IRA Issues and Other Estate Concerns

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Overview

The most recent IRS regulations substantially simplify rules for required minimum distributions (RMD) from IRAs.

1. There are new life expectancy tables that allow for smaller distributions over a longer period (see Tables attached).
2. The calculation of the RMD has been simplified.
3. Rules regarding separate accounts w/ different beneficiaries have been clarified.
4. There is more flexibility in changing beneficiaries and separating accounts for the heirs to retain more the tax-deferred nature of these investments.

When Must You Withdraw Assets from an IRA?

<u>IRA Owners</u>

A. ***When must you withdraw (RBD)*** 70 ½
What if you take out more than the RMD, will you get a credit for your next year RMD? No
What if you forget to take out your RMD? Penalty

B. ***Figuring your RMD*** – (See IRS Tables found at www.irs.gov – Publication 590)

$$\frac{\textbf{TOTAL VALUE}}{\textbf{DISTRIBUTION PERIOD (based on tables)}} = \textbf{MINIMUM DISTRIBUTION (RMD)}$$

1. ***Total Value*** is determined starting with the balance of all IRAs as of the close of business December 31st of the previous year PLUS all contributions or rollovers made in the previous year MINUS any distributions made in the previous year.

2. ***Distribution Period***: Which table do you use?
   Determining Age: Use the owner's oldest attained age for the year of distribution.
   When do you use a table other than Table III? When your spouse is much younger.

3. ***Minimum Distribution (RMD)***: Now that I know the RMD, when do I take it? Before 12/31

   Where do I take it from? Any IRA account

IRA Beneficiaries

A. When death of IRA owner occurs on or after RBD.

1. ***Surviving spouse as sole beneficiary***: The IRS permits a sole beneficiary spouse far more options than it does other beneficiaries. When the spouse is the sole beneficiary, the spouse has the following options
   a. Roll-Over the account to the surviving spouse's own account as owner
   b. Leave the account in decedent's name and take the account benefits as beneficiary

2. ***If the beneficiary or beneficiaries include individuals other than the spouse***, then the first required distribution is the calendar year following the year of the IRA owner's death. Using the Single Life Table (Table 1), the post-death distribution period used to determine the RMD is the longer of:
   a. The remaining life expectancy of the deceased IRA owner using the deceased's attained age in the year of death and subtracting one for each subsequent year after the date of death, or
   b. The remaining life expectancy of the IRA beneficiary using the beneficiaries' attained age in the year of death and subtracting one for each subsequent year after the date of death.
      i. The beneficiaries' remaining life expectancy is determined using the oldest beneficiaries' age as of their birthday in the calendar year immediately following the IRA owner's death OR for those accounts that were separated by the end of the year after the year of death, the age of each beneficiary. Where the beneficiaries include the spouse, account separation must be completed by Sept. 30 of the year following the year of death instead of year-end to take advantage of the spouse as sole beneficiary provisions.

3. ***If the beneficiary is not an individual,*** then Table 1 is used as it applies to the deceased owner of the IRA starting with the age of the decedent on his/her birthday the year of death reduced by one thereafter.

4. ***Five-year Option***: A beneficiary who is an individual may be able to elect to take the entire account by the end of the fifth year, following the year of the owner's death. If this election is made, no distribution is required for any year before that 5th year.

B. When death of IRA owner occurs before RBD.

1. ***Determine who is the beneficiary***. Generally, the designated beneficiary is determined on Sept. 30th of the calendar year following the year of death. In order to be a "designated beneficiary", an individual must be a beneficiary as of the date of death. Any person who was a beneficiary on the date of death, but is not a beneficiary on Sept. 30th in the year following death (because of splitting or disclaiming) will not be taken into account in determining the designated beneficiary. If a beneficiary dies before Sept. 30th, that deceased beneficiary continues to be treated as a beneficiary for determining the distribution period.

2. ***If the designated beneficiary is an individual***, and that individual is
   a. *Surviving Spouse* – the spouse has the same options as outlined above or if the surviving spouse is older than the deceased spouse, the surviving spouse could leave the ownership in the deceased spouse's name and withdraw as a beneficiary until the owner would have reached 70.5.
   b. *Other individual named* – You use Table 1 for distribution requirements which begin the year following the year of the owner's death.

