Special Report:

The Top 10 Mistakes People Make When They Inherit an IRA - and How to Avoid Them

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How to Help Ensure that Uncle Sam Isn't the Biggest Beneficiary of Your IRA!

Written by

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Updated to Include New 2014 Rulings and Tax Laws

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Introduction

It is estimated that there is now over $11 trillion in retirement accounts. Retirement accounts make up the majority of many people's estates and, unfortunately, many owners of IRAs and their advisors are not aware of all of the complicated tax laws regarding distributions from these retirement accounts.

Why is this? Because retirement accounts are different! People often forget that retirement accounts have to be in the name of an individual and the beneficiaries of retirement accounts will override the beneficiaries of any of the other estate planning documents, such as your trust, will, etc. Therefore, you must separate the retirement accounts from the rest of the estate and establish a proper plan for distribution of these assets.

Although many individuals have established complex estate planning strategies, such as revocable living trusts, irrevocable life insurance trusts, etc., many individuals have not addressed the complex estate planning issues of inheriting an IRA.

I have often had IRAs referred to as "Individual Riddle Accounts" because the rules can be very complex and cause many mistakes.

IRA accounts are significantly different from most of your other assets in your estate because they:

- Do not pass through the will
- Are not subject to probate
- Receive no capital gains treatment
- Receive no step-up in cost basis upon death
- Cannot be gifted
- Title cannot be transferred to a trust
- Are subject to required minimum distributions

First of all, your IRA account has what is called a beneficiary, which will override everything that you have in your will or living trust. For example, you might have changed your will to reflect new beneficiaries of your estate. However, if you do not change the actual beneficiaries on your IRA account, then that won't make any difference! Your IRA accounts do not pass through your will or your living trust in most cases, and therefore this must also be taken into consideration when revising any estate plan.

In addition to this, the IRA accounts also are not usually subject to probate. For example, if you have an ordinary will, most of your assets inside of your estate will pass through probate, unless you have a living trust or your accounts are held as joint tenants with someone else.

Most of your other assets are subject to reduced capital gains taxes if you sell them after one year. However, any distributions from an IRA are taxed as ordinary income and not at lower capital gains tax rates.

In addition to this, there is no step-up in cost basis upon the death of the IRA owner. Most other assets owned by an individual receive a step-up in cost basis upon the death of the person, eliminating all capital gains on those assets up to that point in time.

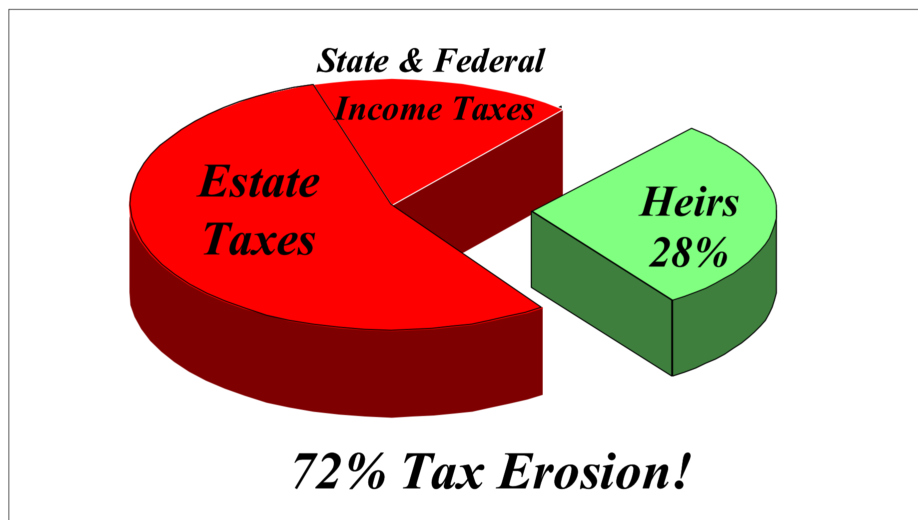
Another major issue is that IRA accounts cannot be gifted in their current form. For example, if you want to give an appreciated stock that is held outside of an IRA directly to another individual, you can do that at any time. However, if you want to give some of your IRA to someone else, you must first take a distribution, pay the income tax on this, and then make the gift.

In addition to this, it must be remembered that you cannot place the title of an IRA into a trust! If you do so, this would cause immediate taxation! The beneficiary can be in the name of a trust, but the title of any IRA accounts must be in the name of an individual. It is extremely important to review your account to make sure that your title is held properly.

And, last but not least, IRA accounts are different because you must start taking out a required minimum distribution. No other assets in your estate are required to take out a minimum distribution other than retirement accounts.

Many people are faced with very important decisions when they inherit an IRA and make a decision that is often not the best choice. And to top it all off, this decision is usually irrevocable!

Unfortunately, IRA accounts are subject to many different types of taxes and penalties upon death, which is often referred to as the "triple tax syndrome". This is comprised of estate taxes, federal and state income taxes and possible excise taxes which can lead to tax erosion of 72% or more!



