Financing Your Retirement Future

September 2008

Tax-Wise Gifting Strategies for Seniors

You've spent most of your life building your wealth. Now, your concern may have shifted to reducing your estate and saving taxes. Making gifts is one way to reduce your estate. But because gifting can trigger federal gift tax, as well as federal generation-skipping transfer tax (GSTT) if the gift is to someone who is more than one generation below you (e.g., grandchildren), you'll want to consider making gifts in ways that will minimize tax. Here are some tax-wise gifting strategies to consider.

Take full advantage of the federal annual gift tax exclusion and lifetime exemption

For 2008, you can give tax free up to $12,000 per recipient ($24,000 if the gift is from both you and your spouse) under the annual gift tax exclusion. Gifts over that amount are tax free to the extent of your $1 million lifetime gift tax exemption ($2 million lifetime GSTT exemption).

Contribute to 529 plans

If you fund a 529 plan for your grandchild's college education, you can contribute up to five years' worth of gifts at once; that's $60,000 per child, or $120,000 per child if you and your spouse elect to make the gift.

Pay tuition and medical expenses

You can make unlimited tax-free gifts by paying medical bills or college tuition on behalf of a recipient. Payments must be made directly to the medical care provider or college.

Make charitable donations

Donations to charity are completely free from gift tax and are also generally deductible for income tax purposes, subject to certain limitations.

Make gifts and pay the gift tax

This may seem counterintuitive, but sometimes making gifts and paying the gift tax can be advantageous. The reason is that gift tax paid is removed from your estate. So, gift taxes paid on lifetime gifts can significantly reduce overall federal gift and estate taxes.

Types of property to gift

Selecting the type of property to gift can be very important. Here are some things to consider:

- Gift property that may grow substantially in value overtime, such as common stock, antiques, art, and real estate. This strategy removes any future appreciation of this property from your estate.

- Be careful when gifting appreciated property. Because a property's basis (generally its cost) is carried over to the recipient, gifts of appreciated property can be good in some circumstances but not in others. You may not want to give highly appreciated property if the recipient will recognize a substantial capital gain when the property is sold. On the other hand, you may want to make that gift if the sale of the property is imminent anyway and the recipient would owe less tax than you upon the sale.

- You should avoid giving property that is likely to lose value after the gift has been made. Also, it's generally a good idea to give away depreciated property. The recipient's basis for recognizing a loss is the lower of your basis (carryover basis) or the current fair market value. The recipient may be unable to recognize the loss on the property. Both you and the recipient may lose the loss deduction.

- Gift assets that yield higher amounts of income instead of those that yield lower amounts. This will prevent the buildup of income in your estate. Similarly, gift assets that produce taxable income instead of those that produce less taxable income, such as municipal bonds.

- It may be possible to reduce your ownership interest in a closely held business (or an interest in real estate) so that it may be valued at a discount. For example, if you have a minority interest (49% or less) in the stock of a closely held business, you may qualify for a discount. Also, a fractional interest in real property may be valued at a discount. It may be beneficial to make a gift of stock or an interest in real estate to qualify for the discount.

- Be careful when giving S corp stock to a trust, as the business may lose S corp status.

Ask the Experts

Can I roll over funds from my 401(k) to a Roth IRA?

Yes, beginning in 2008, you can make a rollover from a 401(k) plan (or other qualified employer plan, 403 (b) plan, or governmental 457(b) plan) to a Roth IRA, as long as you meet certain requirements.

First, you must be entitled to a distribution from your plan. Generally, you can access your account when you terminate your employment. But, in some cases, you may also be able to make in-service withdrawals of your or your employer's contributions (for example, at age 59½). The terms of your plan control, so talk with your plan administrator or review your plan's summary plan description (SPD).

Second, your distribution must be an "eligible rollover distribution." In general, this is any distribution you receive from the plan that isn't a hardship withdrawal, certain periodic payments, or a required minimum distribution. Third, you must meet income guidelines. You can roll over funds from a 401(k) plan to a Roth IRA only if your modified adjusted gross income is $100,000 or less (this dollar limit applies whether your tax filing status is single or married filing jointly). If you're married filing separately, you can't make a rollover at all. (These limitations will be repealed in 2010.)

You must include in gross income any amount that would have been taxed if the distribution had been paid to you, and not rolled over. But that's the price you have to pay to be able to receive tax-free qualified distributions from your Roth IRA in the future.

In most cases you should elect a direct rollover, where your 401(k) plan transfers the funds directly to your IRA. If instead the plan pays you, you'll have 60 days to complete the rollover, but your 401(k) plan will be required to withhold 20% of the taxable portion of your distribution.

Note: *If you have funds in a Roth 401(k) or Roth 403(b) account, different rules apply. If you receive an eligible rollover distribution, you can generally make a tax-free rollover (direct or 60-day) of those funds to a Roth IRA without restriction.*

I inherited my spouse's traditional IRA. Now what?

When you inherit your spouse's traditional IRA, you have a number of options.

Option 1: You can roll the proceeds of the inherited IRA over to your own traditional IRA. This can be a new IRA, or one you already own.

Option 2: You can treat the inherited IRA as your own by designating yourself as the owner of the IRA. If you're the sole beneficiary, you'll also be deemed to have elected to treat the inherited IRA as your own if you make any contributions to the IRA, or if you fail to take required minimum distributions (RMDs) as the IRA beneficiary.

