Price & Farrington's Estate and Tax Planning *Fast*Facts August, 2007

Estate, Tax , Business and Wealth Planning for Advisors and Clients

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Inherited IRAs: *The Best Ways To Trim the Tax on Distributions*

We've been addressing IRAs more regularly in recent FastFacts because of the increasingly important role they play in our clients' estate planning. The increasing size of a typical plan and the complex issues involved in smart IRA planning make this an area of crucial importance for clients.

If you inherit a traditional IRA, withdrawals are probably taxable. But in some situations you can reduce the tax payments. Read on...

The nondeductible loophole. Generally, traditional IRAs are funded with ***pretax* (i.e., deductible)** contributions. The deferred tax will be payable when money is withdrawn. Some people make ***after-tax* (nondeductible)** contributions to IRAs, because any investment earnings inside the IRA are tax-deferred until withdrawal. They also may make nondeductible contributions to 401(k) plans which are later rolled into IRAs. Any such nondeductible contributions, made with *after-tax* dollars, generate untaxed withdrawals. ***The proportion of traditional IRA withdrawals that is attributable to after-tax contributions is not taxed.***

Strategy. If you inherit an IRA, ask the estate's executor (in a will) or the successor trustee (in a living trust) to see the decedent's income tax returns. If **Form 8606** has been attached, it tracks nondeductible contributions. The IRS will let you know the extent of any after-tax contributions in the IRA you inherited, assuning that information is available from Form 8606. If no 8606 has been filed, you're out of luck and will owe tax on all the IRA distributions. Taxpayers must file Form 8606 for each year that they make a nondeductible contribution to a traditional IRA and for each subsequent year that they take a distribution from any traditional IRA. Failure to file carries an IRS penalty. **IRA custodians are not required to keep track of deductible and nondeductible assets or indicate the portion of an IRA distribution that is nontaxable.**

Example. Say you inherit a $100,000 IRA from your Aunt Alice, who has made $12,000 in nondeductible contributions.If your first withdrawla from that IRA is $10,000, $1200 (12%) will be untaxed. That's the ratio of nondeductible contributions to the overall balance. Now you have $10,800 of non-deductible, and therefore tax-free, dollars in the inherited IRA — $12,000 minus the withdrawn $1,200. Going forward, track the proportion of remaining niondeductible dollars to the overall IRA to see what part of each future withdrawal won't be taxed.

Avoiding double taxation. You also can avoid paying tax on distributions from an inherited IRA if the IRA owner's estate paid estate tax. **The estate tax attributable to the IRA provides a deduction that can offset taxable distributions.** (*See* November 2000 *Fast*facts on our website at www.pricefarrington.com.)

Example. You are the sole beneficiaty of your Uncle Hiram's $500,000 IRA. His records indicate no non-deductible contribtuions to that IRA. Hiram died in 2007 with a $2.4 million estate. Without the IRA, his estate would have been $1.9 million, escaping the federal estate tax.

Including the IRA, Hiram's estate is $400,000 over the threshold. At a 45% rate, Hiram's estate owes $180,000 in tax. Thus, Hiram's $500,000 IRA generates $180,000in estate tax. This 36% ratio ($180,000 to $500,000) is called the **income in respect of a decedent (IRD) ratio**.If you withdraw the $500,000 in one lump sum you will have $500,000 in income and a $180,000 deduction. The IRS has never indicated the proper method for taking this deduction when the beneficiary withdraws from the IRA in installments. Most practitioners advise simply applying the IRD ratio to

"Perkins here, representing taxes."

THOUGHTS

Keep Going…..
"The best way out is always through."
Robert Frost (1874-1963)

Ask questions later…..
"Life can only be understood backwards: but it must be lived forwards."
Soren Kierkegaard (1813-1855)

A welcome by-product…..
"Success usually comes to those who are too busy to be looking for it."
Henry David Thoreau (1817-1862)

Job satisfaction…..
"Pleasure in the task puts perfection in the work."
Aristotle (384-322 B.C.)

Excess baggage…..
"There is no heavier burden than having too many desires."
Laozi (6th century. B.C.)

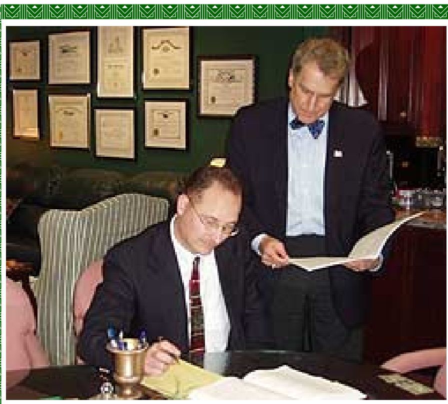
each distribution as it is received.