Since the individual who accumulated them owns these retirement accounts, they are included in that person's taxable estate and therefore are subject to estate taxes. Additionally, you must remember that retirement accounts accumulate on a tax-deferred basis, which means you have not paid income taxes on these assets. Thus, upon death these assets are subject to federal and state income taxes. In addition to this, there may also be penalties, as we will soon see, that are often referred to as excise taxes by the government. Therefore, the triple tax syndrome is where you pay estate tax, federal income taxes and state income taxes.

There are many taxes that can apply to retirement accounts:

- Estate taxes (up to 40%)
- Federal income taxes (up to 39.6%)
- State income taxes (up to 9.3%)
- Generation skipping tax (40%)
- 59½ penalty tax (10%)
- Minimum distribution tax (50% post age 70½)

People often like to leave assets to their grandchildren upon their death. The first $5,340,000 transferred is considered the Generation Skipping Tax (GST) exemption. Anything beyond that is subject to the 50% GST.

Additionally, there is a 10% penalty for premature distributions from the IRAs prior to age 59½.

Finally, we have the minimum distribution penalty tax that is equal to 50% of the required minimum distribution that should have been taken from the retirement account, but was not, in a given year.

The purpose of this book is to review not just what to do, but what not to do. You have heard of the expression, "Learn by your mistakes"; well, I am a big believer that it is cheaper to learn by other people's mistakes!

I've assisted hundreds of people with their IRA rollovers and inheritances over the past 19 years and have personally seen over $1,000,000,000 of mistakes in retirement distributions. I would like to review with you some of the more common mistakes so hopefully you won't have the same problem as others have!

This report is a summary of the various laws, rules, regulations, and private letter rulings that most people encounter with respect to taking out their minimum distributions.

This report also summarizes the importance of choosing the right beneficiary or beneficiaries of your retirement accounts.

This report is intended to give you the information and guidance you need to be able to talk with your financial advisor about the best options for you.

This report is not intended to be used as a substitute for expert advice. The publisher is not hereby rendering legal, accounting, tax or other professional advice. The services of a competent professional should be sought before applying the information provided here.

In the event that you already have an IRA and are concerned about whom you should choose as the beneficiary, the author recommends that you get a copy of one of his other publications called "Is the Beneficiary of Your IRA the IRS?"

In the event you have not yet retired but will do so soon and you're concerned about what your options are, the author recommends that you get a copy of his other publication called "What You Ought To Know Before You Receive Your Retirement Distribution".

The Taxpayer Relief Act of 1997 and IRS Restructuring and Reform Act of 1998 also created a new IRA called the "Roth IRA." Minimum distributions required from these Roth IRAs are significantly different from those required from other "old" IRAs and retirement plans; with proper planning, you may avoid many of the minimum distribution rules applicable to "old" IRAs by converting to the Roth IRA.

The Pension Protection Act of 2006 made many sweeping changes including rules related to establishing Inherited IRAs out of 401ks, allowing Roth 401k contributions, and allowing pensions more leeway in calculating interest for participants.

More recently in 2010, Roth IRA conversions became available for everyone regardless of income. In 2013 Roth conversions were extended to include conversions within 401ks.

2014 has seen some less beneficial rulings which has disallowed protection of inherited IRAs from creditors. We touch on some of the new ramifications in this pubilcation but highly encourage readers to talk with a financial professional as well if this is a concern.

DISCLAIMER

These materials are intended to review a number of complicated tax laws. Despite the best efforts to include accurate and current information, especially with respect to a number of unresolved questions and constantly changing tax laws, it is important to review your planning specifically with a specialist in this area. These materials do not constitute legal, accounting, or professional advice. The author, or any other individual or companies affiliated, will not be liable with respect to any direct, indirect, or consequential loss or damage caused, or alledged to be caused by the use of these materials.

Important Note:

The information herein takes into consideration the numerous tax law changes in the "Proposed Regulations" issued by the IRS in 2001, the Pension Protection Act of 2006 and various extra rulings since then including the Supreme Court ruling in June of 2014. However, these rules may be subject to significant changes in the event of any amendment, correction, or interpretation of the current tax law -- please make sure that any advice that you get is current with respect to existing tax laws.

Improper decisions can be financially devastating. Therefore, it is extremely important that you seek qualified, competent counseling *before you* make your final decision with regard to what action you will take.

These tax laws pertain to most retirement accounts, including, but not limited to Individual Retirement Accounts (IRAs), Profit Sharing Plans, 401(k) Plans, Employee Stock Ownership Plans (ESOPs), and most other defined contribution plans. However, many of these rules do not apply to non-qualified plans, such as Section 457 Plans, non-qualified deferred compensation plans, Roth IRAs, and many other plans. In addition to this, some of these rules do not apply to 403(b) Plans, also known as Tax Sheltered Annuities (TSAs). These type of plans have additional specific rules with respect to their minimum distributions.

