IRA UPDATE: DECEMBER 2011

IRS Private Letter Ruling (PLR 201139011)

IRS allowed a 13 year old beneficiary of her deceased father's employer plan to transfer previously tax lump-sum distribution to an inherited IRA. In the case, the child's mother as legal guardian took the balance of the plan in a lump-sum distribution that was fully taxable and then spent some of the money for her own benefit. The ruling does not indicate how much was spent however it appears to be a significant portion of the inherited funds.

For an unknown reason (we can speculate) a court-appointed conservatorship was established for the young beneficiary and the conservator subsequently filed suit against the mother for the distribution and misappropriation of the funds. The state court ordered that the funds be repaid and the IRS granted the taxpayer's request to transfer funds to the Inherited IRA.

This is a fascinating ruling because IRS has previously stated, many times, that once funds are distributed from a deceased owner's retirement account to a non-spouse beneficiary, that the funds cannot then be transferred to an inherited IRA. This has always been one of the IRA mistakes that cannot be fixed; until now. It appears from the ruling that the primary driver for the decision was based on the mother clearly not acting in the best interests of the child and using the money for herself.

How to establish an Inherited ("Stretch") IRA

Before Death:

1. Check the beneficiary form. Make sure you have named a living, breathing person(s) as a beneficiary. Non-person beneficiaries such as an estate or charity can result in complications to the life expectancy factor used since these entities have no life expectancy.
2. Informed your family of their ability to "Stretch" the IRA once they inherit it. Beneficiaries who are unaware of the ability and proper procedure risk losing the inherited IRA to unnecessary and accelerated taxation.

After Death:

3. Make sure you are working with an advisor who understands IRA rules and procedures to set up a properly titled Inherited IRA. Don't assume the bank or broker understands the correct procedures as they may not be familiar and/or execute the procedure properly as many IRS Private Letter Rulings have shown. Ask questions about their credentials in this area and ask them to describe the process before taking any action.
4. Set up the properly titled inherited IRA first before attempting to transfer the funds. Verify the account has been set up properly using the correct paperwork. The inherited IRA must be properly titled by generally including language such as the decedents name and "inherited" or "beneficiary." For example, "John Doe, Deceased (xx/xx/2011), IRA FBO (FBO means For Benefit of) Jane Doe, Beneficiary."

5. Be sure to name successor and contingent successor beneficiaries that will be allowed to continue distributions over the original beneficiary's remaining life expectancy if any funds are left.
6. Before you transfer the funds, verify that the account owner's Required Minimum Distribution for the year of death has been taken. If not, this distribution must be taken before transferring the account.
7. Once set up, the transfer from the decedents retirement account to the Inherited IRA can only be moved via a "Trustee-to-trustee" transfer. If the funds are made payable to the beneficiary directly, then that's the end of the IRA; the distribution would be taxable all in one year and the tax deferral is lost forever. The receiving custodian may require the beneficiary to set up the inherited IRA at the other custodian before transferring so that the account registration matches. If a check is sent to the beneficiary but made payable to the properly titled inherited IRA, then this is ok as it is still considered a trustee to trustee transfer.
8. If no beneficiary was named on the form, or the form cannot be found, don't give up yet. Check the IRA custodial agreement which is the document that governs the IRAs rules. Each custodian has different rules so do not make any assumptions, always obtain the document. The IRA custodial agreement will contain a provision in the event there is no named beneficiary. Such provision might say that the estate is the beneficiary, however if you are lucky it might say that if there is no beneficiary, then they will look first for a spouse, if no spouse then they might look for children, if no children they then might look for grandchildren, etc. This procedure all depends on the individual custodian. This is also something to consider before death when choosing a custodian for your IRA.
9. If one of the beneficiaries is a non-person such as a charity, make sure that beneficiaries share is distributed prior to September 30th of the year following the year of death which is the beneficiary determination date.
10. Take your beneficiary Required Minimum Distribution (RMD) before 12/31 of the year following the year of death. Verify that the proper code is used on the 1099-R form which should be "4", the death code, in box 7 of the form.
11. Do not combine your inherited IRA with any other retirement account as this will result in a taxable event and 6% excess contribution penalty for each year it is not fixed. The only inherited IRAs that can be combined are when the IRA owner and beneficiary are the same. Inherited IRAs from different owners cannot be combined.

The above is not an exhaustive list; always consult a qualified professional.

<u>Year End Alert- Qualified Charitable IRA Distributions (QCD)</u>

An IRA is loaded with tax and if you are older than 70 ½, you are required to take distributions annually whether you need them or not. These Required Minimum Distributions (RMDs) increase your taxable income and can affect other areas of your tax return such as deductions, taxation of Social Security, Medicare premiums, etc. If you are charitably inclined consider the Qualified Charitable IRA Distribution.

These rules, if you qualify, allow the IRA owner to transfer funds, up to $100,000 (per IRA owner) from their IRA to a qualified charity tax free and use the distribution to satisfy their RMD. If you distribute funds from an IRA, and then give to a charity, you will get a corresponding charitable IRA deduction however your deduction may be limited and can also affect other areas of your finances as mentioned above. By making the charitable transfer, no deduction is allowed, but no income is realized making this a valuable tax planning strategy.

You must be older than 70 ½, not just the year in which you turn 70 ½. This provision is only available for IRAs, including inactive SEP and SIMPLE IRAs, not employer plans such as 401(k)s. So if you want to take advantage of this rule, you must rollover applicable funds from your employer plan to an IRA before the end of the year.

The QCD seems to expire each year and is then extended however there is no guarantee that congress will extend this again for 2012 or beyond.

As always, feel free to contact me directly to ask any questions you may have on these topics.

Sincerely,

Jeremy E. Portnoff

Jeremy E. Portnoff, CFP®, AIF®, CRPS®, CES™, CFS®, CTS™, CAS®, CIS™
NAPFA Registered Advisor
Ed Slott Master Elite IRA Advisor
HS Dent Master Certified Advisor
Paladin Five-Star Advisor