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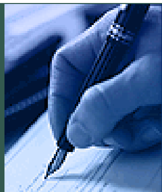
Weatherby & Associates, PC

Counselors at Law

Helping Families Preserve and Protect Assets and Values



The Wealth Counselor

A monthly newsletter for wealth planning professionals

Upcoming Events & Seminars

Estate Planning Seminars

There are no Estate Planning Seminars at this time.

Continuing Education Webinars

March 28, 2013

Financial Planners: Alaska Community Property Trusts

At our office in Bloomfield
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You have received this newsletter because I believe you will find its content valuable, and I hope that it will help you to provide better service to your clients. Please feel free to contact me if you have any questions about this

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Our firm focuses our practice on Estate Planning, Business Planning, Trust Administration, Probate, Elder Law and Life Care Planning. We help families preserve and protect assets and values; we help business owners maximize their businesses' value.

Using Trusts to Protect Inherited IRAs

Many clients have large IRAs and retirement plan accounts and need special estate planning for these assets. A 2009 study by the Investment Company Institute found that retirement plans account for 34% of all household financial assets, up from 14% in 1978; IRAs alone account for more than 10% of all household financial assets; and 47 million U.S. households have IRAs.

Compare these numbers to the approximately 4,000 estate tax returns that will be required to be filed annually under the new "permanent" estate tax exemption of $5 million adjusted for inflation, and it is easy to see that planning for retirement accounts presents a more significant opportunity for the estate planning advisory team than does estate tax planning.

Clients want to protect their IRA and retirement plan assets for their families, but most do not underst and what can happen to those accounts after they die. And, unfortunately, much of the information plan owners and beneficiaries receive from family members, other lay sources, and, surprisingly, even some advisors is outdated or incorrect.

Without proper planning, trillions of dollars in IRAs and qualified plans that are passed down to clients' beneficiaries upon death could be exposed to the beneficiaries' creditors and other beneficiary-associated

or any matters relating to estate or wealth planning.

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risks. By using specially designed IRA trusts, the plan owner's beneficiaries can be protected from creditors, predators, and the temptation inherent in "found" money and thus ensure that the beneficiary achieves the maximum tax deferral that the client intends.

In this issue of *The Wealth Counselor*, we will explain some of the rules about retirement plans that every member of the advisory team must know and how a properly prepared retirement plan trust (which we will he re refer to as an "IRA trust") can protect the plan assets after the owner's death.

Problems with Inherited IRAs and Retirement Assets

Impact of Income Taxes

Unless the client's retirement plan assets are in a Roth IRA or other Roth vehicle, income taxes must be paid whenever assets are withdrawn from these accounts. The top federal income tax rate is now 39.5% and state income taxes, where applicable, are in addition. (The 3.8% Medicare surcharge does not apply to retirement account withdrawals but the withdrawals from non-Roth accounts do get counted in determining if and by how much the taxpayer has exceeded the applicable threshold amount for the surtax.)

Impact of Income Tax Deferral

Different Levels of Protection for IRAs and Inherited IRAs

Qualified retirement plans, including SEP and Simple IRA plans, are protected under ERISA, but traditional, Roth, and inherited IRAs are protected under state laws, which vary greatly. For example, during the original IRA owner's lifetime, protection can range from unlimited protection to a specified dollar amount or, as in California, to an amount reasonably necessary for the owner and any dependents. Protection for inherited IRAs may be different than that provided to the owner. This varies from state to state and is determined by the beneficiary's state of residence when the protection question arises. Therefore, only the surest result is obtained through good, proactive planning.

Planning Tip: It is critical to understand how the laws in your state apply to an original owner and to someone who has inherited an IRA. You cannot assume that the beneficiary residing in another, often currently unknown state will have the same asset protection as the owner or a beneficiary residing in your state.

"Found" Money Is Extremely Slippery

We have all heard of the result of studies of how fast the

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average beneficiary goes through life insurance proceeds. Spending “found” money simply does not carry the significance of spending one’s own hard earned money. An IRA or other retirement account passing to an individual beneficiary is also “found” money and just as slippery.

IRAs and other retirement plans offer the substantial tax benefit of income tax deferral. Stretching out the inherited retirement plan’s distributions over a beneficiary’s actuarial life expectancy yields a much greater return than if the beneficiary cashes out the plan and pays taxes immediately on the full distribution plus on any future earnings on those assets.

