Rollover Planning Strategies

# What is it?

Rollovers are permitted between various qualified plans and IRAs. In general, a rollover is a transfer of assets from one retirement plan to another that is completed within 60 days. The effect of a rollover is generally to avoid a currently taxable event and defer taxation upon what otherwise would be treated as a distribution. However, a rollover to a Roth IRA is generally a taxable event.

# When is the use of this Device Indicated?

1. When a person would like to change where an investment in a qualified plan or IRA is held.

2. Perhaps, when a person would like to change the type of investment for a qualified plan or IRA.

3. When a person prefers the tax benefits of the retirement plan to which the rollover would be made over the tax benefits of the retirement plan from which the rollover would be made.

4. When a person can stretch out payments (and therefore, defer income tax) longer by rolling the assets over to another plan.

5. When a person prefers the asset protection of the retirement plan to which the rollover would be made over the asset protection of the retirement plan from which the rollover would be made.

# Advantages

1. Rollovers are generally not taxable.

2. Rollovers allow a person some flexibility to change trustee or custodian, investments, and, sometimes, tax characteristics or distribution methods.

3. Rollovers to a surviving spouse after the other spouse’s death can permit the surviving spouse to be treated as the plan participant or IRA owner for tax purposes. This can be particularly useful for RMD purposes (see Chapter 16).

# Disadvantages

1. A rollover to a Roth IRA (other than from another Roth IRA) is taxable. The client must come up with money to pay the taxes now rather than later. There is uncertainty as to whether income tax rates in the future will be the same, higher, or lower than presently.

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2. Rollover from a qualified plan to an IRA could eliminate certain special tax benefits of the qualified plan.

3. Not all amounts can be rolled over and certain rollovers are not permitted.

4. Only one rollover is permitted from a particular IRA to another IRA within a 12-month period starting with the earlier rollover.

# What are the Tax Implications?

1. A rollover is generally not currently taxable.

2. A rollover to a Roth IRA (other than from another Roth IRA) is generally immediately taxable.

3. Rollovers are often done when a person prefers the tax benefits of the retirement plan to which the rollover would be made over the tax benefits of the retirement plan from which the rollover would be made.

# Rollover Planning

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, IRA and profit sharing plans share many commonalities. However, from an asset protection standpoint, as discussed later in this chapter, ERISA plans (i.e., profit sharing and pension plans) generally provide enhanced asset protection.

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.

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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.

Prior to the Tax Reform Act of 1996, certain individuals taking lump sum distributions from their qualified retirement plans could choose to pay the income tax on the distribution using either a five-year averaging or ten-year averaging method. This would often result in tax savings between five and fifteen percent. However, beginning in tax years after 1999, only individuals born prior to 1936, are allowed to use the ten-year averaging method; the five-year averaging method is no longer available for any taxpayer.

If a taxpayer qualifies for ten-year averaging on a lump sum distribution, he may make an election on his income tax return, using Form 4972, whereby the distribution is excluded from adjusted gross income (AGI) and is taxed at special income tax rates. In this case, the total amount of tax on the lump sum distribution is determined using the following formula:

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STEP 1: Figure the tax on 10% of the lump sum distribution amount using the 1986 tax rates applicable to single taxpayers (the 1986 tax rates are located in the instructions to IRS Form 4972).

STEP 2: Multiply the result from STEP 1 by ten.

*Example:* Roger, age 73, married and filing a joint income tax return, has $300,000 in his qualified retirement plan. Assuming Roger currently has $45,000 of net taxable income and takes a lump sum distribution from his qualified retirement plan during the 2007 tax year, the following summarizes the income tax liability that would be incurred with and without ten-year averaging:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| RegularIncome Tax | Ten-YearEffectiveTax Rate | AveragingTax | EffectiveTax Rate | $ Difference | % Difference |
| $93,050 | 27.8% | $72,298 | 21.0% | $20,752 | 28.7% |

The tax was computed as follows:

Regular Income Tax:

* $45,000 of net taxable income + $300,000 lump sum dist. = $345,000 of net taxable income
* Tax on the net taxable income = $93,050 (AMT is disregarded)

Ten-Year Averaging Tax:

* $300,000 / 10 = $30,000
* Tax per 1986 rates 🡪 tax on $30,000 (per the tax table) = $6,157 + .34($30,000 – $28,600) = $6,633
* $6,633 x 10 = $66,330 = Ten-Year Averaging Tax on the Lump Sum Distribution
* Plus: Tax on Ordinary Net Taxable Income of $45,000
* Per 2007 tax rates 🡪 tax on $45,000 (per the tax table) = $1,565 + .15($45,000 - $15,650) = $5,967.50
* Total Tax in 2007 using the Ten-Year Averaging Provision = $72,298

