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Ticking Time Bombs in IRA Planning for Professionals

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Ticking Time Bombs in Individual Retirement Account Planning for Professionals (An IRA Checklist for the Professional Planner)

Individual retirement accounts (IRAs) are now a significant, if not the most *significant, part of a client's estate. Professional estate planners must familiarize themselves with the multifarious rules that affect IRAs and take into account basic planning requirements to avoid potential catastrophic tax traps for the client and liability for the advisor. Twenty-two such tips and traps are given here.*

By Jack E. Stephens

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As the individual retirement account (IRA) continues to appreciate significantly in value, coupled with the introduction of the Roth IRA, professionals must exercise due caution when doing estate planning for their clients. In many cases, the IRA has become the most valuable asset in the client's estate. Yet, many professionals are overlooking basic planning requirements, which can lead to catastrophic tax traps and potential liability for the advisor. The professional must now address the IRA in the estate planning process by either becoming familiar with the multifarious rules that affect IRAs or referring the client to an IRA advisor who is knowledgeable in such rules. Clearly, retirement funds can no longer be ignored in a properly arranged estate plan.

The following checklist highlights significant issues that must be addressed in the estate planning process with IRAs. It is by no means exhaustive but represents important IRA ticking time bombs that can explode in the face of the professional planner.[1]

Custodial Plan (Disclosure Agreement)

The custodial plan must be scrutinized prior to the required beginning date (RBD), which is April 1 of the year after the client becomes age 70½.[2] Various options and elections provided by the plan become *irrevocable* after that date. These decisions could affect the IRA owner and beneficiaries for the duration of the IRA. Beware of new distribution manuals by the larger companies, for example, Salomon Smith Barney, Schwab, Fidelity, and Vanguard, which may require designation of beneficiaries in a client's will under certain circumstances.

Salomon Smith Barney IRA Distribution Manual (Issued November 1998)

If your planning includes an IRA with Salomon Smith Barney as custodian, you must be aware of the various requirements of designating a remainderman in a will for the IRA funds. The designation of a remainderman in a will is required on the death of the surviving spouse if taking term-certain distribution with a previously deceased spouse. If the surviving spouse fails to designate a remainderman in a will, the IRA funds are then payable by December 31 of the year following the year of death (one-year rule). Based on this requirement, the one-year rule applies to the term-certain method of distribution under the Salomon Smith Barney Custodial Plan.

The distribution manual also precludes designating a beneficiary to receive IRA funds after the death of a spouse if the spouses were recalculating distribution based on their joint-life expectancy. Thus, only the estate can receive the IRA funds and this may well result in a probate.

In addition to this negative outcome, nonspouse beneficiaries are required to name their beneficiaries, designated as "remainderman," in their individual wills in order to continue an IRA payout. This case would occur where the nonspouse beneficiary died prematurely with years of life expectancy remaining from the original distribution method chosen by the IRA owner. Instead of designating the beneficiaries on a beneficiary form, the beneficiaries must be indicated in a will.

Designated Beneficiary Forms

Make sure your clients have an acknowledged copy of the form that designates IRA beneficiaries *in their possession*. Some companies do not have designated beneficiary forms, so you must create one for the client. Additionally, these forms are lost from time to time, even by the larger firms. If there is no existing beneficiary forms the custodial plan will normally dictate who receives the IRA funds. Many times, it is the decedent's estate that receives, and this situation could create a probate.

Five-Year Rule

The five-year rule is an "IRA-killer" rule that must be addressed if the IRA owner dies prior to the RBD. If a nonspouse is the designated beneficiary, he or she must elect out of the rule and take a distribution by December 31 of the year following the year of the owner's death (exception to five-year rule).[3] Otherwise, the entire IRA fund must be distributed in its entirety by December 31, which includes the fifth anniversary of the owner's death.[4] A spouse beneficiary may elect out of the five-year rule by the later of:

1. December 31 of the year following the year of the owner's death, or
2. December 31 of the year the owner would have become 70½.[5]

Protective Election

If the custodial plan so provides, the professional should advise the IRA client on a protective election out of the five-year rule for the beneficiary prior to the owner's death. This rule allows the owner to elect the exception to the five-year rule for the beneficiary. This election would be important for unsophisticated or youthful beneficiaries who might well default into the five-year rule after the death of the owner.

