Estate Planning
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Legal Matters

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# Be very careful with inherited IRAs

Leaving someone an IRA as an inheritance can have a lot of tax advantages, and it's often a very good estate planning strategy. However, the rules for inherited IRAs are complicated, and it's easy to make mistakes.

If you have recently inherited an IRA, or if you expect to inherit an IRA, it's important to speak to an estate planner or other advisor right away before you make any decisions about the account. And if you're planning to leave someone an IRA, you'll want to make sure that person knows what to do, so the tax benefits aren't lost through an innocent mistake.

The big advantage of an inherited IRA is that the assets may be able to remain in a tax-sheltered account and grow tax-free for years before they're taken out. So generally, you want to make sure the assets are left in the account for as long as possible.

The exact rules depend on the kind of IRA and whether the beneficiary is the surviving spouse of the owner. For example:

***If a surviving spouse inherits a traditional IRA,*** there are a number of options, but the three primary ones are:

(1) The spouse can roll the IRA into his or her own IRA. This is simple – there's only one account to deal with – and the spouse can postpone required minimum distributions (RMDs) until age 70½ and calculate them based on his or her own life expectancy. The downside is that there's a 10% penalty on withdrawals before age 59½, and there might be


accelerated RMDs if the surviving spouse was older than the deceased spouse.

(2) The spouse can transfer the assets into a separate account that's titled as an "inherited IRA." This is more complicated, but it might avoid the 10% penalty on early withdrawals and the accelerated RMDs.

## Moving an elderly relative? Think about state taxes

It's a common scenario: An elderly relative is no longer able to live alone, so family members sell the relative's house and have the relative start living with them or in a nursing home or assisted living facility that's closer to the family.

One thing you might not consider during this stressful process is that if the relative moves to a different state, you might have just changed the person's official state of residence for tax purposes. And that could have a significant effect on his or her estate plan.

For instance, if someone moves from a state with no state estate tax to a state with such a tax, and he or she passes away, an estate tax might be owed on the value of the person's assets – even if he or she lived in the new state for only a very short time.

This is a significant danger because, while the federal estate tax generally doesn't apply to estates unless they're worth well over $5 million, many state estate taxes start at a much lower figure.

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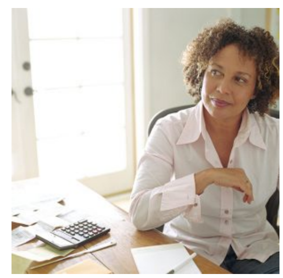
Such an outcome could even lead to friction between heirs. For instance, suppose the relative's will leaves one child certain specific assets and the other child "everything else." The relative may have set things up so the children would receive more or less equal bequests. But under the law, if a state estate tax is suddenly due, all of it will come from the share of the child who gets "everything else." This could upset a careful estate plan and create family disharmony.

## Four big mistakes executors make

Executors have a tough and often thankless job. They have to marshal all the estate's assets, file tax returns, and distribute property according to the will. Sometimes, they make mistakes. Here's a look at the most common ones:



***Paying bills too soon.*** Executors often see bills arrive in the mail and decide to pay them right away to avoid any problems. But this can actually create problems.

There's an order in which bills must be paid: Items such as taxes, funeral expenses and the costs of estate administration typically take priority over credit card statements, for instance. If an estate turns out to have a lot of debts (perhaps the person who passed away had an unexpected tax bill), and the executor has paid off low-priority debts first, there might not be enough money to pay the high-priority debts, and the executor might be personally liable for them.

It's best not to pay low-priority debts until the estate administration has been completed, or at least until you know exactly what the estate's tax and administration liability will be.

***Paying heirs too soon.*** Often, beneficiaries are impatient to receive their inheritance and pressure the executor to start making distributions. An executor can get into trouble if he or she makes distributions quickly and it later turns out there aren't enough remaining assets to pay off the estate's debts.

A related issue is that an executor has an obligation to secure and properly value estate assets. If beneficiaries are using "self-help" to make off with personal property – vehicles, artworks, furniture, a piano –

Because of the RMD rules, this option might be better in cases where the spouse who passed away hadn't yet reached 70½.

(3) The spouse can take the additional step of converting the account to a Roth IRA. This can be smart in certain situations, such as if the spouse expects to be in a higher tax bracket later in life.

***If someone other than a spouse inherits a traditional IRA,*** the beneficiary can transfer the assets into a separate "inherited IRA." The beneficiary will have to take RMDs starting the next year, but they'll be based on the beneficiary's life expectancy, not the owner's, which can save taxes.

***If a surviving spouse inherits a Roth IRA,*** there are two main options:

(1) The spouse can roll the IRA into his or her own existing or new Roth IRA. There are no RMDs, and distributions are tax-free as long as the beneficiary is at least 59½ and five years have passed since the original owner set up the account.

(2) The spouse can transfer the Roth IRA assets into a separate "inherited IRA." With this method, the spouse will have to take RMDs, but there can be some tax advantages for early withdrawals.

***If someone other than a spouse inherits a Roth IRA,*** the beneficiary can transfer the assets into a separate "inherited IRA." The beneficiary will have to take RMDs starting the next year.