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Along with the above tax benefit, if a participant was born before 1936, and was a participant in the qualified retirement plan prior to 1974, a certain portion of the distribution is eligible for taxation at a special income tax rate of 20-percent, provided that the ten-year averaging method has been elected. In this situation, the amount eligible for this special 20% tax rate would be determined as follows:

|  |  |
| --- | --- |
| Calendar years of active participation in the qualified plan prior to 1974 | x Lump-sum distribution |
| Total calendar years of active participation in the qualified plan |

*Example:* Assume the same facts as above, except that Roger had been an active participant in his employer's qualified retirement plan from 1957 until he retired in 1999. Given these facts, the following summarizes the income tax liability that would be incurred with and without ten-year averaging (including the special 20% tax rate on pre-1974 participation):

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Regular Income Tax  | Ten-Year Effective Tax Rate  | Averaging Tax | Effective Tax Rate | $ Difference | % Difference |
| $93,050 | 27.8% | $61,779 | 17.9% | $31,271 | 50.6% |

The tax was computed as follows:

20% Capital Gain Election with Ten-Year Averaging Tax:

* 17/43 x $300,000 = $118,605
* $118, 605 x .20 = $23,721 = Tax attributable to the “Capital Gain” Portion of Lump Sum Distribution
* $300,000 - $118,605 = 181,395
* $181,395 / 10 = $18,140
* Tax per 1986 rates 🡪 tax on $18,140 (per the tax table) = $2,954 + .26($18,140 – $17,160) = $3,209
* $3,209 x 10 = $32,090 = Ten-Year Averaging Tax on the Lump Sum Distribution
* Plus: $23,721 Tax attributable to the “capital gain” portion

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* Plus: $5,967.50 Tax on ordinary net taxable income of $45,000
* Total Tax in 2007 using the 20% Capital Gain Election and Ten-Year Averaging Provision = $61,779

Once again, it is important to point out that in order for the taxpayer to be eligible for these special tax treatments, he must:

(1) take a complete distribution from the qualified retirement plan,

(2) the distribution must take place in one tax year

(3) no portion of the distribution can be rolled over into an IRA or other qualified retirement plan, and

(4) the distribution must be “on account of” one of the listed triggering events. It is also notable that this election may be applicable to the beneficiary of a decedent that would have been eligible for these rules.

If an amount eligible for these rules is rolled over to an IRA, no distribution from the IRA will be eligible for such rules. However, if the assets from a plan that would have been eligible for the ten-year averaging provision are held in a stand-alone “conduit IRA,” such amounts may be rolled into another employer retirement plan in the future, and the ten-year averaging provision may be made with respect to that plan.

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

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time of distribution, but rather it is taxed at a later time when the stock is disposed of in a taxable transaction.

*Example:* In 2007, 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.

Given the current all-time low tax rates on capital gains of five-percent and fifteen-percent, and the size of the potential difference between capital gains tax rates and the top ordinary income tax bracket of 35%, taking employer stock out of a qualified retirement plan has become a much more viable retirement distribution planning strategy from a tax planning perspective.

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 to pay 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.

In general, the lesser the cost basis is, as a percentage of FMV, the more favorable it is to take employer stock out of a qualified retirement plan. The primary reason for this is that while the retiree is paying a significant amount of income tax in the year of distribution, he is receiving a greater tax benefit from the NUA component. For example, assume that a retiree has employer stock which has a FMV of $50 and a cost basis of $10 and is in the 25% tax bracket (15% capital gains). Further, assume that the stock is

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sold three years later for $60. In this situation, the retiree would have to pay $2.50 of income tax ($10 x 25%) on the cost basis of the stock in the year of distribution and pay $7.50 in capital gains tax [($60 - $10) x 15%] when the stock is later sold, incurring $10 of total tax. Conversely, if the stock had been rolled over to an IRA, the retiree would not have had to pay any income tax on the rollover, but rather would pay income tax when there is a distribution from the IRA. Assuming in the alternative scenario that the retiree takes a $60 IRA distribution three years after the rollover, he would pay $15 of income tax ($60 x 25%).

