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TAX PLANNING FOR RETIREMENT

Vada Waters Lindsey*

INTRODUCTION

Most individuals recognize the importance of saving for retirement. Retirement saving is becoming increasingly important because of inflationary increases, including increases in the cost of energy and health care. Recent studies indicate that a retiring elderly couple needs to have saved between \$200,000 and \$300,000 to pay for *basic* medical coverage.¹ During 2004, health care expenditures rose at a rate of 7.9%, three times the rate of inflation.² Studies establish that energy prices are instrumental in driving up the country's inflationary rate, a result of a 6.4% increase in gas prices.³ In addition, as the average age of mortality increases, retirees are required to save substantial sums to support themselves during increased expected life spans. According to the National Center for Vital Statistics, the life expectancy for males and females of all races

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1. National Coalition on Health Care, *Facts on Health Care Costs*, <http://www.nchc.org/facts/2006%20Fact%20Sheets/Cost%20-%202006.pdf> (last visited Nov. 10, 2006) (emphasis added).

2. *Id.*; see also *Health Care Growing Faster than Inflation*, DAILY NEWS CENTRAL, June 21, 2005, available at <http://health.dailynewscentral.com/content/view/0001104/39> (last visited Nov. 10, 2006).

3. Michael Englund & Rick MacDonald, *Inflation's January Jump*, BUSINESS WEEK ONLINE, Feb. 23 2006, available at http://www.businessweek.com/investor/content/feb2006/pi20060223_534485.htm (last visited Nov. 10, 2006).

increased between 2002 and 2003.⁴ The preliminary data for 2004 indicates that the life expectancy at birth for the total population is 77.9, a record high.⁵ Finally, the uncertainty of Social Security benefits compels workers to save an appropriate amount for retirement.⁶

Today, several avenues are available to workers to save for retirement. These options include traditional individual retirement accounts (IRAs), 401K pension plans, Keogh plans, stocks, bonds, mutual funds, and Roth IRAs. Tax considerations influence different types of retirement savings. Investments in 401K plans, Keogh plans, and traditional IRAs are tax deferred, while the other forms of investment are not. Retirees must give proper regard to considerations as they switch from contributors to recipients of distributions from these funds. This area of law is frequently amended. One recent amendment to the Roth IRA

4. Elizabeth Arias, *United States Life Tables, 2003*, 54 NAT'L VITAL STAT. REP., at 4 (Ctr. for Disease Control Apr. 19, 2006), available at http://www.cdc.gov/nchs/data/nvsr/nvsr54/nvsr54_14.pdf (last visited Nov. 10, 2006). According to the statistics, the life expectancies for White and Black males and females are as follows:

Gender & Race	Life Expectancy at Birth in 2003	Increase from 2002
White Females	80.5 Years	0.2 Years
Black Females	76.1 Years	0.5 Years
White Males	75.3 Years	0.2 Years
Black Males	69.0 Years	0.2 Years

Id.

5. Arialdi M. Miniño et al., *Deaths: Preliminary Data for 2004*, 54 NAT'L VITAL STAT. REP., at 3, (Ctr. For Disease Control June 28, 2006), available at http://www.cdc.gov/nchs/data/nvsr/nvsr54/nvsr54_19.pdf (last visited Nov. 10, 2006).

6. The trustees of the Social Security trust fund estimate that Social Security payments will exceed revenue by 2018, and the Social Security trust fund will be completely exhausted by 2042. See June E. O'Neill, *Why Social Security Needs Fundamental Reform*, 65 OHIO ST. L.J. 79, 84-85 (2004); see also Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C.L. REV. 975 (2000) (rejecting the assumption that adequate provisions for retirement can rely on private or public equity and challenging the ideological messages embedded in the current Social Security debate); Daniel Halperin, *The Case Against Privatization*, 65 OHIO ST. L.J. 75 (2004) (arguing against privatization and suggesting that reform can be achieved through a combination of increased taxes and reduced benefits); Howell E. Jackson, *Accounting for Social Security and Its Reform*, 41 HARV. J. ON LEGIS. 59 (2004) (arguing that the current method of accounting for Social Security is deceiving and suggesting that the accrual method of accounting would more accurately reflect the state of Social Security).

provisions was enacted under the Tax Increase Prevention and Reconciliation Act.⁷ Under this amendment, upper income individuals will be allowed to rollover money from a traditional IRA to a Roth IRA during 2010.⁸ Another recent amendment allows individuals to contribute to a Roth IRA under an employer's qualified Roth contribution plan.⁹ This article addresses the recent changes to the Roth IRAs and the factors that individuals must address prior to converting a traditional IRA to a Roth IRA or contributing money to a Roth IRA under an employer's plan. This article also discusses the general tax issues surrounding the distribution of pensions and IRAs.

Individuals must be aware of state taxation of pensions, traditional and Roth IRAs, and other forms of retirement income. Many states follow federal law regarding the taxation of distributions. Other states have enacted independent tax schemes to determine the taxation of distributions. A retiree must engage in effective estate planning to avoid losing a large portion of accumulated wealth to state or federal estate taxes. This article discusses the importance of effective estate planning, notwithstanding the phase-out of the federal estate tax.

While this article primarily addresses the federal and state income tax consequences of the distribution of retirement saving, there are non-tax considerations that may affect retirees. For example, retirees occasionally do not claim retirement benefits because of shortcomings in today's system.¹⁰ Pensions, IRAs and other forms of retirement savings may be exempt from garnishment, execution, attachment, or other legal proceedings under state law. Pensions are subject to none of these actions in

7. H.R. 4297, 109th Cong. § 512 (2d Sess. 2006).

8. *Id.*

9. Pension Protection Act of 2006, H.R. 4, 109th Cong. § 824 (2d Sess. 2006) (enacted).

10. See generally, Ellen A. Bruce & John Turner, *Lost Pension Money: Who is Responsible? Who Benefits?*, 37 J. MARSHALL L. REV. 695 (2004) (discussing the shortcomings in today's system that allow pension benefits to go unclaimed because of shorter vesting periods and increased worker mobility); Nikolay A. Ouzounov, *Keeping Employees' Trust: The Rocky Road Ahead for Pension Plan Trustees*, 37 J. MARSHALL L. REV. 903 (2004).

some states,¹¹ while other states do not exempt retirement benefits from judgment.¹² A state may have a statutory exemption, but except certain actions or limit the exemption.¹³ Moreover, even if the state allows an exemption, it is important for the individual to know the types of retirement funds eligible for the exemption.¹⁴

This article begins with a discussion of the federal taxation of retirement savings. It then discusses the state tax implications of distributions from retirement savings. The next section considers a hypothetical retiree with a \$2,000,000 net worth and evaluates the retiree's potential federal estate tax liability. The article concludes by addressing the potential state estate tax liability of the hypothetical retiree.

