The Key to Making Your Money Last as Long as You Do

# Retire Secure!  Pay Taxes Later

By James Lange

## THE SUMMARY IN BRIEF

In *Retire Secure! Pay Taxes Later,* Attorney and CPA James Lange provides comprehensive strategies for getting the most from your IRA or retirement plan. He explores the differences in tax treatment for IRAs, Roth IRAs, 401(k) plans, and other employer-provided plans. Regardless of the plans available to you, Lange argues that you should contribute to each plan the maximum that you can afford.

Lange provides practical strategies for maximizing your retirement savings during your accumulation years (while still employed). He then illustrates creative techniques to preserve those savings during the distribution years of retirement, and to work with the IRS's minimum distribution rules. Finally, he explores the integration of your retirement plans with estate planning – to choose the appropriate beneficiary for the plan, to reduce federal estate taxes, and to benefit both family members and charities after you're gone.

Using skilled analysis, experienced insight, and realistic case studies, Lange demonstrates how to increase the odds that you and your spouse will have sufficient income for the rest of your lives and even improve the prospects for your children and grandchildren. *Retire Secure! Pay Taxes Later* shows that taking action today to reduce your tax burden will greatly enhance your chances of financial security tomorrow.

## IN THIS SUMMARY, YOU WILL LEARN HOW TO:

- Improve your financial outlook with the tax-free growth of a Roth IRA, Roth 401(k), and/or a Roth IRA conversion, including the May 17, 2006 changes

- Cut taxes on your IRA withdrawals so you and your heirs keep more money

- Dramatically reduce your risk of running out of money by learning which assets to spend first and which to spend last

- Apply the best accumulation and distribution strategies for your IRA and/or retirement plan

- Explore how to use Lange's Cascading Beneficiary Plan™ to get the ultimate protection for your spouse, while preserving valuable "stretch IRA" options for your children and grandchildren (works for single individuals as well)

Sidebar 1

**The Author:**

**James Lange**, CPA/Attorney, is a nationally respected IRA, 401(k), and retirement plan distribution expert with twenty-seven years of hands-on experience. In *Newsweek*, Jane Bryant Quinn introduced the entire country to Jim's mantra, "Pay Taxes Later!" His advice has been cited twenty times in the *Wall Street Journal*, and his articles appear frequently in other prestigious financial and tax journals.

For additional information on the author, go to http://my.summary.com.

## The Accumulation Years: The Best Way to Save for Retirement

### *Fund Retirement Plans to the Maximum*

You should contribute the maximum to your retirement plan, assuming you can afford it. Money contributed to a retirement plan, whether a 401(k), 403(b), SEP (Simplified Employee Pension), SIMPLE (Savings Incentive Match Plans for Employees), 457, deductible IRA, or any other type of retirement plan, is a pre-tax investment that grows tax-deferred. There are no federal income taxes on the wages contributed. You are getting a tax break for the amount of the contribution multiplied for the tax rate of your tax bracket.

In addition, once the contribution is made, you do not have to pay income taxes on the interest, dividends, and appreciation until you take a distribution from the retirement plan. In other words, you pay taxes later.

By not paying the taxes up front on the wages earned, you reap the harvest of compounding interest on the money that would have gone to paying taxes – both on the amount contributed and on the growth had the money been invested outside of the retirement plan.

There is not only a tax advantage to saving in a retirement plan, but there is the built-in discipline of contributing to your retirement plan every paycheck. Those who have the most money saved at retirement are usually the ones who religiously contributed to a retirement plan during their long career.

Of course, if your employer offers a matching contribution to your retirement plan, it would be foolish to not take advantage of that offer. Matching contributions are most commonly found in 401(k), 403(b), and 457 plans. The cardinal rule is: contribute whatever the employer is willing to match – even if the match is only a percentage of your contribution, and not dollar for dollar.