While the example would seem to initially indicate that it would be better to take the stock out of the qualified retirement plan, it does not take into consideration the time value of money. In the example, the retiree had to pay $2.50 of income tax in the year of distribution, whereas in the rollover scenario the retiree did not have to pay any income tax at the time of rollover. Assuming that the retiree's cost of capital is 6.25%, the present value of the income tax paid by the retiree in both scenarios is summarized as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | PVSS factor (6.25%, 3 years) | = | 1/((1+.0625)^3) |  |
|  | PVSS factor  | = | 0.833706 |  |
|  |  |  |  |  |  |  |
|  | **100% Rollout** | **100% Rollover** |
|  | **Taxes** | **PV factor** | **PV** | **Taxes** | **PV factor** | **PV** |
| Now | $2.50 | 1 | $2.50 | $0.00 | 1 | $0.00 |
| Year 3 | $7.50 | 0.833706 | $6.25 | $15.00 | 0.833706 | $12.51 |
| Total | $10.00 |  | $8.75 | $15.00 |  | $12.51 |

As evidenced above, although the retiree had to pay $2.50 in income tax in the year of distribution, the tax savings afforded by the NUA component more than offset the immediate income tax paid on the cost basis, even in a present value context. Nevertheless, one must carefully analyze the relationship of cost basis to FMV and compare the tax rate differential of the client's current and future ordinary income tax rates against his current and future capital gains tax rates. Furthermore, one must also take into consideration the time period for which the stock will be sold. In this case, the sale of stock/IRA distribution was within a relatively short period of time. Had this taken place over a longer period of time, the result may have been skewed more in favor of the IRA rollover.

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On the other hand, a decision to retain the stock for an extended period of time after the NUA distribution introduces a significant investment risk issue. This is particularly problematic if the value of the NUA stock forms a significant portion of the retiree’s total investment portfolio. Consequently, a retiree must be careful not to be injudiciously lured by the tax savings alone. Accordingly, the retiree and her financial advisor must work together in analyzing the retiree's current investment portfolio, other sources of retirement income (e.g., Social Security and pension income), and the retiree's adversity to risk in determining how much employer stock to take from the qualified retirement plan.

The investment risk 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.

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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.

Grandfathered Retirement Plans

*TEFRA 242(b) election.* Distributions from a qualified retirement plan may not be subject to the required minimum distribution rules if a TEFRA 242(b) election was made before 1984; pre-TEFRA distribution rules would still apply. For example, for those who made the election, post-mortem distributions are not subject to the five year or the “at least as rapidly” rule. Rolling the plan over to an IRA results in the loss of the election. A revocation of the election is retroactive, thus prior deferred required minimum distributions must be taken.

*Estate Tax Exclusion.* Originally, there was an unlimited estate tax exclusion for retirement plans. The exclusion was limited to $100,000 for decedents dying after 1982. However, if a taxpayer was in pay status on December 31, 1982 and irrevocably elected the form of benefit before 1983, then an unlimited amount of certain portions of the retirement benefit generally qualify for the old federal estate tax exclusion for retirement plan benefits, and is therefore excluded from the taxpayer’s taxable estate. This transitional rule is considered met if a taxpayer separated from service before 1983 and does not change the form of benefit before death.

The estate tax exclusion for distributions at death from qualified retirement plans was totally eliminated for decedents dying after 1984. The entire distribution is now 100 percent includable in the gross estate of the plan participant-decedent. However, if a taxpayer was in pay status on December 31, 1984 and irrevocably elected the form of benefit before July 18, 1984, then the $100,000 exclusion is available. This transitional rule is considered met if a taxpayer separated from service before 1985 and does not change the form of benefit before death. The separation from service transitional rules apply only to qualified plans, not to IRAs; furthermore, it is not available if a qualified plan is rolled over to an IRA.

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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. Figure 1 and figure 2 illustrate the advantage.

**Figure 1 – Five-Year Distribution**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | Age | RMD Fact. | 401(k) | Outside Account | Total End. Bal. |
| **Begin. Bal.** | **Dist.** | **Pre-Tax Growth 7%** | **End. Bal.** | **Begin. Bal.** | **After-Tax Dist. Rec. 40%** | **After-Tax Growth 6%** | **End. Bal.** |
| 1 | 38 | - | 500,000 | (121,945) | 35,000 | 413,055 | 0 | 73,167 | 0 | 73,167 | 486,222 |
| 2 | 39 | - | 413,055 | (121,945) | 28,914 | 320,023 | 73,167 | 73,167 | 4,390 | 150,724 | 470,748 |
| 3 | 40 | - | 320,023 | (121,945) | 22,402 | 220,479 | 150,724 | 73,167 | 9,043 | 232,935 | 453,415 |
| 4 | 41 | - | 220,479 | (121,945) | 15,434 | 113,968 | 232,935 | 73,167 | 13,976 | 320,078 | 434,046 |
| 5 | 42 | - | 113,968 | (121,945) | 7,978 | 0 | 320,078 | 73,167 | 19,205 | 412,450 | 412,450 |

