

**ADVANCED PLANNING WITH  
IRAs AND RETIREMENT PLANS**

AICPA Advanced Estate Planning  
Conference  
July 25, 2007

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**Current Developments**

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**PLR 2007-20023**

- Taxpayer with 72(t) program moves portion of IRA into second, new IRA for investment diversification opportunity
- IRS rules that this is an improper modification, subjecting all distributions to 10% early withdrawal tax, plus additional tax representing interest

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**Rev. Rul. 2007-24**

- Taxpayer wished to move annuity money to second company
- First company would only issue check to taxpayer
- Taxpayer endorsed check to second company
- IRS rules that it is NOT a 1035 exchange

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**PLR 2007-17026**

- Taxpayer taking SOSEPP (72(t) plan) from IRA
- Taxpayer getting divorced and transferring portion of IRA to spouse under Sec. 408(d)(6)
- IRS rules that transfer is tax free, and taxpayer can recompute new payment schedule based upon retained portion of IRA

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**PLRs 2006-34017, 2006-34018,  
2006-34019, 2006-34020, 2006-  
34021, 2006-34022**

- Taxpayers told they could take partial distribution in the form of company stock and utilize NUA
- NUA NOT available – wanted to do rollover
- The IRS will NOT permit a late rollover of retirement plan funds when the late rollover is due to alleged bad information on the part of a financial advisor

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## Roth IRAs & Roth 401(k)s

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### Roth 401(k)s

- Roth 401(k)s made permanent by PPA 2006
  - Had been scheduled to 'sunset' after 2010
- 401(k) plan needs to be amended to accept Roth 401(k) contributions
- Differences from Roth IRA
  - Normal annuity rules
  - Mandatory distributions
  - Can only be rolled to another Roth 401(k), Roth 403(b) or Roth IRA

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### Roth 401(k)s

- IRS issued final regulations relating to distributions from Roth 401(k) accounts on April 30, 2007

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**Roth 401(k)  
Contributions**

- Contribution limits
  - Total contributions between regular and Roth 401(k) accounts cannot exceed annual contribution limits
    - Under age 50 - \$15,500 for 2007
    - Age 50 and over - \$20,500 for 2007
- Roth contribution is designated by employee as not excludible
- Must be maintained by employer in separate designated Roth account

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**Roth 401(k)  
Employer Matching Contributions**

- Any employer matching contributions **MUST** be made to the **REGULAR** 401(k) account, **NOT** the Roth

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**Roth 401(k)s**  
Conversions

- There is no provision for allowing a conversion of any money into a Roth 401(k)
- Roth 401(k) plans can **ONLY** be funded with annual contributions, or rollovers from other Roth 401(k) plans

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### Roth 401(k) Distributions

- Qualified distributions are excludable from income
- Non-qualified distributions are includable in income, in accordance with the annuity rules of Sec. 72
  - Distribution ordering rules of Roth IRAs do NOT apply to Roth 401(k)s
  - An account inherited within first five years, with lifetime payout, will have some taxable component

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### Roth 401(k) Distributions

- A Qualified Distribution from a Roth 401(k) is a distribution after
  - The employee has been a participant in the Roth 401(k) for over 5 years, AND
  - The employee is
    - Over age 59½, OR
    - Dead, OR
    - Disabled

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### Distribution Chart

	Not more than 5 years in plan	More than 5 years in plan
Under age 59½	NOT qualified	NOT qualified
Over age 59½ (or dead or disabled)	NOT qualified	<b>QUALIFIED</b>

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## Rollovers

- Generally, any distribution to an account participant, or the **spouse beneficiary** of a deceased account participant, can be rolled over
- Exceptions are –
  - Any payment that is part of a series of substantially equal periodic payments, i.e. 72(t) plan, or annuity, 10 years or greater
  - Any required minimum distribution
  - Any hardship distribution from a qualified plan

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## Roth 401(k) Rollovers/Transfers

- Roth 401(k) assets can only be transferred to
  - another Roth 401(k) or Roth 403(b), or
  - A Roth IRA
- There does not seem to be any published guidance on how to correct Roth 401(k) assets erroneously rolled into a non-Roth account

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## Roth 401(k)s

- Basis in Roth 401(k) can only be transferred to a new company's Roth 401(k) plan in a Direct Trustee to Trustee transfer
  - Holding period tacks
- In a partial rollover (60 day rule) income goes in first
  - Basis can remain out tax free, if desired
  - No holding period tack in company plan

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**Roth 401(k)  
Rollovers/Transfers**

- Any distribution can be rolled over to a Roth IRA in either a DIRECT ROLLOVER or a 60-DAY ROLLOVER

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**Roth 401(k)  
Rollovers/Transfers**