3. ***If the designated beneficiary is not an individual,*** the entire IRA account must be distributed by the end of the fifth year following the year of death.

C. Miscellaneous Beneficiary Issues

1. ***Multiple Individual Beneficiaries***. If as of September 30th of the year following the year in which the owner dies there is more than one beneficiary, the beneficiary with the shortest life expectancy will be the designated beneficiary if both of the following apply:
   a. All of the beneficiaries are individuals, and
   b. The account or benefit has not been divided into separate account or shares for each beneficiary

   Separate Accounts: Separate accounts with separate beneficiaries can be set up at any time, either before or after the owner's required beginning date. As a general rule, the RMD rules separately apply to each account. However, the distribution period for an account is separately determined only if the separate account was set up by the end of the year following the year of the owner's death. This rule cannot be used by beneficiaries of a trust. Keep in mind that if one of these multiple individual beneficiaries is a surviving spouse, September 30th of the year following the year of death is the important date of separation to take advantage of the spouse as sole beneficiary provisions.

2. ***Non-Qualifying Trust, Estate and/or Charity as Beneficiary***. These beneficiaries must transfer their inherited IRA assets to an Inherited IRA Beneficiary Distribution Account (BDA). If the IRA owner died before his RBD, the distributions are made by December 31 of the fifth year following the year of the IRA owners death. If the IRA owner died after his RBD, the distributions are based on the remaining life expectancy of the IRA owner as if he/she were still alive.

Designating a Trust as Beneficiary of IRA Benefits

The most commonly asked question I encounter is whether or not to designate a Revocable Living Trust as the beneficiary of an IRA and what the tax consequences of doing so are. In the overwhelming majority of cases, it is my recommendation that a client name their spouse as the primary beneficiary of their IRA and name the Trust as the contingent beneficiary. Financial advisors frequently inform clients that by doing so the entire balance of the IRA will be taxable upon the owner's death. This is not the law, and it has not been the law for over 6 years.

The advantages of naming the trust as beneficiary, as opposed to naming the children directly as IRA beneficiaries include:

- The trustee can control the age of distribution to the beneficiaries. This is especially important with minor children, young adults or spend thrift heirs. (note that the taxable distribution occurs when the payment of the IRA is made to the trust, not when the trustee makes a distribution of the proceeds of the IRA to the beneficiary).

- The trust can define where any beneficiary's share will go if the beneficiary dies before receiving their entire share.

- Keeping a beneficiary's share in the trust can preserve its status as their sole and separate property.

- Keeping a beneficiary's share in the trust can protect it from creditors.

- To solve the underfunded Bypass Trust encountered frequently (see below).

The owner of an IRA may designate an individual, trust, estate or any other person as a beneficiary to receive the account balance on the death of the owner. The rules relating to trusts as "Designated Beneficiaries" changed substantially a few years ago. Until recently, if a trust was named as beneficiary of an IRA, the entire balance would be taxable in the year of the owner's death. That is because the general rule is that a trust does not qualify as a "Designated Beneficiary" for the minimum distribution purposes. That portion of the 1997 Internal Revenue Service's Regulations dealing with trusts as "Designated Beneficiaries" was revised significantly in January of 1998, and these revised requirements were carried over largely intact into the final Regulations issued by the Internal Revenue Service on April 16, 2002.

If satisfied, these new provisions allow the beneficiaries of a Living Trust that has been named as an IRA beneficiary to be treated as "Designated Beneficiaries," and defer the taxability of their distribution in exactly the same manner as if they were named as beneficiaries individually. Under the 1997 Regulations, these requirements had to be met as of the IRA owner's RBD and for all periods thereafter during which the trust is a plan beneficiary. Now, the final Regulations make clear that they need not be met until September 30, of the year AFTER the year of the IRA owner's death. The requirements are as follows:

1. The trust must be valid under State law;
2. The trust must either be irrevocable, or become irrevocable upon the IRA owner's death;
3. The trust beneficiaries who are beneficiaries with respect to the trust's interest in the IRA must be identifiable from the trust instrument; and
4. Either a copy of the trust instrument or a special affidavit must be filed with the Plan Administrator by October 31 of the year after the year of the IRA owner's death.