11. See, e.g., ARIZ. REV. STAT. ANN. § 48-227(A) (2000); HAW. REV. STAT. ANN. § 653-3 (LexisNexis 2002); IDAHO CODE ANN. § 11-604A(1) (2004); ILL. COMP. STAT. § 15-185 (2005); MISS. CODE ANN. § 71-1-43 (2000); PA. CONS. STAT. ANN. § 8124(b) (2005); TEX. PROB. CODE ANN. § 42.0021(a) (Vernon 2006). In Illinois, the exemption applied to a debtor's income tax refund in a bankruptcy action because it resulted solely from a distribution from the debtor's qualified retirement plan. See *In re Gathmann*, 95 A.F.T.R. 2d (RIA) 2243 (2005). In Illinois, exemption statutes are liberally construed. *Id.*

12. See, e.g., ME. REV. STAT. ANN. tit. 14, § 3126-A(1)(E) (2003); MONT. CODE ANN. § 25-13-608 (2005); OR. REV. STAT. § 18.345 (2005); WASH. REV. CODE §§ 6.27.010, 6.27.150 (2006).

13. See, e.g., CONN. GEN. STAT. § 52-321a(b) (2005) (excepting qualified domestic relations orders, recovery of incarceration costs and recovery of damages by victims of crimes); GA. CODE ANN. §§ 18-4-20(d)(2), 18-4-22(a) (2004) (excepting pensions until paid to the retiree at which time retiree is allowed partial exemption); IOWA CODE § 627.6(8)(e) (2006) (excepting payments under pension plan except extraordinary contributions made within one year of bankruptcy petition); MD. CODE ANN., CTS. & JUD. PROC. § 11-504(h)(1) (LexisNexis 2002) (excepting claims by the Department of Health and Mental Hygiene); NEV. REV. STAT. ANN. § 21.090(1)(q) (LexisNexis 1998) (excepting up to \$500,000 held in IRA and pensions); UTAH CODE ANN. § 78-23-5(1)(b) (2006) (stating the exemption does not apply to a qualified domestic relations order or amounts contributed or accrued within one year of a bankruptcy petition).

14. For example, a bankruptcy court determined that in a Chapter 7 bankruptcy action, a debtor's Roth IRA was not excluded from an estate because the statute exempted only traditional IRAs. See *In re Bramlette*, 333 B.R. 911 (Bankr. N.D. Ga. 2005).

TAXATION OF RETIREMENT INCOME

An individual must carefully consider various factors that impact the income tax consequences of distributions. These factors that impact federal taxation include the timing of distributions, designation of beneficiaries and amount of distributions. In addition, prior to retirement, an individual should weigh the costs with the benefits of converting a traditional IRA to a Roth IRA or making designated Roth contributions. A retiree must also consider the state tax consequences of distributions. As will be discussed, there is a lack of consistency in the states exemption amounts and eligible age minimum for exemption.

FEDERAL TAXATION

The Employee Retirement Income Security Act of 1974 (ERISA) governs the tax treatment of pensions.¹⁵ Under ERISA, employee and employer contributions to qualified plans are not included in gross income upon contribution.¹⁶ During 2006, individuals are entitled to contribute up to \$15,000,¹⁷ and individuals who are age fifty or older can make "catch-up" contributions up to \$5000 to their pensions.¹⁸ ERISA also governs the tax treatment of IRAs.¹⁹ During 2006, an individual under age fifty is entitled to a deduction for a contribution of up to \$4000 to a traditional IRA,²⁰ and an individual who is age fifty and over is entitled to make an additional catch-up deductible contribution of up to \$1000 to a traditional IRA.²¹ While the individual is entitled to a tax deduction for the contribution, this deduction is subject to a phaseout based on the individual's

15. 29 U.S.C. § 1002(1) (2006).

16. I.R.C. § 402(c)(1) (2006).

17. I.R.C. § 402(g)(1)(B).

18. I.R.C. § 414(v)(2)(B)(i) (2006).

19. I.R.C. § 408(d) (2006).

20. I.R.C. § 219(b)(5)(A) (2006).

21. I.R.C. § 219(b)(5)(B)(ii).

adjusted gross income.²² In addition, the individual is not permitted to contribute to the IRA after the individual attains the age 70.5.²³ A retiree is required to take minimum distributions²⁴ from a pension or traditional IRA by April 1 of the year following the later of retirement or attainment of age 70.5.²⁵ If the minimum distribution is not made, a retiree may be subject to a fifty-percent excise tax.²⁶ The Internal Revenue Service (IRS) may waive the penalty if the shortfall is due to reasonable error and reasonable steps are taken to remedy the shortfall.²⁷ The IRS publishes publications that set forth tables for computing the requisite minimum distribution.²⁸ To the extent that a minimum distribution must be made, the custodian, trustee, or issuer is required to either report the required minimum distribution for the retiree or offer to calculate the minimum distribution for the retiree.²⁹ If a retiree has multiple IRA accounts, the minimum distribution must be computed separately for each IRA account; however, the minimum distribution may be taken from one or more of the accounts.³⁰

The entire benefits under a retirement plan must be distributed: (1) over the individual's life; (2) over the lives of the individual and a designated beneficiary; (3) for a period not exceeding the individual's life expectancy; or (4) for a period not

22. See I.R.C. § 219(g).

23. I.R.C. § 219(d)(1).

24. See Karen S. Gerstner, *The New Minimum Distribution Rules for Qualified Retirement Plans and IRAs*, 53 BAYLOR L. REV. 625, 644-45 (2001) (discussing minimum distribution rules for qualified pension plans and traditional IRAs); Cynthia Lamar-Hart, *New IRS Regulations Greatly Simplify Minimum Distribution Rules for IRAs and Qualified Plans*, 62 ALA. LAW. 366, 367 (2001).

25. I.R.C. §§ 401(a)(9)(C); 408(a)(6) (2006).

26. See I.R.C. § 4974(a) (2006) (tax is fifty percent of difference between minimum required distribution and actual amount distributed); I.R.C. § 4974(b) (2006).

27. I.R.C. § 4974(d).

28. See I.R.S., *INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)* (2005), Pub. No. 590, available at <http://www.irs.gov/pub/irs-pdf/p590.pdf> (last visited Nov. 10, 2006) (establishing distribution rules of IRAs) [hereinafter Pub. No. 590].

29. *Id.* at 3.

30. *Id.* at 35.

exceeding the joint life expectancies of the individual and a designated beneficiary.³¹ An important decision that an individual must make is to designate beneficiaries. If an individual dies prior to the distribution of all retirement savings, those savings are inheritable.³² For estate tax purposes, the retirement savings are includable in the individual's gross estate.³³ The unified credit against the estate tax for 2006 through 2008 allows an individual to bequeath up to \$2,000,000 before imposition of the estate tax.³⁴

There are substantial tax benefits where the beneficiary is the surviving spouse. There is an unlimited estate tax deduction for the value of any interest that passes to the individual's spouse.³⁵ Generally, in order for an individual to qualify for the marital deduction, the surviving spouse's interest in the property must not terminate at the death of the surviving spouse.³⁶

Two favorable techniques allow the surviving spouse to receive terminable interests without sacrificing the marital deduction. First, if the surviving spouse is entitled to receive income payable at least annually from an annuity or other property, and the surviving spouse has a general power to appoint the remainder, the marital deduction is allowed.³⁷ Second, if the executor elects to treat the property passing to the surviving spouse as "qualified terminable interest property" (QTIP), the individual is able to claim the marital deduction and designate who receives the remainder upon the surviving spouse's death.³⁸ A QTIP is a flexible device that enables the

31. I.R.C. § 401(a)(9)(A).

32. I.R.C. § 401(b).

33. I.R.C. § 2033 (2006).

34. I.R.C. § 2010(c) (2006) (explaining that in 2008, the unified credit for estate tax is \$3,500,000, and it is unlimited if an individual dies in 2010. Unless Congress enacts legislation repealing the "sunset" provision or enacting a higher unified credit, the unified credit will return to \$1,000,000, its level in 2001).