Remember that you may qualify for more than one retirement plan such as a 403(b) with a 457 plan and a Roth IRA. You might want to consult a financial advisor to learn about all your options. The key is to contribute the maximum you can afford to all the retirement plans to which you have access.

### *Comparing the Traditional IRA and Roth IRA*

As a rule of thumb, the Roth IRA is usually preferable to a traditional IRA or a non-matched contribution to an employer's retirement plan. IRAs allow individuals

with earned income to make contributions to their own retirement accounts. IRA owners can deduct IRA contributions if they (and their spouse if married) do not have a retirement plan at work, and they earn less than the adjusted gross income limit prescribed by law for deducting IRA contributions.

Within limits, the IRA owner deducts the contribution to the IRA and the IRA grows tax-deferred. The owner does not pay income taxes until the money is withdrawn. Many employer-provided retirement plans can be rolled over into an IRA, income tax-free, at retirement or termination of employment.

With a Roth IRA you contribute after-tax money so you don't get an income tax deduction for your contribution. As with the traditional IRA, you don't pay income tax while the Roth IRA is invested. The striking advantage, however, is that when you (or even your heirs) eventually do make a withdrawal from your Roth IRA, that distribution is income tax free! By contrast, the distribution from a traditional IRA will be taxable. One of the few things in life better than tax-*deferred* compounding is tax-*free* compounding.

Sidebar 2

***The Traditional and Roth IRA Quick Comparison***

| | **Roth IRA** | **IRA** |
|---|---|---|
| Investment | Grows tax-free | Grows tax-deferred |
| Withdrawals | Tax-free | Taxed as Income |
| Contributions | Not deductible | Deductible |
| Income Limits | Much higher than for IRA | Much lower than Roth IRA |
| Contribution Limits | Same as IRA | Same as Roth IRA |
| Penalty for withdrawal before 59½ | No, limited to previous contributions | Yes, with limited exceptions |
| Required Distributions at 70 ½ | No | Yes |

## The Distribution Years: Spend the Right Funds First

### *Which Assets Should I Spend First?*

With retirement, an individual moves into distribution mode. That is not to say that accumulation stops. You may be fortunate enough to find that your Social Security, dividends and interest on investments, pension, and required distributions from your IRA (if any) produce enough funds for your living expenses.

Let's assume that isn't the case, however, and you are forced to either invade your after-tax savings (your nest egg) or make (additional) taxable withdrawals from your IRA or retirement account to make ends meet. In general, it is preferable to spend principal from your after-tax investments rather than taking taxable distributions from your IRA and/or retirement plan. Leaving money in the tax-deferred environment for

as long as possible confers advantages that almost always outweigh concerns over paying capital gains on your after-tax assets.

Sidebar 3

***The Optimal Order for Spending Classes of Assets***

1. After-Tax Assets Generated by Income Sources
    - Pension distributions
    - Dividends, interest, and capital gains
    - Earned income, not reinvested
    - Social Security
    - Required minimum distributions from IRAs

2. After-Tax Assets (Investments that are not part of a qualified pretax retirement plan that would generate income subject to taxes annually):
    - Investments that will either sell at a loss or break even
    - Then, more highly appreciated assets

3. IRA and Retirement Plan Assets (Assets subject to ordinary income tax):
    - IRA, 403(b), 401(k), etc., dollars over and above minimum required distributions

4. Roth IRA dollars

***Minimum Required Distribution Rules***

Even if you stick to the game plan to spend your income and after-tax dollars first, you will eventually be required to withdraw funds from your IRA or retirement plan (but not your Roth IRA). For most people, annual minimum distributions must begin by April 1st of the year following the year that you reach 70 ½. An exception to the rule: if you have an employer plan and have not yet retired, you can delay the first distribution until April 1st of the year following the year you retire. (This exception doesn't apply if you own more than 5% of the company.)

