

Price & Farrington's Estate and Tax Planning FastFacts

September, 2006

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

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Flash! New IRA Planning Options: The Pension Protection Act of 2006

In a major piece of legislation, the U.S. Senate on August 3 in a 93-5 vote passed the *Pension Protection Act of 2006*. Although the primary focus of the act was reforming defined benefit plans, there are several important provisions regarding IRAs which permit brand new planning opportunities:

☑ Non-spousal beneficiary “rollovers” of inherited qualified retirement plan benefits into inherited IRAs

☑ Tax-free distributions from IRAs for charitable purposes

☑ Direct rollovers of qualified retirement plans to Roth IRAs.

Let's take a look.

Non-spousal “rollovers” of inherited qualified retirement plans.

The most significant provision affecting individual investors in the entire 900 page Pension Protection Act is the new ability for a non-spouse beneficiary to take inherited money from a qualified plan and move it into an IRA. Up until now *only a surviving spouse* could roll an inherited retirement plan into his or her own IRA. Starting January 1, 2007 this privilege

is extended to *non-spousal beneficiaries* for the first time ever. Further, the new law also permits post-death transfer of these plans to inherited IRAs *that are held by trusts* for the benefit of non-spousal plan beneficiaries. **Note:** Both provisions apply to distributions made *after* December 31, 2006.

The benefit of this new right to “roll” money into an IRA is that you can postpone having to pay tax on it all at once. The IRA “stretch out” rules require only a portion of the retirement funds to be withdrawn each year, permitting ongoing compounding and growth of the investments in the IRA on a tax-deferred basis.

Example. Let's say your favorite Uncle Carl died unexpectedly in June at age 63. He never married and had no kids. To your surprise, he left his entire 401(k) to you - \$326,000, and you don't want to make any mistakes with it. The letter from his company retirement plan says that you've got two years to close out his account.

Here's the difference: If you close out your uncle's 401(k) account this year, you'll lose about one-third of it to federal income taxes alone. On the other hand, if you wait until January, you can rollover the value of Uncle Carl's 401(k) into an IRA and just take out the required minimum distribution (RMD) each year based on your life expectancy. The first withdrawal must be made no later than December 31, 2007.

As a non-spouse beneficiary, your life expectancy is based on your age in the year after your uncle died. In 2007, you'll be 39, giving you a life expectancy of 44.6 years, according to the IRS Single Life Expectancy Table (IRS Publication 590). In addition, let's



Glenn Price and Chuck Farrington.

assume that over this period the investments in this IRA earn an average annual return of 8% and that you only withdraw the minimum amount each year. Uncle Carl's \$326,000 401(k) would provide you with more than \$3 million in income over your life expectancy. This “stretch out” allows income tax payments to be deferred until actual distributions are taken, which translates into many years of tax-free compounding.

The new law is very specific about the steps a non-spouse beneficiary must follow in order to “roll over” inherited retirement plan assets. The first requirement is simple: don't touch Uncle Carl's account until next year (January 1, 2007) when this strategy becomes available. Second, the trustee of Uncle Carl's retirement plan must send the money directly to something called an “inherited IRA” If the trustee cuts you a check and instructs you to deposit it into the IRA, you have just lost the ability to stretch out the withdrawals. The assets in the plan must be delivered via what's called a “trustee-to-trustee transfer”.

Third, an inherited IRA (sometimes called a “beneficiary IRA”)

Sidebar: Use an Advisor!

Qualified retirement plans hold an ever-increasing proportion of our clients' overall wealth. IRA rules relating to minimum distributions, tax deferral, transfers, rollovers, stretch outs and beneficiary designations can be complicated. Mistakes handling IRAs can be costly and result in adverse tax consequences, blown deferral opportunities, stiff penalties and poor beneficiary planning. Clients should always seek advice from a trusted, knowledgeable advisor.

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must be established in the decedent's name, not yours. Uncle Carl will be listed as the "owner" with the benefits payable to you as the beneficiary. (e.g., "Uncle Carl, Deceased IRA f/b/o [your name]"). (This is the same arrangement you would have if you inherited your uncle's IRA instead of his company retirement plan.)

Note: The inherited IRA should be a completely new IRA set up specifically to receive the balance in your uncle's 401(k) account. You *do not want to co-mingle* the money from Uncle Carl's 401(k) with other IRAs you already have—*ever*.

