

Protect Your IRA

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Iowa City estate lawyer Dean Carrington recently advised a client in her 60s to revise the beneficiary form for her Vanguard Individual Retirement Account so her family could stretch out its income tax deferral, while minimizing estate taxes. The primary beneficiary would still be her husband, but the contingent beneficiary would vary, depending on which spouse died first. In a letter, Vanguard rejected the new form as "too complex." A manager of Vanguard's retirement resource center tells FORBES the fund company doesn't want to be on the hook for determining who died when, but will reconsider its decision.

It should. With IRAs making up a growing share of affluent families' financial assets, fancy estate and financial planning moves involving them are increasing, too. (See box on p. 252 for one new idea.) But, complains estate lawyer Carrington, the banks, brokers and mutual fund companies that act as custodians for \$2.4 trillion in IRA assets are getting in the way. They aren't very tolerant of novel legal arrangements for determining payouts from IRAs.

We do have some sympathy for custodians. Despite the Internal Revenue Service's recent efforts to make IRA rules simpler and more humane, they're still complex and unforgiving of mistakes. The latest version of IRA distribution rules, issued in April, runs 154 pages.

Much of this mess stems from the fact that the law forces IRA owners older than 70 1/2 to take money from their IRAs, whether they need it or not, and puts tricky limits on continued tax deferral by heirs. Miss a minimum required distribution and you'll get hit with a 50% penalty tax on the amount you should have taken; distribute an IRA directly to an estate and your children lose the chance to stretch out its tax deferral over their own life spans.

So custodians are understandably wary of another layer of complications. Worse, account reps often misstate the law or wrongly insist that something their employer just doesn't want to do is prohibited by law, says M. Sean Fosmire, a Marquette, Mich. attorney who runs the Web site ira-web.com.

That's what Indianapolis resident Douglas Johnson says happened after his father died suddenly of heart failure last year, leaving an IRA to Douglas and his brother. A Metropolitan Life rep gave him incorrect information about withdrawal options, and insisted he couldn't transfer the account to his own broker, complains Johnson, 50. It took threatening letters from an attorney to get the account moved. "Met Life was dragging its feet," Johnson says. Met Life declines to comment on Johnson's case, but says it processes transfer requests in four days on average once it receives all the required documentation.

Bottom line: The onus is on IRA owners to make the most of the rules, while avoiding the traps--both those in the law and those custodians create.

BENEFICIARY BLUES

Your IRA beneficiary form is crucial, because the form, not your will, controls who gets your IRA. You can't skirt this problem by leaving your IRA to your estate. If you do, your heirs can't stretch out its tax deferral over their own lives; IRAs left to an estate must be fully distributed over five years. (Or, if distributions have already begun, over what was the projected life expectancy of the deceased.)

In the past, IRA owners typically named a spouse as beneficiary and left it at that. Before the IRS liberalized the rules last year, once you were older than 70 1/2 you had little latitude to revise the beneficiary form anyway. Now you have more freedom, so take a new look. Consider adding children or grandchildren as contingent beneficiaries. If your spouse dies before you, or survives you but is wealthy enough to give up the IRA to the contingent beneficiaries (to "disclaim" it, in legal jargon), the kids or grandkids will be able to stretch out withdrawals over their own life expectancies.

When adding children, beware the following trap: One child dies before you do and the whole IRA goes to the others, meaning you've stiffed the offspring of the deceased child and possibly created a legal or family mess. You can avoid this (as well as avoid cutting out a child or grandchild born between the time you revise a form and your death) by using "to my descendants per stirpes." That legalese means: If a beneficiary dies, his descendants get his share. Fidelity introduced per stirpes as an option on paper forms this year, and Vanguard will next year. Unfortunately, some custodians, such as MBNA Bank, still reject per stirpes designations.

If a custodian's standard beneficiary form doesn't suit you, your lawyer can write an attachment or a whole new form. Dodge & Cox does not offer per stirpes on its standard form, but will accept it on a custom-written form. Here again, policies vary. Fidelity won't consider custom-written forms unless you have at least \$100,000 invested with it, and then the form must still comply with its rules. Vanguard insists that you or your lawyer call before submitting customized forms. You'll also need legal advice if you're leaving your IRA to a trust; the area remains treacherous.

Note that IRS rules allow beneficiaries who inherit an account to name their own beneficiaries. An adult child, for example, might name a grandchild born after the original owner's death. Should the child die prematurely, the grandchild could continue drawing down the IRA over his parent's remaining life expectancy, rather than face a sudden forced liquidation. Not all custodians have permitted this, although policies are changing. Example: In June PNC Financial Services prohibited it and a phone rep wrongly blamed the ban on the IRS. In August PNC changed its policy. If you run into problems, transfer the IRA and insist on an institution-to-institution transfer.

Okay, you've got your beneficiary form in order. You've done your duty to your heirs, right? Nope. It turns out that some IRA custodians won't discuss your IRA with your executor, only with the named beneficiaries. Boston trust lawyer and IRA expert Natalie Choate advises giving the custodian written instructions to give executors the same access to information as beneficiaries. Whatever you do, keep records. Ask the custodian for a copy of the beneficiary form in its files and keep that copy with your

will.

DISTRIBUTION DANCE

With the Dec. 31 deadline for taking required 2002 distributions nearing, remember that if you have more than one IRA account, you need not withdraw money from each. Instead, you can aggregate required distributions from your IRAs (but not with IRAs inherited from a non-spouse) and take the total from whichever IRAs you choose, even if they have different custodians. That could come in handy if you have an IRA you don't want to touch because it's stuffed with stocks or funds you think will rebound. To head off problems, notify custodians in writing that you are withdrawing from a different account.

Warning: If you're calculating your own minimum required withdrawals, use the table issued in April 2002; the January 2001 table can still be used this year, but the newer one requires you to take less. If your spouse is more than 10 years younger, you can withdraw even less using a special joint life expectancy table--provided your spouse is your sole beneficiary.

Don't be buffaloes into taking withdrawals before you have to. The IRS requires custodians to send notices to IRA owners when they turn 69 1/2. Read the fine print: You don't have to withdraw the funds until Apr. 1 of the year after you turn 70 1/2. Remember, you need not take distributions from your own Roth IRA, or one rolled over from a late spouse; other heirs must take Roth distributions.

Finally, if you started taking fixed distributions from your IRA before 59 1/2 (a technique used to avoid a penalty for premature withdrawal) and your IRA's value has tanked, a new IRS rule could help. You can lower your withdrawals with a one-time switch to a payout based on your current age and balance. One catch: You must keep withdrawing at this new rate for five years, even if you pass 59 1/2, the age at which you would otherwise be able to stop regular premature withdrawals.

EXOTIC ASSETS

A growing number of IRA owners are sticking real estate, partnerships and other alternative assets in their accounts. The law puts some restrictions on what an IRA can own--no collectibles or investments in companies you run, for example--but some custodians put even more limits. Don't try to work around this; find a custodian who will accommodate you, even if it costs a little more.

That's the lesson of a recent tax court case. New Orleans physician Robert Ancira wanted to invest \$40,000 of his IRA in a private company. On the advice of his investment adviser, who believed the custodian wouldn't make the investment, Ancira got a check from the custodian and made the investment himself in the IRA's name. The IRS saw this as a taxable distribution and assessed back taxes and a penalty. Fortunately, in September a U.S. Tax Court judge agreed with Ancira that he had merely been the "conduit" for the investment and that it wasn't a distribution. Yes, Ancira won, but it cost him time, aggravation and \$2,500 in legal fees.