35. See I.R.C. § 2056(a) (2006).

36. See I.R.C. § 2056(b)(1).

37. I.R.C. §§ 2056(b)(5)-(6).

38. See I.R.C. § 2056(b)(7).

executor to evaluate the estate tax exposure and determine whether the marital deduction should be claimed for the retirement savings.

In addition to this marital deduction, there are other benefits where the surviving spouse is designated. Where the individual designates the surviving spouse to receive a traditional IRA, the surviving spouse may be entitled to roll over the inherited traditional IRA into the surviving spouse's own traditional IRA.³⁹ If the surviving spouse receives a distribution, and it is rolled over into the surviving spouse's traditional IRA within sixty days after receipt of the distribution, it is not included in the surviving spouse's gross income.⁴⁰ In addition, if a surviving spouse inherits a traditional IRA, the surviving spouse is entitled to make additional contributions to the traditional IRA because the surviving spouse can elect to be treated as the owner of the traditional IRA.⁴¹ However, if someone other than the surviving spouse inherits the traditional IRA, that beneficiary is unable to make additional contributions.⁴²

Retirees may choose to receive distributions greater than the required minimum distributions, though a retiree must consider the effect the distribution will have on the determination of the taxability of Social Security benefits. In determining the amount of taxable Social Security benefits, a retiree must complete the Social Security Benefits Worksheet.⁴³ For example, assume that an unmarried retiree receives \$16,000 of Social Security benefits and the required minimum distribution from qualified plans is \$15,000 during 2006. In such a case, none of the social security benefits will be taxed. However, the receipt of the higher amount may result in taxable Social Security benefits.

39. I.R.C. § 408(d)(3) (2006).

40. See I.R.C. § 408(d)(3)(i).

41. See I.R.C. §§ 408(a)(6), 401(a)(9)(A) (2006).

42. Pub. No. 590, *supra* note 28, at 18.

43. See IRS, 2006 1040 INSTRUCTIONS (2006) 32, available at <http://www.irs.gov/pub/irs-pdf/i1040gi.pdf> (last visited Dec. 5, 2006) [hereinafter 2006 1040 INSTRUCTIONS].

Distributions	Taxable Social Security Benefits
\$15,000	\$0
\$20,000	\$1500
\$25,000	\$ 4000
\$30,000	\$ 7900
\$40,000	\$13,600
\$50,000	\$13,600

Therefore, a retiree should understand a distribution from a qualified plan or traditional IRA may impact the taxation of Social Security benefits and, if possible, should restrict distributions to a level that minimizes taxable Social Security benefits.

Today, many individuals are able to choose between traditional IRAs and Roth IRAs. Roth IRAs are substantially different from traditional IRAs. Unlike traditional IRAs, the individual is not afforded a § 219 deduction for contributions to a Roth IRA.⁴⁴ However, all earnings and accessions are excluded from gross income upon distribution to an individual after reaching age 59.5 and five years after the first contribution to the Roth IRA.⁴⁵ Distributions also are excluded from gross income when they are made after the individual becomes disabled or dies.⁴⁶ An individual is disabled if the individual is unable "to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."⁴⁷

Roth IRAs are distinguishable from traditional IRAs because there are no early withdrawal penalties for Roth IRA

44. See I.R.C. § 408A(c)(1) (2006).

45. I.R.C. §§ 408A(d)(1)-(2).

46. I.R.C. §§ 408A(d)(2)(ii)-(iii).

47. I.R.C. § 72(m)(7) (2006).

distributions,⁴⁸ and the individual is not required to receive distributions during the individual's lifetime.⁴⁹ Distributions from Roth IRAs are not included on the Social Security Worksheet for purposes of determining the taxable Social Security benefits.⁵⁰ Additionally, contributions may continue after the individual reaches age 70.5.⁵¹ The amount an individual may contribute to a Roth IRA begins to phase out where adjusted gross income reaches \$95,000. The amount that may be contributed is completely phased out when the individual's adjusted gross income reaches \$110,000.⁵²

After the enactment of Roth IRAs in 1997, an individual was not authorized to make a rollover contribution from a traditional IRA to a Roth IRA if the individual did not have adjusted gross income exceeding \$95,000 and was not married filing separately.⁵³ The individual was required to include a Roth IRA distribution in gross income during the year of the distribution, but the individual was not subject to the ten-percent penalty under § 72(t) for an early distribution.⁵⁴

Congress significantly amended this rollover rule under the Tax Increase Prevention and Reconciliation Act of 2005 enacted during 2006.⁵⁵ Under the amendment, Congress repealed the income limit imposed under the original legislation and allowed married couples filing separate returns to qualify for the conversion.⁵⁶ The amendment is not effective until 2010.⁵⁷ If an individual makes a rollover during 2010, the amount required to be included in gross income is ratably included in gross income

48. I.R.C. § 408A(c)(5).

49. *Id.*

50. 2006 1040 INSTRUCTIONS, *supra* note 43, at 32.

51. I.R.C. § 408A(c)(4).

52. I.R.C. § 408A(c)(3). For a married couple filing a joint return, the phaseout begins where adjusted gross income reaches \$150,000, and it is completely phased out where income equals or exceeds \$160,000. *Id.*

53. See I.R.C. § 408A(c)(3)(B) (2006).

54. I.R.C. § 408A(d)(3)(A).

55. Tax Increase Prevention and Reconciliation Act of 2005, Pub. L. No. 109-222, 120 Stat. 345 (2006).

56. See I.R.C. § 408A.

57. *Id.*

during 2011 and 2012.⁵⁸ An individual must carefully evaluate the taxpayer's potential liability under the two-year inclusion period compared to the single year inclusion in the year of distribution. The two-year income inclusion rule is automatically effective unless the individual elects out of that method.⁵⁹ In some cases, it may be within the individual's interest to include the entire amount in gross income in one year rather than spreading it out over a two-year period of time. For example, if an individual has a substantial business loss during the year of distribution, the inclusion of the entire IRA conversion in gross income during that taxable year may offset the rollover amount. While the individual may have a deductible net operating loss carryover in the following taxable year, under basic time-value-of-money principles, it is better to claim a loss during the earliest possible taxable year. In addition, as will be discussed in the next section, the individual must also consider the state statutory rules regarding taxation of IRAs.

Another recent statutory amendment permits an individual to designate a partial or full amount of deferred compensation as "designated Roth contributions" if the qualified plan includes a qualified Roth contribution program.⁶⁰ Where an individual makes this designation, the contribution is not excluded from gross income.⁶¹ However, consistent with Roth IRAs, qualified distributions from employer-based elective Roth contributions are excluded from gross income.⁶² Before making a designation, an individual must weigh a number of factors, including the individual's age, current tax bracket, projected tax bracket at the time of distribution, phase out of personal exemption, itemized deductions, and the value of income deferral.

