

New tax breaks for retirement savings

Recent federal reforms provide a slew of perks for high-earners and their families.

By David J. Schiller, JD

Seeking to avert a meltdown and taxpayer bailout of traditional pension plans, Congress passed two important pension reform bills this spring. Both the Pension Protection Act of 2006 and the Tax Increase Prevention and Reconciliation Act not only strengthen traditional pension plans, but they also extend and improve more than 20 retirement tax savings benefits. It's important that you understand and utilize aspects that will both help your practice and help you plan for retirement.

Roth conversions. In 2010, wealthy Americans can convert a traditional IRA into a Roth IRA, regardless of income. Before, taxpayers with an annual modified adjusted

gross income of more than \$100,000 weren't permitted to make Roth conversions. Although the Roth conversions can't occur until 2010, physicians and their spouses can currently (regardless of income) make *nondeductible* IRA contributions each year. Then, when the contributions are transferred into a Roth IRA, no income taxes will be due on them. Tax is due on the converted amount, but if you make the switch in 2010 the tax obligation can be spread over the succeeding two years; after that, the amounts converted and any earnings on that money should ultimately receive tax-free treatment.

Although the standard advice is to pay taxes later, I've always made an exception for Roth IRAs, especially for high-income

David J. Schiller is a Norristown, PA, attorney, a tax and estate-planning specialist, and an editorial consultant to this magazine.

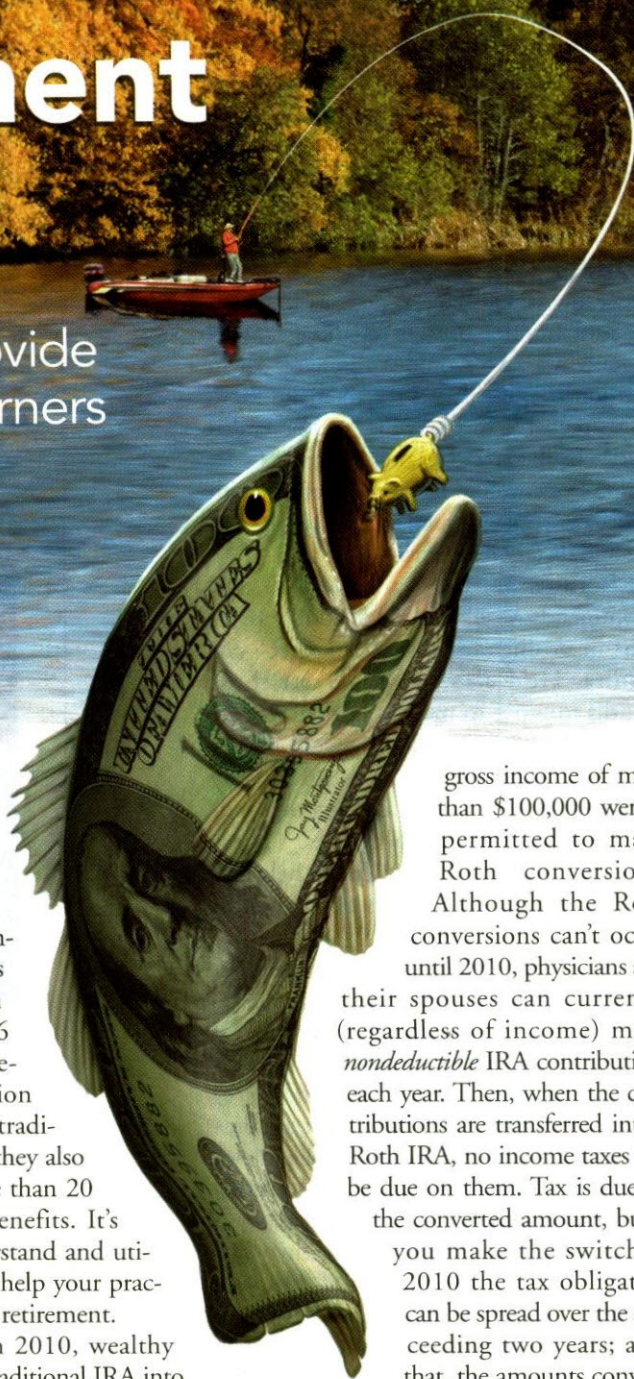


Illustration by JayMontgomery.com

taxpayers. Assuming you're in the top tax bracket of 35 percent and have \$1 million in your qualified plan or IRA, you'll be better off to the tune of about \$500,000 in 2030 if you make the conversion in 2010. The benefit multiplies if you leave your Roth IRA to your children because, as your beneficiaries, they won't have to pay income taxes on that money. One important caveat: For a Roth conversion to be most beneficial to you and your heirs, you must pay any tax liability with outside funds—not with funds from the converted account—so that the maximum amount is working for you in the Roth.