Example. Suppose you begin to take distributions in 2008, when you withdraw $25,000. You multiply the $25,000 withdrawal by the 36% IRD ratio to get $9,000. That's a deduction you can take on your 2008 return. In effect, only $16,000 of your distribution is taxable. Suppose you withdraw $30,000 in 2009. You could take a $10,800 deduction — the 36% IRD ratio X $30,000. And so on, year after year.

These deductions won't last forever. You must keep track of the total. When it reaches the $180,000 in estate tax generated by the inherited IRA, no more deductions will be permitted. Withdrawals thereafter will be fully taxable.

Note. Suppose in the above example all the facts are the same except that the inherited IRA is only $300,000. The non-IRA estate ($2.1 million) would have paid $45,000 in federal estate tax — 45% of the $100,000 over the exempt amount. The total estate tax, $180,000, would be the same. Only $135,000 in estate tax would be attributable to the IRA, but since the IRA was smaller, the IRD ratio would be larger — 45% (the $300,000 inherited IRA compared with the $135,000 in estate tax it caused). The result? 45% of each IRA distribution can be deducted, until you reach the $135,000 in estate tax generated by the inherited IRA.

Double tax breaks. It's possible to use both tax breaks we've discussed: (1) the break for withdrawing amounts attributable to nondeductible after-tax contributions and; (2) the break for withdrawing IRA money that triggered estate tax.



Chuck Farrington and Glenn Price.

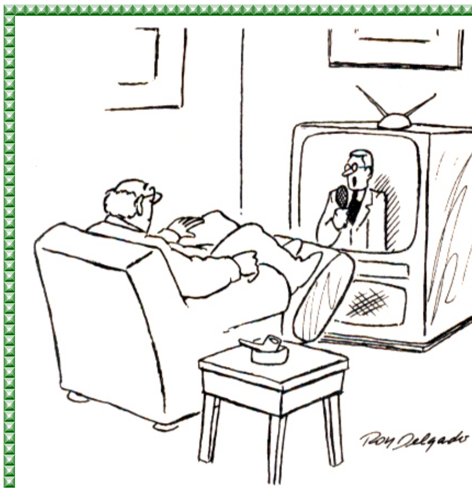
Example. You inherit a $500,000 IRA from your Uncle Larry. His total estate was $2.4 million and his estate owed $180,000 in estate tax, as above. You discover that Larry's IRA includes $40,000 of nondeductible contributions.

Only $460,000 goes into the IRD calculation — the $500,000 IRA balance minus $40,000 in after-tax contributions. The estate bill would be the same whether or not the contributions are nondeductible, so the IRD ratio is 39.13%, which is the $180,000 in estate tax caused by the income-taxable portion of the IRA divided by $460,000.

Result. If you withdraw $25,000 in 2008, only $23,000 (92% of $25,000) is taxable. That's because 8% of the IRA ($40,000 of $500,000) came from nondeductible contributions. Then you would apply the 39.13% IRD ratio to the $23,000 distribution to get a $9,000 income tax deduction in 2008. Going forward, you would track the amount of nondeductible dollars pulled from the inherited IRA *and* the deductions you've taken to recover the estate tax that was paid as a result of the taxable portion of the IRA.

Multiple beneficiaries. In many cases, more than one beneficiary will be named to inherit the IRA. Each beneficiary will be entitled to a pro-rata share of the tax benefits. Say you were named a 25% beneficiary of your Uncle Harry's IRA. *You could avoid paying income tax on 25% of the nondeductible dollars withdrawn from the plan and use the IRD ratio to take deductions for up to 25% of the estate tax paid because of the IRA.*

Taking the deduction. For one or for multiple beneficiaries, the deduction that's based on the IRD ratio is claimed on Schedule A of your tax return as a miscellaneous itemized deduction. Most miscellaneous itemized deductions are deductible only to the extent that their total exceeds 2% of your adjusted gross income (AGI). That's not the case with the IRD deduction, though. You can take the write-off no matter how many dollars are involved, or how it compares with your AGI. ■



"...and on Wall Street today, trading was suspended in response to renewed rumors that money isn't everything!"

Making the right decisions for your IRA spans estate planning, tax, asset protection and fianncial planning. For more on this important topic, see these recent FastFacts articles, all located on www.pricefarrington.com:

- **How To Retitle Your Inherited IRA+ IRA Withdrawals: *Ways to Slice the Pie*……June/July, 2007**
- **IRA Minimum Distribution Rules: *A Quick Review* ………………………April, 2007**
- **New IRA Planning Options: *The Pension Protection Act of 2006…………...September, 2006***
- **The IRA Inheritance Trust: *A New Strategy To Protect Your Family………………April, 2006***