With both options 1 and 2, because you own the IRA, you'll name the beneficiary who'll receive the funds after your death. You'll need to start taking RMDs by April 1 of the year following the year you turn 70½. Because you own the IRA, distributions prior to age 59½ will be subject to income tax plus a 10% early distribution penalty, unless an exception applies.

Option 3: You can remain the beneficiary of the inherited IRA. Because you're the beneficiary and not the IRA owner, any distributions you receive from the IRA will be subject to income tax, but will be exempt from the 10% early distribution penalty. This might be a good choice if you'll need to access the IRA funds before you turn 59½. In general, you won't need to start taking RMDs until the end of the year your spouse would have turned 70½ (or, if later, the end of the year following the year your spouse died).

Option 4: You can roll the taxable portion of the distribution over to an employer retirement plan (for example, a 401(k), 403(b), or governmental 457(b) plan) that accepts rollovers.

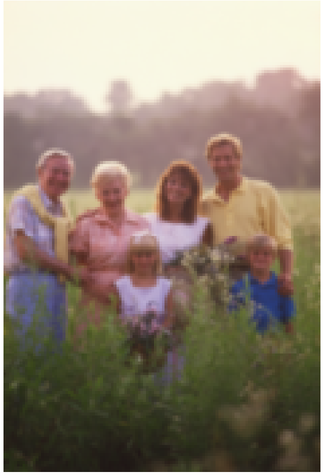
Option 5: You can withdraw the funds. You'll have to include the taxable portion of the distribution in gross income (the 10% penalty won't apply).

Annuity Maximization: A Strategy to Leave More to Your Heirs

What if you're living comfortably in retirement and find that you don't need a deferred annuity you bought years ago? Instead, you want to leave it to your heirs at your death. What you may not know is that transferring your deferred annuity at death may subject it to both estate and income taxes. A strategy that can minimize the impact of these taxes is called annuity maximization using permanent life insurance.

Some background

When you die, the portion of the annuity death benefit received by your beneficiaries (either in a lump sum or as periodic payments) that exceeds your investment in the annuity is includible as taxable income to your beneficiaries.



In addition, the full accumulation value of your deferred annuity is includible in your gross estate at your death. If your estate is large enough to owe federal and/or state estate taxes, your deferred annuity will be subject to those taxes as well.

The combination of estate and income taxes can erode a significant portion of your annuity's value. The result is that your beneficiaries may receive an annuity worth much less than you anticipate.

How annuity maximization works

Here's the basic way this strategy works: you exchange your deferred annuity for a single premium immediate annuity (SPIA) that provides an income stream to you for the rest of your life. You then obtain permanent life insurance with you as the insured, and use the SPIA distributions to pay the insurance premiums. At your death, the SPIA payments stop and the insurance proceeds are paid to your beneficiaries.

Alternatively, if you prefer to retain the deferred annuity instead of converting it to an SPIA, you may be able to take penalty-free withdrawals from your deferred annuity, which also can be used to pay the insurance premiums. However, annuities vary as to penalty-free withdrawal availability, so for complete details, be sure to check with the annuity issuer, or review your annuity contract or prospectus.

Caution: *Annuity distributions before age 59½ may be subject to a 10% federal tax penalty. Annuity guarantees are based on the claims-paying ability of the annuity issuer.*

The annuity maximization strategy may pose some income tax issues for you. SPIA payments and annuity withdrawals may be taxable to you. A portion of each SPIA payment you receive is subject to income taxes and a portion is considered a nontaxable return of premium. Conversely, withdrawals from your deferred annuity (for annuities issued after 1982) are taxed as income first, meaning the entire withdrawal is includible as income until all of the annuity's earnings are withdrawn, after which withdrawals of principal are not includible as income.

Why annuity maximization works

Instead of getting the deferred annuity at your death, your beneficiaries receive the life insurance proceeds, income tax free. And you can effectively remove the value of the deferred annuity from your estate by converting it to a SPIA. Since the SPIA payments cease at your death, the SPIA is not included as an asset of your estate.

In addition, the life insurance can escape estate taxes if the policy is not part of your estate at death. To achieve this goal, you can't own the policy; it must be owned by another (e.g., your child or an irrevocable life insurance trust). You then make gifts to the policy owner equal to the annual insurance premium. However, gifts may be subject to both federal and state gift taxes, so you should consult your tax professional before making such gifts.

The bottom line

If you own an annuity that you want to transfer to your heirs at your death, a significant portion of its value may be lost to estate and income taxes. Annuity maximization is a strategy that lets you replace part or all of a taxable asset (your deferred annuity) with an asset (permanent life insurance) that may be subject to neither income nor estate taxes at your death. This approach may effectively allow you to increase the amount you pass on to your beneficiaries.

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Dave Williams is originally from Philadelphia, PA. He has been a "transplanted" Hoosier for the past 30 years. Dave strives to educate his clients on how to invest profitably and avoid loss by providing conservative options. He is dedicated to properly helping his clients reap the rewards of a well planned retirement. In addition, Dave is a well established speaker in Indiana and is committed to educating the community with his workshops on topics relating to conservative alternatives. Dave is a graduate of Indiana University with a BS in Finance. He is also a member of the National Ethics Bureau. He resides in Indianapolis with his wife of 27 years, 3 mini-Daschunds, and is enjoying his new granddaughter, Elly.

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