Vol. 8, No. 1 **Choate's Notes** Spring 2006

A free newsletter for estate planners, from Natalie B. Choate

Dear estate planning professional:

A new type of plan administrator hell: As an estate planning attorney, you prepare beneficiary designation forms for your client's substantial retirement plans. You get the blank form from the plan administrator, fill it out for the client to sign, and send it back to the plan. But what do you do if the PA has no paper form to send you because employees are required to complete their forms electronically, on the employer's "intranet?" The lawyer I talked to who was confronted with this tells the client to print out every screen there is, and bring him the results, but fears he may end up sitting with each client at the computer while they jointly fill out the form. The biggest problem: he represents a former employee who still has money in that company's plan, but no longer has access to the employer's intranet…but the PA still insists there is no paper form! Guess this PA thinks ex-employees should not be allowed to change beneficiaries.

IRS drops pay-first requirement for 50% penalty waiver: If a client misses taking a minimum required distribution (MRD), the client owes a 50% penalty on the shortfall, which is to be reported on Form 5329 (attached to the original or amended Form 1040 for the year of the missed distribution). Until now the IRS has asserted (in the instructions for Form 5329 and in IRS Publication 590) that, in order to request a waiver of the penalty, the individual must first pay the penalty. The new IRS Publication 590 and Form 5329 (both for 2005 returns) have dropped this onerous requirement (which was not supported by the IRS's own regulations in the first place). Thus, to request a waiver, the taxpayer now need only file Form 5329, attaching a letter of explanation (showing reasonable error and reasonable steps to remedy the shortfall).

Roth conversion eligibility: To convert an IRA to a Roth IRA, the taxpayer must have "modified adjusted gross income" (MAGI) under $100,000, not counting (in 2005 and later) MRDs. The Code is vague about exactly *which* MRDs are ignored: From all plans, or just IRAs? Now, IRS Publication 590 tells taxpayers to exclude MRDs "from qualified plans, including IRAs." That statement doesn't jibe with earlier IRS pronouncements, which indicated only *IRA* MRDs are excluded. Should taxpayers rely on Pub. 590? No. It seems most likely this is an IRS mistake. Prudence suggests that we continue to exclude only IRA MRDs from "MAGI" when determining a client's eligibility to convert to a Roth IRA.

"**How will the IRS ever find out?"** Here are the best answers I've collected for that client who is considering "just saying no" to reporting a gift or income transaction. From Ed Slott, CPA (publisher of the highly recommended *Ed Slott's IRA Adviser* newsletter, www.irahelp.com): "I don't know how they find out…why don't you ask the guy in the cell next to you?" From Attorney Bob B.: "Do the terms 'disgruntled former employee' or 'embittered ex-spouse' resonate at all?" From Attorney Len S.: "You're wasting your money paying me $600 an hour to tell you how to do things legally, if you just want to commit tax fraud; you can do that on your own, for free!"

Until the next issue,
--Natalie B. Choate

Rolling over from a DRAC to a Roth IRA

This year, for the first time, 401(k) and 403(b) participants have the option to send their salary deferral contributions to either a "designated Roth account" (DRAC) or to a "regular" 401(k) account, assuming the employer has adopted the necessary plan amendment authorizing this. (Estate planning reminder: A client may need separate beneficiary designation forms for his regular 401(k) and DRAC accounts; for example, if the regular account is left to charity…that's NOT the best beneficiary for the income tax-free DRAC!)

Like Roth IRAs, DRACs require the participant to pay income taxes up front, when the money is contributed to the plan, but allow later tax-free "qualified distributions" of all plan accumulations after age 59½, disability, or death, once a 5-year holding requirement is satisfied. That's where the similarity ends.

A DRAC is part of a qualified retirement plan, and has the pluses and minuses of that status. One minus is that DRACs must pay minimum required distributions (MRDs) starting at age 70½ (or upon later retirement, in the case of non-5% owners), unlike Roth IRAs (which have no MRDs until after the participant's death). So the goal will be, for most DRAC participants, to roll over the DRAC to a Roth IRA eventually, to avoid the lifetime MRD requirement. That process is tricky because of how the 5-year holding period works according to new proposed IRS regs.

First of all, there is no possibility of rolling over from a DRAC to a Roth IRA until after termination of employment, because elective deferral contributions cannot be distributed for rollover prior to that time. That's just a long-standing rule for 401(k)/403(b) plans, and DRACs are subject to it too, since a DRAC is just another account inside a 401(k)/403(b) plan.

Then, once the employee terminates employment and rolls his DRAC to a Roth IRA, he may "lose" all the years he accumulated in the DRAC. Why? Because the Roth IRA 5-year holding period begins *the first year the individual has any Roth IRA*—and that rule doesn't change just because the Roth IRA receives a rollover from a DRAC, regardless of how long the money was in the DRAC!

This no-carryover rule is actually favorable to someone who has already had a Roth IRA for five or more years. It means the DRAC rollover money coming into the Roth IRA "instantly" meets the 5-year requirement, even if it was held in the DRAC for less than five years. The rule is also not too bad for a person who rolls a QUALIFIED distribution from a DRAC to a Roth IRA: The qualified distribution comes in as 100% after-tax money (which can be withdrawn tax-free from the Roth IRA any time). For this person, the Roth IRA's 5-year holding requirement will matter only with regard to post-rollover earnings on the DRAC rollover amount (as to which the individual will have to satisfy the Roth IRA 5-year holding period in order to have a qualified distribution).

Who is hurt by the no-carryover rule? The person who receives a nonqualified distribution from the DRAC (i.e., a distribution before the person had reached age 59½ or been disabled and/or before satisfying the 5-year requirement for the DRAC) AND who did not have a Roth IRA prior to the rollover. All his years in the DRAC will be lost and he will be starting the 5-year holding period all over again. But even for this person that won't make much difference if he is younger than 54½, because he has to wait five years ANYWAY before he can have a qualified distribution from the Roth IRA (after age 59½).

So where planners will have to be extra careful is, rolling out of a DRAC for an individual who is within striking distance of age 59½, has no prior Roth IRA, and has built up some years in the DRAC. Or, we could just wait and see if final regulations change this rule or Congress allows DRACs to expire altogether in 2011, as current law provides!