

# Estate Planning with Individual Retirement Accounts

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## USING THIS REPORT

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At first glance, the concept of an Individual Retirement Account (IRA) seems simple enough: a structured way to save for your golden years while deferring taxes on your growing nest egg. Unfortunately, that simple idea becomes one of the most complex areas of estate planning once IRS rules are applied. That means that not only must an estate planner consider estate tax reduction techniques but also the amazingly complicated income tax rules the IRS has issued in its regulations. After relying on variations of the “Proposed Regulations” since 1987, the IRS issued Final Regulations in April 2002. This report is intended to provide general guidance on the income and estate tax considerations involved. It is not intended as legal advice. Only an analysis of a client’s particular financial and family considerations provides a sufficient foundation for an estate planner to make appropriate planning recommendations.

## CONSIDER THE COMPLEXITY AND UNCERTAINTY OF THE RULES

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As will be discussed in the following sections of this report, there is considerable complexity and uncertainty in determining how the IRS and your particular IRA administrator will manage the issue of taxation in the case of the death of the owner. Some plan administrators require withdrawal of the IRA balance within a period of 1 to 5 years even though the IRS might allow a greater number of years. You should consider that uncertainty when making your estate planning decisions.

As an example, if you simply name your spouse as the beneficiary of your IRA, you and your spouse can be assured of the maximum income deferral benefits for each of you. However, that form of planning may increase the estate taxes on your estate, ultimately affecting the amount of inheritance your children receive.

## STEPS IN THE PLANNING PROCESS

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Initially, a decision must be made concerning which family members are intended to benefit from the estate plan. Each choice may have important tax consequences. For the remainder of the report, we will assume that Mr. and Mrs. Smith and their two children are the family for whom we will plan. Let’s look at the unique issues involved in IRA planning.

## ESTATE TAX PLANNING

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*All to the spouse*—One option available to married couples is for each spouse to name the other as the beneficiary of the owner’s IRA. When the owner spouse dies, the surviving spouse will own the

IRA and there will be no estate taxes imposed because bequests to a spouse are protected by the Unlimited Marital Deduction. This is a simple plan that protects the surviving spouse from estate taxes or income tax uncertainty. However, this method may cause Mr. and Mrs. Smith's children to bear the burden of paying estate taxes out of their inheritance that may be otherwise avoidable. How would that happen?

Let's assume, for a moment, Mr. Smith has an IRA with a balance of \$2,000,000 and Mrs. Smith also has property with a value of \$3,000,000. If Mr. Smith names Mrs. Smith as the beneficiary of his IRA, at this death, Mrs. Smith will own her own property and Mr. Smith's IRA. If Mrs. Smith dies shortly thereafter, she will have a taxable estate of \$1,500,000. As you may know, each person dying in 2009 can leave \$3,500,000 without any estate taxes imposed. Thus, Mr. and Mrs. Smith could have left their children a combined value of \$7,000,000, consisting of \$3,500,000 from each parent. However, the "simple" plan of naming Mrs. Smith as the beneficiary has erased the ability to use Mr. Smith's \$3,500,000 exemption because his assets were combined with hers and she subsequently died with a \$5,000,000 estate. The Smith children will have to pay estate taxes of \$675,000 at their mother's death. A "simple," but expensive estate plan for the IRA.

Is there a way to avoid the \$675,000 estate tax bill? Yes, Mr. and Mrs. Smith may use a specially prepared qualified trust to receive the rights to Mr. Smith's IRA. When Mrs. Smith dies, the balance of Mr. Smith's IRA will be owned by the trust and not taxable in Mrs. Smith's estate as when she was his beneficiary. The trust pays all of its income to Mrs. Smith and principal for her health, education, maintenance or support. Mrs. Smith is economically protected and the children inherit the entire estate without taxation. **However, say goodbye to "simplicity."** With the trust having become the current IRA beneficiary, the \$2,000,000 IRA is subject not only to IRS rules but the potentially stricter rules of the IRA Administrator. Let's review the IRS distribution rules.

## **MINIMUM REQUIRED DISTRIBUTION RULES**

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IRAs represent savings that have grown tax-deferred. That means that when funds are withdrawn, they are subject to ordinary income tax rates. Congress enacted the IRA rules so that taxpayers could save for their retirement. However, Congress' generosity has its limits. To ensure that taxpayers ultimately pay income taxes on their IRA balances, Congress enacted the "Minimum Required Distribution (MRD) rules." These MRD rules require taxpayers to begin withdrawing their IRA balances when they reach age 70½. For the sake of simplicity (at least relative simplicity), we'll use 70½ as our benchmark. This is called your "Required Beginning Date (RBD)." Let's apply the MRD rules to the Smiths.

Mr. Smith has just turned 70½ and will be considered 70 under IRS rules. Mr. Smith has to make some decisions soon about withdrawing funds from his IRA. He has several choices. He can take all the funds at one time. However, that would require the deferred income taxes to be paid all at once, so he won't do that. Another choice is for Mr. Smith to withdraw the minimum amount required under the Treasury Regulations. Mr. Smith has chosen this option to defer the income taxes for as long as possible.

