Individual Retirement Accounts as Estate Planning Tools: Opportunities and Pitfalls

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Retirement Plans
A COMPLEX BUT CRITICAL ASSET

Important Factors
• Retirement Savings in U. S. total approximately $16.5 trillion\(^1\)
  – IRAs account for $4.3 trillion\(^1\)
  – Assets in Defined Contribution Plans represent $4.2 trillion
• Likely rollover candidates to fund future IRAs
• Households that own IRAs hold more than one fifth of their financial assets in IRAs\(^1\)
• Numerous changes in retirement plan legislation in past 5 years\(^2\)
  – In past 2 years, 10 modifications at the federal level alone
• Different rules for qualified and non-qualified plans
  – Some more favorable to IRAs, others favor qualified retirement plans

\(^1\)Investment Company Institute, March 2010
\(^2\)Publication 590.
\(^3\)NFO World Group. Wealthy households are defined as those with more than $1 million in investable assets.
\(^4\)LifeSpan Communications, Millionaire Insight Program. Millionaire households are defined as those with more than $1 million in investable assets.

IRAs as Estate Planning Tools
AGENDA

Beneficiary Designations
• Beneficiary Designation Forms; choice of beneficiaries

IRA Payable to Trust
• When to consider trusts as beneficiaries

Retirement Assets and Charitable Giving

Roth IRAs: estate planning advantages

APPENDIX
Exception to 10% withdrawal penalty
Divorce & IRAs
Creditors’ Claims & IRAs
Beneficiary Designations
OPTIONS AND CONSIDERATIONS IN BENEFICIARY SELECTION

Beneficiary Designation Form

• Governs who receives assets
  – Generally takes precedence over will, revocable trust, power of attorney, etc.

• IRA agreement governs if no beneficiary named
  – Typically estate or surviving spouse

• Important to update
  – History of rigid endorsement of original designees by court, despite divorce, etc.

• Customized beneficiary designation
  – Provides for detailed sequence of beneficiaries
    • Important to name contingent beneficiaries for flexibility
  – Not all investment firms allow this; BNY Mellon Wealth Management does


“Designated Beneficiary”

• Key to maximizing distribution deferral after IRA owner’s death
  – Critical from an income tax perspective

• Individual person(s) OR

• Trust which satisfies IRS requirements
  – IRA Custodian/trustee has copy of trust
  – Trust becomes irrevocable at IRA owner’s death
  – Trust Beneficiaries are clearly ascertainable
  – Trust is valid under state law
Beneficiary Designations
OPTIONS AND CONSIDERATIONS IN BENEFICIARY SELECTION

Choice of Designated Beneficiary
• Spouse generally best option
  – Provides greatest number of choices later
• Defer income and estate taxes by choosing
  – Roll over assets to spouse’s own IRA OR
  – Keep in deceased spouse’s name

• Individual non-spouse beneficiary/beneficiaries are usually second best option
  – Allocate fractionally on beneficiary designation form (specify percentage for each)

• Trusts (see pages 10 - 14)
  – Use when necessary
  – If trust divides into >1 subtrust, best to name each subtrust on the IRA beneficiary designation form
  • Can pay out per life expectancy of oldest beneficiary of each subtrust

Beneficiary Designations
OPTIONS AND CONSIDERATIONS IN BENEFICIARY SELECTION

No Designated Beneficiary
• Assets must be distributed more quickly
  – Accelerates income tax: not a stretch IRA

• Estate not a Designated Beneficiary but a possibility under certain circumstances
  – May be fine if small IRA and probate is easy
  – Worse for large IRAs; may accelerate income tax

• Charity not a Designated Beneficiary
  – Take special care when naming a charity as one two or more beneficiaries
Beneficiary Designations
OPTIONS AND CONSIDERATIONS IN BENEFICIARY SELECTION

IRAs vs. Qualified Retirement Plans (QRPs)
• QRPs less flexible for beneficiary designations and payouts
  – Spousal waiver needed if non-spouse beneficiary

• Pension Protection Act of 2006 provided some relief for QRPs
  – Non-spouse beneficiary may elect to take distributions over his/her life expectancy
  – Previously, lump sum was often the only option

• IRAs usually provide more options for beneficiary designations
  – Some IRA providers accept customized beneficiary designations
  • Drafted by estate planning attorney

IRA Payable to Trust
RARELY THE BEST OPTION

Typically Best to Leave IRA Outright to Individual, Not to Trust
• May be difficult to establish trust as Designated Beneficiary

