

RETIREMENT BENEFITS

A Golden Opportunity

The wealthy are doing just fine when it comes to retirement; it's the middle and working classes that we need to worry about. This is not a bleeding heart cause. All Americans have a lot at stake

By **Susan Slater-Jansen**, partner,

The year 2005 saw a lot of legislative and Treasury Department action in the employee benefit area. This is nothing new. Since the Employee Retirement Income Security Act (ERISA) came into being in 1974, the laws and Internal Revenue Service's actions interpreting them, related to retirement plans and planning, have evolved continually. What never ceases to amaze me, is that, although the rules are meant to secure the retirement years of our increasingly aging population, much of the legislative and Treasury action actually penalizes the aging middle class. The past year was no different. Many new laws and Treasury decisions enacted in 2005 significantly benefit high-net-worth individuals—but have had the exact opposite effect on the working and middle classes.

This is not just a problem for the working and middle classes. Everyone eventually will have to foot the bill for a system that isn't working properly—or tolerate living in a country with increasingly glaring inequities.

What's wrong with the nation's retirement system?

One long-standing problem is the difference between the penalty for taking an early distribution (prior to age 59 1/2), and the penalty for not taking a minimum required distribution (MRD) after age 70 1/2, the required beginning date (RBD). Well-off individuals rarely need to take early distributions from their pension plans, which spark a 10 percent penalty tax. Even when they do, they (with or without expert advice) can usually take advantage of one or more of the numerous exceptions. The penalty for not taking an MRD is 50 percent of the difference between the MRD and the amount actually distributed. This is meant to assure that those with large accumulations are not able to avoid income taxation on these accumulations during their lifetimes, and then pass untaxed benefits along to the next generation.

The wealthy can afford numerous tax advisors who will make sure that they do not miss an MRD. Supposedly, the less wealthy have help calculating their MRDs as well. Since the second set of Section 401(a)(9) proposed regulations were issued on June 17, 2001, custodians of individual retirement accounts (IRAs) have been required to advise IRA owners of the MRDs—and compute them if asked. Trustees of corporate plans also will calculate MRDs for applicable participants (and often their beneficiaries).

But participants of self-trusted plans are on their own. Numerous one-person corporations and businesses are encouraged by financial institutions to set up self-trusted plans, adopting a master plan offered by the financial institution. The problem is that the financial institution is not the trustee, usually the business owner is. If—as is often the situation—neither the individual adopting the plan nor his tax-preparer is familiar with the convoluted and extremely complex requirements of IRC Section 401(a)(9), the participant can easily miss the RBD for his first MRD and subsequent annual MRDs.

These business owners are often at added risk with the constant mergers and takeovers in the financial industry. It's becoming more common to discover that plans set up 10 years ago at now-defunct institutions cannot be

located. The beneficiary designations are lost and the actual adoption provisions are nowhere to be found. Individuals over age 70 1/2 (when MRDs must commence) who are participants in these lost plans, and cannot afford the expert financial advisors familiar with the rules, are probably the least likely segment of our population able to navigate the IRC 401(a)(9) rules, let alone know that they exist, and how to calculate their MRDs. Since the financial institution holding the account is not the trustee, they do not advise the participant(s) of the required distributions. If the MRDs are not made, however, a 50 percent under-distribution penalty is immediately applied. Even if there is a reasonable explanation for the failure to make the required distribution, the participant is required to pay the 50 percent penalty tax with the application (Form 5329) to have the penalty abated for cause.

This stump-the-middle-class trend is exacerbated by legislation passed in 2005. Congress meant the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), effective April 20, 2005, to correct many perceived abuses by debtors of the bankruptcy system. BAPCPA exempts assets in qualified plans and rollover IRAs from inclusion in a bankrupt's estate. Excluded from exemption, however, are assets in standard (contributory) IRAs in excess of \$1 million. This would appear to be a boon to all participants of qualified plans and IRA owners. After all, the minimal amounts permitted to be contributed to standard IRAs would rarely reach \$1 million. Nevertheless, consistent contributions coupled with excellent earnings and gains eventually could amount to or exceed \$1 million. Because these standard IRAs were meant to provide retirement savings for those individuals and their spouses with modest incomes who are not otherwise eligible for qualified plans, generally the \$1 million limitation would seem to be more than sufficient. But why is the \$1 million limitation applicable only to these plans that may be the sole retirement vehicles of the working and middle income segments of our population?

The Katrina Emergency Tax Relief Act

Even when Congress supposedly is trying to be helpful, it benefits the rich but creates a potential harm for the middle and working classes.