In addition, in all of the scenarios above, there are two other options:

♦ A beneficiary can always take an immediate lump-sum distribution. But unless this is absolutely necessary to pay bills, it's by far the worst choice tax-wise.

♦ A beneficiary can also disclaim the IRA assets. The advantage here is that the assets might pass to younger family members who can stretch the distributions out over many more years, thus compounding the tax benefits. Also, when the beneficiary dies, the assets won't be subject to estate tax.

Of course, a disclaimer makes sense only if the beneficiary doesn't need the assets to live on. Moreover, the beneficiary can't simply choose who will get the account; it will go to the person who would legally be entitled to it if the primary beneficiary hadn't been named as a beneficiary.

This is an important point if you're leaving someone an IRA. You'll want to carefully consider who should be named as the alternate beneficiary – so that if the primary beneficiary chooses to disclaim, the assets will go to the right person tax-wise.

It's also possible to leave an IRA to a trust. This can have a number of benefits, such as protecting assets from creditors and preventing a beneficiary from withdrawing the money prematurely and losing the tax benefits. However, it's very complicated and should only be done with expert advice.

One thing to keep in mind is that a beneficiary may need to act quickly. For instance, there are strict time limits for rolling over inherited IRA assets into a new account.

Also, if an IRA owner passed away before taking out an RMD for the year in which he or she died, the

If you're thinking of moving an elderly relative to an out-of-state home or facility, it's a good idea to speak with an estate planner about the change. There might be ways to avoid having the relative be treated as a resident of the new state. (Of course, you might also discover that there are tax *advantages* to having the relative be treated as a resident of the new state, and you'll want to plan for that as well.)

## Estate planning may be harder for couples without children

You might think that estate planning would be easy when couples don't have children. In fact, it can sometimes be more difficult – and also more important.

Couples with children generally agree about passing on their assets to their kids, and can rely on their offspring to serve as caregivers and executors. It might not be so easy for other couples.

For instance, suppose Mike and Helen write a will leaving their assets to each other. If Mike dies first, Helen will inherit everything. When Helen dies, who will get Mike's assets? Helen could make a new will, but if she doesn't, all of Mike's assets will go to Helen's relatives according to state law.

But what about Mike's relatives? They would be left with nothing. And the same is true for Helen's relatives if she happened to die first.

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Of course, Mike and Helen could agree that the surviving spouse will sign a new will that's fair to both families. But what if the surviving spouse gets remarried, or has a falling out with the in-laws, or dies shortly afterward, or is elderly and simply doesn't get around to it?

A better approach might be for Mike and Helen's will to say that if one dies, his or her assets will go into a trust. The trust can benefit the surviving spouse during his or her lifetime, and then go to the other spouse's family. That solves the problem.

Another issue is who will serve as power of attorney or health care proxy. If Mike and Helen name each other, and one dies, who will be listed as the alternate for the surviving spouse? If there are no children in the picture, this requires very careful consideration.

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before the executor can have them appraised, the executor could be liable.

It's an even bigger problem if a family member takes an asset that the will says should go to someone else.

***Handling real estate.*** If real estate is going to be sold, deciding how quickly to do so can pose a minefield for executors. Sometimes an executor can be caught in the middle between one heir who's living in a house and another who wants it liquidated quickly. And sometimes it's hard to sell a property unless certain repairs or improvements are made first – but it's not always clear whether the executor has the authority to use estate funds to make the improvements.

Another issue arises if a property sits empty for a long time. If a house isn't occupied, it may be hard to obtain insurance for it, and it may become subject to maintenance problems, burglary and vandalism.

***Investing estate assets.*** If an estate will take a long time to settle, executors may be tempted to invest some of the estate assets. That might be okay if the investments are extremely safe, but an executor could be on the hook if an investment loses money and an heir inherits less as a result.

It's important to remember that while executors have an obligation to conserve estate assets, they have no legal duty to try to grow them.

Of course, the opposite problem can come up if the estate assets are already invested in risky things. In that case, an executor must decide whether to leave them there or move them into safer investment vehicles.

## Get a HIPAA release for your college-age child

If you have a child who is away at college, you should be aware that the federal medical privacy rules apply to him or her. Once your child turns 18, the federal HIPAA law says that you can no longer have access your child's medical information without his or her consent.

That's a problem, because if there's an emergency and your child isn't able to provide consent, you might not be able to access the information you need to make important medical decisions. In fact, it might not even be clear that you have the legal right to make such decisions.

It only takes a few minutes for your child to sign a HIPAA release form and a form saying that you can act as a health care beneficiary must take out the RMD before the end of the year or face a 50% penalty. (In fact, if someone dies late in the year without taking out an RMD, it's possible that the beneficiary won't even find out about the bequest until it's too late to avoid the penalty.)

Finally, if your estate plan involves leaving someone an IRA, it's critical to make sure your beneficiary designation form is filled out correctly and on file with the IRA custodian. If there's a glitch and the account ends up going through your estate rather than directly to the beneficiary, the beneficiary might have to completely empty the account within five years, thus destroying most of the tax benefits.

agent. It's easy to do, and it could be very important in an emergency.



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