Methods of Distribution

The professional must become familiar with the methods of IRA distribution and discuss the pros and cons with the IRA client, prior to the RBD. Most custodial plans provide for an election between term-certain and recalculation distribution. However, the hybrid method is becoming popular because it has the positive characteristics of both term-certain and recalculation. Although recalculation based on the joint-life expectancy of the spouses allows for the least amount of withdrawal, it can result in the application of the one-year rule, discussed next.

One-Year Rule

The one-year rule is another "IRA-killer" rule that must be discussed with the IRA client. It results when the client is taking distribution based on recalculating the joint-life expectancy of both spouses and the nonparticipant spouse dies first. The owner must then resort to the single-life expectancy tables, because the spouse has no life expectancy remaining.[6] On the subsequent death of the IRA owner, his or her life expectancy is also reduced to zero. As a result, the IRA beneficiary must withdraw the entire IRA fund by December

30 of the year following the IRA owner's death (one-year rule).[7]

Entity as Beneficiary

The professional must check to determine if an entity (e.g., unqualified trust, estate, charity) has been named as one of the beneficiaries. If so, the owner *must* use the single-life tables, because he or she is considered as having no beneficiary for distribution purposes.[8] This scenario, of course, would preclude taking joint-life distribution with a spouse. A separate IRA should be arranged to benefit a charity.[9]

Inherited IRA

When a nonspouse beneficiary inherits an IRA, the professional must advise such beneficiary not to retitle the IRA. If the IRA is retitled, or rolled over into the name of the nonspouse beneficiary, it will be considered a distribution and the *entire* IRA will be taxed in that year.[10] The only changes that should be recommended are the following:

1. Indicate that the IRA owner is now deceased;
2. Add the beneficiary's name and designation as beneficiary; and
3. Include the beneficiary's Social Security number.

Minimum Required Distributions and the 50 Percent Penalty

As a professional performing financial or estate planning with an IRA, you are "in the loop" as a potential defendant. Although the IRA custodian (e.g., bank, brokerage firm) may be calculating annual required distributions for your client, you may be acquiescing in those calculations. If the distributions are miscalculated and fewer IRA funds are being withdrawn than required by law, the result is a 50 percent penalty on the funds not distributed.[11] The IRA custodian protects itself with a release or holds harmless the provision in its custodial plan for such deficiencies. The professional planner must be cognizant of the amount of distribution and how the calculations are determined. The planner should calculate the distributions or have them calculated by someone knowledgeable in minimum required distributions (MRD) and then advise your client of the results. Notify the IRA custodian in writing of any deficiency and document your file of such written notice.

First Required Distribution Date

Professionals must be aware of another deadline that the IRS has assigned to a surviving spouse who is past his or her RBD and rolls over the owner spouse's IRA.[12] The following action should be accomplished by December 31 of the year following the year of the IRA owner's death when both spouses are beyond their individual RBD, which is referred to as the first required distribution date.

1. Withdraw the MRD prior to rollover, if none taken for that year;
2. Roll over the IRA;
3. Designate beneficiaries; and
4. Elect out of recalculation and/or elect distribution based on the Minimum Distribution Incidental Benefits Tables, if applicable.

Failing to take this action may result in defaulting into recalculation and taking distribution based on the single-life tables. This would, subsequently, require distribution under the one-year rule (discussed earlier) to the beneficiaries on the death of the surviving spouse.[13]

Spousal Rollover to Fresh IRA

Professionals must advise recalculating spouses to roll over a deceased spouse's IRA into a new, fresh IRA account. If both spouses have IRAs and are taking distribution based on joint-life recalculation, we know that the surviving spouse must resort to the single-life tables for his or her own IRA account on the death of a spouse. Should the surviving spouse roll over the IRA of the deceased spouse into his or her own existing IRA under these circumstances, the same requirement applies to both IRAs. After the death of the surviving spouse, the beneficiaries are locked into the one-year rule on the IRA account that now includes the rollover IRA. This is a *catastrophic* planning error.

