IRA UPDATE: OCTOBER 2012

Deadline to Recharacterize 2011 Roth Conversions

October 15th, 2012 is the deadline to recharacterize Roth IRA conversions that were done in 2011.

Roth conversions are great because you have until this October 15th of the year following the year of the conversion to change your mind for whatever reason. Perhaps the account went down in value or you don't have the money to pay the tax, no problem, you get a do-over.

If the value of the Roth IRA has declined after a conversion it might pay to recharacterize. Let's look at an example. Suppose you converted $100,000 on 1/1/2011 and you are in the 25% tax bracket. The tax due for the conversion would be $25,000. Now suppose the account dropped to $50,000; the tax of $25,000 relative to the current account value is now 50%, not 25%. Recharacterizing would allow you to move the $50,000 back to the IRA and you get your tax money back. And once you wait the prescribed period (the later of the following tax year or 30 days) you can re-convert the same funds. In my example, now you only have $50,000 to convert and at 25% the tax is only $12,500. So you still have only $50,000 in the Roth IRA however the cost to get it there was $12,500 less! A great deal. Roth conversions allow you to "bet on the horse after the race is over."

Keep in mind that this is only for 2011 conversions. Some people converted in 2010 and took the 2-year deal which allowed them to spread the inclusion of the income on the conversion, half in 2011 and half in 2012. So for these years you are including income from a conversion that occurred in 2010. If you are wondering if you can recharacterize either of those amounts, the answer was no because the conversion was in 2010 and that deadline was 10/15/2011.

Remember too that the current tax rates are set to expire on 12/31/2012 and unless congress acts to extend the Bush tax cuts, the tax rates are going up and there will be the additional 3.8% surtax on net investment income. So if you recharacterize and plan to reconvert in 2013, be aware of the possibility of higher taxes and depending upon the situation, you may be better off not recharacterizing.

See September's IRA Update for more details regarding Roth Conversions and Recharacterizations.

http://bit.ly/RothConversionConfusion

http://bit.ly/RothRecharacterizationConfusion

Trust Deadline for Inherited IRAs

October 31st is the deadline for trust beneficiaries of IRA owner's who died in 2011.

A trust is not a living breathing person and thus does not have a life expectancy therefore when a trust is named as a beneficiary of an IRA, the "stretch" or life expectancy payouts can be lost (or dramatically reduced) and taxes can be higher unless you plan properly. In order for the beneficiaries of the trust to get the Stretch, the trust must qualify as a "see-through" or "look-through" trust by meeting the following four provisions:

1. The trust must be valid under State law, or would be except for that there is no corpus;
2. Beneficiaries must be identifiable;
3. The trust must be irrevocable at death, and;
4. A copy of the trust (or at least a list of all trust beneficiaries, primary, contingent, and remainder) must be delivered to the custodian by October 31st of the year following the year of the IRA owner's death.

If a trust is named as a beneficiary, and qualifies as a see-through trust, the life expectancy period is still limited to the oldest trust beneficiary. Even if a trust splits off into sub trusts, the age of the oldest trust beneficiary must still be used unless each sub-trust was named as a beneficiary individually. In such a case with proper use of sub-trusts, each sub-trust beneficiary can use their own life expectancy in determining the payout period.

In it also important to understand whether the trust is a "discretionary" or "conduit" trust in determining who's age is used in determining the life expectancy factor. A conduit trust simply receives the payout from the IRA and then passes it on to the ultimate beneficiary; the funds do not stay in the trust. A discretionary trust on the other hand allows the trustee to limit distributions which means that funds can accumulate in the trust. In the case of a discretionary trust, all POTENTIAL trust beneficiaries must be considered in determining whose age is used for the life expectancy payout. For example, suppose three children are named as primary trust beneficiaries, and the contingent is the IRA owner's parent, the beneficiary's grandparent. If it is a discretionary trust, there is a possibility that the grandparent may receive some of the funds and thus must be considered a potential beneficiary which causes the young grandchildren to be stuck with the grandparent's life expectancy which, is much shorter than theirs, in determining the Stretch period.

Naming a trust as a beneficiary comes with many potential pitfalls and rules to follow. Be sure you have consulted with a properly trained IRA expert before naming a trust as a beneficiary.

<u>Age 55 10% Early Withdrawal Penalty Exception</u>

If you take funds from an IRA or other retirement plans before you are age 59 ½, not only do you have to pay the taxes on the distribution, you will also be subject to a 10% early distribution penalty on the distributed amount. One of the many exceptions to the 10% early withdrawal penalty is separation from service from an employer plan in the year the employee turns age 55 or later. This rule is not as clear as some people may think. The key is that the employee must *<u>separate from service</u>* in the year they turn age 55 or later, not when the distribution is made. Gail Marie Watson found this out the hard way in her fight with the IRS which she unquestionably lost.

In this case, the taxpayer took the distribution after attaining the age of 55 however she had separated from service at only age 53 and thus did not qualify for the exception. The court ruled that the "law is clear;" it is the date of separation from service that is the determining factor, not the age of the distribution.

3 Common Age 55 Exception Mistakes:

1. Separating from service prior to age 55

   As the Watson case shows, separation must occur in the year the taxpayer turns age 55 or later. This rules seems to indicate that the person must actually be 55 to be eligible for the exception however this is not the case.

The devil is in the details; the separation must occur *in the year* the person turns 55. This means that separation can occur when the individual is only age 54 as long as they will reach age 55 in that calendar year. This also means that the distribution itself can occur before reaching age 55 as long as the individual turns age 55 that year. For example, if you separate from service on 3/1/2012 when you are age 54, took a distribution from the plan on 6/1/2012, and then turned age 55 on 12/1/2012, you would qualify for the exception.

