IRA UPDATE: SEPTEMBER 2012

Beneficiary Determination Date

September 30th is the beneficiary determination date for those who inherited an IRA from a person who deceased in 2011. This is the date which determines whose life expectancy is used for "stretch IRA" payments. The life expectancy used is based upon the age of the oldest "designated beneficiary." Here a summary points to know:

- The "stretch IRA" is not a product rather it is a common term for the ability to take the Required Minimum Distributions over the beneficiary's life expectancy. This keeps the bulk of the IRA in the tax deferred wrapper of the IRA and minimizes the tax burden for the beneficiary by only requiring the minimum distributions if taxable. If the inherited IRA is a Roth IRA, then the minimum distributions would be tax free however as indicated, the bulk of the account would remain growing in the inherited Roth IRA tax free.
- Only a living, breathing person can be a designated beneficiary and must be named on the beneficiary form. A charity, trust, or estate is does not have a life expectancy and thus the stretch can be lost or minimized if a non-person is a beneficiary. Naming an IRA beneficiary through your will results in no designated beneficiary and loss of the stretch.
- 9/30 is the beneficiary determination date. You cannot add beneficiaries however existing beneficiaries can be paid out before this date. For example if a charity is a beneficiary the stretch can be lost because a charity does not have a life expectancy and the payout period can be limited to 5 years if the owner did not reach their Required Beginning Date (RBD) or the owner's remaining life expectancy if past the RBD. The solution would be to pay out the charity's share before the 9/30 deadline.
- If you are the single named beneficiary, then you will be able to use your age in determining the applicable stretch period. If there are multiple beneficiaries, the age of the oldest beneficiary will be used.
- A beneficiary named through an estate can never be a "designated beneficiary" and therefore the stretch will be limited to 5 years or the remaining life expectancy of the IRA owner.
- When there are multiple beneficiaries, especially if one is a non-person, the accounts can be split, and thus undesirable beneficiaries effectively removed if done prior to the 9/30 date. In order for multiple individual beneficiaries to use their own life expectancy, the accounts must be split by 12/31 of the year after death.
- There are special rules when a trust is named as a beneficiary; get professional help if this applies to you or are thinking of naming a trust as a beneficiary.
- Inherited IRAs can be split after the 12/31 deadline however each inherited IRA owner will still be stuck with the age of the oldest beneficiaries life expectancy for calculating minimum distributions.
- While Roth IRAs do not have lifetime Required Minimum Distributions, they do have RMDs for inherited Roth IRAs.

Net Unrealized Appreciation (NUA) tax break

NUA occurs when you have highly appreciated stock of your employer within your 401k. The NUA is the difference between the price which you purchased the stock and the current value. The NUA tax break allows you to transfer employer stock in-kind (without selling it) to a taxable brokerage account and the only tax you pay at the time will be ordinary income on the original cost. The NUA is taxed at long-term capital gains rates, which are usually lower than ordinary income, but only when the shares are sold.

The shares cannot be sold in the plan or rolled over to an IRA. If either of these events occurs, the tax break is lost forever. The distribution can only be done after a qualifying event such as termination of employment, death, or disability and the entire plan must be distributed in the same year. This means that if you transfer the stock out in kind, the rest of the plan balance must be distributed, or in most cases rolled over to an IRA so that the rest of the balance is not taxable.

Keep in mind that if you execute the NUA strategy and you are not yet age 59 ½, you will pay a 10% early distribution penalty of the value of the shares distributed.

NUA has many nuances. If this applies to you, be sure to consult both a well qualified financial advisor and CPA to assist you in such a transaction as mistakes are often not-fixable.

IRA Tips & Reminders

Remember to check your beneficiary forms and consider naming contingent beneficiaries so that disclaimer planning can be used post-death. A disclaimer allows a beneficiary the option to refuse an inheritance and let it pass to the next person in-line as if they pre-deceased the account owner. Disclaimers must be "qualified," in writing, and the funds cannot be directed to a specific person; they can only pass to the next person in line. Before executing disclaimers, be sure you understand where the funds will go. If there are multiple primary beneficiaries and a disclaimer is executed, the funds could pass to the remaining primary beneficiaries and not a contingent beneficiary depending upon the policies of the IRA custodian.

IRS is cracking down on abusive Roth conversion scams:

FROCO (Financed Roth Conversion Strategy)- consists of a sale of an annuity with high surrender charges to the IRA. The IRA is then converted but due to the high surrender charges, the amount converted is substantially less than the account value making the converted amount appear much smaller and thus the tax due on conversion much less than it would be at the proper value. Once the annuity is in the Roth IRA, the account value magically springs back to its original value and thus the majority of tax is avoided. This is a scam and the IRS has issued a permanent injunction against it's promoter.

Value shifting: IRS ruling states, "certain value-shifting transactions that are designed to avoid the statutory limits on contributions to a Roth IRA have been identified as listed transactions, and the purported tax benefits from such transactions will be challenged."

Roth Restructure- A major CPA firm charged $120,000 for to help set up multiple shell corporations that were used solely for the purpose to shift the value of a pre-tax IRA to a Roth IRA. While the IRS did not get the taxpayers on the income tax which would have been due to the conversion because the statute of limitations on filing the 1040 return

had passed, they did get them on their failure to file form 5329, which reports additional tax on qualified plans (including IRAs) and other tax favored accounts.

IRS form 5329 is a separate return (although often filed with the 1040) and because the taxpayer did not report what should have been an excess contribution to the Roth IRA, the statue of limitations never started. The taxpayer's attempt to circumvent paying income tax on his Roth IRA conversion results in IRS' imposition of over $500,000 in back taxes, penalties, and interest. Moral of the story, file a 5329 and report the penalty.

