
Merry Christmas From The IRS

A Gift of Tax Relief For You

by Cal Brown, CFP

With large IRA's the tax liability can be delayed for many years if you take care of some important details.

They say there are only two things in life that are sure: death and taxes. When it comes to large Individual Retirement Accounts (IRA's), however, that may not be true. That's because the future is uncertain—no one knows when they're going to die. With large IRA's the tax liability can be delayed for many years if you take care of some important details.

Here are the details:

- A. New Tax Rulings allow for changes in IRA beneficiaries after you turn 70 ½ in order to switch to a more favorable distribution method;
- B. You can “stretch-out” IRA distributions which will result in less taxes;
- C. You can make administrative decisions now that will be implemented in the future. Furthermore, if the law changes in the future, you have the flexibility to make further administrative changes which may give you additional tax advantages.

What You Need To Do Now

First, when is (or was) your 70th birthday? / / Six months later would be what date? / / Circle this date—it is very important! It is the date that you reach age 70 ½. And, April 1 of the following year is your Required Beginning Date. Fill in the year and circle this date also: 4/1/

Second, find your IRA paperwork. Look at the original application and check to see who are your Primary and Contingent Beneficiaries. If you are not yet age 70 ½, make sure they are correct before you reach age 70 ½.

Third, If you have reached age 70 ½, write a letter to your IRA custodian to select a distribution method (even if you are already receiving distributions from your IRA, and have been for several years!). A sample letter is provided at the conclusion of this article.

Next, If you have already been receiving distributions and you now want to switch to a different distribution method, notify your IRA custodian in writing. Again, a sample letter is provided at the conclusion of this article.

Last, if a trust is the beneficiary, double-check to ensure that the four essential elements (see below) are present. If so, then the same distribution rules apply as though the

trust beneficiaries were the designated beneficiaries of the IRA.

These details are critical because of two factors: first, some decisions must be made by certain dates, and second, some of these decisions are irrevocable.

A Kinder, Gentler IRS

The IRS may have given your family a huge gift! Some recent Private Letter Rulings (“PLR”) from the IRS have made it possible to change some of these formerly irrevocable decisions. People who don’t know about these changes may lose large amounts to unnecessary taxes. Unfortunately, this information is “off the beaten path” as well as technical and complex. It won’t appear in the popular press, and if it does, it might not make much sense. Furthermore, many unskilled financial advisors may not be aware of it (or even understand it!).

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Included with this article are flowcharts which illustrates the complexity of the details regarding IRA distribution planning.

Decisions, Decisions

Most people know that they have to start withdrawals from their IRA’s at age 70 ½. But that is not the whole story.

One of the first determinations that must be made is this: “What is your Required Beginning Date (‘RBD’)?” The RBD is April 1 *following the year* in which you attain age

70 ½. It may be easier to remember it as your April Fools’ joke on the IRS.

Many people are unaware that if they wait until April of the following year, they must actually take two distributions that first year: the first distribution for the year in which they turned 70 ½ must be taken by April 1 (the RBD); the second distribution must be taken for age 71 by December 31 of that same year.

For example, if your birthday is November 1, 1930, you would have attained age 70 in the year 2000. But you won’t get to 70 ½ until May 1, 2001. Thus your RBD would not be until April 1, 2002. You would have to take a distribution from your IRA by April 1, 2002 for the year 2001. You would also have to take another distribution by December 31, 2002 for the year 2002.

Who Gets What? And When?

One of the most important decisions that you must make regarding your IRA is to name your primary and contingent beneficiaries. It is extremely important that you do this prior to your RBD. This is known as a “Timely Named Beneficiary.” It has become even more important to have timely named beneficiaries in light of these new PLR’s.

If you have a spouse, in most cases that should be your primary beneficiary designation. Your contingent beneficiaries will probably be your children, if you have any, or a trust. But there are some specific requirements that absolutely must be adhered to if you name a trust* as beneficiary.

If you have a Timely Named Beneficiary, you preserve a great deal of flexibility for yourself and your family, and you may save a large amount of taxes.

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Oh No! More Math!

Once you have named your beneficiaries, you are now in a position to calculate your Required Minimum Distribution (“RMD”). Don’t confuse that with RBD. Your RMD is the minimum amount you must withdraw from your IRA each year. If you do not, the IRS will hit you with a 50% tax, so it is imperative this is calculated correctly.