Planning Tip: It can be very helpful to have a chart or calculator that illustrates to clients the benefits of income tax deferral based on his/her actual account balance, actuarial life expectancy, and beneficiaries’ ages.

Divorce and Unintended Beneficiaries
Although an inherited IRA is not a marital asset, it is “on the table” in a divorce because it can be transferred as part of a divorce settlement. Also, the beneficiary of an inherited IRA will make his/her own beneficiary designation in case of death before the account is depleted. Most clients do not want a child’s ex-spouse to get their IRA or a child’s new spouse to inherit because both carry the risk that the client’s grandchildren will be disinherited.

Loss of SSI/Medicaid
Any inheritance, including assets in an inherited IRA, are considered “resources” for determining SSI/Medicaid eligibility. At least temporary loss of SSI/Medicaid or other government benefits by a disabled beneficiary is hard to avoid if there is more than $2,000 in the inherited IRA.

Planning Tip: Assets held in a properly drafted IRA trust can provide much better protection and ensure maximum stretch out.

Basic Retirement Plan Concepts
A major advantage of qualified retirement plans and IRAs is that the income tax on plan earnings is deferred until withdrawal. With the exception of a Roth IRA or plan account, the account owner (referred to herein as “the owner”) must commence Required Minimum Distributions (RMDs) by his or her Required Beginning Date (RBD). The owner is never required by tax law to

make withdrawals from any Roth account but the Roth account beneficiary is.

Required Beginning Date (RBD)

Generally the RBD is April 1 in the year following the calendar year in which the owner reaches age 70 ½ or, for a qualified plan, the calendar year in which the owner retires from employment. There is a qualif ied plan exception for less than 5% owners. In each year beginning with the year of the RBD, the owner must withdraw at least the Required Minimum Distribution (RMD).

Calculating Required Minimum Distributions (RMDs)

RMDs are calculated by dividing the prior year's 12/31 account balance by the applicable life expectancy factor as provided by the IRS.

Life Expectancy Factors

There are different life expectancy factors for different account holders. That from the *Uniform Table* is used for an owner's lifetime distributions. (This table recalculates life expectancy every year so that even someone age 110 has a life expectancy and will not be required to empty the account.) However, if the owner's spouse is the owner's sole beneficiary and is more than ten years younger than the owner, the *Joint & Last Survivor Table* is used instead of the *Uniform Life Table* during the owner's life. The *Single Life Table* is used by all qualified beneficiaries after the owner's death.

Planning Tip: When working with a qualified plan, be sure to read the plan agreement and become aware of optional plan provisions. If the custodian is not willing to do what the client wants, consider changing to a new custodian where possible or rolling the account assets into an IRA.

Spousal Rollovers

Only a surviving spouse can rollover an IRA (or qualified plan) into his/her own IRA. Once rolled over, the IRA is treated as if all contributions to it had been made by the surviving spouse. In other words, the surviving spouse uses the *Uniform Table* to determine RMDs, which must begin by the surviving spouse's RBD.

Planning Tip: A surviving spouse can defer a rollover indefinitely. If the surviving spo use is younger than 59 ½, rolling over before attaining age 59 ½ risks incurring the 10% early withdrawal penalty. In such cases, consider establishing an inherited IRA and rolling over

when the surviving spouse attains age 59 ½. If the surviving spouse is the sole beneficiary, his or her RBD from the inherited IRA is the same as was his or her deceased spouse's RBD.

Qualified Plan Rollovers by Non-Spouse Beneficiaries

A non-spouse beneficiary is now allowed to do a trustee-to-trustee rollover of a qualified plan to his or her own Inherited IRA.

NOTE: All inherited IRA accounts *must* be titled in the original owner's name for the benefit of the beneficiary (e.g., Mary Smith, Deceased, IRA f/b/o Jim Smith). ***Anything else is considered a 100% taxable distribution.***

Designated Beneficiary

If there is a designated beneficiary of the inherited IRA or plan account, the designated beneficiary's life expectancy is used to determine RMDs in years following the year of the owner's death. This allows the inherited account to be distributed over the beneficiary's actual life expectancy, resulting in maximum stretch out and tax deferral.