- EXAMPLE:
  - Employee has Roth 401(k), basis \$40,000 value \$55,000
  - If employee changes job, \$55,000 can only be transferred to new Roth 401(k) if done via trustee to trustee transfer
  - If employee receives a check, he loses ability to transfer the \$40,000 to new employer's Roth 401(k)

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**Roth 401(k)  
Rollovers/Transfers**

- EXAMPLE (con't)
  - Employee can still transfer \$15,000 earnings to new employer's Roth 401(k)
  - Alternatively, entire \$55,000 can be transferred to Roth IRA, in either a trustee to trustee transfer OR 60 day rollover
    - Transfer to Roth IRA is the preferred action

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**Roth 401(k)  
Record Keeping**

- Plan administrator must keep records of contributed amounts and earnings
- Plan administrator must also keep record of the first year in plan for purposes of five year rule
- This information must be given to recipient plan in case of a direct rollover
  - New plan must keep same records

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**Roth 401(k)  
5 Year In Plan Rule**

- Any distribution within the first 5 taxable years in plan is NOT a qualified distribution
- Five year clock starts on first day of employee's taxable year in which employee makes a Roth 401(k) contribution and ends when five consecutive taxable years are completed
  - Earliest date for a qualified distribution will be 2011

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**Roth 401(k)  
5 Year In Plan Rule**

- In the case of a DIRECT ROLLOVER, the five years for the recipient plan will include the time in the predecessor plan.
- Otherwise, each 401(k) plan has its own five year requirement

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### Roth IRAs and Roth 401k's

- Five year rules mutually exclusive
- Possible to end up with 9 years
  - Example: Individual, age 54 starts participation in Roth 401k
  - Age 58, 4 years later, leaves job and rolls money into new Roth IRA
  - Earnings cannot come out tax free until Roth is over five years old

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### Roth IRAs and Roth 401k's

- EXAMPLE: Individual, age 58, starts participation in Roth 401k
- Individual has Roth IRA opened over five years ago
- After two years, Roth 401k rolled into Roth IRA
- Earnings will be tax free, even though Roth 401k not five years old

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### Roth 401(k) Basis in Roth IRA after Rollover

- If the amount distributed from the Roth 401(k) would NOT be a qualified distribution, then the basis of the Roth 401(k) becomes the basis of the Roth IRA
- If the amount distributed from the Roth 401(k) would be a qualified distribution, then the entire amount distributed from the Roth 401(k) becomes the basis of the Roth IRA

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### EXAMPLES

- Individual, age 58, has contribute \$75K to Roth 401k, now worth \$100K
- Upon a rollover to a brand new Roth IRA, \$75K is considered basis and amounts in excess of \$75K cannot come out tax free until after five years from the rollover

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### EXAMPLES

- Individual, age 60, has contribute \$75K to Roth 401k, now over 5 years old and worth \$120K
- Upon a rollover to a brand new Roth IRA, \$120K is considered basis and amounts in excess of \$120K cannot come out tax free until after five years from the rollover

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- Any amount from a Roth 401k rolled into a Roth IRA will be eligible for tax free treatment in accordance with the Roth IRA rules, e.g. Roth IRA over five years in existence and taxpayer over age 59½, no matter how long or how little the money was in the Roth 401k

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**Roth 401(k)  
Alternate Payee/Beneficiary**

- Qualified Distribution is based upon age, death or disability of participant
  - A non spouse beneficiary will always meet the 'death' component, so only barrier to a tax free distribution for the beneficiary is the 5 year in plan rule
- Exception is if spouse or alternate payee rolls account to own Roth 401(k)

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**Roth 401(k)  
Spouse Beneficiary**

- Each case needs to be evaluated based upon age of spouse and participant, years of participant in plan, spouse's need for account, whether spouse already has a Roth IRA, to determine whether to keep Roth IRA as beneficiary or roll account to Roth IRA
- Roth IRA could be beneficiary account, or account in spouse's name

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**Roth 401(k)  
Non Spouse Beneficiary**

- If plan permits, should do a DIRECT ROLLOVER into inherited Roth IRA, as soon as possible, and start beneficiary distributions no later than December 31<sup>st</sup> of year after year of participant's death
  - Besides getting the ability to stretch distributions, beneficiary gets the advantage of basis coming out first

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Roth 401(k)  
Qualified Distribution

- Determination of a qualified distribution is based upon year of distribution even if distributions commenced in an earlier year, or is attributable to an earlier year.