58. I.R.C. § 408A(d)(3)(A)(III).

59. *Id.*

60. See I.R.C. § 402A (2006).

61. See I.R.C. § 402A(c)(1).

62. I.R.C. § 402A(d)(1). Generally, a qualified distribution from a designated Roth account is consistent with the distribution rules governing Roth IRAs. See I.R.C. § 402A(d)(2)(A).

Under this country's income tax scheme, income is taxed on a progressive tax basis.⁶³ Currently, the lowest marginal rate is ten percent, and the top marginal rate is thirty-five percent.⁶⁴ In comparison to the historical marginal income tax rates, the current rates are more favorable.⁶⁵ It is difficult to predict whether tax rates will increase or decrease in the future. However, as many individuals will have less taxable income during retirement, retirees likely will fall in a lower tax bracket during their retirement years. Consequently, individuals must compare the tax liability resulting from the nondeductible Roth contribution potentially being taxed at a higher tax rate, and the future tax savings in the form of excluded distributions with the current deduction, income deferral, and future tax inclusion potentially at a lower tax rate.

Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001,⁶⁶ the personal exemption and itemized deductions of higher income individuals was limited. Under the 2001 Act, the phaseout of the personal exemptions, dependency exemptions, and itemized deductions is reduced by two-thirds for taxable years 2006 and 2007, and the limitations are reduced by the remaining one-third during taxable years 2008 and 2009.⁶⁷ Consequently, upper income taxpayers will not have the exemptions and itemized deductions limited during those taxable years. However, the limitations on personal and dependency exemptions and itemized deductions will return in full force during taxable year 2010 because of a sunset provision.⁶⁸ For taxable year 2006, the deduction for exemptions, adjusted for inflation, was phased out as the adjusted gross income reached \$225,750 for a married couple filing a joint

63. *See generally*, I.R.C. § 1 (2006).

64. *Id.*

65. *See generally* Vada Waters Lindsey, *The Widening Gap under the Internal Revenue Code: The Need for Renewed Progressivity*, 5 FLA. TAX REV. 1, 13-16 (2001) (outlining graduated tax rates from 1913 through 1994).

66. H.R. 1836, 107th Cong. (1st Sess. 2001).

67. *See* I.R.C. §§ 68(f)(1), 151(d)(3)(E) (2006).

68. *See* I.R.C. §§ 68(f)(2), 151(d)(3)(E)(ii).

return (\$150,500 for a single individual).⁶⁹ The inflationary limit on itemized deductions for 2006 was \$145,950 for a married couple (\$75,250 for a married couple filing separately).⁷⁰

During the years in which itemized deductions and exemptions are limited, it is advisable for an individual to contribute more money to the qualified employee plan, rather than a qualified Roth contribution program where the itemized deduction and exemptions are limited because of the designated Roth contribution's inclusion in adjusted gross income. The individual would sacrifice substantial immediate tax savings in the form of a deferral of the qualified plan contribution, unlimited itemized deductions, and allowable exemptions. By making the designated Roth contribution in this case, the individual benefits from the future exclusion of the distribution from gross income; however, this exclusion may not maximize the individual's tax benefits. During 2008 and 2009, the loss of tax benefits is minimized because the individual is entitled to make a nondeductible contribution to a qualified Roth contribution program without risking loss or reduction of itemized deductions or exemptions.

The amendments that allow upper income individuals to convert a traditional IRA to a Roth IRA, and employees to designate deferred compensation as designated Roth contributions, are more beneficial to younger individuals. This is based on the likelihood that earnings will accrue over a longer period. For example, if two individuals ages forty and fifty each convert a \$50,000 traditional IRA to a Roth IRA, the younger individual theoretically will have ten additional years of accrued earnings. Because the required beginning age of 70.5 is inapplicable to Roth IRAs, gains can potentially accrue for many decades. If an individual has not set aside additional savings toward retirement, the individual may need to liquidate the Roth IRA to cover basic living expenses and may not have the

69. 2006 1040 INSTRUCTIONS, *supra* note 43, at 43.

70. 2006 Instructions for Schedules A & B (Form 1040) (2006), A-7.

option to delay distribution. Consequently, the conversion is not viable for the older individual who has saved an inadequate amount towards retirement. In addition, an individual must carefully evaluate disadvantages of diverting money from a plan that potentially defers taxation for many years to a plan that requires immediate income recognition, or recognition within a few years following the rollover of funds to a Roth IRA. Individuals must consider whether it is better to have a distribution taxed at a potentially lower rate, as the taxable income in retirement years may be substantially lower than the current marginal tax rate. Finally, as will be discussed in the next section, the individual must consider the impact of the state income tax rules, as some states exempt certain retirement income from taxation.

IMPACT OF STATE LAWS

Many retirees may not consider the state income consequences on distributions from pensions or IRAs before they receive distributions. However, it is important for retirees to understand the state tax implications on their receipt of pension income. There is no uniform approach at the state level. Seven states lack a personal income tax; therefore, they do not subject pensions to state income taxation.⁷¹ These states are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.⁷² Other states partially exempt, fully exempt, or impose less stringent exemption requirements for specified categories of retired employees, such as firefighters, schoolteachers, public officers, or military personnel.⁷³ New

71. Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points* (as of January 1, 2006), available at http://www.taxadmin.org/fta/rate/stg_pts.pdf (last visited Nov. 10, 2006).

72. *Id.*

73. See e.g., ALA. CODE § 40-18-19(a) (LexisNexis 2003) (exemption for teachers' pensions, state pensions, federal civil service, and a portion of firefighters' and police officers' pensions); D.C. CODE § 47-1803.02(a)(2)(N) (2006) (exemption for pensions received from D.C. and federal governments); IDAHO CODE ANN. § 63-3022A (2006) (exemption based on maximum benefit allowed under Social Security Act for individuals 65 or older or disabled individuals 62 or older for civil servants,

Hampshire excludes interest and dividends that accrue in IRAs, pensions, and similar plans in the same manner as Roth IRAs.⁷⁴ Ohio's exemption is in the form of a credit ranging from \$25 to \$200 depending on the amount of retirement income the individual receives.⁷⁵ In other states, pensions are subject to tax upon withdrawal without the allowance of an exemption.⁷⁶ Some states treat pensions as a subtraction from federal adjusted gross income, and exempt a portion of retirement benefits from the state income tax.⁷⁷ Minnesota, Missouri, Montana and New Jersey's partial exemptions are disallowed to the extent the adjusted gross income exceeds certain levels, ranging from modest levels of \$14,500 in Minnesota, to \$100,000 in New Jersey for single individuals and higher levels for married couples.⁷⁸ In

firemen, policemen, or military retirees); N.C. GEN. STAT. § 105-134.6(b) (2005) (exempting up to \$14,000 of benefits from government plans but only \$2000 for other plans); N.H. REV. STAT. ANN. § 100-A:26 (2001) (exemption for public officers and employees); N.Y. COMP. CODES R. & RECS. tit. 20, § 112.3(c)(1) (2001) (full exemption for New York and federal employees but less generous exemption for other categories of employees); N.D. CENT. CODE §§ 57-38-01.2(j)-(l) (2006) (exempting up to \$5000 for retired military personnel who are at least fifty years of age and \$5000 received under highway patrolmens', policemen's, and firefighters' pension funds); OKLA. STAT. ANN. tit. 68, §§ 2358(D)(9), (15) (West 2006) (\$7500 exemption for retirees but not imposing adjusted gross income ceilings and age requirements for certain retirees including firefighters, teachers, civil servants, and police officers); PA. STAT. ANN. § 3402-303(B)(10) (West 1995) (fully exempting pensions of military or naval forces with respect to any U.S. war); S.C. CODE ANN. § 12-6-1120(7) (2000) (excluding retirement benefits received for fourteen day annual training). Significantly, the Supreme Court of Colorado found that a state statute was unconstitutional because it discriminated between taxpayers by allowing a \$24,000 exemption for nonmilitary retirees under age fifty-five but only \$2000 for military retirees. *See Kuhn v. State Dept. of Rev.*, 817 P.2d 101 (Colo. 1991).