Reconversions/Recharacterizations of Roth IRAs

Professionals must be knowledgeable of the Roth IRA rules, including reconversions and recharacterizations. We know that in 1998 a traditional IRA could be converted to a Roth IRA if the owner earned $100,000 or less in modified adjusted gross income (MAGI).[14] Converting in 1998 allowed the IRA funds to be spread over a four-year period for tax purposes.[15] If an owner is advised to recharacterize the conversion to a traditional IRA in a subsequent year because the fund has lost significant value, the four-year tax spread for the 1998 conversion is forever lost. Additionally, an owner may reconvert the same fund to a Roth IRA, but taxes will be due on 100 percent of the IRA in that year.[16] Professionals must be mindful of these rules while advising in a roller coaster market.

Roth IRA Beneficiary Traps

Although Roth IRA owners are not subject to the MRD rules as are traditional IRA owners, the rules change drastically after their death. The traditional pre-RBD rules apply to Roth IRA beneficiaries with a major focus on the five-year rule.[17] The problem exists because many beneficiaries are under the mistaken belief that the same Roth IRA rules apply to them as well as the Roth IRA owners. The professional must be prepared to clarify this misconception and provide guidance *after* the death of the Roth IRA owner to avoid these pitfalls.

"Deeming" Ownership of Roth IRA by Surviving Spouse

The professional must review the Roth Individual Retirement Trust Account, IRS Form 5305-R, as well as custodial plans for the Roth IRA. It includes a provision that "deems" the surviving spouse as the new owner of the Roth IRA *automatically* on the death of the Roth IRA owner if he or she is designated as the beneficiary. If the surviving spouse, who is not yet 59½, takes a distribution that includes earnings, such earnings will be subject to tax and penalty as a "nonqualified" distribution even though the Roth IRA may have satisfied the five-year holding period.[18] Conversely, a nonspouse beneficiary under age 59½ could take a "qualified" distribution under these circumstances as a result of the owner's death, because he or she takes as a beneficiary.[19]

The professional should insist that this provision be deleted from Form 5305-R so that the surviving spouse could choose to take a distribution as a *beneficiary*. Because the distribution is based on the death of the owner/spouse, this "qualified" distribution is not subject to tax or penalty.

Community Property

Professionals must realize that many IRAs originate and/or appreciate during marriage. As a result, they are considered a community property asset in community property states. Professionals in common-law states need to be familiar with their individual state law. Just because the name of the owner/spouse, alone, appears on the title does not mean it is the separate property of such spouse. The planner should be conscious of second-marriage situations in which the IRA owner desires to leave 100 percent of the IRA funds to children of a prior marriage without the consent of the present spouse.[20] Major litigation may ensue that could involve the neglectful professional who fails to advise on these issues. Appropriate documents in which the spouses clarify their understanding and intentions with such funds should be executed.

Living Trust as IRA Beneficiary

The advisor must be mindful of this potentially catastrophic time bomb. Over the years, numerous unenlightened "professionals" have advised clients to make their living trust the beneficiary of their IRA without knowledge of the negative repercussions. As a result, the IRA owners have been forced by law to use the single-life tables since they are considered to have no beneficiary for distribution purposes.[21] To this day, many married IRA owners who followed this advice are in violation of the 50 percent accumulation penalty because they continue to take joint-life distribution with their spouse. The professional must advise such clients to either use the single-life tables if they are beyond their RBD or change the beneficiary to an individual if they are prior to their RBD. If they insist on a trust as the beneficiary, it must be "qualified" as provided in "Qualifying a Trust as a Beneficiary" below.

Qualifying a Trust as Beneficiary

If the IRA owner desires that a trust be designated as the beneficiary, the trust must be "qualified" if distributions are to be based on the joint-life tables. There are several ways to use a trust as beneficiary:

1. Fund a qualified terminable interest property (QTIP) trust.
2. Fund a bypass trust.
3. Fund a minor's trust.
4. Fund a special-needs trust.
5. Fund a designated beneficiary trust.

If the trust is to be qualified, the following requirements must be satisfied:[22]

1. The trust must be valid under state law except for no corpus.
2. Trust beneficiaries must be individuals and identifiable in the trust.
3. The trust must be irrevocable or become irrevocable on the death of the IRA owner.
4. A copy of the trust or a list of all beneficiaries and each of their interests and/or entitlements must be reduced to writing and sent to the IRA custodian.
5. The successor trustee must provide a copy of the final trust or list of final beneficiaries on the death of the IRA owner.