You have two sets of two choices. Your distribution method can be either “Term Certain” or “Recalculation”; and you can use either a “Single Life” or a “Joint Life” factor.

Since most people want to keep their distributions as low as possible, the first decision is relatively easy: use “Joint Life.” You can go to the life expectancy tables found in IRS Publication 590 to obtain the factor for this calculation. Want an easier method? Call us, your financial advisor.

Here’s where it starts getting complicated. If your spouse is your beneficiary you simply use his/her age to find the joint life factor. You can then select either Recalculation or Term Certain. Under the Recalculation method, the second year of distributions would be determined by going back to the table and finding the new factor. Under the Term Certain method, the factor for the second year is simply this: the first year factor minus one.

If, on the other hand, your beneficiary is one or more of your children, or a trust, or a charity, you can only use the Term Certain method for them. In addition, there is a rule (the “Minimum Distribution Incentive Benefit” or “10-year rule”) which states you cannot use their actual age. Instead you must subtract 10 from your age and use that joint age to find the factor.

Term Certain Or Recalculation?

If you select the wrong distribution method, your heirs cannot stretch-out your IRA. Most people don’t make a conscious or

written selection and end up with the wrong one by default.

The Recalculation method results in a lower RMD after the first year. That is why it is the method most people use. Here’s the problem with the Recalculation method: upon the death of the IRA owner, the entire IRA must be distributed to the beneficiaries in a lump sum within 5 years. The lone exception is if the beneficiary is the spouse—the spouse (and only the spouse) can roll it over to his/her IRA.

For reasons only actuaries can explain, in the life expectancy tables an individual does not lose a year of life expectancy for each year that passes, so your life expectancy factor goes down more slowly if you recalculate your distribution each year. This is why the Recalculation method results in a lower RMD.

Most people don’t make a conscious or written selection and end up with the wrong one by default.

The Term Certain (also known as the “Non-Recalculation”) method is more logical; instead of recalculating each year, you simply subtract 1 from your original life expectancy factor for the following year. The problem with Term Certain? Under this method the IRA will be completely depleted at age 86 (assuming single life—if you use joint life, it would last longer, depending on the age of the younger spouse; e.g., if both spouses were age 70, it would last until age 90).

So what? What is the advantage of this method? Your heirs can stretch-out your IRA after death. In the example above, if you die before you reach age 86 and you have selected Term Certain, your children will be able to stretch-out distributions from your IRA over their life expectancy instead of being forced to take it in a lump sum and pay all the taxes at once.

This stretch-out will result in tremendous tax savings to your beneficiaries over their lifetimes. It will allow most of the IRA to continue growing on a tax-deferred basis.

The Tombstone Test

Since no one knows when they're going to die—and few people enjoy contemplating that fact—how do you decide to take a chance on outliving the IRA by choosing the Term Certain method?

Until now it was a flip of a coin. And the decision between Term Certain and Recalculation was irrevocable.

The recent Private Letter Rulings have changed all that. Now you can switch from one to the other (or from single life to joint life). The only requirement? Go back to the beginning of this article: you must have named your beneficiaries by your Required Beginning Date. If you have done that, you're home free. Please note that a charity does not meet the IRS' definition of a "designated beneficiary," and your IRA will be treated as not having a beneficiary if a charity is named as one of the beneficiaries!

This now gives you the flexibility to start off with Recalculation, but if your health starts to decline slowly, switch to Term Certain to provide your children with the stretch-out option. Of course, the future is uncertain, and a sudden death could derail this plan. I had a triple bypass operation at age 45, so I am painfully aware of the potential of unplanned events.

The future is uncertain. But using this system, you have some flexibility.

The Stretch IRA

The Stretch IRA can save significant amounts of taxes—the larger the IRA the greater the tax savings. It is the only way to continue tax deferral of an IRA that gets passed to someone other than your spouse.

Upon death, if you have used the Term Certain method, and if the IRA is going to pass to anyone other than your spouse (probably your children), there are more rules to follow.

The first one is a critical date: the heirs must begin distributions within one year of the date of death, *even if the deceased had not attained age 70 ½*.

The heirs can then take annual distributions on a Term Certain basis, and the 10-year rule does not apply. However, if you named more than one beneficiary (e.g., several children) they have to use the life expectancy of the oldest beneficiary.