Note that for tax purposes, because the trust is being ignored and the trust beneficiaries are being considered when determining whether they are the Designated Beneficiaries, ALL of the trust beneficiaries must be individuals, as opposed to charities, businesses, etc. However, under the Final Regulations, the beneficiaries are determined as of September 30 of the calendar year following the calendar year of the IRA owner's death.

Just as when an IRA owner names multiple beneficiaries, if there is more than one trust beneficiary, and if requirements are met, then the beneficiary with the shortest life expectancy (the oldest beneficiary) will be the Designated Beneficiary for purposes of determining the minimum distributions. The Final Regulations make clear that the "separate account" rules are NOT available for trust beneficiaries.

The fact that a trust has been named as beneficiary DOES NOT result in the entire account being taxable upon the death of the owner. That would have been true under the old rules, that were first changed in January of 1998, and clarified under the 2001 rules. Accordingly, the trust beneficiaries shall be considered IRA beneficiaries upon the death of the owner, and the withdrawals to the trust shall be consistent with the legal requirements of withdrawals as if the trust beneficiary with the shortest life expectancy was the Designated Beneficiary for purposes of determining minimum distributions.

Lets review the payout options based on the trust beneficiary designated in the trust contract:

Spouse as primary and sole beneficiary of the Living Trust

1. ***If the owner dies before his RBD:***
    a. the IRA may be distributed by December 31 of the fifth year following the owner's death; or
    b. Distributions may be made to the trust over the life expectancy of the beneficiary/spouse. If distributions are to be made to a spouse beneficiary under the life expectancy method, the distributions must commence by the later of
        i. December 31 of the calendar year following the death of the IRA owner; or
        ii. December 31 of the calendar year in which the IRA owner would have attained age 701/2

2. ***If the owner dies after his RBD:***
   a. The trust must receive minimum distribution over the longer of
      i. The remaining life expectancy of the designated beneficiary/spouse; or
      ii. The remaining life expectancy of the deceased IRA owner
   b. The five year rule does not apply.

Non-Spouse individuals as primary beneficiaries of the Living Trust

1. ***If the owner dies before his RBD*:**
   a. the IRA must be distributed by December 31 of the fifth year following the owner's death; or
   b. Distributions may be made over the remaining life or life expectancy of the designated beneficiary commencing by December 31 of the year after the date of death

   Minimum distributions are calculated by taking the account balance on December 31 of the prior year, divided by the remaining life expectancy of the oldest beneficiary.

2. ***If the owner dies after his RBD*:**
   a. The five year rules does not apply.
   b. The maximum payout period is the longer of
      i. the remaining life expectancy of the designated beneficiary, or
      ii. the remaining life expectancy of the deceased IRA owner.

Note that if there is no designated beneficiary, and the owner died before his RBD, the balance must be distributed by December 31 of the fifth year following the death of the IRA owner. If the owner died after the RBD, the account balance must be distributed over the period of no longer than the remaining life expectancy of the IRA owner (rather than the life expectancy of the oldest beneficiary).

I do not normally recommend naming a trust as the primary beneficiary of an IRA if there is a living spouse. The surviving spouse should almost always be named the primary beneficiary with the trust designated as a contingent beneficiary because of the surviving spouse's opportunity to elect a Spousal Rollover and treat the distributions as an owner, rather than a beneficiary. By doing so, the surviving spouse can now:

- Delay receiving RMD until April 1 of the year following their attainment of age 70.5 (Taking as a beneficiary (and not an owner), the surviving spouse must commence receiving distributions by December 31 of the year following the death of the IRA owner or by December 31 of the calendar year in which the IRA owner would have attained age 70.5)

- Designate new beneficiaries for the IRA

- Make the payout period longer by becoming the owner rather than the spouse who takes as beneficiary.

