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Selling to Seniors

An Effective Trust Solution For IRA Beneficiary 'Stretch-outs'

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"… Beneficiaries often mistakenly cash out the inherited IRA earlier than required."

A huge number of baby boomers have begun to retire and are rolling over large company retirement plan accounts into IRAs. As a result, proper professional IRA planning has become much more critical.

These rollover IRA owners all have the same basic planning objectives. First, they want to "stretch-out" the income taxation of minimum distributions they and their beneficiaries will be required to take, thereby compounding their family's wealth, tax-free, inside their IRA for as long as possible. Second, they want "protection" of their IRA, once inherited, from their beneficiaries' spouses, divorces, lawsuits, creditors, and other similar third-party attacks.

The New IRS "Stretch-Out" Rules

New, longer life expectancy tables permit the IRA owner to stretch-out taxable required minimum distributions (RMDs) over a longer period. More important, after the owner dies, a non-spouse beneficiary may stretch-out RMDs over his or her own life expectancy. Under the old law, if Dad died and Mom rolled over his IRA into her own name, then she died at age 76, her children-beneficiaries would have had to withdraw the entire IRA and pay all of the taxes in as little as six years (her remaining life expectancy). Now, if a beneficiary is 38, he or she may stretch out the RMDs over his or her own life expectancy of about 46 years!

Proper RMD stretch-out planning can produce some staggering results. Let's assume Mom is 65 and has $250,000 in her IRA, including any money she rolled over from her deceased spouse or from her own company retirement plans. Let's also assume that, over time, she enjoys 8% annual growth of the account, both from income and principal appreciation. At age 70½, thanks to the power of tax-deferred compounding, the account will be worth approximately $396,000. If she now begins taking minimum distributions at age 70½, the IRA will continue to grow because the RMD is only about 4%. If she continues to take only RMDs in following years, when she dies at age 80, the IRA inherited by her child will be worth approximately $541,000. If that child is 45 and likewise takes only RMDs each year, by the time the child is 80, he or she will have taken RMDs totaling about $2.9 million and still have more than $700,000 remaining in the IRA that could transfer to the next generation (the original owner's grandchildren). In oth-

I/R Code: 3490.99 Sales Techniques — IRA er words, Mom's original IRA of $250,000 — with proper RMD and investment planning — could be worth more than $3.5 million to her family!

Doesn't This Stretch-Out Occur Automatically?

Many parents and their financial advisers believe that merely naming the children as IRA beneficiaries is sufficient to assure the stretch-out. They assume the children properly will take only RMDs (and use other inherited assets if they need more), or expect the children to seek the assistance of the parents' financial adviser to make sure the stretch-out happens. In reality this is not always the case, however, and beneficiaries often mistakenly cash out the inherited IRA earlier than required.

For example, someone might not be aware of the RMD rules and distribution choices, and as soon as he or she finds out about being the IRA beneficiary, simply cashes out the account. Or, the beneficiary might ask the custodian what to do and be given a check. The taxes are then due and future tax-free compounding is lost. A non-spouse beneficiary does not have the option of withdrawing IRA money and replacing it within 60 days to avoid the taxes. Sadly, the beneficiaries often take these actions before they even seek the advice of their parent's (or their own) professional adviser. This is particularly true if a beneficiary, his or her spouse, or some other third party influencing them just can't wait to yank out the money to spend it.

The "Blowout"

When the IRA is withdrawn too early, the "blowout" occurs rather than the "stretch-out." This can be a huge family disaster. In the previous example, if the 45-year-old child cashes out the IRA in one year, approximately one-third of the future value of that account to the family — about $1.5 million — will be lost. (And if any of the "cashed out" money is spent rather than reinvested, the loss may be even worse.)

In short, merely relying on beneficiaries (or even the parents' adviser) to implement the RMD stretch-out properly may be risky and cost a family large sums that could have grown in the IRA and been available for their financial future.

Using a Trust as IRA Beneficiary For Protection

Instead of the IRA being paid directly to individual beneficiaries, it may be preferable to use a trust as beneficiary. The trustee then could ensure proper stretch-out of RMDs. Even if the IRA owner is not concerned about his beneficiary properly doing the stretch-out, however, there are a number of other estate and financial planning reasons why using a trust as IRA beneficiary makes good sense.