The minimum required distribution is calculated by taking your projected distribution period (based on your age and the age of a beneficiary deemed to be 10 years younger than you), and dividing that factor into the total balance of your IRA or qualified plan as of December 31st of the prior year. This projected life expectancy is not based on anything that has to do with you personally – it is an actuarial calculation done by the IRS and listed in one of three tables.

Most IRA owners will use Table III, the Uniform Lifetime Table, which is based on the joint life expectancy projections of an IRA owner and a hypothetical

beneficiary 10 years younger. Using a joint life expectancy is advantageous because it reduces the annual minimum required distribution.

If you can afford it, take only the minimum the government requires you to withdraw from your retirement plan or IRA. This distribution pattern retains more money in the tax-deferred account and is consistent with our motto, don't pay taxes now – pay taxes later. It's important to note that taking only the minimum required distribution does not prevent you from withdrawing more money should the need arise.

For additional information on the Minimum Required Distribution rules, go to http://my.summary.com.

***Critical Decisions You Face at Retirement***

When someone retires or is "service terminated," the big question is, "What should I do now with my retirement plan?" Contingent on the specifics of any given retirement plan, the basic options are:

1. *Take a lump-sum distribution*. (However, many retirees won't qualify for a lump-sum distribution, and most financial advisors won't recommend it.)

2. *Leave the money in the plan where it already is.* (If, for example, your current retirement plan has an excellent fixed income fund in the form of a guaranteed income contract. Some of these fixed income accounts are paying out higher returns than those available for comparable current investments with the same degree of safety.)

3. *Annuitize the balance.* (Discussed in the next section.)

4. *Transfer the money into a separate IRA*. (Often the preferred option.)

5. *Some combination of options 2, 3, and 4*.

With proper planning you can put in place the mechanisms to stretch taxable distributions from an inherited IRA and certain retirement plans for decades, sometimes as long as 80 years after the original owner dies. If, however, the employer's retirement plan stipulates the wrong provisions, and the retiree never transferred his retirement plan into an IRA, the stretch may be replaced by a tax nightmare for the heirs.

Many investors don't realize that specific plan rules that govern their individual 401(k) or other retirement plan take precedence over the IRS distribution rules for inherited IRAs. Those distribution rules that come into play at the death of the retirement plan owner are usually found in a plan document that few employees or advisors ever read. Many, if not most plan documents say that in the event of death, a non-spouse beneficiary must receive (and pay tax on) the entire balance of the

retirement plan the year after the death of the retirement plan owner. These retirement plans don't allow a non-spouse beneficiary to stretch distributions.

Perhaps even more compelling than the tax reasons to transfer the money out of a retirement plan and into an IRA is the opportunity to take advantage of the universe of investment choices offered by IRAs. That argument becomes even more critical if your plan does not offer good investment choices. Though the trend is to give employees more choices and more advice than in the past, transferring the money into an IRA will always give the retiree even more and often better choices.

For most individuals approaching or at retirement, initiating a trustee-to-trustee transfer of a qualified retirement plan to an IRA is a good decision. With proper titling, you can preserve the stretch, and you can offer your heirs the continued advantage of tax-deferred growth and take advantage of a wider variety of investment choices during your lifetime. That said, you still have to weigh the decision carefully and look at the particular circumstances of your situation.

Deciding how to manage your retirement assets at the time you retire is important and deserves your full attention. Deciding on a good strategy is an area where the appropriate financial advisor can be worth his or her weight in gold.

### *Does Annuitizing Your Distributions Make Sense for You?*

Annuitizing your retirement plan or "after-tax" accumulations can be one way to make sure you don't outlive your money. For some individuals, annuitizing part of their financial assets is a reasonable choice.

Annuitizing your retirement plan means purchasing an immediate annuity. That involves surrendering all or a portion of your money in exchange for receiving regular, recurring payments. The basic concepts of annuitizing apply to both retirement funds and after-tax funds. The major difference is the income tax treatment of the annuity payments.