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Roth 401(k)  
Qualified Distribution

- EXAMPLE: Ken made his first Roth 401(k) distribution in 2006. Ken will attain age 70½ in 2010, and needs to start distributions. If Ken takes a distribution in 2010, a portion will be taxable. However, Ken can wait until the first quarter of 2011 to take the distribution. If Ken does that, the entire distribution will be tax free as a qualified distribution

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Roth 401(k)  
Qualified Distribution

- EXAMPLE: Jean retires at age 57, after more than 5 years in the Roth 401(k). She starts receiving a monthly check from the plan. A portion of each check is taxable, until Jean attains age 59½, after which all distributions will be tax free

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**Roth 401(k)  
Partial Rollover**

- If a participant rolls over a portion of a distribution from Roth 401(k) to a Roth IRA, the taxable portion is deemed rolled over first
  - This allows a participant to keep the basis as a tax free distribution, while rolling the taxable portion to a Roth IRA

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**Roth 401(k)  
Partial Rollover**

- EXAMPLE: Ray receives a non qualified distribution of \$75,000 from his Roth 401(k) in which he contributed \$60,000. If Ray rolls \$15,000 to a Roth IRA, he can keep the \$60,000 tax free

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**Roth 401(k)  
Excess Deferral**

- If an excess deferral is not distributed by April 15<sup>th</sup> of the year after the year of the excess deferral, such excess deferral and attributable earnings will be taxed when distributed, cannot be rolled over, and will be the first amounts distributed until such deferral and earnings are distributed

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## Roth IRAs

### Review of Basics

- Contributions not deductible
- Qualified withdrawals not taxable
- No lifetime required minimum distributions
- Earnings come out LAST, and are the only component that COULD be subject to income tax
- Contributions permitted after age 70½
- All regular IRA rules apply unless Roth rules specifically state otherwise

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## Roth IRAs

### Qualified withdrawals

- A withdrawal of Roth earnings will be tax free, if the account has been open for more than five tax years, AND
  - The account holder is either
    - Over age 59½, OR
    - Deceased, OR
    - Disabled, OR
  - the withdrawal is for a qualified first time home purchase
    - Per person \$10,000 lifetime limit

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## Roth IRAs

### Conversions

- MAGI cannot exceed \$100,000, single or married, MFS cannot do conversion
  - PLANNING POINT – As of 2005, required minimum distributions do NOT count towards the \$100,000 limitation
- Subject to income tax, not subject to 10% penalty
  - Converted amounts withdrawn within five years starting with year of CONVERSION will be subject to the 10% penalty rules
    - All exceptions to penalty apply
- Can do a partial conversion

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**Roth IRA vs. Roth 401(k)  
comparison**

<ul style="list-style-type: none"> <li>• Roth IRA           <ul style="list-style-type: none"> <li>– Income limitation for contributions</li> <li>– If MAGI for year does not exceed \$100K, assets in traditional IRA can be converted to Roth IRA</li> <li>– NO lifetime minimum required distributions</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Roth 401(k)           <ul style="list-style-type: none"> <li>– NO income limitation for contributions</li> <li>– NO provision to convert regular 401(k) assets to Roth 401(k)</li> <li>– Minimum required distributions commence at required beginning date</li> </ul> </li> </ul>
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**Roth IRA vs. Roth 401(k)  
comparison**

<ul style="list-style-type: none"> <li>• Roth IRA           <ul style="list-style-type: none"> <li>– Contributed amounts can be removed at any time without tax or penalty, due to specific ordering rules of distributions               <ul style="list-style-type: none"> <li>• First contributions, second conversions, last earnings</li> </ul> </li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Roth 401(k)           <ul style="list-style-type: none"> <li>– Any distribution will consist of a portion of the amount contributed, but also a portion of the account income</li> </ul> </li> </ul>
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**Roth IRAs**

- Tax Increase Prevention and Reconciliation Act (TIPRA) (May 17, 2006)
  - Starting in 2010, there is no longer an income limitation on conversions
  - MFS can convert to Roths
  - Therefore anyone with an IRA can convert all or part to a Roth
  - Any conversions done in 2010 can spread the tax over two years

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## Roth IRAs

### Conversions/Contributions

- NO BRAINER - Those who cannot deduct their traditional IRA contribution should instead contribute to a Roth, if eligible
- Younger, lower income taxpayers should contribute to a Roth
  - Should also consider converting any existing IRAs to Roths
- Older, high net worth individuals with large IRA balances are prime candidates for Roth conversions

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## Roth IRAs

- Advantage of Roth conversion for a taxable estate
  - With a traditional IRA in an estate, the estate tax is paid first, then the income tax
    - If done correctly, there is an income tax deduction for the FEDERAL estate tax
  - With a Roth IRA in an estate, the income tax has already been paid, so the estate tax is only on the after tax amount

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## Roth IRAs

- Advantage of Roth conversion for a taxable estate
  - With a 35% federal estate tax rate and a 16% state estate tax rate, the heirs will have approx. 7% more, based upon gross IRA value, if there is a Roth conversion