• May negatively impact taxes
  – Income taxes may be higher on retirement plan distributions to a trust

• Ineffective use of estate tax exemption
  – If paid to credit shelter trust, part of estate tax exemption is wasted

• Trustee must determine how to allocate retirement plan asset distribution between income and principal
  – Florida Principal & Income Act – Florida Statute 738

• Fiduciary income tax distribution system and separate share rule complicate who bears income tax burden
IRA Payable to Trust
RARELY THE BEST OPTION

Unique Instances Where Best to Leave IRA to Trust

• Beneficiary is a minor or a spendthrift

• Second marriage situations: QTIP

• IRA is only asset available to satisfy exemption amount: credit shelter trust

IRA Payable to Trust
TYPES OF TRUSTS

Conduit vs. Accumulation Trusts

• Conduit channels Required Minimum Distributions (RMDs) directly through the trust and out to the trust beneficiaries
  – Goal: qualify as look-through trust to base RMDs on life of eldest trust beneficiary

• Accumulation Trust more flexible
  – Trustee takes RMDs from IRA
  – Trustee has discretion to retain all or part of RMDs in trust or pay out to trust beneficiaries
  – Useful where need to restrict beneficiaries’ access to funds
  – Goal: qualify as look-through trust to base RMDs on life of eldest trust beneficiary
IRA Payable to Trust
TYPES OF TRUSTS

QTIP Trust as IRA Beneficiary
• Use: 2nd marriage, sizeable IRA, owner wants to provide for surviving spouse during life but children after that

• Challenges
  – Qualifying for marital deduction
  – Obtaining best tax result

IRA Payable to Trust
TYPES OF TRUSTS

Credit Shelter/Exemption Trust
• Use: Large IRA, few alternative assets available to satisfy estate tax exemption

• Challenges
  – Avoiding a bad tax result
  – Wasted estate tax exemption on assets with an Income tax liability
  – An issue if deceased IRA owner was subject to federal estate tax

• Alternatives
  – Convert to Roth IRA before IRA owner’s death (see page 20)
  – Leave exemption amount to non-spouse beneficiaries outright
  – Use customized beneficiary designation with formulas and disclaimers
  – Charitable Remainder Trust with payout to spouse for life, then children, then charity (see page 17)
Retirement Assets and Charitable Giving

OFTEN ADVANTAGEOUS

Tax Advantages of Gifting IRA to Charity

• No estate tax
  – Qualifies for federal estate tax charitable deduction
• No income tax to donor or donor’s estate
  – Charity not taxed on proceeds
• Distributions under final requirements
  – Now one standard table for life expectancy payouts
  – Naming charity does not negatively impact the required minimum distribution for owner
• Tax-efficient gift
  – Costs roughly 25% to heirs for charity to receive 100% of assets

Retirement Assets and Charitable Giving

OFTEN ADVANTAGEOUS

<table>
<thead>
<tr>
<th>Stock to Charity and IRA to Son</th>
<th>Stock to Son and IRA to Charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charity</td>
<td>Son</td>
</tr>
<tr>
<td>Stock</td>
<td>$500,000</td>
</tr>
<tr>
<td>IRA</td>
<td>--</td>
</tr>
<tr>
<td>Total Bequest</td>
<td>$500,000</td>
</tr>
<tr>
<td>Less Income Tax on IRA</td>
<td>$0</td>
</tr>
<tr>
<td>NET BEQUEST (before any estate taxes)</td>
<td>$500,000</td>
</tr>
</tbody>
</table>

* The son’s stock receives a step-up in basis when decedent dies.
Retirement Assets and Charitable Giving
CHARITABLE TRUSTS

Charitable Remainder Trusts
• Advantage of CRUT vs. outright to beneficiary
  – May spread payment stream longer than outright RMDs would have
  • May defer income tax over many years
  • Especially useful if a sequence of beneficiaries with large age differences
  – Heirs receive steady income stream for life
  • Prevents beneficiaries from quickly depleting the nest egg

• Challenges
  – If too many young (<40) beneficiaries, may not be possible due to IRS regs [re: charitable remainder]
  – Need care in drafting beneficiary designation to avoid tax problems
  – If a taxable estate, not usually a good solution
    • 691(c) deduction often wasted

Retirement Assets and Charitable Giving
CHARITABLE TRUSTS

Charitable Lead Trusts and Pooled Income Fund
• Not good choices as IRA beneficiaries