A trust may provide each individual beneficiary greatly enhanced protection against loss of the inherited IRA to a spouse in divorce, or to lawsuits and creditors, or even to the beneficiary's own poor spending habits. In addition, a trust may preserve a beneficiary's needs-based government benefits, such as supplemental (or disability) income and Medicaid, should a beneficiary require these benefits now or in the future. A trust also may give the original account owner the assurance that the right people eventually will inherit his or her IRA assets, rather than simply allow the owner's (or the beneficiary's) surviving spouse to pass them to his or her future spouse or children of another marriage. Finally, a properly structured trust may provide "generation-skipping" so the IRA will not be estate-taxed when passed down from child to grandchild.

IRS Problems with a Trust as Beneficiary

Unfortunately, the IRS rules have made it difficult for a trust to provide protection and at the same time take advantage of the maximum RMD stretch-out based on each beneficiary's own life expectancy. The IRS has said that if a trust does not comply with its complicated rules, all trust beneficiaries may be forced to use the shortest life expectancy (of the oldest beneficiary) or even cash out the entire IRA in just five years. Many IRA experts have been so concerned about the complexities of these trust rules — and the possibility of losing stretch-out — that they have recommended against using a trust as an IRA beneficiary.

Advantages of the IRA Inheritance Trust℠

A new type of IRA beneficiary trust, designed by this author and known as the IRA Inheritance Trust℠, solves the IRS problems. First, the trust, using a specially designed beneficiary designation form, permits each primary beneficiary to use his or her own life expectancy and maximize the income tax stretch-out of RMDs. Second, this trust offers enhanced protection of the IRA from beneficiaries' spouses, creditors, lawsuits, and other threats.

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This IRA Inheritance Trust℠ has been approved by the IRS in Private Letter Ruling 200537044, published Sept. 16, 2005.* Furthermore, the IRA Inheritance Trust℠ already has been successfully implemented after an IRA owner's death. In other words, this trust is proven and tested!

Coordinate This Trust with the Client's Overall Financial Plan

To have their non-spouse beneficiaries take maximum advantage of the income tax stretch-out, participants in Section 401(k) and other company retirement plans should be counseled about the benefits of rolling that money over into IRA accounts; otherwise, those plans often force taxable distribution in five years or less.

Furthermore, to maximize potential family wealth accumulation through the IRA stretch-out, the financial adviser should review the IRA's investments and consider repositioning them to emphasize growth, even during the client's retirement years. Variable annuities with both "living benefit" and "enhanced death benefit" features may be particularly attractive investment vehicles. These annuities may permit a conservative IRA owner to take advantage of future growth in the stock market, while having the comfort of knowing that the minimum contract value — for his or her future withdrawals (if he or she later needs more than RMDs) and for the family's death benefit — periodically will be raised as the market goes up but not reduced if the market drops.

Life insurance planning may also be warranted. For example, there may be a need to "equalize" the IRA that will pass to a client's second spouse with the inheritance received by the client's children of a prior marriage. Or the client may name grandchildren as IRA beneficiaries to maximize the stretch-out even further (using their longer life expectancies), while the client's children may need to receive the insurance proceeds as "replacement" assets. Life insurance also could be used to pay possible estate taxes on the IRA on the original owner's death, or — if these taxes are repealed — to pay the income taxes on beneficiaries' RMDs.

Benefits to the Client

The tremendous benefits of the IRA Inheritance Trust℠ can be summarized simply for a client with two words: "stretch-out" and "protection." The trust may help ensure the income tax stretch-out, thereby maximizing family wealth accumulation, potentially for several generations. In addition, the trust may provide greatly enhanced protection for the client's beneficiaries against divorce, lawsuits, creditors, loss of government benefits and additional estate taxes when the remaining IRA is passed down to the next generation.

A professional adviser may assist IRA owners with sizeable accounts by educating them about the new IRA Inheritance Trust℠. As a general rule of thumb, if the retired client (and his or her spouse) has $200,000 or more in IRAs (including company plans that will be rolled over into IRAs) and it is assumed the client's beneficiaries will outlive him or her by at least 10 to 15 years, properly implementing the IRA Inheritance Trust℠ could mean millions more to the client's beneficiaries.

