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Estate Planning with Individual Retirement Accounts

Introduction

Proper estate planning ensures that there is a legacy left behind after you have passed away. It ensures that your affairs will be managed by who you want and how you want when incapacity or death occurs. It also enables you to leave all of your hard earned assets to who you want and how you want with the least amount of expense and delay and the greatest amount of privacy.

One of the largest assets that people own these days is in the form of retirement accounts (e.g. IRA, 401(k), 403(b)…). Yet it is one of the most under-planned-for assets in an individual's estate. Retirement accounts are subject to many technical rules and regulations; thus, careful consideration and planning is required to achieve the optimum outcome for these highly unique assets.

Using This Report

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, IRS rules make that simple idea one of the most complex areas of estate planning. This report is intended to provide general guidance on the income and estate tax considerations involved with IRA planning. This report is not intended as legal advice—only an analysis of a client's particular circumstances can provide a sufficient foundation for estate planning recommendations.

IRA Objectives

IRA owners usually have two main objectives when it comes to their IRA's. First, they want the flexibility to stretch-out the income taxation of Minimum Required Distributions that they and their beneficiaries will be required to take to compound their family's wealth tax free inside of the IRA. Second, once the IRA is inherited, they want protection from their beneficiaries' creditors, ex-spouse, lawsuits and other third party attacks. If structured properly within a comprehensive estate plan the retirement account can become one of the most dynamic assets left to a loved one.

Supreme Court Ruling

On June 12, 2014, the Supreme Court of the United States unanimously held in Clark v. Rameker that funds in an inherited IRA are not "retirement funds" within the meaning of 11 U.S.C. §522(b)(3)(c) and are therefore not exempt from a bankruptcy estate.

The key issue in this case was whether a beneficiary's inherited IRA is subject to creditors' claims in the beneficiary's bankruptcy. Clark addressed whether an inherited IRA is considered a "retirement account" and thus afforded the protections under the bankruptcy code. One argument was essentially "once a retirement account, always a retirement account." The counter-argument was that the basic characteristics of an IRA change when it passes to a beneficiary, such that the transfer constitutes an inheritance, thereby subjecting the IRA to the beneficiary's creditors. The Court agreed with the latter.

With the baby boomer generation reaching retirement age, IRAs will soon pass to beneficiaries in the form of inherited IRA's in never before seen numbers. This ruling means that an inherited IRA left to a beneficiary cannot be protected from creditors. The Court's ruling will have long reaching effects on the millions of people who have billions of dollars in their IRAs. Thus, proper planning is more essential than ever before.

STEPS IN THE PLANNING PROCESS

Initially, you must decide 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 with IRA planning.

ESTATE TAX PLANNING

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 with no estate tax imposed. Bequests to a spouse are protected by the Unlimited Marital Deduction. This is a simple plan that protects the surviving spouse from estate tax or income tax uncertainty. However, this method may cause Mr. and Mrs. Smith's children to pay estate taxes out of their inheritance. How would that happen?

Let's assume that Mr. Smith has an IRA with a balance of $4,000,000, and that Mrs. Smith has property valued at $3,000,000. If Mr. Smith names Mrs. Smith as the beneficiary of his IRA, Mrs. Smith will own her property and Mr. Smith's IRA upon his passing. If Mrs. Smith dies shortly thereafter, she will have a taxable estate of $1,570,000 ($7,000,000 - $5,430,000 = $1,570,000).

As you may know, any person who dies in 2015 can leave $5,430,000 without any estate tax imposed. Thus, Mr. and Mrs. Smith could have left their children a combined value of $10,860,000, consisting of $5,430,000 from each parent. However, the "simple" plan of naming Mrs. Smith as the beneficiary erased the ability to use Mr. Smith's $5,430,000 exemption. Consequently, the Smith children will have to pay $628,000 in estate taxes at their mother's death. A "simple" but expensive estate plan for the IRA.

Is there a way to avoid the $628,000 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 trust will own the balance of Mr. Smith's IRA, making Mrs. Smith's estate nontaxable. The trust will pay all of its income and principal to Mrs. Smith for her health, education, maintenance and support. Mrs. Smith will be economically protected and the children will inherit the entire estate without taxation. However, say goodbye to "simplicity." With the trust as the current IRA beneficiary, the 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

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's 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 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. Another choice is for Mr. Smith to withdraw the minimum amount required under the Treasury Regulations. Mr. Smith will likely choose this option to defer the income taxes for as long as possible.

HOW MUCH MUST MR. SMITH WITHDRAW?

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 by 26.5, and so on. As an example, assume Mr. Smith's IRA balance was $4,000,000 in the first year. He would divide $4,000,000 by 27.4 and find that he must withdraw $145,985. We now know how much Mr. Smith must withdraw, but when does he have to make a withdrawal?

WHEN MUST WITHDRAWALS BE MADE?

If Mr. Smith turns 70½ in 2015, there is an MRD due for 2015, which must be withdrawn by April 1 of 2016, which will be his RBD. Should Mr. Smith wait until 2016 to take his first MRD, then he must take two distributions in 2016—one for 2015 and one for 2016.

Now that we have covered the MRD rules, let's look at the rules for trusts as beneficiaries of IRAs.

USING TRUSTS AS THE IRA BENEFICIARY

A trust may be the beneficiary of an IRA without causing a loss of most of the income deferral opportunities if the following criteria is met:

1. The trust is irrevocable or, by its terms, becomes irrevocable 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 30th 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 31st of the year after the IRA owner's date of death; and
5. The beneficiaries of the trust must all be individuals.