A surviving spouse MAY NOT elect to treat the IRA as the surviving spouse's IRA if a trust is the designated primary beneficiary. This rule applies even if the surviving spouse is the sole beneficiary of the trust and receives distributions directly from the IRA.

If this is a second marriage and the IRA owner wishes for the IRA to be payable to the children as opposed to the second spouse, then I would not advise naming the spouse as the primary beneficiary.

Note also that if a primary beneficiary disclaims his or her benefits and the IRA passes to a trust as a result of either State law or the contingent beneficiary is the estate and through the decedent's Last Will a testamentary trust is created, the beneficiaries of the testamentary trust are not considered a "Designated Beneficiary" for purposes of the RMD. The lesson here is that one should NEVER name the estate (as opposed to the trust) as the contingent beneficiary because that will cause the account balance to be distributed as if the IRA owner had no designated beneficiaries.

In conclusion, I normally recommend that IRA owner's designate the spouse as the primary beneficiary and designate the trust as a contingent beneficiary for the best results. An increasing problem I encounter has to do with what is generally known as the Underfunded Bypass Trust issue. More and more of my clients have a larger portion of their estate value in IRA accounts. If that owner dies first, naming the surviving spouse as the beneficiary, all of those dollars will be included in the surviving spouse's taxable estate, and may result in the deceased spouse's Bypass Trust being grossly underfunded. This can result in significant Federal Estate Taxes due on the surviving spouse's death, even though the "AB Trust" allows each spouse to take advantage of the maximum amount that can pass free from Federal Estate Taxes. Consider this example:

> Let us assume that the current law that provides that the unified credit against taxation is $1 million for persons dying after 2010 remains in effect. Assume that we have a couple with a $2 million estate consisting of a home valued at $600,000, investments and savings valued at $600,000 and Husband's IRA valued at $800,000. They have created an AB Trust which allows each of them to take advantage of the $1 million exclusion. Husband dies first naming Wife as the primary beneficiary of his IRA. The trust assets consist of the house ($600,000) and the investments ($600,000) for a total of $1.2 million. Half of those trust assets will go into the Husband's Bypass Trust and the other half will go to the Wife's A trust. Since I almost always select the house for the Surviving Spouse's trust (to preserve the exclusion from capital gains taxes for sale of a primary residence owned two of the last five years), the house will go into Wife's A Trust and the investments ($600,000) will go into the Husband's Bypass Trust. Wife as beneficiary of Husband's IRA, does a Spousal Rollover. Husband's Bypass Trust is underfunded by $400,000. Wife's taxable estate is

now $1.4 million. Upon her death, only the first $1 million is excluded from taxes and the $400,000 excess amounts (that could have gone into Husband's Bypass Trust) is subject to taxes of $166,000.

If Husband named Wife as the primary beneficiary on the IRA and named the Trust as the contingent, then Wife could have disclaimed half of the Husband's IRA upon his death. If the Trust was named as contingent, then that $400,000 would roll over to a "look through" IRA account owned by the Bypass Trust. It would be includable in Husband's estate. The remaining half of the IRA would go into Wife's Spousal Rollover IRA account. In the "look through" IRA account held by the Bypass Trust, Wife is the measuring life for determining the RMD. She is the Trustee and she is the Beneficiary. She will control how much of the IRA she takes. She will manage the investments. But it will be includable in Husband's estate, which is now valued at $ 1 million. $1 million is exempt from taxation. Upon Wife's death, only the house and her half of the IRA is includable in her taxable estate, totaling $1 million. Since the first $1 million in each estate is exempt, there are no taxes at her death and we have saved the children $166,000.

Had Husband named Wife as the primary beneficiary and the children as the contingent, Wife probably would not have done the disclaimer, because that would have meant $400,000 of Husband's IRA being payable to the kids while mom is alive. Wife might need those dollars while she is alive, so it would not be my advise for her to make that kind of disclaimer.

Underfunded Bypass Trusts are one of the biggest problems I encounter in estates that I administer. Naming the spouse as the primary beneficiary and the Trust as the contingent beneficiary gives me a huge planning option which in most cases saves the family hundreds of thousands of dollars in Federal Estate Taxes.

COMMENTS AND NOTES