The Commerce Trust Company

Financial Advisory Services

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Unleashing the Power of Your IRA

Planning Strategies for IRAs

Is your IRA a significant part of your net worth? While you accumulated and grew your account, it provided you with significant income tax savings benefits. Now you're faced with having to take distributions even when you don't need the funds, and those tax benefits could come back to bite you. If you try to leave your IRA assets to your children, your beneficiaries may be subject to even greater taxes.

Despite significant exposure to taxes, both income and estate, these funds can, if utilized properly, provide you with significant planning opportunities to achieve your financial goals. New IRS rules and regulations became effective in 2002 and have provided much greater flexibility to IRA owners if you know how to use them!

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IRA Distribution Basics

Taxability

Traditional IRAs. Each distribution from your IRA will generally be taxed as ordinary income, whether or not the earnings of the account come from interest, dividends, capital gain or other sources. If the IRA contains non-deductible or after-tax contributions, then each distribution will contain a portion of that after-tax amount that will not be considered income when distributions are made.

Roth IRAs. Distributions from Roth IRAs are not taxable so long as the IRA owner is at least 59½ and has held the account for five years.

Additionally, a 10% penalty is imposed on distributions taken from either a Roth or traditional IRA when the IRA account owner is under age 59½.

*The penalty does not apply when the distribution is:

- due to the death or disability of the IRA owner;
- rolled over to another IRA;
- converted to a Roth IRA;
- taken to pay for qualifying medical expenses or health insurance for unemployed individuals;
- taken to pay first-time home purchase expenses or the higher education expenses of qualified individuals;
- pursuant to a seizure due to an IRS levy; or
- as part of a series of substantially equal periodic payments.

***Note:** *These exceptions refer to specific instances and official definition of the terms listed above. It is suggested that professional income tax assistance be employed if these situations occur.*

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IRA Distribution Basics *(continued from page 1)*

Timing

You must begin distributions from your traditional IRA the year you turn 70½. Your first distribution may be delayed until April 1st of the following year, but your distribution for that following year will also be required, resulting in a double distribution. Failure to make your distribution will result in a penalty of 50% of the amount you should have distributed for that year.

Your Roth IRA has no distribution requirements while you are alive.

Amount

Once upon a time, not too long ago, there were many choices with regard to how much of a distribution you were required to take. Much depended upon the person you named as your beneficiary. New rules, required for the year beginning January 1, 2003, have simplified the matter enormously. Now (with the exception of one situation) every IRA owner uses the same table to calculate the percentage that must be distributed from the IRA balance. Everyone who is the same age will be required to withdraw the same fraction of the account. Thus, a person aged 73 with a $100,000 IRA, who has named a 68-year-old spouse as a beneficiary, has a life expectancy of 14.8 years according to the IRS table. That individual will withdraw $6,757, or 6.76% (1 ÷ 14.8) of the balance. An individual aged 73 with a $200,000 IRA and a 23-year-old grandchild named as a beneficiary will withdraw $13,514, which is 6.76% (1 ÷ 14.8) of the balance of the IRA. (The same percentage as our first 73-year-old.)

The one exception is for IRA owners whose spouse is more than 10 years younger. That owner may use a calculation method that will somewhat reduce the amount required to be distributed.

Once the IRA owner dies and a beneficiary must begin minimum distributions, the life expectancy of the beneficiary is determined according to a different table. A spouse and a non-spouse beneficiary, however, will use the table differently. *(See Page 3: Combined Estate, Income Tax and Distribution Consequences)*

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The minimum distribution rules are just that -- they prescribe only the **minimum** that must be distributed. You can always take more without penalty if you are over the age of 59½. Even under age 59½ you may still take distributions as long as they are "annuitized" over your life expectancy, which means you receive substantially equal payments designed to last for your lifetime. You may annuitize the aggregate of all your IRA accounts or you may separate and annuitize only that amount that you require to supplement your income. The payments must then be made for at least five years or until you turn 59½, whichever occurs later.

