A Tale Of Two IRA Beneficiaries

BY CLARK D. RANDALL

THIS IS A TALE of two beneficiaries who relied on their professional advisors for recommendations on the distribution options available regarding the IRAs they inherited. Unfortunately, both individuals received improper guidance. As you will see, the minimum distribution rules for IRA beneficiaries are quite different from those for IRA account owners.

NAVIGATING THE 5-YEAR RULE

Janice died from cancer in January 2003 at age 58. Since she was single with no children, she named her sister, Marion, as sole beneficiary of both her IRA and 401(k) plan. Marion, not knowing what to do, asked her banker for help. The banker said, "You don't have to take any money out of the IRA for 5 years. If you don't need the money, I would suggest you roll it over to a beneficiary IRA and let it grow tax-deferred until then." Since Marion planned to work for another 7 years, she opted to delay the distribution.

I met Marion from a client referral in November 2004, nearly two years after her sister died. She had engaged me to prepare a comprehensive financial plan as she anticipated retirement. By that time, she had already rolled Janice's IRA over to a beneficiary IRA at the bank, but was unable to move the 401(k) because Janice's retirement plan did not permit rollovers to non-spousal beneficiaries, so Marion left the assets with the company.

When I started my discovery process, I asked if she had taken any distributions from the accounts. She told me the story about the banker and the "5-year rule" that he explained to her nearly two years earlier. I asked her if she needed the money, and she said "no," just as she told the banker. Then I asked if she might need the money in the next 3 years, to which she gave the same response.

Finally, I queried why she had not taken any distributions. She said, "I want the money to grow tax-deferred as long as possible and the banker told me that was 5 years." My response was "we need to act immediately!"

Since Marion had stated her objective was to defer income taxation on the qualified assets as long as possible, the banker gave defective advice. While the "5-year rule" is certainly an option to consider (in fact, it is the default option if no other election is made), Marion had another choice. Since Janice had not yet reached her required beginning date (RBD), prior to her death (generally, age 70½), Marion could take minimum distributions over her own life expectancy.

At age 55, the IRS estimates that Marion should live another 29.6 years (IRS Publication 590, Appendix C, Table I). If Marion had elected to wait until the end of the 5th year following the year of her sister's death to take a distribution, she could have deferred the taxes on all of the proceeds for 5 years.

At that time, however, the full account would have to be distributed and the taxes paid. Aside from the obvious concern of a large tax bill in one year, this choice could easily place her in a higher tax bracket in the year of distribution.

When an IRA account owner dies prior to the RBD, the first distribution is required by December 31 of the calendar year following the year of the deceased IRA owner's death. On Dec. 31, 2003 (the year of Janice's death), her total qualified assets were $135,605 (all RMD assets must be aggregated for calculations). On or before Dec. 31, 2004, Marion had to withdraw $4,683 ($135,605 divided by 29.6 years) or she would automatically default to the "5-year rule".

BIG TAX DIFFERENCE

A TALE OF TWO METHODS

Assumptions: Growth Rate 6%; Income Tax Rate 25%

		MINIMUM DISTRIBUTION METHOD				FIVE YEAR RULE METHOD		
Year	Age	Remaining L.E.*	Account Balance	Distribution	Tax Paid	Account Balance	Distribution	Tax Paid
2004	55	29.6	138,605	(4,683)	1,171	138,605	0	0
2005	56	28.6	141,958	(4,964)	1,241	146,921	0	0
2006	57	27.6	145,214	(5,261)	1,315	155,737	0	0
2007	58	26.6	148,350	(5,577)	1,394	165,081	0	0
2008	59	25.6	151,339	(5,912)	1,478	174,986	(174,986)	43,746
Total Taxes Paid					**6,599**			**$43,746**
Difference In Taxes Paid								**$37,147**

**IRS Publication 590, Appendix C, Table 1*

At 6% growth rate and a 25% tax rate, Marion would be able to defer more than $37,000 in taxes over her remaining life expectancy of 24.6 years (see chart) by selecting the minimum distribution method. Fortunately, we were able to make the required distribution by the deadline and preserve the lifetime tax deferral.

To calculate the required minimum distribution for the following years, the initial life expectancy figure is reduced by one each subsequent year. This continues until the account balance is fully distributed. This is unlike the rules for non-beneficiary account holders, who look to the tables each year to determine their revised life expectancy for each distribution.

BAD ADVICE THAT'S COSTLY

In May 2006, I met Barry, whose 73-year-old mother, Edith, passed away in 2004.

▸ continued on page 32

▸ **Clark D. Randall**, CFP, is a financial planner at Lincoln Financial Advisors Corp., Dallas, Texas. You may e-mail him at CRandall@LNC.com.

