The Wealth Counselor

A monthly newsletter for wealth planning professionals

New Opportunities Under the Worker, Retiree, and Employer Recovery Act of 2008

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This issue of The Wealth Counselor examines two key provisions of H.R. 7327, the "Worker, Retiree, and Employer Recovery Act of 2008" (WRERA):

1. The holiday from required minimum distributions (RMDs) from IRAs and qualified plans for 2009; and
2. The long-anticipated requirement for qualified plans to allow non-spouse rollovers to Inherited IRAs (but not until 2010).

These provisions are very beneficial to clients and all wealth planning professionals who understand their implications.

WRERA provisions not explored here include other technical corrections to the Pension Protection Act of 2006 (PPA 2006) and provisions to ease funding requirements for employer-sponsored pension plans and multi-employer plans that, absent this legislation, would have required significantly increased contributions during the current economic downturn.

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At Price & Farrington, PLLC, we work closely with our professional colleagues to help our clients plan, protect and pass their legacies to their loved ones through caring and confidential counseling.

Worker, Retiree and Employer Recovery Act of 2008

On December 11, 2008, Congress passed WRERA and on December 23, 2008, President Bush signed it into law. The Joint Committee on Taxation has published a detailed explanation of WRERA. You can find it at http://www.house.gov/jct/x-85-08.pdf. You can also read the full text of the bill at http://frwebgate.access.gpo.gov/cgi bin/getdoc.cgi?dbname=110_cong_bills&docid=f:h7327eh.txt.pdf.

No Required Minimum Distributions for 2009

WRERA suspends, just for 2009, the 50% excise tax imposed on a taxpayer for failure to take a Required Minimum Distribution (RMD). As a result, no RMD is required for calendar year 2009 from any IRA or defined-contribution employer-provided qualified retirement plan (within the meaning of section 414(i)). The next RMD will be for calendar year 2010. This suspension applies to both lifetime distributions to employees and IRA owners and after-death distributions to their beneficiaries.

2010 Required Beginning Date
For those participants whose required beginning date (RBD) is April 1, 2010 (*i.e.*, they attain age 70 1/2 in 2009), since there is no RMD in 2009, WRERA drops the requirement that they take a distribution by April 1, 2010. However, WRERA does not change the rules for determining their RMD for calendar year 2010. Therefore, those participants whose RBD is April 1, 2010 must take their entire RMD for 2010 no later than December 31, 2010. And if such an individual dies in 2010 on or after April 1, regardless of whether their 2010 RMD had actually been taken before death, the worst-case scenario is their beneficiaries may use the participant's "ghost life" expectancy in determining their own RMDs and defer taking the remainder of the decedent's 2010 RMD until December 31, 2010.

Application of the Five Year Rule
For decedents' accounts that would have been required to be distributed by the December 31 following the 5th anniversary of the account owner's death, WRERA provides a one-year extension. Thus, for example, for an account whose owner died in 2007, the required distribution period will end December 31, 2013, instead of December 31, 2012.

Planning Opportunities
The suspension of the RMD rules in 2009 does not help with 2008 RMDs (which may have come from accounts with severely reduced values). However, the 2009 RMD holiday creates some interesting planning opportunities. Here are some to consider:

Roth Conversion/Contribution
Individuals who are eligible to do Roth IRA conversions (*i.e.* single or filing jointly with modified adjusted gross income (MAGI) below $100,000) cannot convert their RMDs for the year of conversion. However, because there are no RMDs for 2009, they can convert what would have been their RMD to a Roth IRA. After doing so, they will be in the same income tax position as if they had taken the RMD (had the RMD rules applied), but they will have moved that portion of their retirement funds into a tax-free Roth environment.

Planning Tip: Check clients' eligibility to do Roth conversions and make Roth IRA contributions in 2009. Small business owners may have 2009 losses. Retired taxpayers who have not been eligible to do conversions or make Roth IRA contributions because of their large RMDs may be eligible in 2009.

Planning Tip: Consider converting what would have been an eligible client's 2009 RMD to a Roth IRA. For clients who are eligible to contribute to a Roth IRA but not eligible to do a Roth conversion, consider taking a non-required withdrawal to fund the Roth IRA contribution.

Planning Tip: Clients can obtain additional leverage by using other funds to pay the income taxes on their Roth conversions.

Rental Real Estate
Another opportunity may exist for those actively involved in rental real estate. Under the general passive activity rules, an individual who has "active participation" in a rental real estate activity generally may deduct up to $25,000 in rental losses. However, the rental loss deduction phases out once the taxpayer's MAGI exceeds $100,000. For those individuals who have relatively large RMDs, the suspension of the RMD rules in 2009 may allow them to deduct some or all of their rental real estate losses in 2009.

Planning Tip: Clients who are actively involved in real estate may be able to deduct up to $25,000 in rental losses because of the suspension of the 2009 RMD rules.

Social Security Benefit Taxation
An individual who has MAGI of less than $32,000 if married or $25,000 if single does not pay income tax on Social Security benefits. If a married person's MAGI goes above $44,000 ($34,000 if single), up to 85% of Social Security benefits become taxable. Individuals who otherwise would have had to take even modest RMDs in 2009 will stand to benefit from this temporary provision in that less (or none) of their Social Security benefits may be subject to income tax.