If you can't cover the taxes from other funds, don't despair. This isn't an all-or-nothing proposition since you can instead choose to convert only a portion of your IRA. Although some advisers project that you'll be in a lower tax bracket during retirement and question the wisdom of converting to a Roth IRA, I believe it's more likely that there will be higher tax rates for everyone in the future. Furthermore, Roth IRAs don't have minimum required distributions at age 70½, so your tax-free piggybank could continue to get fatter over your retirement years.

Nonspouse beneficiaries. Starting in 2007, nonspouse beneficiaries can transfer amounts from a qualified retirement plan or tax-sheltered annuity directly into an IRA, which will be treated as an inherited IRA for minimum distribution rules. If you're unmarried, or if you have sufficient other assets to pass to your surviving spouse, naming a child, grandchild, or other beneficiary could allow this person to defer income taxes. For how long depends on the minimum distribution rules that apply to nonspouses, including whether you had been receiving payouts at the time of your death. If you were at least age 70½ and minimum distributions had begun, your nonspouse beneficiary must continue to take them at least as rapidly; if payouts hadn't begun, they can be taken over the beneficiary's life expectancy, stretching them over many years.

Automatic enrollment. It's now easier for employers to enroll employees in a

401(k) plan. Specifically, to pass the nondiscrimination tests, a plan can provide that elective deferrals are made automatically out of employee wages unless the employee elects otherwise. The purpose, of course, is to encourage employees to participate in the plan and save for retirement.

«New Roth conversion rules make it worth looking into even nondeductible IRA contributions.»

But the employer also benefits because its required matching contribution is at a rate slightly less than the current required rate for most safe-harbor plans.

An additional benefit of automatic enrollment: Unlike the current safe-harbor plans that require immediate 100 percent vesting of all employer contributions, business owners can require at least two years of service to be 100 percent vested. That means most short-term employees would likely forfeit the employer contribution.

Does this mean an automatic enrollment plan is the way to go for a medical office? Perhaps, if you have a fair amount of turnover. However, the benefits of automatic enrollment plans should be balanced against the higher number of small accounts that will be established for short-term employees, plus the additional administrative burden of tracking such accounts and paying people out when they leave the practice.

Default investment options. Starting in 2007, retirement plan fiduciaries will be protected from liability in cases where employees don't make their own investment choices and instead have their contributions invested by default—generally in a mix of asset classes that emphasize capital preservation and long-term appreciation.

Each plan participant must be provided with an explanation of her right to designate investments under the plan and how the account balance will be invested in the

power points

» Consider IRA contributions because the income restriction on Roth conversions disappears in 2010.

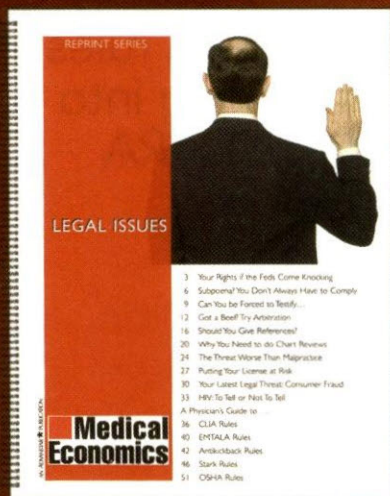
» It'll be easier to automatically enroll employees in a practice's savings plan.

» Starting in 2007, retirement plan fiduciaries can't be held liable in cases where employees don't make their own investment choices.

» IRA distributions of up to \$100,000 can be taken tax-free if donated to charity.

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absence of specific choices. Furthermore, the participant has to be given a reasonable amount of time after the receipt of the

«Beginning in 2007,
retirement plan
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advice.»

notice and before the beginning of the plan year to make these choices.

Employee education and investment advice. Beginning in 2007, 401(k)s and other employer-sponsored plans will be able to engage investment advisers to provide plan participants with tailored investment advice, and to help meet the education guidelines of self-directed plans. For a 401(k) plan specifically, the adviser must use either an unbiased and certified computer model or charge set fees that aren't tied to the various investment options selected. He or she may be affiliated with the investment funds offered in a 401(k) plan, but must meet disclosure, qualification, and other self-dealing safeguards.

IRA distributions for charitable purposes. If you're at least age 70½, you may donate traditional or Roth IRA distributions of up to \$100,000 per year—without owing any tax—to charitable organizations during calendar years 2006 and 2007. Not only is this a great opportunity to fulfill charitable intentions, your contributions will count toward satisfying the minimum amounts that you're required to take as distributions. The downside is that, in the case of assets from a traditional IRA, you won't get an income tax deduction since you've already gotten a deduction for those contributions. In fact, if you're in a low tax bracket it may be more advantageous to you to give stock that has appreciated in value, instead. Meet with your accountant and financial adviser to decide on the wisest course of action. ■