Sometimes advisors, banks and brokerage firms are not familiar with these complicated tax laws. One of the most important concerns of these minimum distribution rules is, of course, the tax law. Whatever you do, make sure you deal with someone who is very familiar with the tax laws governing these minimum distribution rules.

NOTE: It is extremely important to remember that there are usually two sets of rules:

1) The IRS rules

2) The IRA Custodian or Retirement Plan Administrator Rules

Many people are not aware that the custodian is not always current with respect to new tax laws. In fact, the IRS, on many occasions, state that although their particular rules are allowed, the specific contract of the IRA custodian or retirement plan must also reflect these laws as well. Therefore, it is extremely important not only to know what the IRS allows, but what your custodian allows as well! Please make sure that you review <u>your</u> agreement carefully.

Table of Contents

Required Minimum Distribution 1

Required Beginning Date 2

Choosing a Beneficiary 2

Naming the Spouse or Children as Beneficiaries. 2

The Inherited IRA 3

Mistake #1-Not Seeing a Qualified Tax or Financial Advisor Before Making Your Decision . 4

Mistake #2-Not Keeping Up With All Of The Current Tax Law Changes 6

Mistake #3-Having Too Many IRA Custodians 7

Mistake #4-Immediately Rolling Over the Money From the Decedent's IRA over to the Spouse's IRA 9

Mistake #5-Rolling Over an IRA When This Is Not Allowed 9

Mistake #6-Taking the Money From the IRA Either in One Year or in a Five-Year Period Of Time, Rather than Properly Establishing an Inherited IRA 10

Mistake #7-Not Establishing the Inherited IRA Properly 11

Mistake #8-Improper Funding of the Exemption Trust, Martial Trust, Q-TIP Trusts, or Any Other Trusts 12

Mistake #9-Waiting Until The Last Minute To Make Changes On The IRA 13

Mistake #10-Not Reviewing What The Cost Will Be Before Splitting The IRA Into Inherited IRAs 14

Conclusion 15

Table for Determining Factor Lifetime Distributions 16

In order to help avoid some of the more common mistakes that people make, it is important for you to understand some of the basics of the tax laws. Therefore, let us review some of the more important items in order to get through this tax maze properly.

I. Required Minimum Distribution (RMD)

The concept of the Required Minimum Distribution Rule is simple; however, the actual calculation often is not!

The concept is that the IRS does not want you to let your retirement accounts accumulate forever. Therefore, the IRS has created a set of rules in order to make sure that you take out a required minimum distribution, also known as the RMD.

This required minimum distribution applies not only to owners but to beneficiaries as well!

The formula for determining the required minimum distribution is fairly straight forward.

All you need to do is to take the balance of your IRAs at the end of the previous year and divide the balance by the life expectancy of you and your beneficiary, which is determined by charts provided by the IRS. The result is your required minimum distribution - this is the amount that you are required to withdraw during the current year.

There were a number of major tax law changes on January 11, 2001, which are called the "Proposed Regulations". Although many people might read this as only being "proposed", theses laws are actually now in effect.

These new rules significantly change the required minimum distribution calculations for many people. There used to be a number of other complicated formulas in order for an owner of an IRA to determine the RMD and the new rules basically use one uniform distribution table, which assumes that the beneficiaries are 10 years younger than the owner of the IRA. (The table is shown on page 16.)

An exception to this rule is if the beneficiary is the spouse and the spouse is more than 10 years younger. In that case, you may use the actual jointlife expectancy, which will reduce your RMD.

One of the issues of the RMD is that it is only a minimum distribution. You obviously can take out more at any time, but if you do not take out at least your minimum distribution, there will be a 50% penalty for not taking out enough!

For example, let us assume that your required minimum distribution is $10,000 and you only took out $6,000. The difference is $4,000 and the penalty is $2,000!

II. Required Beginning Date (RBD)

The Required Beginning Date (RBD) is April 1st of the year following the year you turn age 70½ in most cases. (However, there is an exception in the event that you are working, own less than 5% of the company and it is a qualified retirement plan at work; if these conditions are met, then you may delay taking out your required minimum distribution until your actual retirement date.)

For example, if your birthdate is July 1, 1945, you would turn age 70 on July 1, 2015 and age 70 ½ in the year 2016. Your required beginning date would therefore be April 1st, 2017. Please note that although you can delay your minimum distribution until this date, it usually is recommended to take out your distribution during the year you turn age 70 ½, rather than the year after you turn age 70 ½ since you would have to take out two minimum distributions in the year of your required beginning date, and this would most likely increase your income taxes!

III. Choosing a Beneficiary

In most cases, the majority of the readers of this publication will be the beneficiary of an IRA who is either a spouse, an individual, or a beneficiary of a trust who is the beneficiary of an IRA. Let us briefly review the follow options for these beneficiaries. (For a more complete review, please review the author's other publication called "Is the Beneficiary of Your IRA the IRS?".)

