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Retirement Income Solutions

RMDs and the 70 1/2 Tax Trap

Strategies for high-income wage earners

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This year's Motion Picture Academy Award nominations will be announced on February 2, 2010 amidst glitz and glamour. For the first time in Oscar history, 10 movies will be nominated for Best Picture honors.

It is also award season in the financial service industry for issues that affect retirees and people nearing retirement or age 70 1/2. Based on the blitz of media exposure and press attention in the financial news, two of the leading, high-profile celebrity contenders for this year's top award in 2010 have to be:

- The 2010 Roth IRA Conversion opportunity offering tax-free income and growth for tax-payers earning over $100,000
- The real near term possibility of increasing tax rates at both the federal and state level

For sure, these interrelated subjects of Roth Conversions and increasing tax rates will be on the red carpet as the nominees for best performance in a leading role. For many people, the new ability to convert traditional, qualified money balances into tax-free balances represents a tax diversification strategy, a tax shelter strategy and a gift-giving legacy strategy that must be considered.

Yet, for high income tax payers, perhaps more attention should be paid to the powerful, yet dark and sinister supporting role played by required minimum distributions (RMDs).

Dark role played by RMDs

RMDs have been well-documented requirements of traditional qualified retirement accounts for a long time. When considered in a vacuum, and particularly when assisted by software tools, they are easy to understand. The government does not want these tax-deferred accounts (Traditional IRAs, 401(k) and 403(b) plans) to escape income taxation after age 70 1/2. Therefore, the IRS requires that the combined balances of traditional qualified retirement accounts be totaled together at age 70 1/2. The aggregated account balance is then divided by a life expectancy formula. The result is the Required Minimum Distribution.

The RMD withdrawal payment can come from any of the traditional accounts if they are not aggregated into one holding account. For example, at age 70, the government life expectancy factor for most couples is 27.4. To calculate the RMD withdrawal, simply divide this factor into the balance of the combined accounts. If the account balances total $1,000,000, the RMD is $36,496 for that year.

For the higher income tax payer with $1,000,000 in qualified money, the $36,496 might not be a lifestyle altering number. However, consider the ramifications of a married couple with $3,000,000 in qualified money as they approach 70 1/2. The $36,496 RMD becomes $109,489 in required distributions.

Furthermore, it is important to remember that this RMD force-out is imposed by the IRS every year after the required start date. (It was voided by Congress, for one year in 2009, due to the market collapse.) It is also critical to understand that Congress is not looking for less money in the future; rather it is looking for a great deal more. Real money is needed to pay for the war in Iraq and Afghanistan, to pay for the TARP program, to pay for the Cash for Clunkers program, to pay for the mortgage restructuring program, to pay for Medicare, to pay for Social Security and on and on.

Nasty tax trap lies in wait for high-income earners

As if directed by Alfred Hitchcock himself, the IRS has baited and set a nasty tax trap to snare the unsuspecting and unprepared high-income wage earners as they reach age 70 1/2. At this point, the RMDs will force a successful couple into or near the top marginal tax brackets. In addition, large RMDs could expose up to 85 percent of their Social Security benefit to be subject to ordinary income taxes, taxable at the maximum marginal rate. The 70 1/2 tax trap is easy to see graphically when illustrated in concert with pension income cash flows, Social Security payments and other post-retire-

ment income payments. In the example below, the unsuspecting couple who will need $310,000 in income in 2014 to support their life style(see arrow on graph) will see their taxable income jump to over $419,000 in 2015 because they are forced to take the RMD after reaching age 70½.

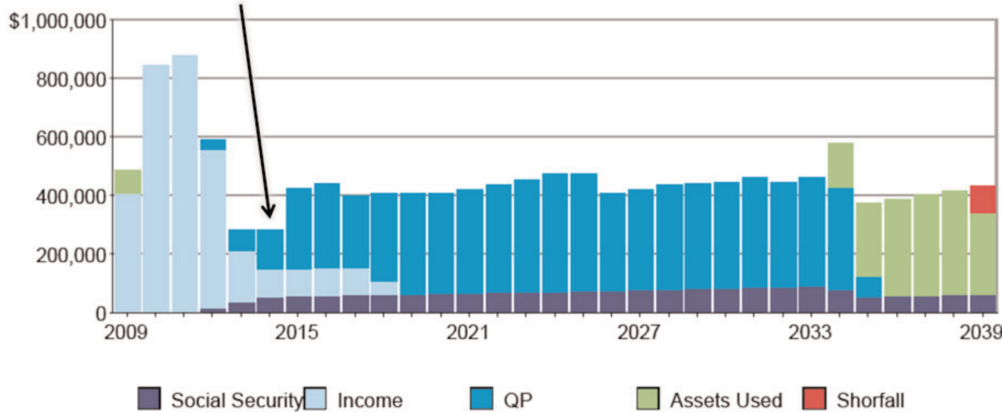
If Congress allows the Bush tax cuts to expire at the end of 2010, the RMD of $109,489 will be taxed at the top marginal rate of 39.6 percent which would increase their underlying tax bill by $43,358. This higher tax bill is a conservative estimate because it does not consider any health insurance surtaxes or deficit-correcting higher income tax rates that may come in the future.

Three planning strategies for high income clients

Here is the good news. At least three proven planning strategies exist to help high-income wage earners mitigate the 70½ tax trap:

- Roth Conversions
- Life Insurance
- Asset Liquidation Order

As a tax-diversification strategy, the presence of RMDs offers a powerful reason for higher-income wage earners to consider moving some portion of their qualified money into Roth IRA accounts. There are web calculators that may be generally helpful to illustrate this concept. However, in order to tailor your recommendations to a specific client's needs, a more comprehensive system may be needed. Be sure the analysis system can consider all sources of income for the client (like pensions, Social Security and the liquidation of non-qualified assets) that it can project income and asset growth into the future, and that it can graphically illustrate Roth Conversions so you can show the before and after impact of RMDs on your clients' plans for retirement income security. When these projections expose the 70½ tax trap, Roth conversions become increasingly meaningful and urgent. Roth IRA plans have no required minimum distributions so, by default, they can play a key role in a retirement tax diversification strategy.



A second strategy to make RMD payments tolerable is using them to buy new life insurance, especially if it is held in an irrevocable life insurance trust (ILIT). This is a sound strategy if the RMD payments are not required to support lifestyle needs in retirement. In the above example, $106,000 in RMD payments will buy a $3,150,000 permanent policy on a 70-year-old male in good health. The RMD payments are used as the source to pay the premiums. Income tax-free death benefits are paid to his family upon his death. This is a perfect way to systematically convert tax-toxic, qualified assets into tax-free life insurance death proceeds. It's also an effective technique to systematically remove tax-qualified assets from the client's estate. Placing the policy in an irrevocable life insurance trust may cause the policy's death benefits to avoid estate taxes as well. Again, when choosing software to illustrate this strategy for the client, be sure to look for tools that can illustrate income and estate tax consequences, as well as income in respect of a decedent (IRD) income tax ramifications.

The third strategy that might reduce RMD payments and avoid the 70½ tax trap is to simply start spending qualified assets well before age 70½. By holding the non-qualified assets in reserve and using taxable distributions earlier in retirement to support lifestyle needs, the client might be able to lower his/her RMD payments or eliminate them entirely. Although this option seems to run counter to accepted logic of "always defer taxes", the presence of large or looming RMDs can change the game-plan rules.❖