• Not income tax exempt: trust must take distribution in lump sum and pay tax
Roth IRAs and Estate Planning
THE ROTH IRA ADVANTAGE

Required Minimum Distribution (RMD) Requirements
• Do not apply during life of original owner of Roth IRA

Surviving Spouse
• May elect to treat inherited Roth IRA as his/her own
• No RMD

Non-spouse Designated Beneficiaries:
• Default: the entire balance must be distributed within 5 years
• Could elect to take distributions over his/her lifetime(s) (Single Life Table)
  – Distributions must commence in the year following the year of owner’s death
  – No tax, no penalties regardless of age or other factors
  • Providing at least required minimum amount is withdrawn

Roth IRAs and Estate Planning
KEY REASONS TO CONSIDER CONVERSION TO A ROTH IRA

Expect Client’s/Beneficiary’s Income Tax Rates to Be Higher at Time of Planned Distribution

Avoid Administrative Burden of RMD

Estate Planning Benefits
• Paying taxes on converted amount reduces estate tax liability
  – Reducing the estate by amount of income taxes paid
• If need IRA to fund credit shelter trust

Leave Beneficiaries An Income-tax-free Asset
• But possibly subject to estate tax
• Paying income tax = significant gift without using any gift tax exemption
Retirement Plans

An Important Asset
• Significant portion of your wealth
• Could considerably impact your legacy
• Often underexploited and under protected
  – Complex and changing rules
  – Myriad, but complicated alternatives for maximizing tax-efficiency, investing and gifting opportunities
• Regular maintenance critical
  – Monitor for legislative and tax changes
  – Review against evolving personal goals and circumstances

Appendix: Other Planning Issues

Divorce

Exceptions to 10% Early Withdrawal Penalty

Creditor’s Claims
Divorce and IRAs
KEY CONSIDERATIONS

Avoid Taxation
• Transfer IRA to ex-spouse pursuant to valid divorce decree

• Alternative ways to transfer IRAs
  – Best method: establish IRA rollover in ex-spouse’s name
  – Transfer assets directly from IRA to ex-spouse’s existing IRA
  – Possible alternative: IRA owner rolls over assets to newly established IRA
  • In IRA owner’s name and then assigns IRA to ex-spouse
  – Not recommended: change name on account from original owner to ex-spouse

Note: Inherited IRAs not divisible in divorce without negative tax result
  - Portion transferred to ex-spouse considered a taxable distribution

Divorce and IRAs
KEY CONSIDERATIONS

Beneficiary Designation
• Don’t rely on “savings clauses” in state statutes to give results you want

• Should update beneficiary designation after divorce
  – Remove ex-spouse
Exceptions to 10% Early Withdrawal Penalty
DISTRIBUTIONS WHERE PENALTY IS WAIVED

From Retirement Plans
• To deceased employee’s estate or beneficiary
• To disabled employee
• As reimbursement for medical expenses

From Qualified Plans
• To alternate payee pursuant to Qualified Domestic Relationship Order
• For separation from service after age 55

From IRAs
• For higher education expenses
• To assist first-time homebuyer ($10,000 lifetime)
• To unemployed individuals for health insurance premiums after separation from service

As Substantially Equal Periodic Payments
• Must be made at least annually, for the longer of 5 years or until age 59½

• Consider separating into two IRAs before beginning payments
  – Safeguard against needing additional funds before age 59½

• Cannot change or modify distributions once begun without incurring taxes

• Three ways to take periodic distributions
  – Minimum required distribution (MRD) method
  – Amortization method
  – Annuity factor method
Creditors’ Claims

STATE AND FEDERAL CONSIDERATIONS

Three Types of Creditors’ Claims

• Bankruptcy
  – Changed with bankruptcy abuse prevention and consumer protection act
  – Qualified plan assets: 100% free from creditors
  – Rollover IRAs, SEP IRAs and SIMPLE IRAs: free from creditors
  – Traditional IRAs and Roth IRAs: exemption limited to $1 million

• IRS
  – Qualified plan assets: can put lien or levy on assets
    • Generally lien, don’t levy, until participant reaches RMD age (59 ½)
  – IRAs: take at any time

• Judgment Creditors
  – Qualified plan assets: exempt from creditors’ claims under ERISA
    • anti-alienation clause
  – IRAs: not governed by ERISA, must look to individual state statute to determine if IRA is exempt from creditors’ claims
    • Many states exempt IRA rollovers
    • State may change law
    • Each state statute is different
    • Take IRA owner’s change of domicile into account