TRUSTS & ESTATES

The Stretch IRA

If you want to make inherited retirement money last a long time, some fancy footwork may be required before year-end | BY ASHLEA EBELING

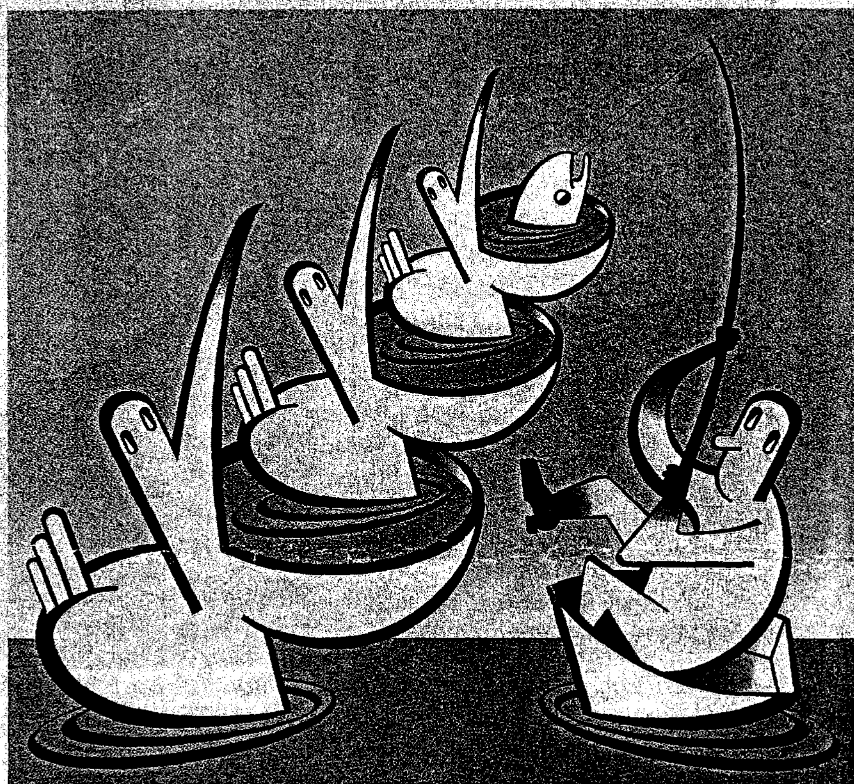
ONE OF THE GREAT LOOPHOLES in modern tax law: retirement accounts that go on compounding for decades after the worker's death, for the benefit of heirs. One of the great morasses of tax complexity: retirement accounts.

If you inherited an IRA between 1998 and 2001, or if you plan to leave one to a trust when you die, pay attention: You may need to act now. What follows is complicated, but could produce decades of extra tax deferral for you or your heirs. And it applies not just to Individual Retirement Accounts but to inherited Keoghs, 401(k)s and even some company pension plans.

If you inherit a retirement account from a spouse, you can treat it as if you earned the money, meaning you can delay taking withdrawals until after you're 70½. Inherit one from someone else, though, and you have to start liquidating right away. But you are able in many cases to stretch out taxable withdrawals over your own life expectancy—if you avoid some traps in the rules.

One of those traps is a trust. Even after April 2002, when the Internal Revenue Service issued "final" rules covering most distribution questions, the treatment of accounts left to heirs through a trust remained fuzzy. Now, in three "private letter" rulings, the IRS has cleared things up—in a way that isn't trust-friendly. Some taxpayers will have to redo their estate plans.

As some IRA gurus interpreted the April 2002 rules, you could name a trust as beneficiary, and after your death the trust could be divided into separate subtrusts, say, for three children. Each subtrust could then use that child's life expectancy for calculating distributions. The new private-letter rulings nix that



THOMAS FUCHS FOR FORBES

strategy—if you name a single trust as beneficiary, your heirs are all stuck with the life expectancy of the oldest heir.

"The IRS flip-flopped with no warning," grouses Boston lawyer Natalie Choate, author of a book on IRAs and trusts. An IRS official disagrees, insisting that the rulings are consistent with earlier proclamations. Whoever's right on that point, you'd better play along with the new rules. So if the beneficiaries of your trust are very different ages—say, kids from a first and second marriage—your younger heirs could be robbed of years of deferral unless you do some extra planning now. Revise your beneficiary forms to name separate trusts for each child and hire a lawyer to complete the paperwork creating these trusts before you die.

Worse, not any old trust will work. For example, a trust that doesn't pay out to the beneficiary until age 35 usually won't qualify, nor will one where payouts are at the trustee's discretion or predicated on the heir's doing something, like staying out of jail. What kind of trust always qualifies? One where all required payouts must pass to the beneficiary each year. (If the beneficiary is a minor, the money will go into a custodial account.) "You have to ask, 'What do I want: the longest stretch for payouts, or more control?'" says Edward Slott, a CPA who runs www.irahelp.com. Given these limitations, a better alternative might be to forget the trusts and (for children over 18) leave the account to your children directly.

Now, for those who have recently inherited retirement accounts: There was a special dispensation written into the April 2002 rules for you, but you must take advantage of it by Dec. 31, says Michael Jones, a CPA in Monterey, Calif.

Here yet more background is needed. If you inherit a retirement account from a parent, the wording of the plan affects whether you can stretch out payments over your lifetime. While most IRA custodians now provide for stretch-outs, a company 401(k) plan might not permit them or might not say whether they're allowed. Before 2001, if a plan was silent on the issue, you might have been forced to empty out the account within five years. Proposed IRS rules released in 2001 changed that—now, if the plan doesn't say, a child who inherits an account can stretch out payments over his lifetime.

The final April 2002 rules contained

Your trust says the kids don't get the money until age 35? Zap! The tax shelter evaporates.

an added break: They allowed folks who had earlier inherited accounts that were silent on stretch-outs the option of switching to lifetime withdrawals. The same option was given to heirs who had elected the five-year payout, or had simply missed taking the annual withdrawals necessary to start an annual payout. To make the switch, by the end of this year you must notify the custodian of the account and take out the amount that should have been withdrawn already under a lifetime payout.

A hassle? Sure. But particularly if you're young, it's worth the effort. San Francisco financial planner Ann Terranova has a 35-year-old client who inherited a $250,000 IRA in 1998 and was going to be forced to empty it by Dec. 31, 2003, because he originally failed to elect a lifetime payout. Now he's switched to lifetime distributions and will have 49 years to drain the account. F