2. Taking funds from a different retirement account

The age 55 exception only applies to a plan where the individual has separated from service from the plan. Distributions from IRAs (including SEP & SIMPLE IRAs) never qualify for this exception and distributions from other employer plans will only qualify if the individual separated from service from that plan in the year they turned age 55 or later.

3. Rolling over plan funds to an IRA

The age 55 exception only applies to employer plans where eligible, not IRAs as indicated in item #2 above. If you qualify for this exception and then rollover your balance to an IRA, the exception is lost and there is no way to fix this. So if you separate from service from your employer in the year you turn age 55 but before you are age 59 ½, you might consider waiting to rollover the funds until you are age 59 ½ just in case you need some of the money.

Remember that the exceptions to the penalty only avoid the 10% penalty; taxes on the distributions are still due. Also in order to qualify from penalty free distributions on retirement accounts without any exceptions, you must actually *be* age 59 ½ when the distribution occurs. Unlike the age 55 penalty exception where you need only reach age 55 in the year of the distribution, you must actually turn age 59 ½ before you take the distribution to avoid the 10% early distribution penalty.

More 60-Day Rollover Rulings

When you take funds from an IRA (or other retirement plan) payable directly to you, you have 60 days to get the entire amount into an IRA (or other plan) to avoid the distribution being taxable as income. There are many reasons why some IRA owner's are unable to complete the rollover in the 60 day period. IRS has the authority to grant waivers and give the IRA owner's additional time to complete the rollover however the IRA owner must have a valid reason. In many cases, IRS denies these requests. The following are new PLR requests that have come out:

PLR 201146024: Denied- IRA owner used funds for an assisted living facility. The IRA owner's daughter who had power of attorney for her mother took the IRA distribution to get her into the assisted living facility and intended to put the money back within 60 days when her mother's home was sold. Unfortunately the sale of the home took longer than expected and she was not able to get the funds back to the IRA with 60 days. IRS denied the request because she used the funds.

PLR 201206023: Denied- IRA owner thought he had 90 days to complete the rollover. In many PLRs, the IRS has granted extensions of the 60 day period to allow a taxpayer the additional time to complete a rollover when in the case of advisor/bank/broker/institution error. In this case, the IRA owner claimed that the employee of the bank told him he had 90 days however he did not have any documentation to prove this claim and presumably the bank/bank employee was unwilling to admit error (assuming the IRA owner was telling the truth and received bad advice) and thus IRS denied his request.

These PLR requests are expensive and in many cases unnecessary. PLR requests for 60 day rollovers begin at $500 and go up to $3,000 just for the request, not including the professional fee to properly draft the request. First many of the mistakes can be avoided, and when some of these mistakes occur, often the rules are clear and relief is unlikely to be granted. If you plan to do a 60 day rollover, make sure that you get the funds back into the IRA within the 60 days and avoid using the money for anything while out of the IRA. Better strategy to work with an advisor who knows the rules and can help you avoid these mistakes in the first place.

Inherited IRA Horror Story

In anticipation of Halloween, I thought this real client horror story from Ed Slott & Co is timely.

The beneficiary of an IRA, Casey was 17 when she inherited the IRA worth approximately $170,000 at the time. The advisor made the (unfortunately all too common) error of moving the funds into an IRA in Casey's name rather than a properly titled inherited IRA. Casey had no idea if taxes were paid or were supposed to be paid; she relied on the guidance of the advisor.

Over the last 14 years, the account was moved several times to different IRA custodians and no one ever asked how a young person had such a large IRA. Casey only took out about $20,000 in the first three years she had the account and nothing since. Fast forward to the present when she needs some money so she makes a request to the advisor for a distribution. This prompted the current advisor to ask how she had an IRA that large at such a young age which uncovered the truth; it was an inherited IRA gone wrong!

Since a non-spouse cannot do a rollover, the transfer of funds from the inherited account to her own IRA was a taxable event the value of which should have been included on her income tax return for that year. Since it has been more than 3 years, the statue of limitations for audit has passed. However in a case such as this, the funds that went into Casey's IRA was an excess contribution subject to the 6% excise penalty per year until fixed. Normally this penalty would be filed on form 5329 which is considered a separate return, and since not filed, the statue of limitations never started.

The penalty is approximately $10,200 (6% of $170,000) per year for 14 years for a total of $142,800! The excess contribution amount would actually be reduced by the net eligible IRA contribution amount for each year which would make the penalty approximately $124,620 assuming full eligibility for the maximum allowable IRA contributions going back to 1998 and assuming she never made any of her own IRA contributions during those years.

Any distribution from the IRA Casey takes will be taxable. If she takes out the excess amount of $124,620 to pay the penalty, the tax due assuming a 25% tax bracket would be $31,155 plus the 10% early distribution penalty of $12,462 for a total of $43,617. Add these up and we have a total amount due of $168,237. All is not lost however because earning on the excess contributions are not distributed and if we assume a reasonable growth rate of 5% (which is below the 6% penalty amount), then her IRA would be worth approximately $336,588 minus the $168,237 penalty leaves her with $168,351 in her IRA. There would be the other penalties such as failure to file form 5329, accuracy related penalties, and interest due on those penalties for 14 years which would further reduce her IRA.

Note that had a distribution occurred when inherited, she would have paid the tax then presumably at lower rates because she was 17 and single, avoided the 6% annual penalty, and the 10% early distribution penalty which does not apply to beneficiaries of IRAs. More importantly if the original advisor was competent and set up a properly titled inherited IRA for Casey, she could have done the stretch and would still have the IRA today and paid much less tax along the way.

Don't let this happen to you or anyone you love!

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

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