Two Ways to Minimize Taxes on Current Distributions

Many individuals wish to preserve IRA balances for their beneficiaries. Even the minimum required distributions are more than they need. Instead, they want to provide the largest amount with the least amount of taxes to beneficiaries. Some would like to benefit charities. Others want to protect their spendthrift children or grandchildren. For those individuals, it is first necessary to understand the income tax, estate tax, and other consequences inherent in the choice of beneficiaries. Then it's a matter of crafting a plan to best meet your goals. Here are two ways to minimize taxes on current distributions:

1. You can synchronize your distribution with your charitable contribution deductions. However, unlike gifts of appreciated stock to a charitable organization (which avoid the tax on the capital gains as well as provide an additional charitable deduction), a gift from an IRA directly to a charity does not avoid the tax on the deferred income. The distribution is first reported as income on the IRA owner's income tax return. Any amount of the distribution which is contributed to a charity will create a charitable income tax deduction. The deduction may or may not fully eliminate the tax on the distribution. The effect is not as beneficial as gifting appreciated stock to a charitable organization but can produce substantial tax savings.

2. If you meet the requirements to convert your traditional IRA to a Roth IRA, you may or may not save taxes in the long run. Converting your IRA to a Roth will in fact create a tax liability on the total amount converted. The upside is the tax is paid on the initial conversion and future qualified withdrawals are completely tax-free. Again, you may be able to mitigate the tax through timing of your charitable contributions. You should have your tax adviser run the numbers to help you determine when a conversion could make sense.

Combined Estate, Income Tax and Distribution Consequences

Individual Retirement assets may be subject to estate taxes at the IRA owner's death.

This applies to both the traditional and Roth IRA. This would occur if the total assets of the owner, including the IRA, exceed the current estate exemption ($1,500,000 in 2005 and $2,000,000 in 2006-2009).

In addition, distributions to the beneficiary of an IRA continue to be subject to the same income tax rules as distributions to the original owner. If estate taxes are actually paid as a result of the inclusion of IRA assets in an estate, there may be a deduction (not a credit) for the estate tax attributable to those assets. This may mitigate the double taxation that would occur when the beneficiary actually takes distributions from the inherited IRA.

For a beneficiary in the highest income tax bracket receiving a total distribution from a $500,000 IRA when the deceased IRA owner was in the highest estate tax bracket (47% in 2005; 46% in 2006; 45% in 2007-2009), taxes would be paid as follows:

- first, $235,000 (2005) of estate tax would be owed and must be paid from the IRA or other assets within nine months of the owner's death ($500,000 x 47% estate tax);
- as distributions are made ($500,000 in our example) the distribution amount is included in taxable income and the portion of the estate tax attributable to the IRA is deducted from the income. The balance is subject to income tax in the beneficiary's bracket, in this case the highest bracket, resulting in an income tax of $92,750 [($500,000 - $235,000) x 35%].
- a state income tax of 5% could bring the total tax hit to over 68% of that immediate distribution.

As you can see, the effect of income and estate taxes can take a significant toll on the amount beneficiaries actually keep. Even without being subject to estate tax, the federal and state income taxes can reduce the benefit by 40% or more depending on the state if distributions are made when the beneficiary is in the highest tax brackets. Planning by the IRA owner may increase the after-tax amounts to the beneficiary depending on the specific situation.

The solution depends upon your choice of beneficiary and the manner in which distributions are made to your beneficiaries (i.e., whether in trust or outright).

Choosing a Spouse as a Beneficiary

Naming your spouse as the primary beneficiary of your IRA provides the greatest flexibility for taking distributions and minimizing taxes. Some of the options include:

Inherited IRA. The spouse may choose to leave the assets of a deceased spouse in the deceased spouse's IRA. This may be beneficial for the spouse who is under 59½ and in need of funds from the IRA. Maintaining the funds in the inherited IRA would allow for distributions without penalty.

The downside is that if the account holder was older than the beneficiary, then distributions must begin at least when the IRA owner would have turned 70½. If a goal is to minimize taxes and maximize the balance to beneficiaries, the next option should be considered.

Rollovers into Spouse's IRA. A spouse may rollover or transfer the account into his or her own IRA for further deferral of income taxes. The spouse would also be able to designate his or her own beneficiaries.

If the spouse is under 59½, this option would penalize the spouse for taking distributions from the IRA on any amounts that were rolled into the account. If the spouse wants to delay or minimize distributions through a rollover, but may need funds from the IRA, then the spouse should withdraw the needed funds prior to the rollover.