Payments from an after-tax annuity are partially taxable in the early part of the payment stream. They are *partially* taxable because one portion of the payment is considered a return of the original capital and is not taxable until the entire original cost is recovered. The other portion of the payment is considered ordinary taxable income. Distributions from annuities purchased with retirement funds, on the other hand, are fully taxable like pension income.

Possible payment choices include for:

- The remainder of your life
- The remainder of your and your spouse's life
- A fixed number of years
- One of the above plans with an extra provision to extend benefits to your heirs

An ideal candidate for an annuity is a healthy single person with a long life expectancy who doesn't care about leaving any money behind. If the person is married, then a joint life annuity to last through both lifetimes could work equally well. Annuitizing over a lifetime or joint lifetimes is sometimes considered a conservative strategy because it practically ensures that you will not outlive your money. And it's possible to annuitize only a portion of the available funds.

On the other hand, some would consider annuitizing a gamble. Since most annuities are based on an actuarial life expectancy, you are gambling that you will outlive your actuarial life expectancy, and the insurance company is gambling that you won't. If you have reason to believe that you will not survive your actuarial life expectancy, then annuitizing is probably a mistake.

Another risk is that the issuing insurance company will go bankrupt and be unable to meet its obligations to pay the annuity. Reduce your risk by choosing insurance and annuity companies that have the highest quality ratings, and/or buy annuities from more than one company.

If you don't need the money, then annuitizing retirement plan assets needlessly accelerates the payment of income taxes on your retirement accumulations. Also, if you need more than the annuity payment and you've annuitized everything, then you're out of luck unless you can borrow money. If, on the other hand, you are taking minimum required distributions from a retirement plan, you can always take a larger distribution from principal when and if you need it.

### *Net Unrealized Appreciation*

The difference between the market value of your company stock still in your retirement plan at the time of distribution, and its value at the time your employer made the contribution to your plan, is called net unrealized appreciation or NUA. At retirement, it is critical to check for NUA before rolling money into an IRA. NUA qualifies for favorable tax treatment.

Employers, in spite of the Enron fiasco, are still allowed to fund qualified plans with their own stock, using fair market value to value the contribution. A pension plan may not have more than 10% of its assets invested in employer stock. Stock bonus plans and some profit-sharing plans could have 100% of their assets invested in employer stock.

If the proposed distribution from a retirement plan qualifies as a lump sum distribution, then the NUA is not taxed at the time of distribution. The employee pays tax only on the original value of the stock when the employer contributed it. Employees do not pay tax on NUA until they sell the stock in a taxable transaction. And then, the employee pays taxes at the capital gains rates instead of ordinary income tax rates. It's important to seek professional advice if you believe you are impacted by this.

## Estate Planning: It's Never Too Early to Start

It's hard to draw clear lines between retirement planning and estate planning because both are on one continuum. Optimal estate planning for IRA and retirement

plan owners usually involves the same principle taught throughout this book: Don't pay taxes now – pay taxes later.

### *Reducing Your Federal Estate Tax Burden*

The federal gift and estate tax system is a transfer tax levied when individuals transfer assets during their lifetime (gift tax) or at their death (estate tax). It's rare that individuals pay gift taxes during their lifetime, so most often the transfer taxes are imposed on the death transfer.

Tax law allows you to transfer an unlimited amount of property to your spouse (as long as they are a U.S. citizen) free of transfer taxes. This is called the unlimited marital deduction.

For transfers to non-spouses however (such as children and grandchildren), the IRS sets an upper limit on how much money can be transferred before a transfer tax is charged. The amount an individual is allowed to transfer to non-spouse beneficiaries without incurring a federal transfer tax is referred to as the Applicable Exclusion Amount. Unfortunately, the Applicable Exclusion Amount is a moving target because of current legislation.

For the years 2006-2008, the Applicable Exclusion Amount for federal estate tax equals $2 million. During 2009 it will be $3.5 million. In year 2010 the estate tax is scheduled to be repealed altogether! And in 2011, unless Congress takes action, the estate tax comes back and the Applicable Exclusion Amount reverts to $1 million. The lower the Applicable Exclusion Amount, the higher the number of Americans subject to the transfer tax. Obviously, this state of flux requires flexibility in your planning.