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**Figure 2 – Maximum Stretch**

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| Year | Age | RMDFact. | Inherited IRA | Outside Account | TotalEnd.Bal. |
| **Begin. Bal.** | **Dist.** | **Pre-Tax Growth 7%** | **End. Bal.** | **Begin. Bal.** | **After-Tax Dist. Rec. 40%** | **After-Tax Growth 6%** | **End. Bal.** |
| 1 | 38 | 45.6 | 500,000 | (10,965) | 35,000 | 524,035 | 0 | 7,675 | 0 | 7,675 | 531,711 |
| 2 | 39 | 44.6 | 524,035 | (11,750) | 36,682 | 548,968 | 7,675 | 8,225 | 461 | 16,361 | 565,329 |
| 3 | 40 | 43.6 | 548,968 | (12,591) | 38,428 | 574,805 | 16,361 | 8,814 | 982 | 26,156 | 600,961 |
| 4 | 41 | 42.6 | 574,805 | (13,493) | 40,236 | 601,548 | 26,156 | 9,445 | 1,569 | 37,171 | 638,718 |
| 5 | 42 | 41.6 | 601,548 | (14,460) | 42,108 | 629,196 | 37,171 | 10,122 | 2,230 | 49,523 | 678,719 |
| 10 | 47 | 36.6 | 748,616 | (20,454) | 52,403 | 780,565 | 115,073 | 14,318 | 6,904 | 136,295 | 916,860 |
| 15 | 52 | 31.6 | 915,409 | (28,969) | 64,079 | 950,519 | 246,446 | 20,278 | 14,787 | 281,511 | 1,232,030 |
| 20 | 57 | 26.6 | 1,093,206 | (41,098) | 76,524 | 1,128,633 | 460,826 | 28,769 | 27,650 | 517,244 | 1,645,877 |
| 30 | 67 | 16.6 | 1,385,057 | (83,437) | 96,954 | 1,398,574 | 1,339,221 | 58,406 | 80,353 | 1,477,980 | 2,876,554 |
| 40 | 77 | 6.6 | 1,153,971 | (174,844) | 80,778 | 1,059,905 | 3,453,166 | 122,391 | 207,190 | 3,782,747 | 4,842,652 |

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.

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IRC Section 72(t) 10% Early Withdrawal Penalty

As discussed in Chapter 15, 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.[[1]](#endnote-1) 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.[[2]](#endnote-2) 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 safely 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.[[3]](#endnote-3) 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).[[4]](#endnote-4)

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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. The SEPP exception is discussed in detail in chapter 15.

Therefore, in taking into consideration the non-spousal beneficiary trustee-to-trustee transfer now allowed by PPA 2006 and the creditor protection issues discussed subsequently in this chapter, the 10% early withdrawal penalty and its related exceptions may have a bearing on the investor’s decision as to whether a rollover of his qualified retirement plan funds into an IRA is appropriate.

Rollovers after Death

Spouse Beneficiary

If an individual dies while maintaining her funds in an ERISA-governed plan, her spouse will be allowed to roll over the funds from the ERISA plan to an individual retirement account in the spouse’s own name. This is called a spousal rollover. However, before executing a spousal rollover, one must ensure that the rollover makes sense from an estate planning perspective, and furthermore, avoids what is called the “spousal rollover trap.” The spousal rollover trap is best illustrated in an example.

*Example:* Jon dies at age 47 leaving his million dollar profit sharing plan to his 47-year-old wife Patti. If Patti rolls 100% of the profit sharing plan to an individual retirement account in her own name, her only access to these funds, without incurring the 10% penalty, will generally be via substantially equal periodic payments, because she is under the age of 59½. In the alternative, if all or a portion of the funds are retained in Jon’s ERISA-governed plan or rolled over to an inherited IRA, Patti will be able to take distributions from the plan without incurring the 10% penalty because the distribution will be from a decedent retirement account in Jon’s name after Jon’s death.

Rollover Planning Strategies

In general, to avoid the spousal rollover trap, a portion of the funds could be retained in the profit sharing plan or in an inherited IRA (i.e., an IRA in the decedent’s name for the benefit of the spouse), if the surviving spouse is under age 59½. To determine the amount to be retained in an inherited account, the financial planner must carefully analyze Patti’s cash flow needs, relative to her outside resources and qualified plan assets. In many cases a balancing approach is in order, where one rolls over a portion of the funds and leaves the rest in the inherited account.