There are many different rules regarding minimum retirement plan distributions depending on who the beneficiary is on the retirement account. Most people usually name one or more of the following beneficiaries for their retirement accounts:

1) Spouse
2) Children/Grandchildren
3) Trust
4) Charity
5) Estate

IV. Naming the Spouse or Children as Beneficiaries

1. If the surviving spouse (SS) is the primary beneficiary, the spouse has a very unique option in that he or she can roll over the funds into his or her own IRA and name new beneficiaries and start all over again. No beneficiary except the spouse has the right to do so (except in a certain specific case where the trust is the beneficiary and the spouse is the primary beneficiary of the trust).

2. The SS can delay the commencement of benefits until the end of the calendar year in which the decedent would have reached age 70½, and then take them out in installments based on his/her life expectancy at that time.

3. Another option that the spouse has and almost all of the other beneficiaries have is that the 2001 proposed regulations allow most beneficiaries to elect to continue the IRA and take out distributions from the IRA over their remaining life expectancy. This is known as an "Inherited IRA".

   This can be very beneficial in the event that the surviving spouse is under 59½. This will allow the surviving spouse to take distributions from the IRA of the decedent without having to pay any penalty. If, for example, the IRA would have been rolled over into the spouse's name, and if the spouse would need to take the funds from the IRA before 59½, then there would most likely be a 10% penalty. The distributions could be taken from the decedent's IRA without paying a penalty, even though the surviving spouse was under 59½.

V. The Inherited IRA

Let us now look at the benefits of establishing an Inherited IRA. This is also known as the Stretch IRA, Eternal IRA, or Multi-Generation IRA.

Total IRA Distributions from Inherited IRA over Beneficiaries Lifetime*

	Life	Value of IRA when inherited by Beneficiary		
Age	Exp.	$ 100,000	$ 500,000	$ 1,000,000
20	61.9	$5,881,640	$29,408,198	$58,816,396
30	52.2	2,756,394	13,781,972	27,563,944
40	42.5	1,329,456	6,647,280	13,294,560
50	33.1	678,471	3,392,357	6,784,714

**Assumptions: required minimum distributions withdrawn, 10% annual return. Distribution subject to income taxes. For illustrative purposes only.*

For example, let us assume that your granddaughter is 20 years old and inherits a $500,000 IRA from you. Her life expectancy is 61.9 years and, over her life expectancy, this $500,000 IRA can provide her with over $29,000,000 in retirement distributions!

> These examples shown above are based on a 10% annual rate of return and assumes that only the required minimum distributions are taken out each year. These figures are for illustrative purposes only.
>
> Obviously, this income is subject to income taxes, but the tax bracket of your granddaughter at the age of 20 is probably quite low. For example, her minimum distribution the first year would only be about $8,000 and she would only have to pay taxes on this $8,000 rather than paying income taxes on the entire $500,000 all in one year!
>
> These illustrations obviously show how tax deferred compounding can make a huge difference over a long period of time!

Now that we understand some of the basic rules, let me share with you ten of the most common mistakes that many beneficiaries (and sometimes, advisors and IRA custodians!) often make.

MISTAKE #1 - NOT SEEING A QUALIFIED TAX OR FINANCIAL ADVISOR BEFORE MAKING YOUR DECISION.

Unfortunately, many beneficiaries do not seek a qualified tax or financial advisor and make the decision on their own or through the use of an unqualified individual or company. It is critical that you remember that once you make a decision and offically change the retirement account by taking a distribution, it is usually irrevocable!

As you can see, there a number of different rules that must be followed in order to prevent the IRS from being a primary beneficiary of your retirement account.

This advisor should be competent in all of the different areas of financial planning, especially estate planning, income tax planning and retirement distributions. Please also remember that they should determine whether or not there is any estate tax due on the IRA account. Unfortunately, many people confuse "probate" with estate taxes. The IRA distribution will usually avoid probate, but is always subject to estate taxes. Therefore, please make sure that your advisor reviews this issue as well.

Many advisors may have heard of the Inherited IRA; however, it is often that the advisor has never established one before! Please ask your advisor/custodian how many Inherited IRAs they have established in the past because if this is the first time they have established one, we all know what happens the first time we do anything! It is called the learning curve. Many of the mistakes that I see are because the advisor is not familiar with all of the details and, unfortunately, the client is the "guinea pig".

Remember the old expression - "We have theory, and then we have the real world." Please make sure that your advisor understands the "real world".

The problem is that we often have many "experts" informing you how to establish these Inherited IRAs, but many of these teachers have not actually "worked in the trenches" and received the hands-on experience on exactly how to establish one properly.

Unfortunately, it is often the case where the client has a question for the advisor and the advisor cannot answer it, and in turn will then call the IRA custodian. This is also often a major mistake, once we look at the "big picture".

Think very carefully about the revenue centers of brokerage firms and insurance companies and ask yourself whether or not one of their major sources of income is their IRA fees. In most cases, it is not! I am not trying to be mean, rude, or negative, but instead I am trying to address what goes on with many custodians today.

