

# ESTATE PLANNING NEWS



## New Rules for Inherited IRAs: More Deferral Opportunities for Non-Spouse Beneficiaries

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The recently enacted Pension Protection Act of 2006 offers good news for non-spouse beneficiaries of qualified retirement plans ("qualified plans"). Qualified plans include 401(k)s, 403(b)s, and 457s. Effective January 1, 2007, it is possible for a non-spouse beneficiary of a qualified plan to arrange a trustee-to-trustee transfer to an inherited IRA.

#### **Background - Prior Law**

Qualified plan rules vary according to the company's plan documents. Oftentimes, upon the plan participant's death, the plan documents require that a non-spouse beneficiary take a lump sum distribution. The beneficiary would then pay income tax on the entire distribution.

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# Estate Planning News

## Announcements

The **Pension Protection Act of 2006** (“the Act”) was signed into law during the last Congressional season. The Act includes important provisions relevant to estate planning.

### **Qualified Charitable Distributions**

For calendar years 2006 and 2007 only, the Act permits an individual who has reached age 70.5 to make gifts from an IRA to qualified public charities without including the distribution in taxable income. Since no income is reported, an income tax charitable deduction is not available. However, distributions will count toward the IRA owner’s minimum required distributions.

### **Section 529 College Savings Plans**

Withdrawals from 529 college savings plans will continue to be exempt from federal income tax for use on qualified college expenses. This tax benefit is now permanent.

### **Charitable Gifts of Clothing, Household Items and Money**

There are new requirements for the income tax deductibility of certain donations to charity. Clothing and household items must be in “good used or better condition.” For money gifts, the donor must maintain a written record regardless of the amount of the gift. The record must be in the form of a receipt from the charity, a cancelled check or any other reliable written record verifying the donation.

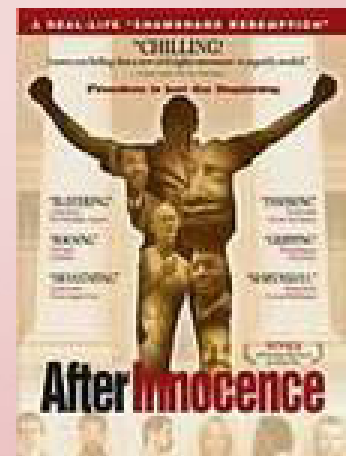
### **Conservation Property**

The Act increases the income tax charitable deduction limit for individuals from 30% to 50% of their adjusted gross income (or 100% of adjusted gross income for qualified ranchers and farmers). The carryover period now extends 15 years.

## Entertainment

### **After Innocence (2005)**

With the emergence of DNA evidence, the justice system is seeing a wave of reversed criminal convictions. But what happens to those who are set free, sometimes decades after being imprisoned for a crime they didn’t commit? This gripping documentary provides a critical inquiry into the justice system and a touching look at those profoundly impacted by it.



# Estate Planning News



The question isn't at what age I want to retire,  
it's at what income.

-- GEORGE FOREMAN

## New Rules for Inherited IRAs

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### **Taxability of Lump Sum Distribution**

For example, imagine that Gina has accumulated \$250,000 in her 401(k). Gina, who is 60 years old, named her son, Howard, a single 35-year-old accountant with an annual income of \$155,000, as her sole beneficiary. When Gina dies, Howard withholds 33% of the 401(k) benefit (\$83,333) for federal income taxes and another 9.3% (\$23,250) for California state income taxes. Howard's lump sum distribution is whittled down to \$143,417.

### **The New Law**

The Pension Protection Act changed the undesirable result described above by allowing non-spouse beneficiaries to make rollovers to IRAs provided the transfer of funds is made by directly from trustee to trustee. In other words, if the distribution is paid to the beneficiary (rather than directly transferred to the IRA trustee), the beneficiary who receives the funds loses the right to make the rollover.

Inherited IRAs are an attractive option because they permit a beneficiary to stretch distributions over the beneficiary's lifetime. Smaller distributions will likely result in lower income taxes and more tax-deferred growth inside the IRA.

### **Taxability of Inherited IRA**

Returning to the example of Gina and her son, Howard, consider what would happen if Howard arranges a trustee-to-trustee transfer to an inherited IRA.

Since Howard will celebrate his 36th birthday in the first half of this year, he checks the single life expectancy table and learns that his remaining life expectancy is 47.5 years. Howard then plugs these figures into a required minimum distribution ("RMD") calculator and discovers that he must take a \$5,263 RMD for 2007. Of this distribution, Howard will withhold \$1,737 for federal income taxes and \$489 for California state income taxes, leaving him with \$3,037.

Assuming a modest rate of return, Howard's inherited IRA will grow tax deferred more rapidly than he is required to withdraw RMDs. Howard expects that he will not have to take any large distributions until he is retired. During retirement, Howard will likely be in a lower income tax bracket, and he may even move to a non-income tax state such as Florida, Nevada, or Texas.

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## New Rules for Inherited IRAs

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### **Clarification Provided by Notice 2007-7**

The IRS recently issued Notice 2007-7 to clarify a number of issues regarding the new rollover rules:

(1) Inherited IRAs must be identifiable with respect to the decedent and the beneficiary. Returning to the original example, an inherited IRA would be titled: "Gina's IRA for the benefit of Howard."

(2) Qualified plan providers are not required to offer rollover distributions. This suggests that plans will have to be amended to provide the rollover IRA option. If a plan is not amended, the beneficiary must investigate the possibility of having a check from the qualified plan transferred directly to an IRA trustee. Terminated defined contribution plans will be considered to offer direct rollovers regardless of plan terms.

(3) Beneficiaries who elect lump sum distribution avoid the mandatory 20% withholding rules.

(4) For qualified plans that authorize rollovers to inherited IRAs, RMDs may be taken based on the beneficiary's life expectancy starting in the year following the death of the deceased plan participant.

(5) If the deceased plan participant dies after her required beginning date, but has not taken the annual RMD, that unpaid RMD is not eligible for rollover. Rather, the unpaid RMD must be distributed to the beneficiary.

(6) If a trust is named as beneficiary of a qualified plan, the trust qualifies as a designated beneficiary of a retirement account, and the trust satisfies the RMD rules, then the IRA may be opened in the name of the trust as beneficiary of the decedent. However, the IRA documents should be reviewed to ensure that only the trustee of the trust has the right to withdraw funds from the IRA.

### **Conclusion**

The new rules expand the income tax deferral opportunities for non-spouse beneficiaries which were previously available only through IRAs. With proper tax planning, qualified plan benefits make a more attractive inheritance, especially for younger beneficiaries.

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