74. *See* N.H. REV. STAT. ANN. § 77:4-b (2003).

75. OHIO REV. CODE ANN. § 5747.055(B) (LexisNexis 2005).

76. *See, e.g.*, CAL. REV. & TAX CODE § 17501 (West 2006); CONN. GEN. STAT. § 12-701 (West 2006); NEB. REV. STAT. § 77-2734.04(11) (2003); VT. STAT. ANN. tit. 32, § 5822 (2005).

77. *See* ARK. CODE ANN. § 26-51-307 (1997) (exempting the first \$6000 from state income tax); IOWA CODE ANN. § 422.7(31) (West 2006) (\$6,000 exemption for single retirees and \$12,000 for married retirees filing joint tax returns); KY. REV. STAT. ANN. § 141.010(10)(i)(K) (LexisNexis 2006) (exempting the first \$41,110 of total distributions from retirement plans); LA. REV. STAT. ANN. § 47:44.1 (2001) (exempting up to \$6000 from state taxation and \$12,000 for a married couple if both are at least sixty-five and are receiving retirement income); ME. REV. STAT. ANN. tit. 36, § 5122(2)(M)(1) (2005); MO. ANN. STAT. § 143.124(1) (West 2006) (exempting up to \$6000 from state taxation).

78. In Minnesota, the maximum exemption is \$9600 for single individuals,

some states, withdrawals from pensions or IRAs are included in income even though those amounts are not included in the Federal adjusted gross income.⁷⁹

Another complicated aspect of state tax consequences surrounding the distribution of pensions or IRAs is the asymmetric rules pertaining to the distribution age eligible for exemption. For example, the age for a partial exemption from state taxation is sixty-two years of age or older in the District of Columbia,⁸⁰ New Jersey,⁸¹ Georgia,⁸² and Oregon;⁸³ but the exemption age is sixty or older in Delaware;⁸⁴ fifty-five or older in Iowa⁸⁵ and Maine;⁸⁶ fifty-nine-and-one-half in Arkansas⁸⁷ and New York;⁸⁸ and sixty-five or older in Louisiana,⁸⁹ Minnesota,⁹⁰

\$12,000 for married couples filing a joint return and \$6,000 for married couples filing separate returns. See MINN. STAT. ANN. § 290.0802(2) (West 2006). The adjusted gross income thresholds are \$18,000, \$14,500, and \$9,000 for married individuals filing joint returns, single individuals or if one spouse is under the age of 65, and married individuals filing separate returns, respectively. *Id.* In Missouri, individuals are entitled to the maximum \$6,000 exemption if the adjusted gross income is less than \$25,000 for single individuals, \$32,000 for married individuals filing joint returns and \$16,000 for married individuals filing separate returns. See MO. ANN. STAT. §§ 143.124(1), (3) (West 2006). Montana's \$3,600 exemption begins to phase out when the individual's federal adjusted gross income exceeds \$30,000. See MONT. CODE ANN. § 15-30-111 (2005). In New Jersey, the exemption is up to \$20,000 for married couples filing joint returns, \$10,000 for married couples filing separate returns, and \$15,000 for single individuals. N.J. STAT. ANN. § 54A:6-10 (West 2006). While the adjusted gross income threshold was relatively modest in recent years, the current threshold is \$100,000. *Id.*

79. See, e.g., IDAHO CODE ANN. § 63-701(5)(d) (2006).

80. D.C. CODE § 47-1803.02(a)(2)(N) (2005) (exempting up to \$3,000 for D.C. and federal pensions).

81. N.J. STAT. ANN. § 54A:6-10 (West 2006) (allowing an exemption up to \$15,000 for single taxpayers).

82. GA. CODE ANN. §§ 48-7-27(a)(5)(A)(xi)-(xii) (2005) (excluding up to \$30,000 between January 1, 2007, and January 1, 2008, and \$35,000 thereafter). The exemption also applies to individuals who are permanently and totally disabled. See GA. CODE ANN. § 48-7-27(a)(5)(D)(ii) (2005).

83. OR. REV. STAT. § 316.157 (2005) (providing a credit of up to nine percent of net pension income).

84. DEL. CODE ANN. tit. 30, § 1106(b)(3) (2004) (allowing amounts from qualified retirement plans to be subtracted up to \$12,500 for individuals who are at least sixty but substantially lesser amounts for other plans).

85. IOWA CODE ANN. § 422.7(31) (West 2006) (excluding up to \$5,000 for individuals who are at least fifty-five years old or disabled individuals).

86. ME. REV. STAT. ANN. tit. 36, § 5122(2)(M)(2) (2005).

87. ARK. CODE ANN. § 26-51-307(a)(1) (1997) (providing a \$6,000 exemption).

88. N.Y. COMP. CODES R. & REGS. tit. 20, § 112.3(c)(2) (2001) (providing an

New Mexico,⁹¹ Oklahoma,⁹² and Utah.⁹³ Colorado provides different exemption amounts depending on the retiree's age.⁹⁴ Georgia provides an additional tax benefit by allowing \$4000 of the retirement income exemption to be derived from earned income.⁹⁵ The Georgia exemption provides a tax savings to retirees who supplement their retirement income by working part-time.

In determining the amount of pension to withdraw annually, retirees must be careful not to withdraw an amount that exceeds the exemption levels for any elderly exemptions. For example, New Hampshire allows an exemption for property taxes for real property owners who are at least sixty-five years old with net income less than an amount determined by the town or city, but not less than \$13,400 for single individuals and \$20,400 for married individuals.⁹⁶ Pension payments are expressly included in the definition of net income.⁹⁷ Hence, elderly individuals must exercise care in withdrawing an appropriate amount so as neither to violate the ceiling amount nor the floor amount.

It may be difficult to determine the state residency of pension and IRA recipients, as many retirees reside in warmer climates during the winter months. An individual is not required to pay taxes for income earned while residing in a state

exemption up to \$20,000, but no exemption for New York, local, or federal employees); N.Y. COMP. CODES R. & REGS. tit. 20, § 112.3(c)(2)(i)(d) (2001).