Be careful in choosing a custodian. It is often very difficult for custodians to keep up on all the new tax law changes and apply these to their custodial accounts because this is not usually a major priority since the profits on IRA accounts for many custodians is minimal. In addition to this, many custodians have informed the author that their annual fees do not even pay for all the expenses that they incur to keep track of everything and keep current with the tax laws! Therefore, please do not assume that these custodians are going to be as up-do-date as you might think they are.

Your tax or financial advisor should also review your financial picture before any decision is made because this inheritance can affect your current financial affairs. The financial advisor should review the impact on this inheritance on the following areas:

1) Income taxes - remember that you will have to pay income tax on this IRA distribution (unless you are a spouse and roll it over into your own IRA.) Therefore, if your financial advisor does not ask to look at your tax return, this is a red flag because it will be very difficult, if not impossible, for that advisor to give qualified tax advice without looking at your tax return and determining the tax impact on this IRA distribution.

2) Reviewing your estate plan. You might not have had a large estate and now you do! It is very possible you might need to have this updated due to the inheritance.

3) It is also possible that the decedent paid estate taxes on the IRA and you are eligible for a deduction called "income in respect of a decedent" which you can deduct as an itemized deduction on your personal tax return. Please also note that this deduction is not subject to the 2% limitation that most miscellaneous itemized deductions are subject to. In addition, this deduction is allowed even though the beneficiary does not actually pay the estate tax and even if the estate has not yet paid it either.

4) Investments - Your risk tolerance level could be significantly different from that of the individual who just passed away. Please check each of the investments to determine whether or not they are appropriate. In most cases you will be able to reposition these assets within the IRA without any income tax consequence. In addition to this, you can usually change your Inherited IRA to a different IRA custodian (this is covered under Mistake #3).

5) Cash flow needs - It is very possible that you do not need the entire IRA balance all at once. As we will soon see, this is another major mistake that people make and distribute the IRA proceeds out immediately when they do not actually need the money.

6) Insurance - This can also affect your amount of life insurance that you might need. For example, you may have needed to have life insurance in order to help support your family in the event that you passed away. It is now possible this is no longer an issue. However, please have your financial advisor review this before you change any insurance policies.

MISTAKE #2 - NOT KEEPING UP WITH ALL OF THE CURRENT TAX LAW CHANGES.

This is a major issue, since many new tax laws may come into effect and, as mentioned earlier, the IRA custodian may not be familiar or have even implemented these new rules.

Here's a simplified re-cap of the tax laws that were passed in 2001, 2006, 2010, 2013 and 2014.

- Uniform life expectancy table (2001)
- No more recalculate/term certain life expectancy (2001)
- Can change beneficiaries without increasing required minimum distribution (2001)
- Can change beneficiary until December 31st of the year after the year the owner dies (2001)
- More stringent reporting requirements (2001)
- Stretch IRAs allowed from 401ks and Direct Rollovers to Roth IRAs (2006)
- Roth 401ks contributions allowed (2006)
- Roth IRA Conversions allowed for everyone in IRAs and 401ks (2010)
- Roth 401k Conversions allowed for everyone in 401ks (2013)
- Creditor Protection Disallowed in Inherited IRAs (2014)

First of all, we now have a uniform life expectancy table for calculating all minimum required distributions, which significantly simplifies the RMD calculations.

We also used to have very complicated rules regarding the various life expectancy methods, such as term certain, recalculation, and even the hybrid method. We no longer have to calculate this and instead merely use the life expectancy table on page 16.

In addition to this, you can change beneficiaries at any time without increasing your required minimum distribution. This is true whether or not you have reached the required beginning date or even after the required beginning date, as we will be discussing in a moment. This is an excellent planning idea especially for people who have chosen single life calculation or have circumstances that will now be able to extend their life expectancy factor for calculating RMDs.

Another benefit is that you can also change the beneficiary until December 31st of the year after the year the participant passes away. This allows disclaimers and other additional planning.

Unfortunately, there are also major negative revisions. IRA custodians will now be required to report the required minimum distributions due from a particular IRA. In the past, it was difficult for the IRS to keep track of who did not take out their minimum distributions and impose a penalty. Now the IRS will receive all of the information in order to track the accuracy of required minimum distributions and compare what was taken out as to what should have been taken out.

Let me give you an example of the impact of one of the new tax laws.

Let us assume that you have an IRA and the beneficiaries are three children to get 30% each and a charity to receive 10%. Prior to 2001, if this would happen, then the charity would "taint" the entire IRA and the three other beneficiaries would have to take out their money within a five-year period of time. They would not be allowed to establish an Inherited IRA and obviously this would be very poor planning.

However, with the new tax laws, you are now allowed to transfer the 10% to the charity, and then split the IRA into three separate Inherited IRA accounts and establish Inherited IRAs for each of the three children individually. In addition to this, you would also be able to use the life expectancy of each of these individuals as long as the IRA would be split no later than December 31st of the year after the year that the original IRA owner passed away.

