ESTATE PLANNING CONSIDERATIONS FOR IRA AND QUALIFIED PLAN BENEFITS[1]

Introduction

The benefits of contributing to a qualified retirement plan or IRA account as an effective way to save for retirement are well understood. However, many people labor under the misimpression that retirement accounts are not an effective way to transfer wealth at death. Unlike personally owned investments, these accounts do not receive a "step-up" in income tax basis when the owner dies. As a result amounts distributed from qualified plans and IRAs will be subject to income taxes when received by the account owner's heirs.

Planning for IRAs and Qualified Benefit Plans

However, careful advanced planning can enable a person who inherits a qualified plan or IRA to enjoy significant income tax benefits. That's because the designated beneficiary of such a retirement account can annuitize the retirement account over his or her life expectancy following the account owner's death.

Example 1:

Mary, age 30, contributes $3,000 to an IRA each year until she attains age 65. If those contributions grow at a rate of 10% (pre-tax), then by the time Mary turns 70 the IRA account will have a balance of $1,445,265. Assume Mary designates her grandchild, age 20, as the beneficiary of her IRA. Mary then begins to withdraw the smallest amount possible from her IRA. At Mary's death her grandchild continues to withdraw the smallest amount permissible under the law. In this scenario the total amount distributed to Mary and her grandchild would be $56,649,162.

Example 2:

Assume the same facts as Example 1, but with a Roth IRA. The Roth IRA would be worth $3,748,645 at Mary's death assuming no lifetime withdrawals were made. The Roth IRA could distribute $87,225,645 to Mary's grandchild if minimum distributions were taken and estate taxes were paid from a different source.

While the potential income tax benefits of an inherited qualified plan or IRA account cannot be overstated, the IRS (for obvious reasons) has been cool to this type of planning. As a result, it has sought to try and limit a beneficiary's ability to "stretch-out" a retirement account after the account owner's death.

One of the traps for the unwary which has been set by the IRS is a rule that applies when a trust, rather than an individual, is named as the beneficiary of the retirement account.

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[1] We cannot guarantee that this information is consistent with current law. Please contact Willms, S.C. for current information on this topic.

A trust will be the appropriate beneficiary where the account owner is survived by a spouse and children from a prior marriage, the account owner is concerned about the beneficiary's ability to manage their inheritance (either due to age or spending habits), or the account owner would like to protect the beneficiary's inheritance from creditor claims in the event of a divorce, bankruptcy, or lawsuit.

Three Private Letter Rulings Affecting Planning for IRAs and Qualified Benefit Plans

Recently, the IRS has issued three "private letter rulings" interpreting the Treasury Regulations which govern distributions from qualified plans and IRAs following the account owner's death. These rulings were issued in response to questions posed by individual taxpayers and are not binding on others. However, they are a good indication of how the IRS is likely to treat other taxpayers who are in similar circumstances.

Each of the three rulings were issued in response to a question which related to an IRA whose designated beneficiary, following the account owner's death, was a single trust for the benefit of several individual beneficiaries. In each case, the single trust was to be divided pursuant to its terms into separate trusts for each of the beneficiaries following the account owner's death. Likewise, the beneficiary designations for the IRAs in question provided the IRAs were to be divided into separate IRA accounts following the account owners' death, so that the beneficiary of the separate IRAs was a separate trust for the benefit of a single beneficiary. The question presented to the IRS was whose life expectancy was to be used when determining the rate of distributions from the individual retirement accounts.

If separate accounts are established for the beneficiaries of a qualified plan or an IRA before December 31st of the year following the account owner's death, the Treasury Regulations indicate that distributions from each account can be based upon the life expectancy of the beneficiary of that separate account.

Example 3:

Willy Smart names his three children as the beneficiary of his IRA. Following Willy's death, but before December 31st of the year following his death, the IRA is divided into three separate IRAs on behalf of each of his three children. Each child may compute the required distribution from the account established on his or her behalf based solely on his or her age.

Given the foregoing, it would seem that if a trust is the designated beneficiary of a qualified plan or IRA, and the trust has more than one beneficiary, that each individual beneficiary's life expectancy could be used when determining the amount of the required distribution, so long as the IRA and the trust are divided into separate accounts within the timeframe required by the Treasury Regulations. However, this is not what the IRS indicated in the three private letter rulings referred to above.

Instead, the IRS concluded that in order to use the individual life expectancies of the various trust beneficiaries when determining the amount of the required minimum distribution required, each separate trust must be in existence on the date that the account owner dies, and the beneficiary designation form must include a formula for the division of the qualified plan or IRA among the separate IRAs. Accordingly, in each private letter ruling the IRS concluded that distributions from the IRA must be made based on the life expectancy of the oldest trust beneficiary.

Effects of Private Letter Rulings

How might these private letter rulings effect your personal estate planning? If you have named a trust for more than one person as either the primary or secondary beneficiary of your qualified plan account or IRA, and that trust has more than one beneficiary, these rulings (if upheld) could cause the rate at which the retirement account assets will have to be distributed following your death to be accelerated. As such, the greater the age discrepancy between the different beneficiaries of the trust, the greater the potential tax advantages that could be lost as a result of these rulings.

Fortunately, there are steps that you can take today to prevent this problem from arising tomorrow. In some cases an amendment to the trust which is designated as beneficiary may be required. In other cases all that will be necessary is a revision to the beneficiary designation to the retirement account in question.

If these rulings could adversely affect your estate planning, and you would like to discuss with us the best way to address this problem, please contact us to schedule an appointment. We would be pleased to meet with you.