If it seems too good to be true, it probably is.

Roth IRA Conversion Confusion

- Partial conversions can be done.
- The 2-year deal is no longer available.
- Income restrictions are permanently repealed; anyone regardless of income can convert.
- You can convert at any age.
- You do not need earned income to convert; earned income is required for IRA contributions.
- After-tax money can be converted tax free using the pro-rata rule.
- Inherited IRAs cannot be converted but inherited plan funds can be converted.
- Roth conversion funds can be accessed before the 5 year period is up however if you are under 59 ½, the 10% penalty will apply. If earnings are taken before the 5 year rule is up then income tax is due.
- Required minimum distributions can never be converted. Before executing a Roth conversion, RMDs must be taken first.
- There are no lifetime RMDs for Roth IRA Owners; there are Required Minimum Distributions for non-spouse beneficiaries of Roth IRAs.

Roth Recharacterization Confusion

- A Roth recharacterization is the process of undoing all or part of a Roth conversion as if it never happened and eliminating the income tax that would have been due on the amount converted.
- A Roth conversion can be recharacterized for any reason.
- A partial recharacterization can be done.
- Recharacterizations must go back to an IRA, even if the conversion was done from a plan.
- The deadline for recharacterization is October 15th of the year following the year of conversion.
- In-plan Roth 401(k) conversions cannot be recharacterized.
- If the tax return has already been filed, a recharacterization can still be done and the tax return amended.
- The amount recharacterized may not be the same amount moved from the Roth IRA back to the IRA. For example, if an IRA worth $100,000 were converted to a Roth, dropped in value to $75,000 and then recharacterized, the amount moved back to the IRA is the $75,000 however the amount recharacterized is the original $100,000.

RMD (Required Minimum Distribution) Aggregation Rules

- Some RMDs can be aggregated and some cannot. Those that can be aggregated are not required to be. The following is not an exhaustive list of RMDs that may be aggregated:
- IRAs must be calculated separately but can be taken from just one account. For example, you have two IRAs; The RMD for one is $2,000 and $3,000 for the other. You can take $5,000 from one or the other, each calculated amount, or any amount from each as long as the total is $5,000.
- RMDs from different account owners may never be aggregated. For example, a husband cannot take his RMD from his wife's account even if they file a joint return.
- RMDs from multiple 401(k)s must be calculated separately and taken separately.
- RMD's from multiple 403(b)s must be calculated separately but my be taken from just one account.
- RMDs for Inherited IRAs from the same person must be calculated separately but can be taken from one.
- RMDs for Inherited accounts from different decedents may never be aggregated even for IRAs and 403(b)s which normally can be aggregated, they must be calculated separately and taken separately.
- RMDs for inherited 401(k)s must be calculated separately and taken separately.
- RMDs for inherited 403(b)s from the same person must be calculated separately but can be aggregated.
- RMDs for inherited Roth IRAs from the same person must be calculated separately but can be aggregated.

60-Day Rollovers

A 60 day rollover occurs when funds are distributed from a retirement account directly to the owner who then has 60 days to "rollover" the funds to an IRA to avoid paying tax. If the funds do not make it to the proper account, the whole amount is taxable. There are many pitfalls to the 60 day rollover and mistakes happen frequently however there is possible relief by requesting a Private Letter Rulings (PLR) from the IRS. It is best to avoid the mistake because fees for rollover PLRs start at $500 for a rollover less than $50,000 and $3,000 for rollovers over $100,000 not including the professional fee to properly draft the PLR request which can thousands of dollars.

The best way to avoid the 60 day rules is to do a trustee-to-trustee transfer (from one IRA custodian directly to the other) where you do not take what is known as "constructive receipt." If a check is sent to you, as long as the check is made payable to the IRA (i.e.- TD Ameritrade FBO: John Doe), then it is considered a trustee-to-trustee transfer not subject to the 60 day rollover rules because you cannot cash a check that is not made out to you directly.

In order to qualify for relief of a 60-day violation, you must be able to show that you had a true intent to do a rollover. If the funds were used for anything during the 60 day period, chances are your PLR will be denied. The following are summary examples or PLR Rulings:

- PLR 201117046: Denied- Taxpayer thought she had 90 days to complete her "search" for a new custodian. Ignorance of the rules is not a defense.
- PLR 201118025: Denied- Taxpayer used funds as a short-term loan to help finance handicapped mother's residence.
- PLR 201123048: Denied- IRS denies wife an extension to roll deceased husbands plan distribution to her own IRA. Normally a spouse beneficiary can do a rollover (a non-spouse beneficiary can never do a rollover) however in this case, the funds were distributed from the company plan into a joint account before the husband died not after and thus IRS denied it
- PLR 201126041: Denied- IRS tells taxpayer the failure to complete a rollover was her own fault, not the advisors. In many PLRs, where the taxpayer was able to prove that the advice they were given by the advisor, bank, or brokerage was inaccurate causing them to miss the 60 day deadline, the PLR is granted and they then have 60 days to fix the

mistake. In this case, the IRA owner moved her IRA because she was unhappy about the high fees in the account. The advisor told her to get the funds into another IRA within 5 days. Even though the advice of 5 days was incorrect, the IRS denied the ruling stating that had she followed the incorrect advice, there would be no 60 day violation.

- PLR 201122032: Granted- IRS grants relief after taxpayer's get bad advice.
- PLR 201130014: Denied- IRA owner withdrew from an IRA due to financial hardship. This was denied because there was no intent to do a rollover; the funds were used during the 60 day period.

The IRS is denying more and of these PLR requests than they have in the past so the best plan is the trustee-to-trustee transfer whenever possible.

As always if any of this applies to you, give me a call to discuss your situation.

Sincerely,

Jeremy E. Portnoff

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