MISTAKE #3 - HAVING TOO MANY IRA CUSTODIANS

You should try to limit the number of custodians because each IRA custodian is different and in order for you to remain current on the new rules and regulations, you must remember that each of the IRA custodians may or may not be up on all the tax laws and the more custodians that you have, the more work that you will have to do in order to determine whether or not they are current.

Imagine if you have 10 IRA custodians - you would have to review 10 different custodial accounts and keep current on each of these changes as the IRA custodians make them!

Many people have many different IRAs because they like to diversify and believe that putting all of their eggs in one basket would increase their risk. However, many of these individuals are not aware that there is a very easy solution to this problem.

It is usually best to consolidate these various IRA accounts into one "self-directed" IRA, which allows an unlimited number of investments, such as stocks, bonds, mutual funds, certificates of deposits, money market accounts, etc. By establishing this self-directed IRA, this will eliminate many of the unnecessary statements and consolidate all of the investments onto one statement. There will also only be one 1099R that is generated each year and you will also only need one death certificate should that particular person pass away.

Many beneficiaries are not aware that they also can establish a self-directed IRA and usually consolidate their Inherited IRAs into one Inherited IRA statement even after the original participant passed away!

MISTAKE #4 - IMMEDIATELY ROLLING OVER THE MONEY FROM THE DECEDENT'S IRA OVER TO THE SPOUSE'S IRA.

This is also usually not a good idea until the entire finances of the deceased and the beneficiaries are reviewed in detail. I always recommend informing the client's CPA and estate attorney in order to determine whether or not there is going to be any estate tax issues. For example, it is possible that the surviving spouse would actually want to disclaim some or all of the IRA in order to reduce any unnecessary estate taxes. Once the account is rolled over into the spouse's name, then you lose the ability to fund the exemption trust or other trusts that might be part of the overall estate plan the client has established.

In addition to this, if you roll over the money into the spouse's name, it is possible that the spouse is under age 59½ and therefore they may have to pay a penalty in case they need the money before this date.

One of the options that the spouse could take in these circumstances is to utilize section 72(t) of the Internal Revenue code and take out the money before age 59½ without paying a penalty by using "substantially equal payments". However, the spouse is often many years away from this date and, if the surviving spouse left money in the decedent's IRA, then the surviving spouse would have been able to take out money from the decedent's IRA without any restriction at all! Please note - this option has been complicated by the recent Supreme Court ruling making Inherited IRAs unprotected from creditors therefore making IRA Legacy Trusts much more beneficial.
Therefore, please be careful before you automatically roll over an IRA account to the surviving spouse's IRA.

MISTAKE #5 - ROLLING OVER AN IRA WHEN THIS IS NOT ALLOWED.

As I'm sure many of you know, only a spouse may roll over an IRA into his or her name. This can happen in a variety of circumstances:

1) The spouse is the primary beneficiary.

2) The spouse is the contingent beneficiary and the primary beneficiaries disclaim their part.

3) The beneficiary of the IRA is a trust, and the spouse is the primary beneficiary of the trust and that all of the other trust conditions are met.

However, I have seen many cases where the beneficiary other than the spouse, such as the son or daughter, has taken the money and rolled it over into his or her IRA! This is not allowed! Please remember that not only will the non-spouse beneficiary have to pay income taxes on this distribution all at once, but there is also a penalty for rolling over too much!

As mentioned above, the proper thing would be for the non-spouse beneficiary to establish an Inherited IRA and at least allow the tax to be deferred over a long period of time, rather than paying the tax all at once.

MISTAKE #6 - TAKING THE MONEY FROM THE IRA EITHER IN ONE YEAR OR IN A FIVE-YEAR PERIOD OF TIME, RATHER THAN PROPERLY ESTABLISHING AN INHERITED IRA.

This is by far the most common mistake, and even though the Inherited IRA has been around for over 20 years, I still see this mistake several times every year. In fact, my personal experience in dealing with hundreds of IRA distributions is that this mistake happens over 75% of the time!

Why is this?

The reasons are as follows:

1) The client is not aware of the distribution rules and merely asks for a total distribution of the IRA.

2) The client asks the custodian/advisor what to do and is merely asked to sign a form so a check can be sent to them. (Talk about the blind leading the blind!)

3) The beneficiary is made aware of these new rules by the advisor and the beneficiary says, "I need the money now. Give me the check!"

The last one is an example that I encounter frequently. For example, an attorney will refer to me a young man who is the beneficiary of an IRA of his deceased father. The IRA is substantial, say $1 million. I look at the life expectancy table and explain to the son that one of his options is that if he makes the proper election, he will only be required to take out about $30,000 from the IRA and he could leave the other $970,000 tax deferred (I've also reviewed the entire estate and allocated for estate taxes.) In most cases, the child will respond, "Thank you for all that wonderful information and I can appreciate how much tax savings that I could have; however, I would just as soon spend the money now! Close out my dad's IRA and transfer the money into my bank account. Thank you for all of your help. Good-bye."