## **HOW MUCH MUST MR. SMITH WITHDRAW?**

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We know how long Mr. Smith has to withdraw his IRA, but how much does he have to withdraw in any one year? Mr. Smith simply divides the balance of his IRA, at the end of the prior year, by the number of years indicated under the table provided by the IRS. For the first year, he divides the balance by 27.4. For the second year, he divides the balance by 26.5, and so on, as the RS Uniform Lifetime Table provides. As an example, assume Mr. Smith's IRA had a balance of \$2,000,000 in the first year. He divides \$2,000,000 by 27.4 and finds he must withdraw \$72,993. We now know how much Mr. Smith must withdraw, but when does he have to make a withdrawal?

## **WHEN MUST WITHDRAWALS BE MADE?**

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If Mr. Smith turns 70½ in 2009, there is an MRD due for 2009, which for his first year withdrawal he must withdraw by April 1 of 2010, his RBD. Should Mr. Smith wait until 2010 to take his first MRD, then he must take two distributions in 2010, one for 2009 and one for 2010. Now that we have covered the MRD rules, let's revisit the estate tax planning part of the report. Remember that naming Mrs. Smith as the beneficiary is a "simple" plan for the IRA, but increases the estate taxes on the inheritance left to the Smith children. If Mr. and Mrs. Smith want to protect their children's inheritance from unnecessary estate taxes, they must use a trust as part of their estate plan. Let's look at the rules for trusts as beneficiaries of IRAs.

## **USING TRUSTS AS THE IRA BENEFICIARY**

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A trust may be the beneficiary of an IRA without causing a loss of most of the income deferral opportunities if the following criteria are met. However, there is always a risk that the IRS may challenge a trust for a minor infraction. The requirements are:

1. The trust is irrevocable or, by its terms, becomes so at the death of the IRA owner.
2. The trust is a valid trust under state law, or would be if it had corpus (assets).
3. The beneficiaries of the trust who have a right to the IRA benefits are identifiable by the terms of the trust by no later than September 30<sup>th</sup> of the year following the year of the death.
4. A copy of the trust, or a certificate containing certain information, is provided to the IRA Administrator, no later than October 31<sup>st</sup> of the year after the IRA owner's date of death.
5. The beneficiaries of the trust must all be individuals.

If the trust meets these qualifications, the trust beneficiaries are considered to be the beneficiaries of the IRA. As an example, if Mr. Smith's trust provided that Mrs. Smith was the beneficiary of his trust at his death, and his children received his property at her death, Mrs. Smith and her children are considered to be the beneficiaries of Mr. Smith's IRA. Because Mrs. Smith **and** the children are considered beneficiaries, the IRS limits valuable income deferral benefits for inherited IRAs payable to trusts.

The trust beneficiary will receive the MRDs from the IRA **but not exactly** the same as Mrs. Smith would have if she had been the beneficiary. In the next section, we review the IRA minimum distribution rules for inherited IRAs.

## **IRA DISTRIBUTIONS TO A BENEFICIARY**

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The IRS rules for MRDs to beneficiaries of inherited IRAs used to be some of the most complicated in estate planning. Now, under the Treasury Regulations, calculating MRDs has become less complicated. Generally, distributions to a beneficiary are calculated as follows:

1. If the beneficiary is an **individual**, or a qualified trust, the beneficiary may **elect to** withdraw the IRA balance over the beneficiary's life expectancy by beginning withdrawals in the calendar year following the year of the IRA owner's death; or
2. If the beneficiary is **not an individual**, or if an individual or qualifying trust beneficiary **did not begin taking withdrawals by the end of the calendar year following the year of death**, the beneficiary **must** withdraw the entire balance of the IRA by the end of the calendar year which contains the fifth anniversary of the IRA owner's death. However, if the IRA owner died after beginning to take MRDs, the beneficiary can continue taking MRDs using the deceased IRA owner's remaining life expectancy under the IRS' Tables.

There is a special timing rule for spousal beneficiaries. Mrs. Smith, if she is the named beneficiary, may defer taking MRDs until Mr. Smith would have reached 70½. The IRS has taken the position that if a trust is named as the beneficiary, the spouse is **not** able to defer taking payments until the deceased IRA owner would have attained age 70½. **Therefore, trustees who are beneficiaries of an IRA must begin withdrawing the MRDs by the end of the calendar year following the calendar year of the IRA owner's death or be subject to the 5-year rule. This is a very restrictive position by the IRS and can be a good reason to simply name Mrs. Smith as beneficiary. But the income tax benefits of doing so must be weighed against the projected cost in estate taxes, if any.** This is the first IRS complication which arises from using a trust as the beneficiary to protect children from estate taxes. As will be discussed later, trust income tax rates also complicate the decision to use a trust as the beneficiary of an IRA. Don't forget, some IRA Administrators have adopted plans more restrictive than the IRS rules, in which case, the IRA Administrator may ignore the IRS rules and insist on a one-year payout of the entire IRA if a trust is used as a beneficiary. However, these restrictions by an IRA administrator can be resolved by choosing an administrator that will allow the withdrawal based upon life expectancy. Therefore, the best choice for planning purposes is to have the spouse be the primary beneficiary of the IRA and the trust be the contingent beneficiary. The spouse can then disclaim the interest as the beneficiary and allow the trust to become the beneficiary of the IRA. This spousal disclaimer will give the beneficiaries the ability to stretch out the IRA over their lifetime. This includes the children in a beneficiary trust.