You should also be aware of a technical detail that is absolutely vital: the IRA must be left in the name of the deceased IRA owner; it cannot be re-titled in the name of a child.

If you have no spouse you may want to consider setting up separate IRA's with a different child as sole beneficiary of each one. This way each child would use his/her own life expectancy and stretch the distributions out even further for the younger beneficiaries. A recent PLR also allows for this to be done after your death (if you die before age 70 ½).

There is also a rarely discussed method known as the "hybrid method" for non-spouse beneficiaries. The IRA owner selects Joint Life and Recalculation for the owner, and Term Certain for the beneficiary. The joint factor is subject to the 10-year rule because the beneficiary is a child. Upon the death of the IRA owner, the distribution method will revert to the single life expectancy of the primary beneficiary, less the number of years since the owner turned 70 ½.

For example, suppose that the IRA owner elected the hybrid method and passes away at age 78 when his beneficiary, a child, was age 55. The child has a life expectancy of 28.6 years. But to determine the distribution amount, the child would subtract 8 years off of that life expectancy because it has been 8 years since the owner turned 70 ½. So, the life expectancy would be 20.6 years.

The advantages of this method are truly amazing. If your investment returns in the IRA average 8% or higher (based on your

portfolio design), the tax-deferred growth of these funds will far surpass the required distributions.

In the above example, a life expectancy of 20.6 years results in a distribution of 4.85% ($1/20.6 = .0485$). If there was \$1 million in the IRA, the required distribution would be \$48,500 that year. But if the IRA's investment return was 10%, the net tax-deferred growth in the IRA for the year would be \$51,500 (10% of \$1 million = \$100,000; \$100,000 less \$48,500 = \$51,500).

It is good practice to review your IRA Beneficiary Designations and the Distribution Method on an annual basis.

This stretch-out IRA would continue to show net gains as long as the investment returns exceed the distribution percentage. Over the life of the child, the tax-deferred growth of the IRA would be remarkable.

And remember, the child did not have to pay taxes on a \$1 million IRA distribution in one year! The child only pays taxes annually on the actual distribution (and no 10% penalty) in a much lower tax bracket. If the child had to add \$1 million of taxable income to his/her income, 75% or more of it would be taxed at the highest bracket (39.6%). But with a much smaller annual distribution, it would be taxed at a 28% rate (depending on the child's other income that year).

What's An IRA Owner To Do?

There are some specific Action Items that should be addressed immediately:

- 1) Determine your Required Beginning Date (April 1 after turning 70 ½);

- 2) Review your Primary and Contingent Beneficiaries and make sure they are properly designated prior to the RBD (please note: a charity is not an acceptable beneficiary designation—it must be an individual or a trust);
- 3) After the RBD, write a letter to your IRA custodian to select a distribution method (single life or joint life, term certain or recalculation, or hybrid);
- 4) If you have already been using a distribution method and now want to switch to a different method, notify your IRA custodian in writing if you had named beneficiaries prior to your RBD;
- 5) If a trust is the beneficiary, double-check to ensure that the 4 essential elements are present (if so, then the same distribution rules apply as though the trust beneficiaries were the designated beneficiaries of the IRA);
- 6) Upon death, leave the IRA in the name of the deceased. This is the only way that beneficiaries can stretch-out the IRA. (Exception: the spouse can roll it over to his/her IRA). A sample letter to accomplish this is provided at the end of this article.

Upon the death of an IRA owner, consult the flowchart at the end of this paper for appropriate actions. Please note that some actions are required within 9 months or 12 months after the date of death. Do NOT miss these deadlines!

It is a good practice to review your IRA Beneficiary Designations and the Distribution Method on an annual basis.

If you have named a trust as the beneficiary of an IRA, it will be deemed that you have not named an individual person as beneficiary. This could be disastrous, because it would require that the IRA be liquidated by Dec. 31 of the year of death, resulting in immediate taxation of the entire amount and

loss of tax-deferred growth into the future. However, if the trust meets certain requirements, then the beneficiaries of the trust are considered to be the beneficiaries of the IRA. There are four essential elements*. If your trust complies, then the IRA is eligible for “stretch-out” using those beneficiaries’ life expectancies.

Proper documentation is key. A sample letter to the IRA custodian notifying them of the delivery of the trust to the custodian is provided at the conclusion of this article.