409A URBAN LEGENDS

continued from page 28

new requirements, "all compensation deferred under the plan for the taxable year and all preceding taxable years" is fully taxable in the year the plan is "not subject to a substantial (409A SROF) risk of forfeiture." Only NQDC plans that otherwise fail to meet 409A's requirements have a concern with 409A's SROF. 409A's SROF does not apply, therefore, to controlling shareholder deferrals in NQDC plans that are otherwise 409A-compliant.

SHOULD YOUR CLIENT DEFER?

Now that we understand that controlling shareholders can enter into an NQDC arrangement with his or her corporation the question becomes: should they? Remember that the foundational reality facing any participant in an NQDC plan is SROF.

If I am a non-family key executive in a family corporation and the owners offer me an NQDC plan funded by the corporation with their own dollars over and above my existing compensation, SROF is a moot issue. I have nothing to lose and everything to gain—I did not contribute one red cent to the plan. Such a plan can serve as a powerful recruiting and retention executive compensation strategy.

But if I am the owner of the corporation—the controlling shareholder—I do not need to "recruit and retain" myself. Corporate dollars contributed to my NQDC plan are in reality my own dollars. Now the opportunity to move dollars out of the corporation on a before-tax basis has to be balanced against my asset protection strategy.

Do I want my retirement supplement carried as a general asset of my business with the name of my business's general creditors on that asset? Only our clients can answer that question. Regardless of the ultimate answer, however, it is clear that the controlling shareholders of "C" Corporations continue to enjoy the opportunity to consider the pros and cons of a deferral strategy after 409A. NU

TALE OF 2 IRA BENEFICIARIES

continued from page 20

Barry was the sole beneficiary of her IRA, which was worth $220,995 on Dec. 31, 2004. Barry discussed the plans for his mother's IRA with his stockbroker, who had also managed his mother's investments.

Barry's broker correctly told him that he could roll the proceeds to a beneficiary IRA. In addition, since Edith had already taken out more than her RMD for 2004, he informed Barry that no additional withdrawals would be required for 2004. Finally, the broker recommended that, if Barry did not need the income, it would be best for him to let the account grow tax-deferred until Barry, then age 48, turned 59½.

While Barry's stockbroker was correct on the first two points, he was, unfortunately, wrong on the last one. Since Edith was already taking her RMDs, Barry's only choice was to continue RMDs based upon his life expectancy. The withdrawals must start no later than December 31 in the year following the year of death (the "5-year rule is not available.)

Barry should have taken a withdrawal of $6,139 in 2005 ($220,995 divided by 36 which is his IRS Table I life expectancy as of 2005). Regrettably, since Barry did not take his RMD by year-end 2005, he was assessed a 50% penalty on the amount not withdrawn. This bad advice cost him $3,070 (50% of $6,139).

My experience is not unique. With an unprecedented transfer of wealth transpiring over the next 10 to 25 years, following IRA beneficiary rules will be more important than ever. NU

BUDGET BONUS

continued from page 25

benefit. She can't afford the extra cost. There has to be an alternative that will let her stay within her budget and still not give Janice a short paycheck.

BUDGET BONUS

Peter then suggested that they let the budget drive the calculation instead of the premium. (See chart 3.) In that context the monthly premium becomes:

- Monthly premium = Budgeted raise - taxes
- Monthly premium = $1000 - ($1000 X 35%)
- Monthly premium = $1000 - $350
- Monthly premium = $650

Now both Eileen and Janice are happy. Eileen stays within her budget and Janice doesn't get a pay cut. Peter had to drop the death benefit a little but he's happy to have served Eileen and Janice. The premium did go down but it's still in excess of target, so Peter is being well compensated for his efforts. In addition, he has two happy customers in Janice and Eileen and he can look forward to more business with both of them in years to come.

Last, but not least, the budget bonus calculation was much easier to grasp, so everyone is more comfortable with that. Truly, the budget bonus is an easier way to place executive bonus cases. NU

FINANCIAL YIN AND YANG

continued from page 22

will drive the estate planning techniques to be used.

The techniques described above are moot if there is inadequate liquidity to make the exit and estate plans feasible. What if the intended buyer of the business doesn't have sufficient capital to purchase the business in the event of a premature death? What if business cash flow is insufficient to pay the owner's desired level of retirement income?

Even with a wealthy client, liquidity may be a challenge if the source of the wealth is the business interest. Many high net worth, closely held businesses have been financially ruined following the owner's death. Transfer taxes, debt and poor cash flow can quickly destroy an otherwise viable business.

The well-designed exit plan can help avoid this outcome by creating an appropriate transfer strategy *in advance*. Funding the nonqualified retirement plan, the buy-sell agreement, or other exit strategy provides the needed capital for payouts. Likewise, the estate plan can use life insurance and other financing techniques to assure wealth is transferred to beneficiaries in the way the owner desires. The exit and estate plan determines the vehicle for the owner's departure, but the funding provides the fuel.

The financial yin and yang for the prosperous business owner is an exit plan coordinated with an estate plan. Divided, these plans may be ineffective; but integrated and funded, they create a whole greater than the sum of its parts. NU