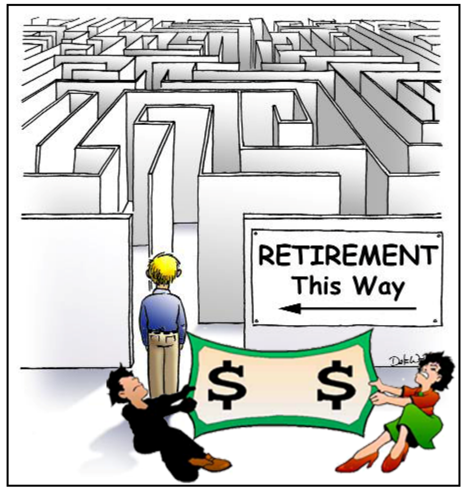
How to S-T-R-E-T-C-H your inheritance

Navigating the Retirement Maze



"I made my money the old-fashioned way. I was very nice to a wealthy relative right before he died." — *Malcolm Forbes*

As members of the Baby Boomer generation, many of us are fortunate enough to have parents who had secure lifetime employment, reasonable college costs for their children, and good retiree healthcare plans. As a result, these parents often hold significant investment portfolios, the unspent portion of which will ultimately pass to their beneficiaries. (Note: For those of you whose parents wear "I'm Spending My Kids' Inheritance" T-shirts, you can skip the rest of this article.)

Yet receiving an inheritance isn't as straightforward as waiting for the check to arrive. In addition to estate settlement issues, there are some tax implications of inherited assets that need to be addressed properly, or you'll wind up paying the IRS more than you should, and possibly a lot sooner than planned. Caveat beneficiary.

Boost your basis

Securities inherited from non-tax-qualified accounts have a seemingly magical property. As soon as they become part of a decedent's estate, the cost basis (i.e., the "cost" figure used for tax calculations) changes from the original purchase price to the price on the day the decedent passed away. Let's say that the original owner paid $1 for IBM shares that are now worth $160. Rather than paying a long-term capital gain tax of $159 per share, the beneficiary is essentially off the hook, tax-wise. When these appreciated assets are moved into your account, make sure that the cost basis is shown correctly stepped up, or else you'll go through a lot of paperwork with the IRS when you eventually sell them.

Inheriting an IRA: Proceed with caution

Nowadays, a large percentage of a retiree's assets may be in tax-deferred plans. Surviving spouses get to move their late spouse's IRAs and 401(k)s directly into their own tax-deferred accounts. Other beneficiaries need to follow the correct procedure for converting an IRA that they inherited into an Inherited IRA – the latter is IRS terminology – lest they get hit with a huge tax bill for doing it incorrectly.

The goal is to convert this asset into a "stretch IRA," which extends the IRS' mandated taxable distributions based on the beneficiary's life expectancy. This reduces the annual taxes due, and allows the account to grow tax-deferred as long as possible. To accomplish this, the estate executor must NOT withdraw the IRA assets prior to distribution. Tax-deferred accounts are like reverse roach motels – assets can come out, but you can't put them back in. It is a taxable event as soon as assets are withdrawn, and beneficiaries are then required to add the full amount of what would have been a tax-deferred inheritance to their year's income.

Instead, tax-deferred accounts should be split up into separate Inherited IRA accounts according to the beneficiary designations, with the proper titling to indicate their inherited status, and then transferred to the beneficiaries' custodians in a "trustee-to-trustee" transfer. Another requirement to ensure that these assets remain "stretch IRAs" is that beneficiaries must take their initial required minimum distribution (RMD) no later than December 31st of the year following the death of the original owner. Failure to do this will trigger the 5-year distribution rule, where all assets must be withdrawn from the Inherited IRAs by the end of the fifth year after the original owner's death, not to mention a 50 percent penalty on the delinquent distribution.

Traps for the unwary

If you are the owner of tax-deferred assets that are likely to become part of your legacy, there are measures you can take to ensure that your bequests go to the proper parties, and with minimal tax consequences:

- Check the beneficiaries on every account. If there are none, or if they are deceased and no secondary beneficiaries, your account will go into your estate when you pass away, the 5-year withdrawal rule for beneficiaries takes effect, and goes through probate.
- If you designate a trust as beneficiary, make sure that the trust is both "see through" and a "distribution trust." The former permits the use of the oldest beneficiary's life expectancy for withdrawal rather than the five-year rule. The latter avoids the hefty tax bills that trusts retaining asset income can incur, as high as 39.6 percent for retained income over $12,300 in 2015.
- If the decedent did not take their full RMD the year that they passed away, then the beneficiaries must do so before year end, or else pay a 50 percent penalty on that amount.
- Don't include a non-person beneficiary such as a charity along with individuals in a tax-deferred account, or the 5-year distribution rule automatically takes effect.

It's always nice to receive an inheritance, but even nicer if you can mitigate the tax hit.

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