* If there is not a designated beneficiary and the owner died *before* his or her Required Beginning Date, the account must be completely distributed by the December 31 following the fifth anniversary of the owner's death (the "five-year rule").
* If there is not a designated beneficiary and the owner died *on or after* his or her RBD, the RMD is determined using the Single Life Table as if the owner were still living (the "ghost life expectancy rule").

A designated beneficiary (as defined by Treas. Reg Section 1.401(a)(9)-4):

* Must be named a designated beneficiary under the terms of the plan or by an affirmative election by the employee;
* Need not be specified by name but must be identifiable on the date of death;
* May be a class of beneficiaries capable of expansion or contraction (e.g., my children or grandchildren);
* Must be an individual alive on the date of the owner's death;
* May be a trust if all of its beneficiaries who have to be considered are individuals alive on the date of the owner's death, the oldest of whom may be determined (a "qualifying" trust).

A designated beneficiary is NOT:
* an estate;
* a charity;
* a non-qualifying trust;
* any non-individual other than a qualifying trust; or
* an individual born after the d ate of the owner's death.

The IRA Trust
The advantages of using trusts in general include spendthrift protection, creditor and predator protection, beneficiary divorce protection, special needs planning, consistent investment management, estate planning, and exercising control over the trust assets after the death of the trust maker.

Disadvantages of trusts include greater complexity; legal, accounting and trustee fees; and for trusts that are not required to distribute all their taxable income, greatly compressed income tax brackets (the 39.5% top income tax bracket for individuals begins at $400,000, for such trusts it begins at $11,950).

To be a qualified trust, and thus qualify as a designated beneficiary of an IRA or retirement plan account, an IRA trust must:
1. Be valid under state law;
2. Be irrevocable not later than the death of the owner; and
3. Have beneficiaries all of whom are individuals who are identifiable from the trust instrument when considered on September 1 of the year following the owner's death.

In addition, the documentation requirement for a trust beneficiary must be satisfied.

Planning Tip: A single revocable living trust would meet requirement #2 because it becomes irrevocable upon the trust maker's death. However, unless it contains a "conduit" provision, discussed below, a single RLT is unlikely to satisfy requirement #3. A joint revocable living trust would not satisfy requirement #2 because it continues to be revocable until the death of the second spouse. For these and many other reasons, a specialized IRA trust is a preferable IRA beneficiary.

Planning Tip: The documentation requirement is fairly easy to satisfy, but it is vital not to miss the documentation deadline. The trust document must be provided to the account custodian by October 1 of the

year following the owner's death.

Types of IRA Trusts

Conduit Trust

The IRS regulations for IRA trusts provide an example that is commonly referred to as a "conduit" trust. This is a trust in which all distributions from the IRA are required to be immediately distributed to the trust's beneficiary(ies). With a conduit trust, identification of countable beneficiaries and qualifying the trust as a designated beneficiary is easier because "downstream" and contingent beneficiaries are not considered. On the other hand, because all distributions, including RMDs, must be immediately distributed to the beneficiary(ies), those distributions are not asset protected as they would be if they could stay in the trust.

Accumulation Trust

An accumulation trust is one in which distributions from the inherited IRA may be ke pt within the trust rather than being distributed to the beneficiary(ies). That way, the trust assets have more protection against creditors and predators. This also more easily allows the beneficiary(ies) SSI/Medicaid eligibility to be preserved. On the other hand, an accumulation trust is a separate taxpayer and is subject to the compressed income tax brackets for undistributed income. Plus, the risk of the trust not being a designated beneficiary (and thus able to take advantage of the stretch) is greater because all beneficiaries have to be considered except those who are "mere potential successor" beneficiaries.

Example: The owner's child is the primary beneficiary and a charity is the contingent beneficiary. With a conduit trust, the charity would not be counted and the child's life expectancy would be used to determine the trust's RMDs, which would produce maximum stretch out and tax deferral opportunity. With an accumulation tru st, the charity would be counted and the trust would not be a "designated beneficiary." That would cause the trust's RMDs to be determined using the five-year rule or the owner's ghost life expectancy, depending on whether the owner's death occurred before or on/after his or her RBD.