Disclaimed IRA. Should a spouse determine that they will not need or desire the additional assets or income, they can disclaim their interest in the IRA and it can pass to another beneficiary. The contingent beneficiary must be named in the beneficiary designation or the disclaimed amount will pass to the decedent's estate creating probate expenses.

Distribution Requirements. The requirements for minimum distributions for the surviving spouse will depend upon which of the above alternatives are taken. If the spouse rolls the assets to his or her own IRA, then distributions must begin when the surviving spouse turns 70½. If the IRA is maintained as an inherited IRA, distributions must begin when the deceased owner would have turned 70½ or immediately if the owner was already taking mandatory distributions. In either case, distributions will be based upon the life expectancy of the surviving spouse determined each distribution year.

EXAMPLE: John died on May 1, 2005, at age 68 leaving his wife, Ellen (age 58). His $500,000 IRA names Ellen to receive 100% of the IRA. A charity, John's alma mater, is named as a contingent beneficiary.

Continued on next page

Consequences *(continued from page 3)*

Ellen's alternatives:

She could withdraw all or any portion of the IRA immediately and pay income taxes but no penalty on any amount withdrawn.

Ellen could roll the entire $500,000 into an IRA she has set up for herself and name any beneficiaries she chooses. She will not need to take minimum distributions for 12 years, when she will turn 70½.

Ellen could also leave the proceeds in John's IRA establishing an FBO account (For the Benefit Of herself). In the event she needs funds, she could withdraw what she needs at any time without penalty. Of course, she will pay income tax on any amount distributed. Ellen will have to begin taking minimum distributions in 2 years, at the time John would have reached age 70½, but the amounts will be based upon her own life expectancy. At 60, her life expectancy is 25.2 years. In the next year she will calculate her life expectancy for a person who is age 61, which is 24.4 years.

Ellen could instead, disclaim her interest in all or a portion of the IRA. The amount disclaimed would be distributed to John's alma mater as the contingent beneficiary, avoiding both estate and income tax.

Finally, she could do any combination of the above alternatives to meet her goals and objectives.

Choosing an Individual Beneficiary Other Than a Spouse

A non-spouse beneficiary cannot rollover the assets into their own IRA. Rather, a full distribution can be made to a beneficiary or an inherited IRA may be established. Income tax, but no penalty, will be due on any amount distributed.

Distribution Requirements. If the beneficiary chooses to maintain an inherited IRA, distributions must be made. By December 31st of the year following the year of the IRA owner's death, the beneficiary must take a minimum distribution based on that beneficiary's own life expectancy. For subsequent years, the life expectancy is reduced by one for each distribution year. Obviously, the younger the beneficiary is, the lower the required distribution and the more that can be left in the IRA to grow tax-deferred.

EXAMPLE: ***Ellen dies at age 78 leaving a balance of $300,000 in the IRA, and naming her daughter Joan (age 42) as a beneficiary.***

Joan's alternatives:

Joan could withdraw up to the entire $300,000 and pay income tax, but no penalty, on any amounts withdrawn.

She could maintain the IRA as an inherited IRA. Even though Joan is not yet 59½, she must begin taking minimum distributions from the IRA by December 31, 2006. Her life expectancy at age 43 (the distribution year) is 40.7 years according to the IRS table. Next year, she will not recalculate her life expectancy (as her mother had been able to do), but will simply subtract 1 from the year before, giving her a life expectancy of 39.7 years.

If multiple beneficiaries are named, the account may be separated in order to allow each beneficiary to utilize his or her own life expectancy for minimum distribution purposes. Without separation of the account, the life expectancy of the oldest beneficiary will be utilized.

When a Beneficiary Dies

What happens when Joan dies at 66, after taking only 24 years of her 40 years of contributions? Joan may designate a beneficiary to continue to take the payments Joan would have received. If Joan names her 40-year-old son, James, he would take distributions based on Joan's remaining life expectancy of 17.7 years, rather than his own life expectancy of 43.6 years.

A Trust Treated as an Individual. Trusts that meet certain requirements are treated as if the trust did not exist and the beneficiary is the individual beneficiary of the trust. In other words, we can "look through" the trust to determine the true beneficiaries.

