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Inherited IRAs: a Sweet Deal



Inherited individual retirement accounts made news earlier this year when the Senate Finance Committee proposed to make heirs empty them within five years of the benefactor's death.

The measure, which was abandoned shortly thereafter, would have upended a system that is highly advantageous to families. Under current rules, heirs get to stretch withdrawals from an inherited IRA across their own life expectancies, meaning the assets could potentially increase in value, tax-deferred, for decades.

Yet many unwitting families cash out the account, losing the possibility of a life-expectancy payout, says Natalie Choate, an estate-planning lawyer at Nutter McClennan & Fish LLP in Boston.

That is a problem, she says, because there is no way to get the money back into the IRA after it has been cashed out.

Sometimes, even when the heir is aware of the opportunity to keep the inherited IRA in tax-deferred investments, financial and legal advisers botch the paperwork so badly that the IRA is disqualified.

Here are some of the snags that can result:

Trust tangles: M.D. Anderson, a tax preparer in Chandler, Ariz., has worked on so many inherited IRA snafus that he set up a website to chronicle the morass, titled InheritedIRAHell.com.

One of the most common problems involves how they intersect with trusts. Many people who set up plain-vanilla living trusts, often marketed as a way to avoid probate, name the trust as the IRA beneficiary.

But a trust isn't a person, and has no life expectancy, so it can't take advantage of the opportunity to stretch withdrawals across decades.

There is a potential fix: Demonstrating that a trust qualifies as a "conduit," or "see-through" trust, meaning its purpose is to get the IRA distributions to a trust's beneficiaries. Doing so, however, could require winning a so-called private-letter ruling from the Internal Revenue Service, which can cost \$4,000 for filing and double that for the accountant or lawyer preparing it, Mr. Anderson says.

His advice: Keep the IRA out of the trust unless your kids' situation is so egregious that there isn't any alternative, like having kids who are in jail.

Titling problems: When you inherit an IRA, you should retitle the account so it reads like this: "William Smith, Deceased (date of death) IRA F/B/O (for benefit of) James Smith, Beneficiary." But Mr. Anderson is working with a client who received forms from the custodian of the account that didn't spell out that he had inherited the account. The second set of forms the client received still needed some edits to avoid possibly disqualifying the account, Mr. Anderson says.

So, when you retitle the account, make sure the paperwork is in the proper format.

Paying the tax twice: If the benefactor's estate were large enough to be subject to federal estate tax, and a federal estate tax were paid, then the IRA beneficiary can get a tax deduction for the estate tax paid on the IRA's value. That is the case even if someone else paid the tax, Nutter McClennan's Ms. Choate says.

Estates worth up to \$5.12 million are exempt from estate tax this year, but the exemption reverts to \$1 million in 2013 unless Congress acts.

For example: a mother leaves a \$1 million IRA to her son and the rest of the estate to her daughter. The daughter ends up paying the federal estate tax on the entire estate, including the IRA, the taxes on which were \$350,000. The son cashes out the \$1 million IRA. He now has \$1 million in gross income and a \$350,000 deduction for the estate tax.

"This is the most overlooked deduction in America," Ms. Choate says. The reason: Heirs often don't realize they are entitled to the "income in respect of a decedent" deduction, as it is known. Estate administrators typically don't feel it is their job to tell beneficiaries about their

future tax situations. Meanwhile, the beneficiary's tax preparer might have no idea that estate tax has been paid on the IRA.

Failing to pass it on: Many wealthier adult children forget they can disclaim an inherited IRA and pass it along to their children—possibly creating tax-deferred growth for decades, says Bobbi Bierhals, an estate-planning lawyer with McDermott Will & Emery in Chicago.

There are two things to keep in mind, Ms. Bierhals says. First, the IRA owner has to fill out the beneficiary designation form in a way that will allow it. The best way is to leave the account "to my then-living descendants, per stirpes," which means the account goes equally to your children, or, if they have died, to their children.

Also, you must act quickly. Disclaimers must be completed within nine months of the benefactor's death, she says.

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