89. LA. REV. STAT. ANN. § 47:44.1 (2001).

90. MINN. STAT. ANN. § 290.0802(d)(3) (West 2005).

91. N.M. STAT. ANN. § 7-2-5.2(C) (LexisNexis 2001) (providing an \$8000 exemption for single individuals with adjusted gross income less than \$28,500).

92. OKLA. STAT. ANN. tit. 68, §§ 2358(D)(9), (15) (West 2006).

93. UTAH CODE ANN. § 59-10-114(2)(e) (2006) (providing up to a \$7500 exemption).

94. See COLO. REV. STAT. ANN. § 39-22-104(4)(f) (West 2005) (allowing amounts a \$20,000 exemption for retirees who are fifty-five years or older but a \$24,000 exemption for those who are at least sixty-five years old).

95. GA. CODE ANN. § 48-7-27(a)(5)(E) (2005).

96. N.H. REV. STAT. ANN. § 72:39-b (2005). In order to qualify for the exemption, the individual must have been a New Hampshire resident for at least five consecutive years. *Id.*

97. N.H. REV. STAT. ANN. § 72:39-a (I)(b) (2005).

that does not have a state income tax, such as Florida or Texas.⁹⁸ However, if the individual relocates to a different state with an income tax, the distribution may be subject to taxation as warranted by the state income tax scheme. In the early Arizona case of *Clark v. Peterson*,⁹⁹ a retired resident of Arizona failed to report retirement income in the state.¹⁰⁰ The retiree relocated to Arizona from New Jersey after his retirement, and he was never employed while he resided in Arizona.¹⁰¹ The Arizona Tax Commission assessed taxes against the retiree arguing that he was required to report the income in Arizona.¹⁰² The retiree argued that the intention of the legislature was not to tax income that had a source outside of the state.¹⁰³ The Arizona statute required taxpayers to pay taxes on "net income."¹⁰⁴ The statute enumerated several items that were required to be included in Arizona income, and one provision expressly limited gross income from real estate to be an Arizona source.¹⁰⁵ Another provision expressly excluded taxation income from business transactions generated outside of the state.¹⁰⁶ The court applied the rule of statutory construction of *inclusion unius est exclusion alicuius* and reasoned that when a statutory scheme excludes certain outside income from taxation, the items not listed are included in income.¹⁰⁷

Some state statutes expressly define the meaning of resident.¹⁰⁸ In New Mexico, an individual is considered a

98. See Federation of Tax Administrators, *supra* note 71.

99. 279 P.2d 451 (Ariz. 1955).

100. *Id.*

101. *Id.* at 451-52.

102. *Id.*

103. *Id.*

104. *Id.*

105. *Id.* at 452.

106. *Id.*

107. *Id.*

108. See, e.g., CONN. GEN. STAT. ANN. § 12-701(a)(1) (West 2006). In Connecticut, an individual is not considered a resident for tax purposes if the individual is domiciled in Connecticut but does not maintain a permanent place of abode in the state and does not spend an aggregate of thirty days in Connecticut. *Id.* If the individual is not domiciled in the state but maintains a permanent place of abode, the individual must be in Connecticut an aggregate of more than 183 days during

resident for tax purposes when the individual is domiciled in New Mexico, or physically present in New Mexico, at least 185 days during the taxable year, unless the individual relocated to another state without the intention of remaining a resident of New Mexico.¹⁰⁹ Under the statute, any pension or IRA distribution received after the relocation is taxed under the new state's tax scheme.¹¹⁰ The policy underlying this rule is that the individual is "receiving benefits and protections of its laws" from the state to which the individual relocated and therefore must contribute to the state by paying taxes on income irrespective of its source.¹¹¹ Retirees have made creative arguments to avoid being subject to taxation in a relocated state. For example, in *Daks v. Franchise Tax Board*,¹¹² a retiree relocated to California from New York after receiving five monthly pension payments.¹¹³ He failed to include pension payments received subsequent to his relocation on his California income tax returns.¹¹⁴ The retiree contended that as an accrual method taxpayer, he was not required to report the pension income in California upon distribution because it accrued while he resided in New York.¹¹⁵ Under a general statutory provision, section 17554 of the Revenue and Taxation Code, income that accrued prior to relocation would not be subject to taxation in California after the relocation to prevent double taxation.¹¹⁶ The retiree argued that the general provision applied to pension distributions.¹¹⁷ However, I.R.C. § 17001 required pension income to be included in income as provided by I.R.C. § 402.¹¹⁸ Under I.R.C. § 402(a), an individual is taxed on the amount of

the taxable year. *Id.*

109. N.M. STAT. ANN. § 7-2-2(S) (LexisNexis 2003).

110. *Id.*

111. *Paine v. Franchise Tax Bd.*, 12 Cal. Rptr. 3d 729, 732 (Ct. App. 2004).

112. 85 Cal. Rptr. 2d 927 (Ct. App. 1999).

113. *Id.*

114. *Id.*

115. *Id.* at 928.

116. *Id.*

117. *Id.*

118. *Id.*

qualified pension income in the taxable year of distribution.¹¹⁹ The court determined that a specific statutory provision mandated inclusion in California, and that provision took precedent over the more general statutory provision.¹²⁰

The question of whether an individual is subject to tax in a state becomes more complicated when the individual receives a distribution from a partnership upon retirement. In *Paine v. Franchise Tax Board*, the plaintiff¹²¹ was a partner in a business consulting partnership.¹²² After thirty-one years, the plaintiff retired from the partnership and subsequently moved to California.¹²³ Under the terms of the partnership agreement, the plaintiff was entitled to receive deferred compensation over a ten year period beginning upon retirement.¹²⁴ The deferred compensation was considered a "guaranteed payment" within the meaning of I.R.C. § 707(c).¹²⁵ While the taxation of partnerships ordinarily is governed by an aggregate approach of income tax accounting, the entity approach governs guaranteed payments. A partner must include guaranteed payments in ordinary income in the year that the partnership deducts the payment.¹²⁶ Because the partnership was a cash basis taxpayer, the plaintiff was required to include the guaranteed payments in income upon receipt even though he was an accrual method taxpayer.¹²⁷

Finally, in determining whether an individual should contribute money to a traditional IRA or Roth IRA (including designated Roth contributions or rollover contributions), an

119. *Id.*

120. *Id.* at 929.

121. There were two plaintiffs in the actions; the other plaintiff was a withdrawing partner rather than a retiring partner. See *Paine v. Franchise Tax Bd.*, 12 Cal. Rptr. 3d 729, 729 (Ct. App. 2004).

122. *Id.* at 730.

123. *Id.*

124. *Id.*

125. I.R.C. § 707(c) (1986) (incorporated in California law by Revenue and Tax Code § 17851).

126. See Treas. Reg. § 1.707-1(c) (2006).

127. *Paine*, 12 Cal. Rptr. 3d at 736 (also addressing § 17554 issue considered in *Daks*).

individual should consider the state income tax consequences. For example, if an individual resides in a state with a high income tax rate during years of employment but plans to retire to Florida (a state without a personal income tax), the individual will save taxes in the end by getting the federal deduction upon making the contribution. In addition, the individual can defer the income until distribution at the federal level and avoid taxation altogether at the state level.