The advantage of leaving the funds in the inherited account is that one avoids the 10 percent penalty because of the “on account of death” exception. In general, the advantage of rolling over the funds is that the surviving spouse can name the children or the grandchildren as beneficiaries and they have the opportunity to “stretch-out” distributions.

Nonspouse Beneficiary

Prior to PPA 2006, nonspouse beneficiaries of qualified plan benefits were not able to roll over inherited amounts to an IRA. Instead, they had to leave the amounts in the qualified plan or take a taxable distribution. As a result, they were bound by the payout provisions of the plan document.

PPA 2006 added a provision that allows nonspouse beneficiaries of qualified plan benefits to roll over inherited amounts to an IRA after 2006.[[5]](#endnote-5) The rollover to an IRA must be done through a trustee-to-trustee transfer to the IRA which must be set up as an inherited IRA. The RMD rules are applied accordingly to the inherited IRA.

A plan is not required to offer a direct rollover of a distribution to a nonspouse beneficiary. If a plan does offer direct rollovers to nonspouse beneficiaries of some, but not all, participants, such rollovers must be offered on a nondiscriminatory basis.

Note that care must be taken in performing the trustee-to-trustee rollover. The inherited IRA must be in the name of the deceased owner of the original retirement account and payable to the designated beneficiary of the original account (e.g., John Smith, deceased, IRA for the benefit of James Smith).

The funds must also pass directly from the original plan to the IRA (i.e., as a direct trustee-to-trustee transfer), and an inherited IRA can generally be used only by a beneficiary who qualifies as a designated beneficiary.

Rollover Planning Strategies

If the applicable payout under the qualified plan was for distributions over the beneficiary’s life expectancy and a rollover is made from the plan to an IRA, distributions from the IRA can be made using the beneficiary’s life expectancy. If the applicable payout under the qualified plan was the five-year rule and a rollover is made from the plan to an IRA, distributions from the IRA can be made using the beneficiary’s life expectancy only if the rollover occurs and the life expectancy payments start prior to the end of the year following the year of death. The amount that can be rolled over is reduced by any prior or current year RMDs.[[6]](#endnote-6)

Therefore, not all nonspouse beneficiaries can take advantage of this new rollover rule to stretch payments. However, beneficiaries who inherit a qualified plan no longer have to simply accept an unfavorable plan provision (i.e., the five year rule). Instead, assuming the plan allows it, rolling the plan into an inherited IRA by the end of the year following the year of death in order to start utilizing the life expectancy method should be an option that is seriously considered.

Asset Protection Issues

In discussing and analyzing various sources of retirement income, the financial planner 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 an 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.[[7]](#endnote-7) 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.[[8]](#endnote-8) 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.

Rollover Planning Strategies

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.

Below is a summary of the current federal creditor protection for retirement assets:

**ERISA Retirement Asset Protection:**

* Exclusion from bankruptcy estate for covered retirement plans
* Retirement plans covered under ERISA:
* defined benefit plans
* 401(k) and 403(b) plans
* money-purchase plans
* profit-sharing plans
* SEP and SIMPLE IRAs
* Protection applies to claims / judgments independent of bankruptcy

**Bankruptcy Code Retirement Asset Protection:**

* Exemption from the bankruptcy estate
* Unlimited creditor protection in bankruptcy for the following plans:
* SEP IRA
* SIMPLE IRA
* 401(k) and 403(b)
* Profit-sharing plans
* Money purchase plans
* Defined benefit plans

Rollover Planning Strategies

* $1,000,000 limitation in creditor protection
* Traditional IRA
* Roth IRA
* Increased if the “interests of justice so require”
* Availability of exemption
* List method – available
* Nonlist method – depends on state law
* Rollover IRAs
* Unlimited protection for amounts rolled over from qualified employer retirement plans
* Separate Accounts – cannot commingle IRA and rolled over IRA

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.

1. IRC Sec. 72(t)(2)(A)(v). [↑](#endnote-ref-1)
2. Notice 87-13, A-20, 1987-1 CB 432. [↑](#endnote-ref-2)
3. IRC Sec. 72(t)(2)(A)(iv). [↑](#endnote-ref-3)
4. IRC Sec. 72(t)(4)(A)(ii). [↑](#endnote-ref-4)
5. IRC Sec. 402(c)(11). [↑](#endnote-ref-5)
6. Notice 2007-7, 2007-5 IRB 395. [↑](#endnote-ref-6)
7. Bankruptcy Code Sec. 541. [↑](#endnote-ref-7)
8. Bankruptcy Code Sec. 522. [↑](#endnote-ref-8)