employee is able to utilize this exception to the 10% penalty and freely withdraw funds from their qualified retirement plan before reaching age 59½. On the other hand, if the employee would have rolled their qualified retirement plan into an IRA, they would be subject to the 10% early withdraw penalty on any pre-age 59½ withdrawals (unless another exception applies) because the early retirement exception applies only to distributions from qualified retirement plans and not from IRAs.

The second exception to the 10% penalty that is especially relevant in planning qualified retirement plan rollovers is the series of substantially equal periodic payments (SEPP) exception. Under this exception, the 10% penalty does not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of such employee and his designated beneficiary. In a nutshell, this exception allows an individual to take equal payments, computed based on the duration of the individual’s life expectancy, which, if continued for that period of time, would completely deplete the retirement account (although the distributions are only actually required to continue until the later of 5 years or age 59½).

This exception is most significant for planning purposes with IRA accounts because, with regard to IRAs, the exception is allowed even if the employee is still working. Although the exception also applies to a participant in a qualified plan, it is not as beneficial for qualified plan participants because it generally only applies if the employee has retired or separated from service (since qualified plans do not generally permit in-service periodic distributions). As a planning point, the SEPP exception provides the opportunity for a participant in a qualified plan, who is still employed, to roll over an amount from their qualified plan into an IRA (if the qualified plan permits in-service distributions) and then take withdrawals, via the SEPP exception, from the IRA prior to age 59½ without incurring the 10% early withdrawal **penalty.** This is a very powerful planning tool and an avenue for qualified plan participants and IRA owners to take withdrawals from their retirement accounts prior to attaining age 59½ without incurring the 10% penalty.

Asset Protection Issues

In discussing and analyzing various sources of retirement income, the retiree must be cognizant of asset protection issues under federal and relevant state law. Debtors in bankruptcy have two fundamental avenues to pursue when attempting to protect retirement plan assets from creditor claims. The debtor in bankruptcy may be able to claim an exclusion from the bankruptcy estate for his retirement assets, or an exemption from the bankruptcy estate. While retirement assets qualifying for exclusion are never brought into the bankruptcy estate, retirement assets that are ineligible for exclusion are brought into the bankruptcy estate but may find protection from creditor’s claims through an exemption.

Exclusions from bankruptcy are available for listed retirement plans (generally, qualified plans) and retirement plans subject to ERISA Title I or the ERISA anti-alienation provision. SEP and SIMPLE IRAs are subject to ERISA (as are qualified plans); traditional and Roth IRAs are not. Therefore, exclusions are available for qualified plans and IRAs other than traditional and Roth IRAs.

A debtor can choose to exempt property from the bankruptcy estate under either the list method or the nonlist method. If the list method is chosen, an exemption is available for qualified plans and IRAs, including traditional and Roth IRAs. If the nonlist method is chosen, an exemption is available for qualified plans and IRAs, including traditional and Roth IRAs, unless the applicable state law specifically does not so authorize. Therefore, if the nonlist method is chosen, whether there is an exemption depends on state law.

The exemptions for traditional and Roth IRAs are limited in the aggregate to $1,000,000 (as indexed). This amount can be increased if the interests of justice require it. Qualified plans and IRAs other than traditional and Roth IRAs, and rollovers (and the earnings thereon) from qualified plans and IRAs other than traditional and Roth IRAs, are not subject to the $1,000,000 limit.

Protection only applies to debtors in bankruptcy. Debtors in non-bankruptcy situations must rely on the laws of the investor’s state of domicile for creditor protection. This protection varies widely from state to state and may leave retirement plan assets unprotected. In addition, a debtor may find declaring bankruptcy to utilize IRA protections to be undesirable, because it may subject other non-IRA assets to bankruptcy liquidation.