If the trust meets these qualifications, the trust—and by default its beneficiaries—are considered to be the beneficiaries of the IRA. Under our scenario, since Mrs. Smith and the children are considered beneficiaries of the trust, and thereby the beneficiaries of the IRA, the IRS will limit valuable income deferral benefits for IRAs payable to trusts.

In the next section, we review the IRA minimum distribution rules for inherited IRAs. The IRS rules for MRDs to beneficiaries of inherited IRAs used to be some of the most complicated in estate planning.

IRA Distributions to a Beneficiary

Current treasury regulations, however, make calculating MRDs less complicated. Generally, beneficiary distributions 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; or

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 did not take MRDs prior to death, 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. Assuming that Mrs. Smith is the named beneficiary, she may defer taking MRDs until Mr. Smith would have reached 70½. However, 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 beneficiaries must weigh the income tax benefits and consequences before making that decision.

Income Tax Considerations When Naming a Trust as the Beneficiary

In our example up to this point, we named a trust as the IRA beneficiary to protect the Smith children from estate taxes. Now it's time to see the income tax consequences of naming the trust. Trust tax rates are "compressed"; meaning, the trust pays income taxes at the maximum rate of 35%—a much lower taxable income than individuals. In 2010, a trust paid 35% of each dollar of taxable income in excess of $11,200. Conversely, a single taxpayer that same year did not pay the 35% rate until taxable income exceeded $373,650.

For example: if a single taxpayer has a taxable income of $50,000, the income tax bill is approximately $8,681. However, a trust with a taxable income of $50,000 has a tax bill of approximately $16,471. Thus, assuming the $50,000 taxable income was from an MRD (with the trust as the beneficiary), the costs to the Smith family would be around a $7,790 in increased income taxes. Multiply that same increase over the course of 20 years of MRDs, and the Smith family would lose approximately $155,800 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 want their economic security decreased by $7,790 per year, due to increased trust income taxes. Is there anything that can be done about it? Yes! If the trustee 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—which would allow Mrs. Smith to pays taxes at the individual income tax rate. As a reminder, the after-tax income will be in her estate and subjected to estate taxes prior to passing to her children. Thus, the family will need to have a discussion about this on an annual basis.

Finally, let's look at the rules for rollovers.

ROLLING OVER AN INHERITED IRA

By "rollover" we mean that the beneficiary of an IRA may elect to treat the IRA as his or her own. Only a surviving spouse may rollover an IRA inherited from a deceased 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" IRA. "Stretch" means that Mrs. Smith may treat the IRA as her own. This would allow Mrs. Smith to name her 42 year-old daughter, for example, as her beneficiary. Mrs. Smith and her daughter would then use the new IRS Table to determine MRD's during Mrs. Smith's lifetime. However, should Mrs. Smith die 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.

PREPARE PROPERLY

Proper estate planning mitigates the risks of ever changing laws and interpretations. With proper estate planning, a person's IRA can be passed to a beneficiary without worrying that the money will be subject to the creditors of that beneficiary.

By naming a properly structured trust as the beneficiary of an IRA we can ensure that each individual beneficiary will be able to stretch out the IRA over their own life expectancy and maximize the income tax stretch-out. This allows the family wealth to continue to grow inside of the IRA, to be passed from generation to generation. By having the trust as the beneficiary of the IRA we can enhance the protections against loss to an ex-spouse in a divorce, or in lawsuits, or from the beneficiary's own poor spending habits. In addition, by having the trust as the beneficiary, needs based government assistance for a disabled loved one can be preserved.

When a properly structured trust is named as the beneficiary of an IRA the decision in Clark will be moot. The trust will provide the mechanism necessary to be able to shield the inherited IRA from the reach of trust beneficiary's creditors.

PLANNING UNDER UNCERTAINTY

An estate planning option that adds some flexibility with the complex IRS rules and accelerated distribution requirements of some plan administrators is called the "disclaimer" method. When this strategy is employed, the IRA owner names the spouse as the beneficiary and the revocable living trust as a contingent beneficiary. 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.

CONCLUSION

As the Supreme Court deliberates the Clark decision, remember that with proper retirement account planning anyone could avoid the issues that befell the Clark family. Proper estate planning for IRAs is imperative to mitigate against the whims of Congress or the interpretations of the Supreme Court. The benefits naming a qualified trust as the beneficiary of your retirement accounts instead of an individual can be summarized in two words: stretch-out and protection. The trust will ensure the maximum stretch-out, thereby maximizing family wealth accumulation, potentially for generations, and will ensure the maximum amount of protection you can offer to your beneficiaries.

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At Morris Hall, we focus on protecting families from the expense and delay of probate and minimizing tax consequences. We also implement basic and advanced estate planning strategies for clients, and assist in the administration of our clients' estates upon death or disability. Since we practice estate planning exclusively, we are able to answer the complex questions and concerns consumers have about estate planning.

MH is staffed with experienced attorneys and paralegals who are trained in the complex areas of probate, trust, elder law, and tax law. Our firm's aim is to help you, our client, understand the basic principles of estate planning and why each individual needs a plan. We have helped thousands of individuals secure their assets. We are confident that our experience will help ease your mind and the minds of the family you leave behind. By taking advantage of the services that Morris Hall has to offer, you can be assured that your legacy and your family will be protected.

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