Compliments of
Baratta, Russell, and Baratta
(215) 914-2222
www.barattarussell.com

Estate Planning with Individual Retirement Accounts

ABOUT THE FIRM

Baratta, Russell and Baratta offers deep knowledge and experience in estate planning, trusts, estate administration and commercial law.

Estate Planning is a means to protect your family and its assets now and in the future. Estate Planning involves a number of different elements, including asset protection, asset maximization from an investment standpoint as well as ensuring an efficient transfer of assets from one generation to another. Estate planning is fundamental to those who recognize that appropriate planning can support a family through the generations.

In these turbulent times, if you or your loved ones would like a complimentary consultation to discuss your estate plan and financial strategy, visit our website at **www.barattarussell.com**, or call us today at **215-914-2222** to schedule an appointment and see how we can help your family today. We present seminars on a variety of estate planning and elder law topics; call us if you want to be on our seminar mailing list.

FOLLOW US ONLINE

www.barattarussell.com

CONTACT US

BARATTA, RUSSELL & BARATTA
THE LOFT AT WOODMONT
3500 READING WAY
Huntingdon Valley, PA 19006
Phone: (215) 914-2222
Fax: (215) 914-2118

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, 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

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 one to five 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, if you name your spouse directly, you lose many protections and cannot be certain that your children will ultimately get the assets as an inheritance.

STEPS IN THE PLANNING PROCESS

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

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. Further, by naming the spouse directly, the surviving spouse can treat the assets as his or her own, i.e., can do a "spousal rollover." We will discuss this later. However, there are some circumstances in which an individual might not want to name their spouse directly. Instead they may wish to name a trust, which can provide for their surviving spouse and children.

Why would you want to do this if the simple plan can work well? Because the simple plan does not provide protections that may be needed in some circumstances. Let's look at Mr. and Mrs. Smith. Mr. Smith has three children and Mrs. Smith has four children of her own. It was a second marriage for each of them. They were not involved in raising each other's children. Each spouse wants to benefit the other spouse and then his or her own respective children. Mr. Smith has a sizable retirement plan. If he leaves it directly to Mrs. Smith, he is concerned that she may not leave it to *his* children at her death. Instead, Mr. Smith could leave the assets in the retirement plan to a trust for the benefit of Mrs. Smith. At Mrs. Smith's death, the trust could distribute to his children. In this manner, Mr. Smith can rest assured that his wishes will be carried out. The trust can also provide creditor protection for the surviving spouse, in other words, the assets in the trust could not be protected if Mrs. Smith is sued. The trust can also provide management for the assets and remarriage protection so that the assets are protected in the case of a divorce after remarriage.

As we'll see later, it's a trade-off. If Mr. Smith leaves the retirement plan assets to the trust, he gains many protections and peace of mind. However, as we will see later, by using the trust, Mrs. Smith will not be able to do a "spousal rollover" and distributions will have to be taken more quickly as a result.

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' 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. Actually, the final date to make the first withdrawal is April 1 of the calendar year following the calendar year the owner reaches 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 newly issued Proposed Regulations. Mr. Smith has chosen 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 the balance by 26.5, and so on, as the IRS Uniform Lifetime Table provides. As an example, assume Mr. Smith's IRA had a balance of $1 million in the first year. He divides $1 million by 27.4 and finds he must withdraw $36,496. 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 2018, there is an MRD due for 2018 which he must withdraw by April 1 of 2019, his RBD. Should Mr. Smith wait until 2019 to take his first MRD, then he must take two distributions in 2019, one for 2018 and the other for 2019. 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. They may also use the "simple" plan of naming the spouse as beneficiary and purchasing a second to die life insurance policy. 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 are met. However, the IRS is interpreting these rules in an inconsistent manner and 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.

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 one year after the IRA owner's date of death.

4. A copy of the trust, or a certificate containing certain information, is provided to the IRA Administrator.

Generally, the missing copy of the trust or the certificate must be provided to the IRA Administrator no later than September 30th of the year after the IRA owner's date of death. 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

The IRS rules for MRDs to beneficiaries of inherited IRAs used to be some of the most complicated in estate planning. 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 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 owner's death. However, if the plan owner died after beginning to take MRDs, the beneficiary can continue taking MRDs using the deceased plan 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 owner would have attained age 70½. **Therefore, even if the spouse is the beneficiary of the trust, and the IRA is made payable to the trust, the trustee must begin withdrawing the MRDs by the end of the calendar year following the calendar year of the 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 other concerns outlined earlier.** This is the first IRS complication which arises from using a trust as the beneficiary to protect the children. 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 the trust is used as a beneficiary.