Planning Tip: Clients collecting Social Security benefits may also gain from suspension of the RMD rules in 2009. If they do not take a distribution in 2009, they may pay reduced or no income tax on their 2009 Social Security benefits.

Non-Spouse Rollovers

Apparent Good News in PPA 2006
Before 2007, a non-spouse beneficiary of a qualified plan was stuck taking distributions under the terms of the plan, which typically required full distribution within five years or less of the participant's death. The Pension Protection Act of 2006 (PPA 2006) authorized non-spouse beneficiaries (before it was only surviving spouses) to roll over to an Inherited IRA. PPA 2006 provides that, effective January 1, 2007, a non-spouse qualified plan beneficiary "may" be permitted to roll over to an Inherited IRA after the plan participant's death.

The January 2007 IRS Roadblock
Because of that "may," in its January 29, 2007, Notice 2007-7 the IRS declared that a qualified plan is not ***required*** to offer non-spouse rollovers. It is optional with the plan provider whether to adopt a plan amendment permitting them. Absent a voluntary plan amendment, a non-spouse was stuck using the plan's payout period. And, major plan providers did not offer such amendments to their prototype plans. Apparently that is not what Congress intended.

Relief in the WRERA
WRERA fixes the problem, but only for plan years beginning January 1, 2010, or later.

What Does This Mean for Your Clients?
Beginning January 1, 2010, non-spouse beneficiaries finally will be able to take advantage of the PPA 2006 provisions and roll over from a qualified plan into an Inherited IRA. In the Inherited IRA, the non-spouse beneficiary can use his or her own life expectancy to determine the RMD. This can significantly reduce the amount that the beneficiary must withdraw each year, thereby deferring income tax and allowing the account balance to continue to grow income-tax free.

There are numerous pitfalls for the unwary in these roll-overs. Here are some tips to help you avoid them:

Planning Tip: Make sure that the transfer is DIRECTLY from the plan Trustee to the Inherited IRA Custodian or Trustee. Any distribution to a non-spouse beneficiary is a taxable distribution.

Planning Tip: Unless the beneficiary is a surviving spouse, the Inherited IRA must remain in the name of the deceased participant. The Inherited IRA should be titled like this: *Participant, deceased, IRA f/b/o Beneficiary.*

Planning Tip: DO NOT re-title the qualified plan in the name of the non-spouse beneficiary. That will be treated as a taxable distribution.

Planning Tip: DO NOT transfer from the qualified plan to an existing IRA in the non-spouse beneficiary's name. That, too, constitutes a taxable distribution.

Planning Tip: A non-spouse beneficiary must begin taking RMDs from the Inherited IRA by December 31 of the year following the year of the participant's death. **Note:** This is different from a rollover to the surviving spouse's own IRA, whereby the surviving spouse can defer taking RMDs until the April 1 after attaining 70 1/2 (but faces penalties for withdrawals before reaching age 59 1/2).

Planning Opportunities
Allowing non-spousal rollovers will provide additional planning options for non-spouse beneficiaries of qualified plans. These options include those listed below, which were outlined in greater detail in a prior issue of The Wealth Counselor (check out our website at http://www,pricefarrington.com for all archived back issues):

- Name a Retirement Trust as beneficiary to ensure the longest term payout possible, while also ensuring consistent account management - in the manner desired by the client using the client's advisors - oftentimes over generations.
- Give the accounts to charity at death and replace with insurance owned by a Wealth Replacement Trust.
- Take the money out during lifetime and buy an immediate annuity to provide a guaranteed annual income, to pay the income tax, and to pay for insurance owned by a Wealth Replacement Trust.
- Take the money out during lifetime and pay the income tax, then gift the remaining cash through an Irrevocable Life Insurance Trust or other Irrevocable Trust.
- Name a Charitable Remainder Trust as beneficiary with a lifetime payout to a surviving spouse; the remaining assets passing to charity at the death of the spouse.
- Give up to $100,000 from IRAs directly to charity **before December 31, 2009**.

Maximizing the Stretch-Out Probability

Experience teaches that beneficiaries often frustrate the stretch-out plans of the decedent and squander their opportunity for tax-free growth by withdrawing far more than their RMD. It is the old "found money has little value" problem.

However, if the participant names a trust as beneficiary of the qualified plan, PPA 2006, as amended by WRERA, will provide a sure way to reap the rewards of the stretch-out, just like the participant can now do with his or her IRA. Naming a trust as beneficiary will allow the trustee to roll over from the qualified plan into an Inherited IRA for the benefit of the trust beneficiary. Clients can thereby protect the beneficiary from his or her creditors (including loss in a beneficiary's divorce) and the temptation to be a spendthrift.

Planning Tip: Naming a trust as beneficiary also allows the participant's trusted financial advisor to continue to manage assets as the participant desired.

Conclusion

As a result of the Worker, Retiree, and Employer Recovery Act of 2008, clients need not take required minimum distributions from qualified plans or IRAs in 2009. Moreover, beginning January 1, 2010, all non-spouse beneficiaries will be able to roll over from qualified plans to Inherited IRAs rather than be stuck with shorter payout under the plan provisions.

These two provisions create numerous planning opportunities for the planning team to meet each client's unique goals and objectives.

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