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## Roth IRAs

- Advantage of Roth conversion for a taxable estate
  - Why is this so?
  - There is a deduction for the federal estate tax attributable to income in respect of a decedent but there is no deduction for the state estate tax so attributable, resulting in double taxation on the state level
  - Paying the income first avoids the double taxation

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## Roth IRAs

### Conversions/Contributions

- Doing a conversion where the resulting tax is paid from outside funds is like contributing excess money to IRA
- Contributions can ALWAYS be withdrawn tax and penalty free
- Conversions can be withdrawn tax and penalty free AFTER five years from conversion
  - Each conversion has its own five year period
- Conversion removes income tax from estate
- Advantage to first time home purchaser

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## Roth IRAs

### First Time Home Purchaser

- With a traditional IRA, one can withdraw \$10,000 penalty free for FTHP
- With a Roth IRA, one can withdraw \$10,000 of EARNINGS, penalty free AND INCOME TAX FREE for FTHP - Once account is more than five years old
- Example: Ten years of contributions total \$20,000, account worth \$30,000
- Regular IRA - can withdraw \$10,000 subject to tax
- Roth IRA - can withdraw \$30,000 TAX FREE

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## Roth IRAs

### Recharacterizations

- Invalid conversion, or simply change mind
- Must be done via trustee to trustee transfer back to traditional IRA - cannot use rollover
- Deadline is October 15th of following year (extended due date)
- Cannot convert same funds back to Roth until LATER of year after recharacterized conversion OR 31st day after recharacterization

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## Roth IRAs

### Planning Tips

- Roth conversions are best done early in year
- Conversions should be deposited into new separate account
- A partial conversion into separate account allows you to do second conversion into different separate account and then recharacterize first conversion
  - Extremely helpful if account declines during year

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## Roth IRAs

- EXAMPLE:
  - \$100,000 traditional IRA; convert \$25,000 to a Roth #1, a brand new account
  - Account declines by 20%, so that \$75K left in traditional is now worth \$60K and Roth #1 is now worth \$20K
  - Convert \$20K of traditional IRA into new Roth IRA account #2
  - Recharacterize Roth #1

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## Roth IRAs

- Result:
  - “Exchange” of \$25K income for \$20K income.
  - This will ONLY work if you use separate Roth IRAs
    - Recharacterizing the entire account does not require you to compute attributable income
    - Recharacterizing part of an account will allocate income or loss over the entire account

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## Roth IRAs

Improper Conversion/Missed Recharacterization Deadline - Remedy

- The only solution if deadline for recharacterization is missed is to get a Private Letter Ruling from the IRS that will permit a late recharacterization
- Reg. Sec. 301.9100-3 provides guidance for the granting of relief
- Generally, relief will be granted when taxpayer can establish that –
  - Taxpayer acted reasonably and in good faith, and
  - Relief would not prejudice interests of gov't
- Numerous PLRs have been issued granting relief
  - New \$9,000 IRS fee!

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## Planning for 2010

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## Planning for 2010

- Steps that can be taken now
  - Have clients fund traditional IRA through 2010, even if non-deductible
    - May want to elect not to deduct IRA even if deductible
  - Alert clients to new provision, and plan for conversion
  - Clarify the pro rata basis rules with clients, so they are aware of tax implications

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## Planning for 2010

- Pro Rata Basis Rules
  - ALL IRAs, including SEP IRAs and Rollover IRAs, but not inherited IRAs, are treated as ONE account
    - You cannot convert only basis
    - You cannot convert only one IRA account and have the entire basis attributable to that one account

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## Planning for 2010

- EXAMPLE:
- Individual has contributory IRA, \$40K basis, balance \$100,000
- Individual also has Rollover IRA from company plan, with a balance of \$900K
- Only **4%** of any withdrawal represents basis, NOT 40%!
- However....

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### Planning for 2010

- However, if an individual is a participant in an employer plan, including a profit sharing plan or a uniK plan, she can roll over all IRA money EXCEPT basis
- If \$960K is rolled into the employer plan, and only \$40K is left in the IRA, the \$40K can be rolled over tax free to a Roth
- Excellent opportunity for individual with self employment income
  - SEP IRA won't cut it

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### Roth IRAs and Roth 401k's

- Five year rules mutually exclusive
- Possible to end up with 9 years
  - Example: Individual, age 54 starts participation in Roth 401k
  - Age 58, 4 years later, leaves job and rolls money into new Roth IRA
  - Earnings cannot come out tax free until Roth is over five years old

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### Roth IRAs and Roth 401k's

- Anyone with a Roth 401(k) should open a Roth IRA, either by contribution or conversion, as early as possible

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## Roth IRAs and Roth 401k's