INCOME TAX CONSIDERATIONS WHEN NAMING A TRUST AS THE BENEFICIARY

What about the income tax consequences of naming the trust as a beneficiary? Trust tax rates are "compressed," meaning that trusts pay income taxes at the maximum rate of 37%, at much lower taxable income than do individuals. In 2019 (indexed), a trust paid 37% of each dollar of taxable income in excess of $12,750. In 2019, a single taxpayer does not pay income taxes at the 37% rate until taxable income exceeds $510,300. Prior to reaching $510,300, the individual pays lower rates on lesser accounts.

As a simple example, if a single taxpayer has a taxable income of $50,000, the income tax bill is approximately $6,859. However, a trust with a taxable income of $50,000 has a tax bill of approximately $16,858. 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 $9,999 in increased income taxes. Assuming the dollar amounts and tax rates are constant 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 over $199,980 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 $9,999 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

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.

By "stretch out" it is meant 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 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 41.7 years. The ability of the daughter to stretch out payments over 41.7 years is a considerable benefit.

ABOUT THE ACADEMY

This report reflects the opinion of the American Academy of Estate Planning Attorneys. It is based on our understanding of national trends and procedures, and is intended only as a simple overview of the basic estate planning issues. We recommend you do not base your own estate planning on the contents of this Academy Report alone. Review your estate planning goals with a qualified estate planning attorney.

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive Membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services.

The Academy expects Members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects. To ensure this goal is met, the Academy provides over 40 hours of continuing legal education each year. The Academy has also been recognized as a consumer legal source by *Money Magazine, Consumer Reports Money Adviser* and Suze Orman in her book, *9 Steps to Financial Freedom*.

ADDITIONAL REPORTS

Request any reports of interest to you or your family. Simply call our office at **(215) 914-2222** or visit our website at **www.barattarussell.com.**

- A Child With Special Needs, Needs Special Planning
- Aid & Attendance: Special Care Pensions Wartime Veterans
- Are Your Bank Accounts Safe? FDIC Insurance Can Cover You – With the Right Planning
- Asset Protection: Reducing Risk, Promoting Peace of Mind
- Beware of Living Trust Scare Tactics
- Charity Begins at Home: The Charitable Remainder Trust
- Creating a Lasting Legacy: The Best Things in Life Aren't Things
- Dangers of Do-It-Yourself Wills and Living Trusts
- Estate Planning Basics For Families with Young Children
- Estate Planning with Individual Retirement Accounts (IRAs)
- Family Farm: The Next Generation
- Family Wealth Trust: Calculating the Benefits
- Fifteen Common Reasons to Do Estate Planning
- Finding the Right Estate Planning Firm
- Funeral Planning: Options for You and Your Family
- Getting the Most Out of Your Life Insurance: The Irrevocable Life Insurance Trust
- Grandparents' Guide to Second Generation Planning
- Keeping Up With the Ever Changing Estate Tax
- Living Trusts: Calculating the Benefits
- Paying for Nursing Home are: A Guide to Medicaid Planning
- Peace Of Mind: Planning For All Of Life's Contingencies
- Planning It Right The Second Time Around
- Probate: A Process, Not a Problem
- Probate: An Executor's Role and Responsibilities
- Protecting Your Assets with the Family Limited Partnership
- Protecting Your Assets with the Limited Liability Company
- Set the Stage for Medicaid Eligibility
- Should You Trust Your Estate Plan – Estate Plan Reviews Ensure Protection for Your Family and Assets
- Special Valuation Benefits for Farms and Other Business Real Property
- The Impact of Divorce on Your Estate Plan
- The Nightmare of Living Probate
- The Trouble with Joint Tenancy
- To My Dog Lucky I Leave $10,000
- Trust Administration: Prior Planning Prevents Problems
- What Every Senior Should Know About Probate
- Where There's a Will, There's Probate
- Your Life, Your Final Say