While Congress has put a temporary suspension on the so-called "success" excise tax, there is no simple answer as to who it would most benefit.

The Excess Distributions Penalty: Is Moratorium a Bonanza—or Trap?

By Myron S. Blatt

As many retirees are only too fully aware, withdrawing money from retirement plans can involve complex navigational skills to avoid or minimize various retirement distribution tax traps.

On the one hand, the tax laws require that minimum distributions be made from retirement plans based upon the life expectancy of the plan participant and his beneficiary starting at age 70½. Failure to take out the required minimum amount will trigger an excise tax of 50% of the amount required to be withdrawn.

On the other hand, taking out "too much" may trigger an additional tax called the excess distribution tax, imposed on a portion of the distribution. This is an excise tax payable when a distribution is in excess of the statutory threshold, which had been set at $160,000 for 1997, but which is indexed to the rate of inflation. The rate of tax is 15% of the amount in excess of the threshold, so assuming a threshold of $160,000, the excise tax for a $200,000 distribution would be 15% × $40,000 ($200,000 – $160,000), or $6,000. [This penalty did not apply to grandfathered amounts for those who were able to make an excise tax grandfather election in 1987 or 1988.]

In addition, all distributions are subject to ordinary income taxes at the applicable rates and the actual effective tax rates may be higher if itemized deductions and exemptions are reduced or eliminated. State and local taxes may also be imposed, which could increase the total taxes due to approximately 50% of the distribution.

The Excise Tax Abatement Window

The recently enacted Small Business Job Protection Act of 1996 contains a provision that temporarily suspends the 15% excise tax on excess distributions for distributions taken in 1997, 1998, and 1999. During these three years, the 15% excise tax will not be imposed regardless of the size of the distribution. However, the new law does not suspend the application of the 15% excise tax on excess accumulations existing at the taxpayer's death. Another provision of the act allows people who continue to work after age 70½ the option of not having to start taking distributions from "qualified plans" or of stopping distributions if they have already started, until they retire. This rule does not apply to IRAs or to people owning 5% or more of their businesses.

The obvious question that arises is: When would an individual benefit by taking advantage of this three-year moratorium on the excise tax?

Unfortunately, there is no simple answer to this question, and adequate planning is necessary before any decisions are made. Among the factors to be considered are:

- Your income tax rate
- The existence of losses from flow-through entities
- Investment allocations
- Rates of return
- Your age
- Your charitable intentions
- Possible loss of protection of funds from creditors
- Shifting of assets for estate tax purposes, and
- Personal financial planning needs.

Generally speaking, taxpayers under age 59½ should not avail themselves of the moratorium, since they would lose over 10 years of tax-deferred compounding (that is, they could keep money invested in tax-deferred accounts until age 70½, when minimum distributions must begin). In addition, they may be subject to the 10% early distributions penalty; to avoid this, they would have to take distributions out over at least a five-year period, and since the moratorium would only be in effect for the first three years of the payout, the distributions after the moratorium would be subject to the 15% excess distributions tax.

For those taxpayers in their early 60s, there would again be the loss of a substantial tax-deferral opportunity, until they reach age 70½. Individuals whose estate plan includes the leaving of their retirement plan to their surviving spouse and then to their heirs should also disregard

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Table 1.
Aftertax Growth of a $1 Million Withdrawal ($560,000 after taxes)

No. of Years	Aftertax Rate of Return** 6%	8%	10%
1	$ 593,600	$ 604,800	$ 616,000
2	629,216	653,184	677,600
4	706,987	761,874	819,896
6	794,371	888,650	992,074
8	892,555	1,036,521	1,200,410
10	1,002,875	1,208,998	1,452,496
12	1,126,830	1,410,175	1,757,520
14	1,266,106	1,644,828	2,126,599
16	1,422,597	1,918,528	2,573,185
18	1,598,430	2,237,771	3,113,554
20	1,795,996	2,610,136	3,767,400

Table 2.
Growth of $1 Million After Taxes and Penalty; Withdrawal Deferred*: Current Age 60

Age	Pretax Rate of Return 9%	12%	15%
61	$ 446,900	$ 459,200	$ 471,500
62	487,121	514,304	542,225
64	578,748	645,143	717,093
66	687,611	809,267	948,355
68	816,951	1,015,145	1,254,199
70	970,619	1,273,398	1,658,679
72	1,151,737	1,594,803	2,189,456
74	1,359,888	1,984,928	2,868,927
76	1,597,923	2,455,675	3,732,928
78	1,868,665	3,020,099	4,823,695
80	2,174,773	3,692,096	6,189,878

Table 3.
Growth of $1 Million After Taxes and Penalty; Withdrawal Deferred*: Current Age 65

Age	Pretax Rate of Return 9%	12%	15%
66	$ 446,900	$ 459,200	$ 471,500
67	487,121	514,304	542,225
69	578,748	645,143	717,093
71	687,611	809,267	948,355
73	813,880	1,010,338	1,247,174
75	958,643	1,253,691	1,628,440
77	1,123,753	1,546,422	2,111,545
79	1,311,005	1,896,206	2,719,101
81	1,522,027	2,311,055	3,476,770
83	1,758,123	2,798,870	4,412,523
85	2,020,038	3,379,376	5,554,870

Table 4.
Growth of $1 Million After Taxes and Penalty; Withdrawal Deferred*: Current Age 70

Age	Pretax Rate of Return 9%	12%	15%
71	$ 446,900	$ 459,200	$ 471,500
72	486,506	513,484	541,200
74	574,431	639,094	709,155
76	674,980	790,662	922,723
78	789,344	972,391	1,192,344
80	918,648	1,188,756	1,530,043
82	1,063,858	1,444,311	1,949,224
84	1,225,664	1,743,362	2,464,082
86	1,404,292	2,089,400	3,088,335
88	1,599,225	2,484,130	3,832,660
90	1,808,680	2,925,565	4,699,113

**Assumes required annual minimum distributions withdrawn starting at age 70; tax rate at withdrawal is 59%*
***Aftertax rate of return uses pretax return rates reduced by a 33⅓% capital gains tax rate*

the three-year moratorium, since the value of tax-deferred compounding over two generations more than offsets the excise tax. Moreover, they can already, starting at age 59½, take annual distributions up to the threshold level free of excise taxes.