- EXAMPLE: Individual, age 58, starts participation in Roth 401k
- Individual has Roth IRA opened over five years ago
- After two years, Roth 401k rolled into Roth IRA
- Earnings will be tax free, even though Roth 401k not five years old

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## Sec 72(t)

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## Under 59½

Exceptions to 10% tax

- Death
- Disability
- Higher Education - IRAs only
- First Time Home Purchase - IRAs only
- Age 55 (50) when separated from Service - Not IRAs
- Health Insurance for Unemployed – IRAs only
- Medical expenses over 7½% of AGI
- Substantially Equal Periodic Payments
- Made on account of a levy on the retirement account
- Amounts paid as dividends under an ESOP
- Amounts paid to alternate payee under QDRO
- Amounts distributed to active service personnel after 179 days of active service

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### Exceptions to 10% tax

- **Education expense**
  - Distribution and expenditure must occur in same tax year
- **Medical expense**
  - Distribution and expenditure must occur in same tax year
- **First time home purchase**
  - Distribution must be used within 120 days starting on date of withdrawal – not necessarily in same tax year
    - Timing crucial

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### Exceptions to 10% tax

WHAT'S MISSING??

- Refinance house, pay for son's wedding, pay off credit cards
  - Vulic v. Commissioner, T.C. Memo 2004-51
- Withdrawing from the wrong spouse's account
  - Owens v. Commissioner, T.C. Summary Opinion 2004-29
- "Undue Hardship"
  - Milner v. Commissioner, T.C. Memo 2004-111

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### White v Commissioner T.C. Summ. Op. 2005-62

- Bankruptcy with an outstanding 401(k) loan

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**Ghazitehrani v. Commissioner**

T.C. Summ. Op. 2006-170

- Financial Hardship does not excuse the penalty
- Neither does the fact that “any errors on the return are attributable to the TurboTax program”
- Beware of retired engineers with lots of time on their hands!

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**Exceptions to 10% tax**

- Substantially Equal Periodic Payments

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**Substantially Equal Periodic Payments**

Three Approved Methods of Computing

- Originally in Notice 89-25, restated in Rev. Rul. 2002-62
- Minimum Distribution Method
  - Can use single life table, joint and last survivor table, uniform table (assumed beneficiary 10 years younger)
- Amortization Method
  - Interest rate equal to or less than 120% of federal midterm rate for either of two prior months
- Annuitization Method
  - Mortality table in Appendix B of Rev. Rul. 2002-62
  - Interest rate equal to or less than 120% of federal midterm rate for either of two prior months

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### Substantially Equal Periodic Payments

- Payments must continue for GREATER of five years or until taxpayer reaches age 59½
- Impermissible modification results in 10% penalty on ALL pre 59½ withdrawals, PLUS an additional penalty equal to interest charge as if penalty was payable each year

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### Penalty Example

- TP starts SOSEPP in 2000 when age 50, taking a distribution of \$50,000 each year
- In 2006 TP withdraws \$60,000; total distribution since 2000 is \$310K
  - It is irrelevant if the extra \$10K was taken for a reason that would exclude the 10K from the penalty
- TP owes \$31K PLUS interest on \$5K from 4/15/01, interest on \$5K from 4/15/02, interest on \$5K from 4/15/03, interest on \$5K from 4/15/04, interest on \$5K from 4/15/05, and interest on \$5K from 4/15/06, all computed until 4/15/07, the due date of the 2006 tax return

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### Pre 59½

- Planning pointer –
  - Before a client starts a SOSEPP, see if need for withdrawal is one shot need, or if client is near age 59½
  - It may be better to pay one shot 10% penalty than to tie client into five year, or greater, schedule

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**Rev. Rul. 2002-62**

- Ruling permits taxpayers to change to the minimum required distribution method
- One time change, designed to protect taxpayer's account from running out of money if there is a downturn in the market
- Will result in major decline in annual payment

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**Substantially Equal Periodic Payments**

Client Choices

- 1. Continue taking original amount until plan runs out of money
  - Good news: IRS will not impose 10% penalty
- 2. Change to MRD method and hope it's enough to live on (or else get a job)
- 3. Bust the plan and pay the penalty
  - 10% of all amounts taken, plus interest
- Probably best option: Take original for a few more years, and then switch to MRD

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**Rev. Rul. 2002-62**

Other Provisions

- Can no longer use an interest rate higher than 120% of fed mid term rate determined under Sec. 1274(d) for either of the two prior months
- Cannot transfer money into or out of the 72t account

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**PLR 2006-34033**

- Inadvertent transfer into account with existing SOSEPP blows up plan
  - 10% penalty on all prior distributions
  - Transfer occurred 3 months prior to final required distribution
  - Probably will be litigated