For married couples whose assets exceed the Applicable Exclusion Amount, the concern is not with the estate tax on the first death (because of the unlimited marital deduction), but rather the estate tax at the second death. It is usually recommended that husband and wife divide their assets equally, or as close to equally as possible. That way each can pass the maximum amount possible using their Applicable Exclusion Amount.

One method of minimizing federal estate taxes has been to draft a trust which, upon the first spouse's death, protects from estate taxation that spouse's applicable exclusion amount. The trust normally carries limitations so that the surviving spouse is only permitted to use the income from the trust, and may invade principal for health, education, maintenance, and support. Because of these limitations, the trust is not considered part of the estate of the surviving spouse and is therefore not subject to estate tax at the second death.

Because of the constant change in tax laws and estate sizes, you could inadvertently and unnecessarily be under-providing for your surviving spouse by transferring too much money to such a trust. If the raised exemption amounts remain in place, fewer estates will be subject to estate tax, and fewer estates will benefit from this trust. Don't get caught with an estate plan that automatically transfers the Applicable Exclusion Amount into a restricted trust for the benefit of your spouse without making sure that is the best choice.

### *Gifting Programs*

Another method for both single and married taxpayers to reduce the size of their estate (with the goal of staying below the Applicable Exclusion Amount) is a formal gifting program. There are three simple types of gifts that can form the foundation of a gifting plan: 1) cash gifts of $12,000 per year per beneficiary; 2) gifts of education; and 3) gifts of insurance.

The IRS allows each individual to make an annual tax-free gift of $12,000 per year to any number of beneficiaries. Gifts are usually given to children and grandchildren, but that is not a requirement. A married couple can jointly give $24,000 per year to each of their beneficiaries without incurring a gift tax. With ten beneficiaries, for example, a wealthy couple with a potentially taxable estate could give away $240,000 per year without paying gift taxes, and without reducing the Applicable Exclusion Amount available at death for estate taxes.

Another popular gift for those who can afford it is to at least partially fund a child's or grandchild's college education. Parents and grandparents can pay tuition (and medical expenses) directly for their children or grandchildren, and these payments do not count against the $12,000 per year limit.

Another method to fund education is to contribute to a Section 529 College Savings Plan. These plans provide income-tax-free growth, give you the freedom to change beneficiaries within the family, offer substantial control over the asset allocation of the investment, and even allow you to take the money back and use the proceeds for non-qualifying purposes (subject to a 10% penalty).

A third gifting method is to provide the premium payments to purchase a second-to-die or other type of insurance policy that can be used to replace the amount taken by estate taxes, or provide liquidity to pay the taxes, leaving the rest of the inheritance intact. The policy would likely be owned by the beneficiaries or an irrevocable trust to keep the insurance proceeds outside the taxable estate.

Beyond these three simple methods, there are a wide variety of more complex and sophisticated estate planning techniques that are in essence variations of making a gift.

### *Gift Taxes*

There is a separate Applicable Exclusion Amount for gift taxes. It sets a cap on the total value of gifts you can give during your lifetime (beyond the $12,000 annual exclusion) before being subject to gift tax. In 2004, that exclusion amount was frozen at $1 million.

If your gifts to one beneficiary exceed the $12,000 annual exclusion amount, the excess is subject to a graduated gift tax with rates ranging from 18% to 46% in 2006. To avoid paying gift tax, you may file a gift tax return (Form 709) and elect to deduct the excess over and above the $12,000 from your $1 million Applicable Exclusion Amount.

For example, if you gave $62,000 to your son in one year – $12,000 would not be subject to gift tax, but $50,000 would be subject to it. You could either pay the gift

tax, or you could file Form 709 to have it deducted from your gift tax Applicable Exclusion Amount. That would leave a total of $950,000 for additional lifetime gifts.