To comply, the trust must:

- be valid under state law;
- be or become irrevocable at owner's death;
- have identifiable beneficiaries;

and, the trust document must be provided to the plan administrator with other documents.

Naming a trust as beneficiary of an IRA may be a good choice if the circumstances warrant more control over the payments from that IRA. It may be that the intended beneficiaries cannot or should not receive direct payments from the IRA due to their young age, disability, or inability to manage funds on their own.

There are also situations such as a second marriage where the IRA account holder may not want his/her spouse to have the ability to name their own beneficiaries and potentially bypass the deceased owner's children.

Continued on next page

Consequences *(continued from page 4)*

There are, however, many issues that must be addressed in naming your trust as beneficiary of your IRA. The trust must be structured very carefully. You should always consult with your attorney or tax advisor before choosing a trust as your beneficiary.

Distribution Requirements. If a trust meets these requirements, the minimum distribution requirements are calculated on the life of the beneficiary of the trust. If there is more than one beneficiary, then the life used is that of the oldest beneficiary calculated for each individual beneficiary of the trust.

Choosing Other Beneficiaries

Certain types of beneficiaries will result in different distribution rules for your IRA. This occurs when an entity, not an individual, is the beneficiary. This includes your estate, a trust that does not meet the requirements discussed above, and a charity.

If the IRA owner dies *before* he or she is required to take minimum distributions (age 70½), the distribution is according to a Five-Year Rule, i.e., everything in the account must be distributed at least by the end of the fifth year following the death of the IRA owner. If the death occurs *after* minimum distributions were required, then distributions may be made over the life expectancy of the IRA owner, determined in the year of death, and subtracting one year from the previous life expectancy for each subsequent year.

A Charity. When a charity is the beneficiary of all or a portion of an IRA, the distribution is subject to neither estate tax nor income tax. Since no taxes or penalties apply, the fact that the distribution must be made immediately is irrelevant when a charity is the beneficiary.

The Estate. Naming your estate (or failing to name a beneficiary resulting in a default to your estate) generally results in distribution of the entire IRA assets within a five-year period unless the decedent was over 70½. It may also subject the proceeds to additional probate expenses and procedures.

A Nonqualified Trust. Naming a trust, which does not meet the qualifications discussed above, will also subject the distribution to the five-year rule unless the decedent was over 70½.

Under the old rules, merely listing one of these types as a beneficiary would taint the entire IRA, requiring all of the funds to be distributed within five years. New rules allow us to separate the portion designating these entities so that only that portion will be subject to the accelerated distribution rules. Alternatively, it may be possible to pay out the portion designated for the non-individual beneficiary prior to September 30th of the year after the owner's death and eliminate the taint of the beneficiary, allowing the balance to be treated as paid to an individual.

EXAMPLE: ***In the previous example, Ellen names Joan her beneficiary for two-thirds of the account and a charity for the one-third balance.***

It is important to pay the $100,000 to the charity (or at least to separate it from Joan's two-thirds in its own IRA) prior to September 30th following the year of Ellen's death. Failure to do so could subject Joan's portion to the rule requiring distributions over the life expectancy of someone Ellen's age (78) instead of Joan's (42). If the charitable portion has been paid in full or Joan's portion separated out from the charitable portion, then Joan may leave her $200,000 in the IRA as an FBO account and must begin taking distributions based upon the life expectancy of a 42 year old (41.7 years). Joan may also name a beneficiary to receive any payments she would have received if she were to die prior to the 42nd year (age 84). The beneficiary would simply continue taking distributions calculated as if Joan were still alive.

A Checklist for a Powerful IRA

- ❑ Who is named as your primary beneficiary?
- ❑ Is this the person you intend to benefit?
- ❑ Will this person handle the assets responsibly Should you consider a trust?
- ❑ Have you named a contingent beneficiary?
- ❑ Have you considered naming a charity for a portion of your IRA?
- ❑ Are you eligible to roll your traditional IRA to a Roth IRA and have you considered the benefits?
- ❑ If you inherited an IRA, have you named a beneficiary to inherit your remaining payments?

Review of your estate plan and careful planning now can possibly save your beneficiaries tax dollars later, so call your Commerce relationship manager or talk to your financial and tax advisors.

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For more information on this and other tax issues, call your Commerce Trust Company relationship manager for your copy of the "2005 Tax Guide."