How about if Uncle Carl named a *trust*, for your benefit, as beneficiary of his 401(k) plan? In that case, the *trustee* would be permitted to make a post-mortem trustee-to-trustee transfer of the 401(k) into an inherited IRA for your benefit.

Tax-free distributions from IRAs for charitable purposes.

After years of proposals that have failed, the new tax law finally permits taxpayers to make direct IRA distributions to charities without having to include the distribution in gross income. In particular, the new law permits up to \$100,000 to be contributed each year directly to charity (as described in IRC

§170(b)(1)(a) for the 2006 and 2007 tax years. **Note:** This direct IRA contribution is limited by the following conditions:

- ☑ The transferor (i.e., the IRA owner) must be at least 70 1/2 on the day of the transfer.

- ☑ The distribution will only qualify to the extent it would have otherwise been includible in gross income.

- ☑ The distribution must qualify under the general charitable deduction rules of IRC §170.

- ☑ The distribution cannot be taken into account for determining the "other" charitable contributions to be allowed as a deduction under IRC §170 (i.e., the distribution cannot be added to adjusted gross income (AGI) for purposes of the AGI limitations).

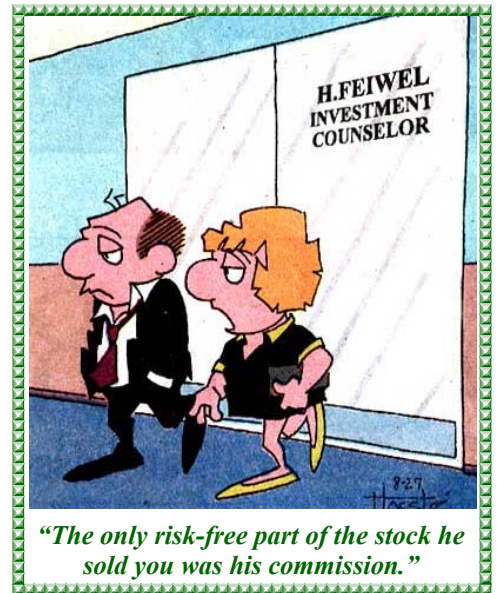
Example. Olivia, age 80, has \$150,000 of adjusted gross income in 2006. In December 2006, Olivia directs the trustee of her IRA to make a direct transfer of \$50,000 to United Way of Seattle (an IRC §501(c) charitable organization). In this case, Olivia is eligible to exclude \$50,000 from her gross income because: (1) the IRA funds passed directly to charity; (2) the distribution would otherwise have been included in Olivia's gross income; and (3) the donation would have otherwise qualified as a charitable contribution under IRC §170.

Note: The transfer from the IRA to the charity must be a *direct* transfer in order for the distribution to qualify for the income exclusion. Thus, the trustee of the IRA must draft the check in the charity's name.

Direct rollovers of qualified retirement plans to Roth IRAs.

In the past, if a taxpayer wanted to do a Roth IRA conversion, he or she would have to first roll the funds from the qualified retirement plan (such as a 401(k) plan) to a traditional IRA and then convert the traditional IRA to a Roth IRA.

Under the Pension Protection Act of 2006, a taxpayer is eligible to directly roll funds from "eligible retirement plans" (as defined under



IRC §402(c)(8)(B)) to Roth IRAs starting in the 2008 tax year. **Note:** the current rules governing the eligibility to do Roth IRA conversions (i.e., \$100,000 AGI limitation) remain unchanged by this new law.

Example. In 2008 Seymour had \$1,000,000 in his 401(k) plan and adjusted gross income of \$80,000. In December, 2008, Seymour transfers \$200,000 of his 401(k) assets into a newly-created Roth IRA. Under the new tax law, he is permitted to make this direct transfer to his Roth IRA.

Let's assume the same facts except that Seymour had AGI of \$110,000. He would be ineligible to convert his 401(k) to a Roth IRA because his AGI exceeds the \$100,000 limitation. ■

As always, we wish you good planning!
GDP

Aphorisms: Self-Knowledge

I cannot tell which part of me deceives the other.

Georg Buchner (1835)

Up to a certain point every man is what he thinks he is.

F.H. Bradley (1930)

We discover in ourselves what others hide from us, and we recognize in others what we hide from ourselves.

Vauvenargues (1746)

Tell me what you think you are and I will tell you what you are not.

Amiel (1866)

It is one thing to praise discipline, and another to submit to it.

Cervantes (1613)



Shawn Ryan