Very wealthy individuals might choose to purposely use up their $1 million lifetime exclusion amount. Although that would reduce what may be passed tax-free at death, it not only reduces the estate size, but also transfers out of the estate all the appreciation that would have been in the estate had the gift not been made.

### *Using the Minimum Required Distribution Rules after Death*

Just as you can profit from deferring income taxes during your lifetime, so can your heirs. Just as it was advantageous for you to keep money in your IRA, it is also best for the beneficiaries of IRAs to retain the money in the tax-deferred environment for as long as possible. A stretch IRA is an IRA that provides for this possibility.

Just as the IRA owner must take minimum distributions of his IRA at some point, the beneficiaries of the IRA must also take minimum distributions after the death of the IRA owner. Naming a younger beneficiary means a longer life expectancy and a lower minimum required distribution. Thus, the younger the beneficiary means the longer the deferral, the greater the portion of assets that remains in the tax-deferred environment and the greater the tax-deferred accumulation.

The inherited IRA has a greater tax deferral potential for the surviving spouse's child than for the surviving spouse. It would have its greatest tax deferral potential in the hands of a grandchild or even a great-grandchild.

If the beneficiary is still a minor, a well-drafted trust will often be the best choice for the beneficiary. There are technical requirements for a trust to qualify as a designated beneficiary and get the stretch treatment. This is an area where an attorney's input is advisable – as long as that attorney is experienced in drafting trusts designed to serve as an IRA beneficiary.

It is important to discuss these stretch concepts with your beneficiaries to that they are aware of the material advantages of taking only the required minimum distributions for as long as possible.

### *Using Disclaimers*

An individual who disclaims an inheritance simply steps aside and the next person in line (the contingent beneficiary or beneficiaries) inherits. Planning with this option in mind allows a family to assess and respond to the actual financial needs of the family after the death of the first spouse. The surviving spouse always has the option to choose not to accept the inherited IRA and disclaim her entire interest or a portion of her interest in it.

In most states, the surviving spouse has nine months to decide whether or not to accept, disclaim, or partially accept and partially disclaim his or her interest. In order to have a qualified disclaimer under federal law, the disclaimer must be irrevocable, unconditional, and in writing. The written disclaimer must be delivered to the owner of the interest no later than nine months after the date of death or nine months after the disclaimant attains age 21, whichever is later.

The one disclaiming cannot have accepted the interest or any of its benefits, and it must pass to the contingent beneficiary without any direction on the part of the disclaimant. The property must pass to either the spouse of the decedent or to a person other than the person making a disclaimer.

The death of a spouse is an emotional time. After a death, if the named beneficiary is even considering a disclaimer, the most important thing is to *do nothing*! The surviving spouse should not take control of the assets nor roll the assets into the spouse's name until a final decision not to disclaim has been made. These issues and choices should be discussed with your advisors ahead of time.

A disclaimer offers several potential advantages. If the surviving spouse disclaims to the children as contingent beneficiaries, the IRA is not included in her estate, which could reduce estate taxes for the children at her death. Perhaps more importantly, the minimum required distribution of the inherited IRA would be based on the life expectancy of the children rather than the shorter statutory joint life expectancy of the surviving spouse. Longer life expectancy equals longer tax deferral.

In many cases the best solution will be for the surviving spouse to keep a portion of the IRA and disclaim the remaining portion. The beauty of the disclaimer is that the decision can be made after the death of the first spouse when a clearer picture of the surviving spouse's financial situation is available. Having the ability to disclaim is more important than ever in light of the shifting target of the Applicable Exclusion Amount.

***The Ideal Beneficiary Designation for Your Retirement Plan***

Wills or trusts do not control the distribution of an IRA or retirement plan on their own. Distribution is determined by the beneficiary designation. A trust can be named as a beneficiary and thereby control distribution, but many people have trusts and have never changed their beneficiary designation to that trust.