(KETRA) issued in October 2005 (with IRS Notice 2005-92) was meant to assist those most in need of relief after the devastation caused by hurricanes Katrina and Wilma. Most of the KETRA relief provisions will effectively be terminated by Dec. 31, 2005. For high-net-worth individuals throughout the country, the main benefit of KETRA is the ability to make contributions to charities in excess of the usual 50 percent of AGI limitations. Further, such contributions will not be subject to the 3 percent phaseout for itemized deductions when the donor has income in excess of \$146,000. Contributions to IRC Section 509(a)(3) supporting organizations (SOs) and gifts to donor-advised funds (DAFs) are not eligible for these benefits. Still, the wealthy could for the 2 1/2 month period ending on Dec. 31, 2005, contribute up to 100 percent of their AGI to charity at no tax cost. Many individuals are using this time-limited benefit to affect the equivalent of a charitable IRA rollover. Although several proposals have been made to implement a permanent charitable IRA rollover, KETRA did not include such a provision when it was finally signed into law. Nevertheless, using the KETRA provisions to affect such a benefit allows donors to take IRA distributions up to their full AGI, and donate the withdrawals to one or more charities for a tax cost of only 1 percent to 2 percent. Only the most well-off are helped here. The only consolation for those who care about the poor: charities receiving these contributions will hopefully benefit our lower-income brethren.

The KETRA provisions instituted to benefit working and middle-income individuals include qualified plan and IRA distributions (QHK distributions) to individuals whose principal place of abode on Aug. 28, 2005, was located in the Hurricane

Katrina disaster area and sustained economic loss because of the hurricane. Nevertheless, maximum lifetime KETRA withdrawals from all qualified plans and IRAs, per individual, are \$100,000. Eligible QHK distributions are: (1) not subject to a 10 percent early withdrawal penalty tax;

Savvy financial firms will see the marketing opportunity in selling to retirement investors the service of helping them comply with the complex tax rules governing pensions and IRA distributions.

(2) able to be rolled over to eligible rollover plans up to three years (instead of 60 days) after withdrawal; (3) eligible for taxation over the three calendar years beginning with the year of distribution if no rollover is intended; (4) not treated as "eligible rollover distributions;" and (5) are not subject to 20 percent mandatory federal income tax withholding. KETRA plan loan rules were expanded as well: Repayment requirements for KETRA loans are suspended for one year; individuals who have sustained economic loss because of Katrina may take increased plan loans: 100 percent of accrued plan balances (instead of 50 percent), up to a total aggregate loan of \$100,000. Finally, certain individuals who

received plan distributions (whether or not QHK distributions) for the purpose of buying or building a principal residence in the Hurricane Katrina disaster area are allowed to roll these distributions back into an applicable qualified plan by Feb. 28, 2006 (to give them time to obtain outside mortgages or other disaster relief).

While these KETRA relief provisions appear to be helpful to those most in need, I can't help wondering if in the long run, they will do more harm than good. After all, moderate- and low-income individuals are the ones who will need these funds most at retirement. If the funds are withdrawn now, thanks to KETRA, what will happen to these people when they are actually eligible to retire?

What can or should be done to repair America's retirement system? Here are three simple action items that the IRS can accomplish on its own—or can be ordered by Congress:

(1) Lower the penalty for missing an MRD payment—especially for those who have aggregate retirement benefits of under \$1 million and/or are in lower tax brackets; and/or who have moderate taxable income.

(2) Do away with the requirement that the penalty be paid when Form 5329 is submitted requesting an abatement of the penalty for reasonable cause. Why should our elderly be required to pay outrageous amounts before their claims are heard—particularly when often there was good cause for the mistake (illness, bad or nonexistent tax advice, etc.).

(3) Require that financial institutions managing funds for all pension and IRA plans (whether or not as trustee or custodian) advise plan and IRA participants annually of their

MRDs, and maintain original plan documents and beneficiary designation forms on file at all times.

I have had to counsel too many clients who have been hurt by what I consider extremely unfair rules. If the IRS does not require our financial institutions to make the calculations and keep the necessary records (as they did not, until relatively recently with respect to IRA custodians), they will not (not because they don't want to, but because of the enormous amount of paperwork they already are responsible for, and because of the constant mergers and takeovers). But if a financial institution wants this business, it should at least be responsible for assuring that the client is in compliance with the myriad and complex tax rules governing the distribution of the very same pension and/or IRA assets they are effectively managing. The savvy firm will see this as a marketing opportunity.

The Baby Boomers are about to retire. They are a huge financial and voting block—particularly the middle class among them.

Now is the time for savvy financial institutions to make it a point of marketing with pride how well they will keep retiree clients informed and how well they will maintain their retiree's files.

Now is the time for savvy politicians to win points with the public by making sure retirement benefits are safe from corporate and governmental bureaucratic nightmares.

Now is the time for the American Association of Retired Persons (AARP) to advocate this agenda.

And now is the time for the IRS to do the right thing. ■

Endnotes

1. Katrina Emergency Tax Relief Act Section 101(d)(2).
2. KETRA Section 101(c)(1).



Edward Broida Collection: American abstract artist Philip Guston's 1957 oil "The Mirror" sold for \$3.2 million, as part of the Broida collection at Christie's "Post-War & Contemporary Art Sale" in New York on Nov. 8, 2005.