For those in their late 60s, the factors cited above—loss of tax deferral and the availability of excise-free withdrawals up to the threshold level—may still apply. Another factor that may also come into play is the possibility of lower taxes due to retirement and the relocation to a state with lower or no income taxes. However, for very large accumulations where distributions must begin within two or three years, the proper distribution strategy most likely would include accelerated withdrawals in order to take advantage of the excise tax moratorium. Likewise, if mandated distributions have already begun and they are subject to the 15% excise tax, it would probably warrant increasing the withdrawals to save excise taxes in the future.

Since there is a three-year window, should you wait until 1999 before taking a distribution or take one every year?

This, too, depends on your situation. The total income taxes paid may be higher under one scenario than another. The value of two more years' of tax deferral must also be considered. Looking at the income tax factor by itself, if you are already in the highest brackets, an accelerated distribution can wait until 1999. Otherwise, it should prob-

ably be taken every year.

Finally, ill health may be a reason for taking large excise tax-free withdrawals. Even after income taxes and estate taxes, the savings on the excise taxes could be considerable. Remember, there is no moratorium on the 15% excise tax that is imposed at death.

Withdrawals vs. Tax Deferment

Tables 1 to 4 illustrate the comparable results of withdrawing $1 million from a retirement plan and growing it outside the plan (Table 1) versus letting the funds earn a tax-deferred rate (except for required minimum distributions) for a period of 20 years and then paying ordinary income taxes and the full 15% excise tax upon withdrawal for taxpayers aged 60 (Table 2), 65 (Table 3), and 70 (Table 4). The tables are based on alternative pretax rates of return of 9%, 12%, and 15% for the tax-deferred monies, and alternative aftertax rates of returns of 6%, 8%, and 10% for the taxable monies. The difference in the tax-deferred and taxable rates of return assume a combined federal and state income tax rate of 44% for all withdrawals and a capital gains rate of 33 1/3%. These rates can be higher if either the loss of itemized deductions and exemptions or the alternative minimum tax becomes a factor.

As an example, from Table 1 it can be seen that an individual of any retirement age who withdraws $1 million from a retirement plan and after paying taxes reinvests the remaining $560,000 earning 6% after taxes, will have $1.26 million after 14 years. This is in contrast to a 60-year-old (Table 2) who starts with the same amount but defers any withdrawals to age 70 and then takes only the required minimum withdrawals; after taxes and penalties, this individual would have $1.36 million after 14 years if his fund earns 9% before taxes. A 65-year-old (Table 3) who defers withdrawal except for required minimum distributions starting at age 70 would have $1.31 million, again assuming a 9% before-taxes rate of return and a $1 million starting amount. And a 70-year-old who only withdraws at the minimum required rate will have $1.22 million after 14 years, all else equal.

From these tables, it can be seen that the benefits of deferral are more valuable at higher pretax rates of return and longer deferral periods, at which point the ultimate excise tax exposure then becomes less significant.

In addition, in all instances, deferring the withdrawal, even at age 70, produces a larger aftertax amount after 20 years. However, for time periods less than 20 years, there are times when the non-deferred amounts are larger. The benefits of deferral overcome the penalties after a period of eight and 18 years, depending on the taxpayer's age and comparative rate of return.

The strategy of leaving the retirement plan to heirs can be the determining factor in taking accelerated distributions, or for that matter, any non-required distributions. (This strategy requires that the taxes due at the death of the IRA owner or his or her spouse be paid from sources other than the IRA). The 60-year-old in Table 2 had accumulated roughly $3 million additional funds after 20 years (mandatory distributions having been made) at a 9% pretax rate of return. These funds could be passed down to children who, if they took annual withdrawals over 30 years, would receive distributions totaling roughly $16 million using the same 9% pretax rate of return. A $1 million IRA passed down to grandchildren, if they took annual withdrawals over 60 years, would generate distributions totaling roughly $39 million using the same 9% pretax rate of return.

The power of long-term tax-deferred investing is strong. Total distributions over a 60-year period for a $1 million IRA range from almost $25 million to over $165 million using rates of return from 8% to 12%.While these distributions to beneficiaries are subject to income taxes, there are no excise taxes of any kind. In addition, the beneficiaries are entitled to a deduction for income tax purposes for federal estate taxes paid attributable to such IRA at the time of the IRA owner's death. With proper planning, retirement vehicles can generate big rewards to heirs. However, the naming of beneficiaries can be extremely complex, and can affect required minimum distributions. [For more on this topic, see the three-part series by Clark Blackman II and Kevin P. McAuliffe in the April 1996, June 1996, and August 1996 Retirement Plans columns.]

Summary

The answer to the question as to whether or not to make extra withdrawals under the 1997 though 1999 excise tax abatements can only be arrived at after careful planning, taking into account the factors enumerated above. Excise tax rates may also be in the new tax bill currently under discussion.

The alternative to careful planning is to turn over more of your assets than is necessary to the IRS.