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Never Pay Income Tax on Your Retirement Plan

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Late in the year, professionals and other taxpayers examine ways to intelligently lower the income tax due on their April 15, 2011 personal returns. There are only a few safe, reliable income tax deductions: interest on the first $1.1 million on the mortgage on a principal residence; charitable deductions; and oil and gas. The list rapidly falls off after that.

Perhaps the largest, and yet one of the safest, deductions in the Internal Revenue Code is a contribution to a tax qualified employee retirement plan. This might be a profit sharing plan, a money purchase pension plan, a Section 401(k) plan, a cash balance plan, a target benefit plan or a defined benefit pension plan. A corporation, a partnership, an LLC or even a sole proprietorship might sponsor the plan. (The latter is especially important since so many lawyers practice as sole proprietors.) The National Office of the Internal Revenue Service does not opine on the amount of the deductible contribution to a tax qualified employee retirement plan. However, it will issue a *favorable determination letter* on the form of the retirement plan, which is a source of a great deal of comfort to the taxpayer taking the deduction.

As we know from the O.J. Simpson saga, retirement plans have another benefit: an extraordinary degree of creditor protection. Whether you kill someone, steal, or commit massive malpractice, your retirement assets are exempt from all creditors, with three exceptions: the U.S. government (The California Franchise Tax Board is not similarly privileged, which means that your retirement plan assets are protected against a lien for unpaid state income taxes); an order for child support; and an order for spousal support. And California's laws protecting retirement plans - Code of Civil Procedure Section 704.115 - is broader and more protective than federal law.

Some tax advisors counsel that taxpayers should not contribute to a retirement plan but, instead, "pay the tax and pocket the difference." Why? In some situations the cost of covering the rank and file employees is viewed as too expensive. In other situations, the cost of maintaining the plan, e.g., filing the annual reports, is viewed as too expensive and complicated. In still other situations, advisors believe that tax rates will surely increase in the future, e.g., to retire the exploding national debt. Therefore, taxpayers are better off investing the after tax proceeds today in muni bonds, rather than deferring the tax to some future day when the rates will be significantly higher.

The purpose of this article is not to prove the first two points (the costs of covering the rank and file and paying for administration) false, though they almost invariably are. Instead, the purpose of this article is to point out that many taxpayers who contribute to a retirement plan today will *never pay the income tax*. That is, and should be, an astonishing statement. Most tax advisors view a retirement plan as a tax deferral vehicle: you get a deduction today, the money accumulates in the plan on a tax *deferred* basis, and you pay the income tax when you receive a distribution. However, the little known fact is that - at least for our clients - they never pay the income tax because they do not need the money at retirement. All they take from the

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Letter to the Editor
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Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal
Panel Lawyers Could Be Curtailed
A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

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A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

retirement plan are the "required minimum distributions."

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Congress added the requirement for minimum distributions to the Internal Revenue Code in an attempt to restrict retirement plans to providing for the retirement of the participants. At that time, retirement plans had become a way to pass on wealth to the next generation. However, the manner in which the IRS has promulgated the rules regarding required minimum distributions does not necessarily accomplish their intended purpose. As a result, taxpayers who do not need the money from their retirement plans are able to pass the wealth on to their heirs.

Required minimum distributions must begin no later than April 1 of the year after the year in which you reach 70 and a half years old - after which a percentage of trust assets must be distributed every year. Note: although the thrust of this article has been about employee retirement plans, the rest of this discussion applies equally to non-Roth IRA's.

Imagine that our retiree starts with $1 million at age 70, takes the required minimum distributions each year and manages to earn 6.5 percent on his retirement trust investments. How much is left at his death at age 87? $1,050,000. In other words, our retiree paid tax on the earnings, but never on the principal of his retirement trust. The principal passes to his heirs. Of course if the heir is the retiree's spouse, the principal passes free of estate tax. If the heirs are the retiree's children, that may be free of estate tax depending upon the nature of our estate tax laws at the time and the size of the retiree's estate.

What if our retiree *only* manages to earn 5 percent on the investments in his retirement trust? Then only $943,000 is left in his retirement trust. So, unfortunately, he has to pay income tax on $57,000 of the principal. This is hardly a reason to hesitate from establishing the plan in the first place.

While there are ways to directly and indirectly eliminate the estate tax from retirement plan benefits - when it comes to tax qualified employee retirement plans, an income tax deferred may be a tax never paid.

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