Unfortunately, this happens in the real world! This is a perfect example of <u>improper</u> planning! One of the key issues that an advisor should discuss with his clients <u>before</u> he or she passes away is the possibility of establishing an Inherited IRA Trust, also known as an IRA Legacy Trust, Stretch IRA Trust, etc. This type of document will specifically state what the child must do in the event the client passes away.

I have seen many cases where the IRA owner establishes in writing what the beneficiary must do, but leaves the action upon the beneficiary to implement these recommendations. It is imperative to realize that if the child is the beneficiary himself, then the IRA custodian will usually honor whatever decision that the beneficiary tells them what to do. What this means in laymen's terms is that the beneficiary could still take the money out all at once, even in the event that the document said that he should establish the Inherited IRA!

How do you prevent this?

You can prevent this by drafting an Inherited IRA Trust, which names a separate trustee that makes the decisions on behalf of the beneficiary, rather than assuming that the beneficiary will follow through on the terms and conditions of the document.

There are also a number of other important reasons for establishing the trust, including the following benefits:

1) Protection against the beneficiary's spending habits, spouses, or creditors.

2) It addresses the issue of "per stirpes", which specifically says what should happen to the remainder of the IRA, should the primary beneficiary pass away before the entire IRA is distributed.

3) It acts very similar to a revocable living trust, which usually includes the provisions on the beneficiary's right to take withdrawals from the IRA, the right to invest money inside of the IRA, changing investment allocation, and the right to transfer the IRA account from the current IRA custodian over to a new IRA custodian.

4) It includes a disclaimer provision that allows the primary beneficiary to disclaim the assets upon the death of the participant and pass on the IRA over to the secondary beneficiary, which can be very helpful in creative planning.

It is very important to determine in advance whether or not the IRA custodian allows this type of document! Unfortunately, many do not. Therefore, as mentioned earlier, please make sure that your custodian is "user-friendly" regarding these documents and planning ideas.

MISTAKE #7 - NOT ESTABLISHING THE INHERITED IRA PROPERLY.

There are a number of rules that must be met in order to properly establish an Inherited IRA:

1) Notification must be made to the custodian in writing.

2) The first minimum distribution must be taken no later than December 31st following the year the person passes away. Note: if the decedent was receiving lifetime RMDs, the beneficiaries must ensure the RMD has been taken for the year of death.

3) The IRA must be retitled properly showing the following information:

   a) The decedent's name, with the named "deceased" or "decedent" after the name.

   b) It must show that it is still an IRA.

   c) It has to state that it is for the benefit of the new beneficiary and the beneficiary's name.

If these requirements are not met, then most beneficiaries will be faced with the following consequences:

1) The entire IRA account must be distributed no later than December 31st of the fifth year after the person passed away.

2) If the account title is not worded properly the entire account could also be subject to immediate taxation all in one year!

I have seen cases where the advisor attempted to establish the Inherited IRA, but forgot to include either the name of the decedent, not mentioning that the person had passed away, or not mentioning that it was still an IRA. If any of these conditions are not met, then the account will usually become immediately taxable!

Please remember that it is usually best to split the IRA between the various beneficiaries no later than December 31st of the year after the year the person passes away. If you do not split the IRA by this date, then each of the beneficiaries will have to take out their minimum distribution based upon the oldest beneficiary! It is extremely important to split this IRA and therefore each of the beneficiaries will be able to take out their RMB based upon their own life expectancy, rather than the oldest.

In addition to this, it is also critical that each of the original beneficiaries inform the IRA custodian of who should be the beneficiary of their Inherited IRA in case the orignial beneficiary passes away before the account is depleted.

MISTAKE #8 - IMPROPER FUNDING OF THE EXEMPTION TRUST, MARTIAL TRUST, Q-TIP TRUSTS, OR ANY OTHER TRUSTS.

Let us assume that the beneficiary of the IRA was a revocable living trust (RLT) and that this trust states that upon the death of the first spouse, a new trust should be established and funded up to the current exemption equivalent, which in this year is $5,340,000. I have seen many cases where the attorney has "carved out" this amount out of the IRA in order to fund this exemption trust, and then suggested to roll over the difference into the surviving spouse's IRA. Although this can be done, it has to be done properly!

I have seen countless examples where this amount was in fact carved out and paid out into the exemption trust! One hundred percent of this money was subject to income taxes in one year, and if that isn't bad enough, it was all taxed at the trust income tax rate levels, which is usually much higher than individual income tax rates!

What should have been done is to establish an Inherited IRA for the benefit of the exemption trust. Let me give you an example:

John has an IRA of $6,000,000. Mary, his spouse, is the beneficiary and does not have an IRA. They have established a RLT and both are co-trustees. John passes away and the decision is to fund the exemption trust with $5,340,000 out of this $6,000,000. Mary is also the trustee of this exemption trust.