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**Substantially Equal Periodic Payments**

Planning Point

- You do NOT need to use all IRAs to compute payments, but you do need to include entire IRA balance in the computation
- You can “size” your IRA to give you the balance that computes to desired withdrawal and segregate that balance into separate IRA – “super size” the withdrawal
- Non “involved” IRA can be kept in reserve
- No prohibition against second computation with second IRA – 2<sup>nd</sup> five year requirement

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**Substantially Equal Periodic Payments**

- Planning point
  - Taking an additional distribution from a SOSEPP destroys the SOSEPP, even if the additional distribution would qualify for an exception, e.g. Higher education
    - Any additional distribution should be taken from non SOSEPP IRA

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**Substantially Equal Periodic Payments**

– When a SOSEPP is started after age 54½, an additional distribution after age 59½, but before the five years are up, is the ONLY time a post 59½ distribution will trigger a 10% penalty

- The penalty, however, is only applicable to the pre 59½ distributions

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**Substantially Equal Periodic Payments**

Planning Point

- Client not required to take into account beneficiary's life expectancy, even when there is a beneficiary
- To maximize the distribution, use single life table
- Annuitization method usually yields highest payout
- Use smallest possible IRA balance to get desired distribution

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**Substantially Equal Periodic Payments**

- Payments MUST continue for the GREATER of five years or until client is 59½
- Five years runs from date of first payment, NOT distributions within five tax years -Arnold v. Commissioner, 111 TC No. 12

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### PLR 2005-03036

- Taxpayer taking substantially equal periodic payments under Sec. 72(t)
- Takes portion of computed amount in year
- Requests balance of amount from broker
- Broker fails to make payment
- Missed payment taken in next year, along with next year's payment
- IRS says it's OK

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### Substantially Equal Periodic Payments

- You may still be able to use a recalculation method
  - PLRs 2004-32021, 2005-44023, 2006-16045
- Contrast PLR 2004-37038
  - Imputed interest rate too high

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### Roth IRAs for Early Retirees

- Advance planning for early retirees
  - People under age 59½ cannot generally tap into their IRAs without penalty
  - Using a 72(t) program allows early tap in
  - 72(t) program must run for GREATER of five years or until age 59½
  - Otherwise, 10% penalty on ALL pre 59½ withdrawals, plus interest factor

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## Roth IRAs

- Basis from contributions comes out tax free at any time
- Basis from conversions comes out tax free after five years from conversion
- Withdrawals come first from contributed basis, then from converted basis, on a FIFO basis (first conversion comes out first)

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## Roth IRAs

- Therefore, a younger individual can convert to a Roth and withdraw the money after five years, tax and penalty free, even though under age 59½
- Individual will be able to tap into Roth IRA without setting up 72(t) program
- Even if individual needs more money, no risk of penalty on all withdrawals
  - Penalty will only be on amount that is either less than five years from conversion, or is earnings

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## Beneficiaries

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What is a Beneficiary?

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Who is a Beneficiary?

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**Designated Beneficiary**

- Each account can have only one designated beneficiary
- If an account has more than one beneficiary, the beneficiary with the shortest life expectancy is the designated beneficiary
  - A charity or estate or trust is considered to have a life expectancy of zero

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### Per Stirpes

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### Separate Share Rule

- If an account with multiple beneficiaries is timely split in separate shares (separate accounts), with each share having one beneficiary, then each beneficiary can use their own life expectancy
- Deadline is December 31<sup>st</sup> of year after year of account holder's death

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### Separate Share Rule Example

- Taxpayer dies with \$300K IRA and names three beneficiaries
- Alan is age 50, Ben is 40 and Charlie is 30
- If no separate share, all must use Alan's age and the first year divisor will be 33.3 (age 51 divisor), and Alan, Ben and Charlie will each have to withdraw \$3,003 the first year ( $\$100K/33.3$ )

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## Separate Share Rule Example

- IF Alan, Ben and Charlie split the accounts into separate shares, Ben and Charlie can each use his own life expectancy
- Ben's divisor will be 42.7 (age 41 divisor) and his first year MRD will be \$2,342 ( $\$100K/42.7$ )
- Charlie's divisor will be 52.4 (age 31 divisor) and his first year MRD will be \$1,908 ( $\$100K/52.4$ )
- Alan's MRD remains unchanged at \$3,003

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## Beneficiary Designation Forms

It's the "Will" of the Retirement Account

- Many clients don't give much thought to the check-the-box forms provided by the custodian or administrator
- Planners need to check the plan or IRA documents
  - Some do not permit multiple accounts with different beneficiaries
  - Some do not permit "per stirpes" designation
  - Some will insist on only using their own, limiting, forms

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## Beneficiary Designation Form