ESTATE TAX CONSIDERATIONS

As an individual enters retirement, the individual must consider potential estate tax exposure. Proper planning is required to reduce state and federal estate tax liability. In analyzing the estate tax considerations, this section will reference a hypothetical sixty-seven year old retiree who owns the following assets:

Asset	Value
Pension/IRA	\$800,000
Stocks/Mutual Funds	300,000
Personal Residence	400,000
Life Insurance	400,000
Cash	100,000
Total	\$2,000,000

FEDERAL ESTATE TAXATION

The federal estate taxation scheme has been in a flux since the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001.¹²⁸ The current \$2,000,000 exemption increases to \$3,500,000 in 2009 and becomes unlimited in 2010.¹²⁹

128. Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001).

129. See I.R.C. § 2010(c) (2006).

In 2011, the unified credit reverts to the \$1,000,000 amount that existed in 2001.¹³⁰ Congressional efforts to make the phaseout of the estate tax permanent have been unsuccessful. On June 8, 2006, the Senate failed to pass the Death Tax Repeal Permanency Act of 2005.¹³¹ Prior attempts to repeal the sunset provision also proved unsuccessful.¹³² Two weeks following the Congress's latest attempt to make the phaseout permanent, the House of Representatives passed the Permanent Estate Tax Relief Act of 2006.¹³³ Under this bill, an individual is allowed a \$5,000,000 exemption for estate and gift transfers beginning in 2010, and the exemption is adjusted for inflation.¹³⁴

Based on the assets owned by the hypothetical retiree, there is no federal tax liability unless the retiree dies after 2010. The retiree's pension/IRA, stocks/mutual funds, personal residence, and cash are included in the gross estate if the retiree continues to own the property at death.¹³⁵ The life insurance is included in the gross estate if it is paid to the retiree's estate upon death, or the retiree possessed "incidents of ownership" ¹³⁶ at the retiree's death.¹³⁷ The retiree's payment of premiums after a gift is not considered an incident of ownership.¹³⁸ Assuming the retiree dies in 2011, and the retiree does not have any deductions, the federal estate tax liability is \$345,800 based on the \$1,000,000

130. *Id.*

131. See Death Tax Repeal Permanency Act of 2005, H.R. 8, 109th Cong. § 2 (1st Sess. 2005).

132. See, e.g., Tax Relief Guarantee Act of 2004, H.R. 3773, 108th Cong. (2d Sess. 2004); Death Tax Repeal Permanency Act of 2003, H.R. 8, 108th Cong. (1st Sess. 2003); Death Tax Permanency Act of 2003, H.R. 57, 108th Cong. (1st Sess. 2003).

133. Permanent Estate Tax Relief Act of 2006, H.R. 5638, 109th Cong. (2d Sess. 2006).

134. *Id.* at § 2(b).

135. I.R.C. § 2033 (2006).

136. See I.R.C. § 2042 (2006); Treas. Reg. § 20.2042-1(c)(2) (2006). "Incidents of ownership" include "the power to change the beneficiary, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc." *Id.*

137. See I.R.C. § 2042.

138. Estate of *Nepstat v. United States*, No. A3-89-54, 1991 U.S. Dist. LEXIS 475, at *5 (D.N.D. Jan. 8, 1991).

exemption.¹³⁹ With proper planning, the retiree should be able to reduce the exposure to federal estate tax liability. If the retiree removes the life insurance policy from the gross estate, the potential estate tax liability is reduced to \$192,800 based on the rate schedule in place during 2001.¹⁴⁰ One of the primary advantages of removing the life insurance from the gross estate is that the retiree is not sacrificing any current disposable income. Another advantage is that where a retiree transfers a policy by gift, the transfer qualifies for the \$12,000 annual exclusion per donee.¹⁴¹ By transferring the policy to multiple donees, the retiree may minimize gift tax exposure. When a retiree transfers an insurance policy by gift, the retiree is subject to a gift tax based on the value of the policy.¹⁴² When an insurance policy is gifted shortly after purchase, the value of the insurance policy for gift tax purposes is the cost of the policy.¹⁴³ In *Guggenheim v. Rasquin*, the insured purchased three single-premium life insurance policies and simultaneously and irrevocably assigned the life insurance policies to her three children.¹⁴⁴ The policies had total face amounts of \$1,000,000 and cash surrender values of \$717,000.¹⁴⁵ The insured had paid \$852,000 in premiums for the policies.¹⁴⁶ In reaching its conclusion that the value of the policies for gift tax purposes was its cost, the court reasoned,

Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to

139. See I.R.C. § 2001(c)(1) (2006). The \$345,800 is based on the tax rates under § 2001(c) applicable for 2001. *Id.*

140. See *id.* Under the 2001 estate tax rates, the tentative estate tax is \$155,800 plus 37% over \$500,000. *Id.* Hence, the \$192,800 is computed as follows: \$155,800 + [(\$600,000 – \$500,000) × 37%].

141. See I.R.C. § 2503(b) (2006); Treas. Reg. § 25.2503-3(a) (2006).

142. *Guggenheim v. Rasquin*, 312 U.S. 254 (1941).

143. *Id.*

144. *Id.* at 256.

145. *Id.*

146. *Id.*

retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value—in the instant case over \$135,000. All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. To single out one and to disregard the others is in effect to substitute a different property interest for the one which was the subject of the gift. . . . Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. Cost is cogent evidence of value.¹⁴⁷

The same rules apply where the insured transfers annual premium policies.¹⁴⁸ If the hypothetical retiree had paid, for example, \$150,000 for the \$400,000 life insurance policy, the retiree would be considered to have made a \$150,000 gift to the donee, the cost of duplicating the policies at the date of the gift. Because the life insurance policy would no longer be in the retiree's gross estate, the retiree would not be required to pay either gift or estate taxes on the difference between the amounts of the gift of the \$400,000 death benefits paid to the beneficiary. If a retiree gives the policy to three donees without retaining any incidents of ownership during 2001, and the insurance is not payable to the retiree's estate upon death, the retiree is entitled to three annual exclusions totaling \$36,000. The retiree's tentative gift tax on the gifts is \$58,000.¹⁴⁹ That amount reduces the retiree's \$1,000,000 unified credit. If the retiree is married at the time of the gift, the retiree's spouse can agree to split gifts with the retiree pursuant to I.R.C. § 2513.¹⁵⁰ By splitting gifts, the retiree and the retiree's spouse increase the total annual exclusions on the gifts to the three donees to \$72,000.

147. *Id.* at 257-258 (citations omitted).

148. See *Phipps v. Comm'r*, 43 B.T.A. 790 (1941).

149. See IRC § 2502(a)(2) (2006).

150. Under § 2513, the spouses must agree to split all gifts made during the calendar year. I.R.C. § 2513 (2006).

Where an insured transfers an insurance policy by gift after it has been in force for several years, and no additional premiums are required, the value of the insurance policy is the "interpolated terminal reserve"¹⁵¹ at the date of the gift plus the proportionate part of the last gross premium paid before the date of the gift that covers periods beyond the date of the gift.¹⁵² When an insured transfers an insurance policy by gift after it has been in force for several years, and additional premiums are required, the value of the policy is the replacement cost.¹⁵³ The basis for the replacement cost is the current age and physical condition of the retiree.¹⁵⁴ In *United States v. Ryerson*, the Supreme Court noted that "[t]he fact that the then condition of an insured's health might make him uninsurable emphasizes the conclusion that the use of that criterion will result in placing a minimum value upon such a gift."¹⁵⁵ Hence, it may be practical for the retiree to gift the life insurance policy to a donee even where the criterion for valuation is replacement cost.