Conclusion

IRA distribution rules are complex. The penalties for noncompliance are high. And the opportunity costs resulting from making wrong decisions are also very high. There are important dates that must be adhered to. Proper documentation and frequent reviews are highly recommended in order to make sure that nothing “slips through the cracks,” or to keep up with changes in the regulations.

*Four essential elements of a trust:

1. Must be valid under state law;
2. Must be irrevocable, or become irrevocable upon the death of the owner;
3. Beneficiaries are identifiable and they must be individuals;
4. A copy of the trust and all amendments must be provided to the plan administrator.

Sample Letter to IRA Custodian regarding
Distribution Method

Ira Owner
705 Distribution Drive
Fairfax, VA 22033

XYZ Trust Co.
123 Custodial Way
Denver, CO

RE: Ira Owner, IRA
Account no. 56789

To the Plan Administrator:

I, Ira Owner, am the owner of the IRA referenced above. I hereby elect to receive my Required Minimum Distribution based on the _____ (choose one: joint life OR single life) and _____ (choose one: recalculation OR term certain) method. <If you selected joint life, add this sentence: For my beneficiary, I elect the term certain method.>

I want to receive my first distribution no later than December 31, ____ (year). <Alternatively, for the first distribution only you could use April 1 of the following year, but this would result in two distributions that year>

My life expectancy under the IRS _____ (choose one: single or joint) life expectancy table is ____ years in calendar year _____.

Thank you for your cooperation,

Ira Owner

Sample Letter to IRA Custodian to
Change the Distribution Method

Ira Owner
705 Distribution Drive
Fairfax, VA 22033

XYZ Trust Co.
123 Custodial Way
Denver, CO

RE: Ira Owner, IRA
Account no. 56789

To the Plan Administrator:

I, Ira Owner, am the owner of the IRA referenced above. I hereby elect to change the method used to calculate my Required Minimum Distribution. Effective immediately, I will be using the _____ (choose one: joint life OR single life) and _____ (choose one: recalculation OR term certain) method. <If you selected joint life, add this sentence: For my beneficiary, I elect the term certain method.>

I want to receive my first distribution under this method no later than December 31, ____ (year).

I certify that I had named my beneficiaries prior to my Required Beginning Date.

My life expectancy under the IRS _____ (choose one: single or joint) life expectancy table is ____ years in calendar year _____.

Thank you for your cooperation,

Ira Owner

Sample Letter to IRA Custodian to
“Stretch-Out” an IRA from a Deceased Person

Sonny Ira Owner

705 Distribution Drive
Fairfax, VA 22033

XYZ Trust Co.
123 Custodial Way
Denver, CO

RE: Ira Owner, IRA
Account no. 56789

To the Plan Administrator:

I, Sonny Ira Owner, am the designated beneficiary of the IRA referenced above, which is held at your institution as custodian. My father, Ira Owner, died on __/__/____ at the age of 72.

I hereby elect to received my Required Minimum Distribution from the Ira Owner, deceased, IRA based on the life expectancy method and not under the five-year rule.

I want to receive my first distribution no later than December 31, ____ (current year).

My life expectancy under the IRS single life expectancy table is ____ years in calendar year ____ (current year).

I direct that you maintain the Ira Owner IRA in the decedent’s name and that you do not retitle the IRA account in my name since that is a violation of the Internal Revenue Code. I further direct that you retitle the account to read as follows:

Ira Owner, deceased, IRA (date of death __/__/____) FBO Sonny Ira Owner,
Soc. Sec. No. 123-45-6789

Thank you for your cooperation,

Sonny Ira Owner

Sample Letter to IRA Custodian toDeliver a Copy of a Trust

XYZ Trust Co.
123 Custodial Way
Denver, CO

RE: Ira Owner, IRA
Account no. 56789

To the Plan Administrator:

Enclosed is a copy of the "Ira Owner Revocable Trust dated July 4, 1997" that I have named as beneficiary of my above referenced IRA. I hereby agree that if the said trust's provisions are changed at any time in the future, I will provide a copy of each new amendment or trust to you within a reasonable time.

Please acknowledge your receipt of this letter and the trust by signing below and returning to me in the enclosed envelope.

Sincerely yours,

Ira Owner

Receipt Acknowledged by:

XYZ Trust Co.

Date

Print Name & Title