In PLR 100537044, the IRS permitted a one-time "toggle" from conduit to accumulation trust. Having such a provision could be important if there is a change in circumstances of a beneficiary (disability, drug problems, etc.) between the time the owner set up the trust and September 1 of the year following the owner's death. In

the "toggle," any general power of appointment given to a beneficiary must be converted to a limited power of appointment, which can create a Generation-Skipping Transfer Tax issue.

Planning Tip: Consider giving the Trust Protector the "toggle" power in any IRA trust to provide flexibility to deal with possible future events.

Separate IRA Trust vs. Trust in a Revocable Living Trust or Will

A separate IRA Trust is more likely to qualify as a designated beneficiary than is either a non-conduit RLT or trust established under a will.

Commonly encountered issues with using RLTs and trusts in wills as IRA/retirement plan beneficiaries include the possible adverse effects of formula funding clauses; pecuniary clauses and recognition of income; powers of appointment (can expand the class of potential beneficiaries); adoption effect clauses; provisions for payment of debts, taxes and expenses; apportionment language/firewall provisions; older or unidentifiable contingent beneficiary(ies), and non-individual remote contingent beneficiaries.

Drafting Issues and Beneficiary Designations

Revocable vs. Irrevocable

A revocable IRA trust allows for c hanges to be made easily, but it may open the IRA to the account owner's creditors at death. See, *Commerce Bank v. Bolander*, 2007 WL 1041760, Kan. App. 2007. Making the IRA trust irrevocable will protect against the Commerce Bank case problem. Making the IRA trust irrevocable does not have to be a final decision by the IRA owner. While an irrevocable trust may not be changed by its maker, a competent IRA owner can always create a new IRA trust and make a new beneficiary designation pointing to the new IRA trust.

Beneficiary Designations—Separate Shares

If an IRA is payable to an IRA trust rather than the separate beneficiaries' shares of the trust, the trust's RMD will be determined by the life expectancy of the oldest trust beneficiary (problematic if one beneficiary is age 60 and another beneficiary is age 2). By contrast, if multiple sub-trusts of an IRA trust are allocated shares of an IRA in the beneficiary designation f orm, the IRA share of each sub-trust will be paid over the life expectancy of the oldest beneficiary of that sub-trust.

Disclaimer Planning
IRA trusts can contain credit shelter and QTIP trusts for the benefit of the surviving spouse. Proper structuring of the beneficiary designation allows for disclaimer planning for the spouse and other beneficiaries. Note that no further stretch is allowed after the death of the spouse with regard to IRAs not rolled over to the surviving spouse's own IRA by instead going to a credit shelter or QTIP trust established by the IRA owner.

Planning Tip: The general treatment for disclaimer planning is 1) spouse; 2) if spouse disclaims, IRA trust (for funding of credit shelter/QTIP); 3) if spouse is deceased, to the separate IRA sub-trusts for descendants, per stirpes. Also, children can be given the power to disclaim so that IRA distributions can be stretched out over the owner&rsq uo;s grandchildren's lifetimes.

Custom-drafted beneficiary designations are required to allow proper disclaimer planning and separate share treatment. (See planning tip above.) However, some IRA custodians will not accept custom beneficiary designations and insist on using their own forms, especially for "smaller" accounts (those under $500,000). In such cases, giving the custodian a choice between losing the account to a more reasonable custodian and accepting the proposed custom beneficiary designation may produce the desired result.

Conclusion
Naming a separate IRA trust as designated IRA or retirement plan beneficiary is preferable to naming beneficiaries outright. It ensures that the client's goals are carried out, including that the client's beneficiaries will use the IRA stretch out potential. It provides asset protection against predators, the beneficiaries' creditors and loss upon divorce. I t can provide bloodline protection, preventing unintentional beneficiaries and disinheriting of descendants. It provides for beneficiaries who have or later develop special needs without jeopardizing their valuable government benefits. And it can even keep the IRA assets under the client's current advisor's management.

Each client's situation is different. For IRA trust planning, individual, case-by-case analysis with input from all advisors is essential.

With so much outdated and incorrect information about IRAs and IRA planning being tossed around, current and

knowledgeable advisors will stand out and prove invaluable to both clients and the other members of the advisory team.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax adviser based on the taxpayer's particular circumstances.

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