In order to remove the insurance policy from the gross estate, the proceeds must not be payable to the retiree's estate upon death, and the retiree must relinquish all "incidents of ownership" within three years before the retiree's death.¹⁵⁶ Under I.R.C. § 2035(a)(2), if a decedent relinquishes or transfers a retained life estate, reversionary interest, revocable interest, insurance proceeds, or incidents of ownership within three years of death, the transferred or relinquished interest is included in the decedent's gross estate for estate tax purposes.¹⁵⁷ Under I.R.C. § 2035, property transferred within three years of the

151. The "interpolated terminal reserve" is the reserve maintained by the insurer to cover the insurance company's liability under the policy. Treas. Reg. § 25.2512-6(a) (2006).

152. *Id.*

153. *United States v. Ryerson*, 312 U.S. 260 (1941) (stating that lapse in time between date of purchase and gift of single-premium policy did not necessitate cash surrender value rather than cost replacement value); *Houston v. Comm'r*, 124 F.2d 518 (3d Cir. 1941) (involving fully-paid twenty-payment life insurance plan).

154. *Ryerson*, 312 U.S. at 260.

155. *Id.* at 262.

156. I.R.C. § 2035(a)(2) (2006).

157. *Id.*

decedent's death is valued as of the decedent's death, not as of the date the property was transferred.¹⁵⁸ The value of property includible in a decedent's gross estate is the property's fair market value at the decedent's death, except if the executor elects the alternate valuation method under I.R.C. § 2032.¹⁵⁹

The retiree continues to face potential federal estate tax liability of \$192,800 after removing the insurance from the estate. If the retiree is married, the retiree can bequeath a sufficient amount to the surviving spouse and claim the unlimited marital deduction to shield the estate from estate tax exposure.¹⁶⁰ There are many additional estate tax reduction techniques. However, it is necessary for any retiree whose estate is sufficient to warrant a potential estate tax liability to consult with a tax professional and engage in proper estate planning.

STATE ESTATE TAXATION

Before relocating to a state, the individual needs to understand the state estate taxation rules. Retirees must understand that states may have their own estate tax schemes that are independent of the federal tax scheme. Prior to the phase out of the federal estate tax, several states relied on a "pick up" tax that provided the maximum tax credit allowed under the federal estate provisions. With the repeal of the state tax credit under I.R.C. § 2011, several states that based their estate tax on the state tax credit no longer have an estate tax. These states include Alabama, Arizona, Arkansas, California, Delaware, Florida, Missouri, and Nevada.¹⁶¹ Consequently, the hypothetical retiree would be subject to neither a federal estate tax nor a state estate tax, if the retiree resided in one of those

158. *Id.*

159. Treas. Reg. § 20.2031-1(b) (2006). "The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Id.*

160. I.R.C. § 2056(a) (2006).

161. State Estate Taxes, Financial Planning Toolkit, <http://www.finance.cch.com/text/c50s15d170.asp> (last visited Nov. 10, 2006) (comparing all states).

states. However, in a state such as Wisconsin, the retiree would be subject to a state estate tax if the retiree's death took place during 2006.¹⁶² In Wisconsin, the exemption in place during 2006 was only \$675,000.¹⁶³ Several states decoupled and no longer base their state estate tax on the state tax credit. Some states, and the District of Columbia, have decoupled their exemption and set it at \$1,000,000, including Kansas, Maine, New York, and Oregon.¹⁶⁴ If the retiree resided in one of these jurisdictions, fifty-percent of the retiree's estate would be subject to taxation.

Retirees cannot transfer a retirement fund, annuity, or other intangible financial asset to a state that does not have a transfer tax. The retiree should consult a tax expert to understand legal implications of holding intangible property in a state in which the retiree is not a resident. For example, Wisconsin imposes an estate tax on individuals who were residents of Wisconsin at death and nonresidents for the transfer of property located in the state.¹⁶⁵ The estate tax provision provides the following exception:

A transfer, which is made taxable under this chapter and is of a nonresident decedent's intangible personal property is not subject to the tax imposed by this chapter if a like exemption is allowed at the time of the death of the decedent by the laws of the state, territory or district of the decedent's residence in favor of residents of this state or if the state, territory, or district of the decedent's residence does not impose a tax on the transfer at death at the time of the death of the decedent.¹⁶⁶

Consequently, in Wisconsin, a nonresident will not be subject to a tax at death upon the transfer of intangible personal property if the jurisdiction in which the decedent resided does not impose a transfer tax or if the jurisdiction exempts

162. *Id.*

163. *Id.*

164. *Id.*

165. WIS. STAT. ANN. § 72.11(1) (West 2004).

166. WIS. STAT. ANN. § 72.11(2).

Wisconsin's residents from imposition of a transfer tax for their intangible personal property located in that jurisdiction.¹⁶⁷ Seemingly, the purpose of the exemption for nonresidents who reside in jurisdictions without a transfer tax is to encourage investments in the state of Wisconsin. Without such an exemption, an informed retiree will remove intangible personal property from Wisconsin to another state that does not impose an estate tax on the transfer of the property at the retiree's death. If the nonresident resides in, for example, Tennessee at the time of death and owned intangible personal property in Wisconsin, the property will be subject to transfer tax in Tennessee upon transfer at the retiree's death and will not be taxed in Wisconsin. Under the Tennessee statute, a transfer tax is imposed on a domiciliary upon the transfer of real and tangible personal property located in Tennessee and all intangible personal property, proceeds of insurance policies, and proceeds of employee benefit plans.¹⁶⁸ When a decedent is not a domiciliary of Tennessee, only real and tangible personal property situated in the state is subject to Tennessee's transfer tax.¹⁶⁹ In such a case, Wisconsin's reciprocity statute will not impose a transfer tax because Tennessee will not impose a similar tax on Wisconsin's residents.

CONCLUSION

Retirees must not overlook the importance of planning for the distribution of retirement benefits and IRAs. Retirees should be aware of the federal tax laws. There are important decisions that an individual should make while employed and as a retired individual. Prior to receiving a distribution, retirees also need to be aware of the state tax implications. A retiree is bound by the residency state at the time of the distribution. Finally, the estate tax implications should not be overlooked. Proper planning will

167. *Id.*

168. TENN. CODE ANN. § 67-8-303(a)(1) (2003).

169. TENN. CODE ANN. § 67-8-303(a)(2).

lessen the likelihood that a retiree's life savings will end up in the coffers of the federal or state government. With the gradual increase exemption until the one-year repeal in 2011, the federal estate tax will affect fewer individuals. Without Congressional action, the exemption for estate and gift taxation will return to \$1,000,000 in 2011. Moreover, even during the years in which the federal estate tax only affects wealthy individuals, the retiree's estate may still be subject to state transfer taxation, and there is little uniformity at the state level.