If this was their only asset, they would transfer $5,340,000 into an Inherited IRA, which would read as follows: John Smith, deceased, IRA For Benefit Of (FBO) Mary Smith, trustee of the John and Mary Smith exemption trust. The IRA should also have the federal ID number of this exemption trust.

The remaining $660,000 could be left as an Inherited IRA in John's name for the benefit of Mary, or Mary may even decide to roll it over into her name, depending on the circumstances.

Please remember that many attorneys and accountants have not heard of an Inherited IRA and believe that the exemption trust beneficiary would have to receive the money in order to have it funded. Please make sure that you inform everyone regarding these rules.

MISTAKE #9 - WAITING UNTIL THE LAST MINUTE TO MAKE CHANGES ON THE IRA.

Many advisors think that the IRA custodian will act very promptly when dealing with these matters. However, as I have mentioned throughout this publication, many of these custodians are not familiar with all of these new rules and will consider them an "exception". They will often have to run these elections through their legal department and it will take usually a lot longer then you might think in order to finalize all of the paperwork. Even though the IRS now gives a long period of time (up to December 31st of the year after the year the person passes away), I often see where it takes three months or longer for the IRA custodian to transfer the accounts and get everything retitled properly. This is especially true if you have multiple IRA accounts.

MISTAKE #10 - NOT REVIEWING WHAT THE COST WILL BE BEFORE SPLITTING THE IRA INTO INHERITED IRAS.

I have seen many cases where the IRA is held in the form of an annuity product, where the insurance company is the custodian. I have read many contracts that if the account is to be split between the beneficiaries as an Inherited IRA, then there would be costs or other expenses in order to do this! Please review your contract carefully to make sure there is no penalty before you make this election. In the event that you find out that there is, at least there is usually a solution:

1) Retitle the account as an Inherited IRA with multiple beneficiaries, but keep it as only one IRA.

2) Open up a self-directed IRA at a brokerage firm with the same title.

3) Transfer the Inherited IRA from the insurance company in kind via a trustee-to - trustee transfer over to the new self-directed Inherited IRA account.

4) Liquidate the annuity product that is held by the self-directed Inherited IRA account - there should be no penalty or income taxes because it is being paid out all at once and into another IRA.

5) Once the proceeds come into this new self-directed Inherited IRA, then split it into the various Inherited IRAs for each of the beneficiaries.

Sounds like a lot of work? It sure is, and that is the reason why you will most likely want to review all of your IRAs at this time in order to avoid having all these problems in the future.

Conclusion

It should be obvious from this report that inheriting an IRA involves a number of complex issues and decisions. Please also keep in mind that your overall retirement planning involves not only these distribution rules, but many other significant choices that will also affect your future.

The author also has an additional publication called "Is the Beneficiary of Your IRA the IRS?", which reviews all of the different beneficiary options and how to help avoid problems that you usually encounter before you pass away. If you would like to receive a free copy, please feel free to give us a call.

One of the major issues at hand is that many specific questions and items with respect to retirement distribution rules have not been answered or sometimes even addressed by the IRS. As of the writing of this publication, there have been many private letter rulings that could effect these specific recommendations and conclusions. Please make sure that any advice that you get is current as of the date of your questions and circumstances.

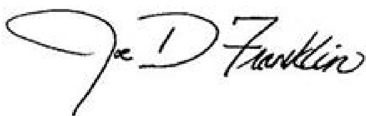
Therefore, it is important that you seek educated, qualified counseling before you make any decisions.

. . . and it's imperative that you get involved in the planning process as much as possible in order to understand which options are the most appropriate for you.

We encourage you to involve any related beneficiaries in your decisions, since it is important for him or her to understand what choices you are making.

If you still have unanswered questions or you are not sure whether or not your custodian allows these rules, or you require assistance in weighing your options, please feel free to give us a call at (423) 870-2140

Yours truly,



Joe D. Franklin, CFP

TABLE FOR DETERMINING FACTOR
LIFETIME DISTRIBUTIONS

Attained Age in year of distribution	Applicable Divisor under New Regulations	Attained Age in year of distribution	Applicable Divisor under New Regulations
70	26.2	93	8.8
71	25.3	94	8.3
72	24.4	95	7.8
73	23.5	96	7.3
74	22.7	97	6.9
75	21.8	98	6.5
76	20.9	99	6.1
77	20.1	100	5.7
78	19.2	101	5.3
79	18.4	102	5.0
80	17.6	103	4.7
81	16.8	104	4.4
82	16.0	105	4.1
83	15.3	106	3.8
84	14.5	107	3.6
85	13.8	108	3.3
86	13.1	109	3.1
87	12.4	110	2.8
88	11.8	111	2.6
89	11.1	112	2.4
90	10.5	113	2.2
91	9.9	114	2.0
92	9.4	115 and older	1.8