## **INCOME TAX CONSIDERATIONS WHEN NAMING A TRUST AS THE BENEFICIARY**

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Remember, we named a trust as the IRA beneficiary to protect the Smith **children** from estate taxes. However, we now need to see the income tax consequences of naming the trust. Trust tax rates are “compressed,” meaning that trusts pay income taxes at the maximum rate of 35%, at much lower taxable income than do individuals. In 2008, a trust paid 35% of each dollar of taxable income in excess of \$10,700. In 2008, a single taxpayer did not pay income taxes at the 35% rate until taxable income exceeds \$349,700. As a simple example, if a single taxpayer has a taxable income of \$50,000, the income tax bill is approximately \$8,924. However, a trust with a taxable income of \$50,000 has a tax bill of approximately \$16,519. Therefore, assuming the \$50,000 taxable income was from a MRD, using the trust as the beneficiary to protect the Smith children from estate taxes costs the Smith family around \$7,595 in increased income taxes. Assume the dollar amounts and tax rates are the same and Mr. Smith’s IRA was left to a trust with 20 years of remaining MRDs and that each distribution created a taxable income for the trust of \$50,000. Mrs. Smith would lose approximately \$150,000 due to increased income taxes. The amount is actually considerably more because of the loss of earnings on the extra taxes. Trust income tax rates are the biggest problem with using trusts as beneficiaries.

### **Balancing the Tax Rates**

Very few surviving spouses are going to want to have their economic security decreased by the loss of \$7,595 per year in increased trust income taxes. Is there anything that can be done about it? Yes, if the trustee of the trust distributes the \$50,000 MRD to Mrs. Smith within 65 days of the end of the year in which the trust received the MRD, the trust is allowed a deduction and Mrs. Smith pays taxes at the individual income tax rate. Of course, the after-tax income will be in her estate and subjected to estate taxes prior to passing to her children. This is a decision the family will need to discuss on an annual basis. Remember how we mentioned that the entire balance in the IRA will be distributed using the IRS tables? If Mrs. Smith survives for 20 years after Mr. Smith’s death, a large percentage of the IRA will have been distributed to the trust and potentially redistributed, so as to avoid the increased income taxes, to Mrs. Smith. If so, the distributions will be in Mrs. Smith’s estate and subject to estate taxes unless she spends them during her life. This generally means that the estate tax savings of naming a trust as the IRA beneficiary will occur only if Mrs. Smith dies before the end of the joint life expectancy period. Finally, let’s look at the rules for rollovers.

## **ROLLING OVER AN INHERITED IRA**

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By “rollover” we mean that the beneficiary of an IRA may elect to treat the IRA as his or her own. Only a spouse may rollover an IRA inherited from a spouse. If a child or trust inherits an IRA, the IRA must remain in the name of the decedent or the entire balance will be taxable when the name is changed to the child’s or trust’s IRA. A spousal rollover can be used to create a “stretch out” IRA. “Stretch out” means Mrs. Smith may treat the IRA as her own and name, as an example, her daughter, age 42, as her beneficiary. Mrs. Smith and her daughter may use the new IRS Table to determine MRD’s during Mrs. Smith’s lifetime. However, if Mrs. Smith dies the next year, the IRA payment period “stretches out” to the daughter’s then-life expectancy of 39.6 years. The ability of the daughter to stretch out payments over 39.6 years is a considerable benefit. However, if any estate taxes are owed by Mrs. Smith’s estate they may have to be paid by the daughter taking an income-taxable withdrawal from the IRA.

## **PLANNING UNDER UNCERTAINTY**

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There is an estate planning option that adds some flexibility in dealing with the complex IRS rules and accelerated distribution requirements of some plan administrators. It's called the "disclaimer" method of estate planning. When this strategy is employed, the IRA owner names the spouse as the beneficiary and the revocable living trust as a contingent beneficiary in the event the spouse refuses to accept the IRA inheritance. A "disclaimer" is a formal refusal to take some or all of the IRA benefits so that they pass to the revocable living trust. In that way, the value will not be included in the survivor's estate. However, to take advantage of this strategy, the survivor must take no benefit from the IRA before disclaiming, and the formal disclaimer must occur within 9 months of the decedent's death.

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