Footnote

** Private Letter Rulings from the IRS are not interpretations of federal tax law in a broad sense but are opinions by the IRS on the specific case for which such rulings are requested. The IRS has issued all of its interpretations of the RMD Rules, however, as Private Letter Rulings. Financial advisers and their clients should consult with competent tax advisers before adopting the IRA Inheritance Trust℠ or other vehicles for estate preservation and transfers.*

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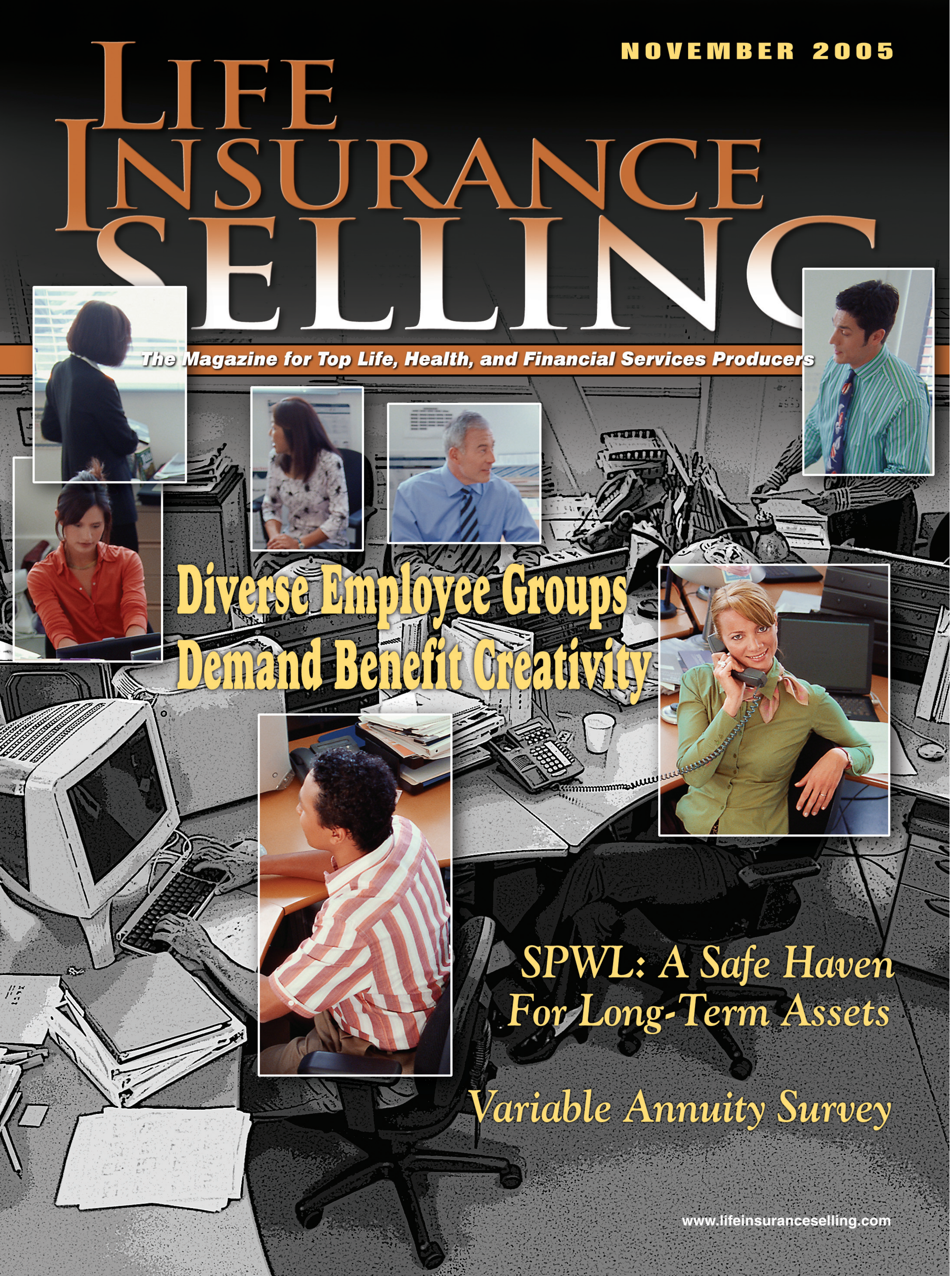

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