- The "will" of the plan

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## Beneficiary Designation Form

- You can achieve....
  - Provide for well being of spouse
  - Save estate taxes
  - Provide for a stretch IRA

### • Choose 2 out 3

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## Spouse as beneficiary

- Well being of spouse
- Stretch IRA if she does rollover and names children or grandchildren
- But does not save estate taxes
  - Entire combined wealth taxed at second spouse's death

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## Child as beneficiary

- Save estate taxes to extent of credit shelter
- Stretch IRA
- But does not provide for spouse's well being

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### Credit Shelter trust as beneficiary

- Provide for well being of spouse
- Save estate taxes
- But no stretch IRA
  - Must distribute IRA based upon older life expectancy of spouse

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### Q-TIP Trust as Beneficiary

- Provides for well being of spouse
- But does not save estate tax or permit stretch IRA
  - Value of trust included in spouse's taxable estate
  - Must distribute IRA based upon spouse's older life expectancy

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### Choosing Beneficiary

- Planning point
  - With proper use of life insurance, all three objectives could be met
    - Children as IRA beneficiary; Spouse as income beneficiary of ILIT

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• **ADDITIONAL PLANNING POINT**

- An individuals with a taxable estate made up mostly of IRAs, needs life insurance to 'protect' IRAs
- Otherwise, a distribution to pay the estate tax will necessitate a distribution to pay income taxes, creating a cycle that will wipe out majority of IRA
- Use Irrevocable Life Insurance Trust to keep insurance out of estate

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**Why not the estate?**

- No stretch
- Subject to expenses and possible delay of probate
- Becomes subject to claims of creditors
- Possible difficulty in assigning account

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**Trusts**

- There is no tax advantage gained by using a trust, that could not be obtained without using a trust
- Translation: Use a trust for NON-tax reasons
  - Beneficiary is a minor
  - Professional management of assets
  - Prevent beneficiary from taking all money in one shot
  - Beneficiary creditor protection
  - Provide for kids from previous marriage
- If trust qualifies, can look through to trust beneficiaries

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## Trusts as Beneficiaries

### CAUTION

- IRS will count all potential beneficiaries, unless trust is a “conduit” trust
  - “Conduit” trust pays out MRD to beneficiary or beneficiaries each year; no accumulation in trust

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## Beneficiary with shortest life expectancy

- IRS counts ALL potential beneficiaries, even if chance of beneficiary actually receiving benefits is remote
- PLR 2002-28025
- 67 year old beneficiary ruled to be the beneficiary with the shortest life expectancy (19.4 years, 5.15%) even though odds are she will never see a penny from the trust
- Grandchild's life expectancy was 76.7 years (1.3%)
- If trust was in higher than 25% tax bracket, gov't got more than the grandchildren would have

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## Trust as beneficiary

### Requirements for a designated beneficiary

- Trust is valid under state law, or would be if it had corpus
- Trust is irrevocable or will be at death
- Beneficiaries are identifiable
- Documentation is provided to custodian
  - Copy of trust and any future amendments, or
  - List of beneficiaries and their interest, plus agreement to provide any amendments, plus agreement to provide trust, if requested

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## Trust as beneficiary

Documentation is provided to custodian

- **Deadline**

- Generally, October 31st of year following year of account holder's death
  - This is one month after beneficiary designation date

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## Trust as beneficiary

- If trust qualifies, beneficiary with shortest life expectancy will be the designated beneficiary
- Problem:
  - If trust is poorly drafted, the estate could be a beneficiary, so there will be no designated beneficiary
- Solution:
  - Make sure trust is drafted by an attorney who understands these rules
- Recommendation:
  - Use separate revocable trust for plan benefits

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## Trust as beneficiary

Separate Share Rule

- Separate Share rule is NOT available to beneficiaries of a trust
- **EXAMPLE:**
  - Trust X is named beneficiary of retirement account
  - Individuals A, B and C are the beneficiaries of Trust X
  - Retirement account cannot create separate shares so that A, B and C can each use their own life expectancies

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## Trust as beneficiary

Separate Share Rule

- Solution:
  - Create separate retirement accounts prior to death, one for each separate beneficiary
  - OR, name separate trusts, one for each individual beneficiary, as the beneficiaries on the beneficiary form – PLR 2005-37044
  - Beneficiary form is key

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## PLR 2006-20025

- Father leaves IRA to 4 children
  - IRA timely split
- One child is disabled
- Court permits guardian of disabled child to create self-settled special needs trust
- IRS in PLR permits that child's portion to be paid to trust over that child's life expectancy

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## PLR 2006-20025

- Remainder of trust will go to state to reimburse state for benefits paid to disabled child
- Had father named the special needs trust directly as the beneficiary, he could have controlled the remainderman
- Lesson learned – special care needed in estate planning when there is a child with special needs