"Loading Up" the Surviving Spouse's Estate

The professional should advise clients on the recurring problem of "loading up" the surviving spouse's estate for estate tax with an IRA. Typically, the surviving spouse winds up with a great majority of the couple's estate when there is a significant IRA remaining after the death of the first spouse. Depending on the value of the estate, federal estate tax could result on the death of the surviving spouse because a considerable portion of the federal estate tax exemption is wasted on the first death. Professionals should advise their clients of this potential eventuality and offer planning techniques such as disclaimers, property agreements, and IRA splitting.

Liquidity Analysis

Because of neglecting the problem addressed in "Loading Up," above, liquidity becomes a common problem. If a spouse refuses to plan to avoid loading up the surviving spouse's estate, the professional must be prepared to discuss liquidity requirements. The professional should urge life insurance so that premium dollars are leveraged against the tax. If the IRA is required to be utilized to pay federal estate tax, the professional will be engulfed in a planning time bomb.

Tax Apportionment

Professionals must inquire who will pay the federal estate tax and insist that this issue be addressed in the estate plan. Many estate plans provide that the residual of the trust estate or the assets remaining in the probate estate shall be responsible for such taxes. Clients must be made to realize that IRA funds are not included in such document provisions and that the IRA beneficiaries receive these funds free and clear of federal estate tax liability. If this is the client's intention, fine. Get it in writing and document it in the file. If it is not the intention, the estate plan documents must apportion estate tax payments from all estate funds or beneficiaries.

Code Section 691(c), Income Tax Deduction

Professionals must be cognizant of Code Section 691(c), which is consistently overlooked. The deduction applies when an income in respect of a decedent (IRD) item, such as an IRA, is included in the gross estate and the estate incurs federal estate tax. The income tax deduction is then allowed for the proportion of federal estate tax incurred by the inclusion of the IRA funds.

Conclusion

As indicated, the foregoing is not intended as an exhaustive list of "ticking time bombs." Rather, it is intended to alert the advisor to some significant rules that may affect IRAs and that can lead to planning problems. The planner must be knowledgeable in all rules that involve IRA planning or be exposed to explosive potential liability.

Endnotes

1. For a more in-depth discussion of each of these issues, *see* Jack E. Stephens, AVOIDING THE TAX TRAPS IN YOUR IRA, AN INDISPENSABLE GUIDE FOR IRA OWNERS, BENEFICIARIES AND ADVISORS (Legalaction Publications 1999).
2. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A b-2, 52 Fed. Reg. 28070 (1987); Prop. Treas. Reg. § 1.408-8, Q&A A-3, 52 Fed. Reg. 28070 (1987).
3. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3, 52 Fed. Reg. 28070 (1987).
4. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-1 and C-2, 52 Fed. Reg. 28070 (1987).
5. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A C-3, 52 Fed. Reg. 28070 (1987).
6. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-8, 52 Fed. Reg. 28070 (1987).
7. *See id.*

8. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-5, 52 Fed. Reg. 28070 (1987).

9. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A H-2 and H-2A, 52 Fed. Reg. 28070 (1987).

10. *See* I.R.C. § 408(d)(3)(C)(ii)(II).

11. *See* I.R.C. § 4974.

12. *See* Priv. Ltr. Rul. 95-34-027 (Aug. 25, 1995).

13. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A E-8, 52 Fed. Reg. 28070 (1987).

14. *See* I.R.C. § 408A(c)(3)(B)(i).

15. *See* I.R.C. § 408A(d)(3)(A)(iii).

16. *See* Treas. Reg. § 1.408A-4, Q&A A-7.

17. *See* Treas. Reg. § 1.408A-6, Q&A A-14.

18. *See* I.R.C. § 408A(d)(2)(A)-(B).

19. *See id.*

20. *See generally* CAL. PROB. CODE §§ 5010-5032 (West 1999).

21. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-5 and D-6, 52 Fed. Reg. 28070 (1987).

22. *See* Prop. Treas. Reg. § 1.401(a)(9)-1, Q&A D-5, D-6, and D-7, 52 Fed. Reg. 28070 (1987).