The problem with beneficiary designations and disclaimers is that there are too many variables and we cannot predict which ones will be relevant at the time of death. Who knows how much money will be left at the first death, or who will die first? What tax laws will be operative in the year of the first death? What will the surviving spouse need? The solution may be Lange's Cascading Beneficiary Plan™ (LCBP™).

LCBP™ takes the layering of beneficiaries through the use of disclaimers to a new level of sophistication and flexibility. It recognizes the importance of providing for the surviving spouse while also keeping her options open.

Typically, to take full advantage of LCBP™ and preserve the surviving spouse's options, the IRA owner should name primary and contingent beneficiaries to their IRA according to the following hierarchy: 1) the spouse; 2) a unified credit shelter trust; 3) a child (or the children equally); and 4) a well-drafted qualifying trust for a grandchild (or grandchildren).

In a perfect cascade the surviving spouse could retain some of the participant's IRA, roll it over into his or her own name, and appoint his or her own beneficiaries. She would also have the option to disclaim a portion to a credit shelter trust or to an

adult child who could then use his or her own life expectancy for minimum required distributions purposes.

At that point, the adult child could retain some of the participant's IRA and take minimum required distributions and/or disclaim a portion to the trust for his or her own child who could then use his or her own life expectancy for MRD purposes. The bulk of the IRA could be tax-deferred for generations!

Using a trust as the potential beneficiary of a retirement plan and/or IRA can be an excellent method of protecting the beneficiary. Creating trusts for minors, trusts for spendthrifts, and trusts for spouses can be appropriate under certain circumstances.

Having a flexible estate plan and cascading beneficiary designations provides the surviving spouse with multiple options for distributing the inheritance based on the family's circumstances at the time of the first death, and regardless of ongoing changes in the tax laws. By incorporating the cascade into an estate plan you give yourself the best chance to "stretch" an IRA and pay taxes later.

Sidebar 4
Insert Figure 12.1, p. 198

***Doing Well by Doing Good***

Some people have charitable intentions, and regardless of any tax benefits, they plan on giving large amounts of money during their lives and at their deaths to worthy charities. Most people, however, also appreciate it when Uncle Sam subsidizes those charitable intentions. Some simple planning can provide great value to the charity, great value to your heirs, and eliminate or at least reduce funds going to the IRS.

Charities don't care in what form (IRA, after-tax, highly appreciated dollars, Roth IRA, etc.) they get their money, because they do not pay income taxes. Individuals do care because of the different tax ramifications of the different types of inherited funds.

Assume, for example, that you have an estate consisting of $500,000 in an IRA and $500,000 in after-tax money. Assume further that you want half to go to charity and half to your heirs. It would make sense to give the IRA to charity unless the beneficiary is 40 or under and would benefit from a stretch IRA. That young beneficiary could enjoy many years of tax-deferred growth.

On the other hand, if the IRA is left to charity, no one will ever have to pay income tax on the IRA or its growth. Roth IRAs are the worst assets to leave to charity, but the best asset to leave to an heir because distributions are tax-free – a tremendous benefit to an individual, but meaningless to a charity.

For additional information on charitable estate planning options, go to http://my.summary.com.

Sidebar 5

## An Overview of the Whole Process

While still working (during the accumulation stage):

1. Contribute the maximum amount to your retirement plan.
2. Allow the amount to accumulate tax-deferred while continuing to make new contributions.

At retirement (during the distribution stage):

3. First, spend the money on which you have already paid income tax.
4. Second, spend any retirement plan or IRA money (tax-deferred or tax-free). Only make withdrawals from your IRA, etc., after you have exhausted your nonretirement plan assets.
5. At 70 ½ you will have to take minimum required distributions. If you can afford it, take only the minimum required distributions and allow the rest of the account to continue to accumulate tax-deferred.