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## After Death Distributions

Beneficiary Determination Date

- Beneficiary is determined on September 30th of year following year of death
- Can use this time to “eliminate” a “bad” beneficiary
  - CANNOT (it is clear!) distribute through estate
  - CANNOT add a beneficiary!!!!
- Beneficiary can disclaim
  - Beneficiary designation form takes on added importance

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## Inherited Accounts

- Death in “gap” period
  - Use dead beneficiary’s life expectancy
- Potential 3 month extension if “bad” beneficiary on 9/30
  - Split account

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## Rev Rul 2005-36

- Question: Can IRA beneficiary who takes a year-of-account-holder’s-death required minimum distribution, do a subsequent disclaimer?
- Holding: They can

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Rev Rul 2005-36

- Year of death required minimum distribution
  - Who takes it
    - The named beneficiary on the account, NOT the estate of the decedent

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Rev Rul 2005-36

- Rules for disclaimers
  - 1. Must be in writing
  - 2. Must be made no more than 9 months after the later of date of death or beneficiary attaining age 21
  - 3. Beneficiary cannot have accepted any benefits
  - 4. Account will pass WITHOUT any direction on the part of the disclaimant to either the account holder's spouse, or to a person other than the disclaimant

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Rev Rul 2005-36

- 3. Not accept benefits
  - Cannot trade securities within the account
  - A spouse beneficiary cannot put the IRA in her/his own name
    - A NON-SPOUSE BENEFICIARY CAN NEVER PUT AN INHERITED IRA IN HIS/HER OWN NAME!
  - A beneficiary CAN retitle account AS A BENEFICIARY account, e.g. Mary Smith, beneficiary of John Smith, dec'd, IRA

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### Rev Rul 2005-36

- 4. Account will pass WITHOUT any direction on the part of the disclaimant to either the account holder's spouse, or to a person other than the disclaimant
  - Follows the beneficiary designation form NOT the will!
    - Beneficiary designation form should be completed with the same care that a client would have a will prepared
    - Importance of contingent beneficiary

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### Rev Rul 2005-36

- Importance of contingent beneficiary:
- PLR 2003-27059
  - Wife named designated beneficiary
  - No contingent beneficiary named
  - Wife disclaims, IRA goes through estate
  - Will provides that assets go to trust for spouse
  - Because account passed through the estate, no stretch
    - Account must be paid out in five years
  - Had trust been named the contingent beneficiary, the account could have been paid over spouse's life expectancy

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### Rev Rul 2005-36

- Beneficiary designations:
  - Beware of –
    - Estate as the beneficiary
    - Lack of contingent beneficiary
    - Beneficiary designations not updated for change in life events such as marriage, children or divorce
      - Prior spouse as beneficiary rather than the incumbent
        - » Divorce does not necessarily negate a beneficiary designation form

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### Rev Rul 2005-36

- Planning situations:
- Spouse is beneficiary, credit shelter trust is contingent beneficiary
  - Spouse can disclaim all or part to make sure credit shelter trust is fully funded
    - Spouse is still measuring life on all of IRA

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### Rev Rul 2005-36

- DON'T DO THIS---
- Child as beneficiary, credit shelter or marital trust as contingent beneficiary
  - Disclaimer will not work unless child also disclaims interest in trust (two disclaimers are needed)

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### Rev Rul 2005-36

- This should work—
- Child as beneficiary, spouse as contingent beneficiary
  - Child disclaims, spouse rolls IRA over into her own name and names child as beneficiary of her IRA
  - Only a problem is pre-arrangement

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### Rev Rul 2005-36

- Spouse as beneficiary, child as contingent beneficiary, grandchild as contingent contingent beneficiary
  - Spouse disclaims all or part and it goes to child
  - Child disclaims all or part and it goes to grandchild
  - Can fund GST
  - If accounts timely split, each gets own life expectancy
  - S T R E T C H IRA!

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### Rev Rul 2005-36

- Planning pointer
  - If beneficiary dies within 9 months of the account holder, consider having the beneficiary's estate do a disclaimer
    - Death of beneficiary during "gap" period results in having to use the beneficiary's life expectancy
    - Disclaimer would permit account to be paid out over contingent beneficiary's life expectancy

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### Rev Rul 2005-36

- Example:
  - H is 80, W is 79 and child is 55
  - H dies. W takes YOD RMD
  - W dies 6 months after H. W never took any action to "accept" account
  - If no disclaimer, account needs to be paid out over 10.2 years (Single life of 80 year old)
  - If estate of W disclaims, and takes the required income from account, child becomes beneficiary and account can be paid out over 28.7 years (Single life of 56 year old)

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**•Questions and  
Answers**

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