When you are planning for your heirs:

6. Develop an estate plan that continues the tax-deferred status of your IRA or retirement plan long after your death. Some variation of Lange's Cascading Beneficiary Plan™ is probably the best solution for the IRA beneficiary form for most readers.

Finally, know when to make an exception to the "pay taxes later" rule. Notable exceptions include:

7. Roth IRAs, Roth 401(k)s and Roth 403(b)s
8. Roth IRA conversions
9. Distributions of IRA and retirement plan money at targeted income tax brackets
10. In large estates, sometimes it does pay to withdraw money from IRAs prematurely to avoid the dreaded combination of estate tax and income tax on the IRA within the estate.

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# ADDITIONAL INFORMATION BLOCKS

***Additional information on the author:***

**James Lange**, CPA/Attorney, is a nationally respected IRA, 401(k), and retirement plan distribution expert with twenty-seven years of hands-on experience. In *Newsweek*, Jane Bryant Quinn introduced the entire country to Jim's mantra, "Pay Taxes Later!" His advice has been cited twenty times in the *Wall Street Journal*, and his articles appear frequently in other prestigious financial and tax journals.

Jim's signature estate plan, Lange's Cascading Beneficiary Plan™, is earning widespread acclaim as readers and financial professionals alike want Jim's solution for their own families.

Jim is a graduate of Pennsylvania State University and Duquesne University School of Law. He is the principal of James Lange & Associates and a popular keynote speaker and educator. He lives in Pittsburgh, Pennsylvania, with his wife, Cindy, and their daughter, Erica.

***Additional information on the Minimum Required Distributions rules:***

Calculating minimum required distributions used to be a nightmare. Prior regulations were full of traps with far-reaching consequences in terms of designated beneficiaries and minimum required distributions. Fortunately, regulations completed in April 2002 dramatically simplified the process.

Currently, minimum required distributions are calculated by taking your projected distribution period, based on your age and the age of a beneficiary deemed to be 10 years younger than you, and dividing that factor into the balance of your IRA or qualified plan as of December 31 of the prior year. It is an actuarial calculation based on of three life expectancy tables provided by the IRS.

Generally speaking, most IRA owners will use Table III. In effect, the age-dependent projected distribution periods in Table III are based on joint life expectancy projections of an IRA owner and a hypothetical beneficiary 10 years younger. Using a joint life expectancy is advantageous because the longer joint-life expectancy factor reduces the annual minimum required distribution. The life expectancy of two people calculated jointly is always greater than the life expectancy of one person alone – regardless of the ages of the two people.

But rather than using the actual life expectancy of the beneficiary for the calculations, the IRS has simplified the terms. Table III deems all beneficiaries – from children to grandmothers – to have a life expectancy 10 years longer than that of the owner. At age 71, the projected distribution period is 26.5 years (roughly the single life expectancy from Table I plus 10 years, although you must refer to the tables for the precise factor).

***Additional information on charitable estate planning options:***

Beyond the simple method of naming a charity as the beneficiary of your IRA or retirement plan, there are several other charitable estate planning options which involve trusts.

Charitable trusts are known as split-interest gifts. Split-interest gifts are gifts where the donor or his family maintains some interest in the property and a charity (or charities) also receives an interest. These trusts can be funded either during life or after death. Those funded at death are known as testamentary trusts and are created in a will, revocable trust, or even the beneficiary designation of an IRA or retirement plan.

In general, there are two types of charitable trusts: remainder trusts and lead trusts. In a remainder trust the donor makes a gift to the trust and then receives income payments for a specified number of years or for the donor's lifetime. After the term of years or the donor's death, whatever is left in the trust (the remainder) goes to charity. In a lead trust, the opposite happens: the charity gets the income payments, and the remainder goes to the donor's beneficiaries.

Charitable trusts are irrevocable and the donor cannot take the gift back. However, the donor gets a charitable income tax deduction based on the value of the income or remainder interest pledged to the charity. In addition, the assets or cash gifted to the charitable trust are out of the donor's estate for federal estate tax purposes.