ESTATE PLANNING MATTERS

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"STRETCH-OUT TRUSTS" FOR RETIREMENT BENEFITS

Individual Retirement Accounts (IRAs) and other retirement assets such as 401(k) and 403(b) accounts always present a special challenge when it comes to estate planning. In addition to being subject to the estate tax, retirement assets are also subject to income tax. While other assets like homes, bank accounts, and investment assets pass to your heirs income tax free, a beneficiary of a retirement account will owe income tax on 100% of the amount inherited.

A nearly universal planning objective is to "stretch-out" the distribution of retirement funds for as long as possible, in order to minimize the income tax consequences. Money held within the "tax-deferred environment" provided by your retirement assets is a very valuable thing and it pays to maintain it for as long as possible.

For a married person, maximum income tax planning is obtained by naming the spouse as the beneficiary. A spouse can do something no other person can do – roll over the inherited benefits into his or her own IRA and let the money grow on a tax-deferred basis until he or she reaches age 70 ½, and then begin taking minimum required distributions over a 28-year period. But in some situations – see the Paul and Paula case below – there might be very good reasons why you might not want to leave all your retirement assets to your spouse.

If you want to leave your retirement assets to your children or others (as opposed to your spouse) or when it comes to designating contingent beneficiaries who would take in the event your spouse didn't survive you, the safest way to ensure the benefits of the maximum stretch-out is to name individual beneficiaries by name, rather than designating a trust as beneficiary. An individual beneficiary is always considered a "qualified beneficiary" under the IRS rules, and can elect to take incremental distributions of the account ("stretched out") over his or her life expectancy. This allows the beneficiary to keep the amount not withdrawn in the tax-deferred environment provided by the IRA for years and years, thereby minimizing the income tax and maximizing the value of the account.

However, there are many situations where a client may not (or should not) want to name his or her spouse, or another individual as an outright beneficiary of the retirement assets. One example would be a second marriage situation, where the client wants the spouse to receive a lifetime benefit, but wants his or her own children to receive the balance at the spouse's death. In such a situation, naming the spouse as a beneficiary could be disastrous. Consider the following scenario:

Paul was married to Paula for 30 years and they had two children, Ron and Rhonda. Paula died in 2005 and in 2010 Paul married Susan, who was a widow with two children, Sam and Sally. Among Paul's assets is an IRA worth $1,000,000. Suppose Paul would like Susan to get some of the IRA money if she needs it, but he wants whatever is left in the IRA account at Susan's death to pass to his two children – Ron and Rhonda. Paul's financial advisor and his accountant both have advised him that, for income tax purposes he should name Susan as beneficiary, because she could do a "spousal rollover" and get the maximum "stretch out." However, if he does that, then at his death the $1,000,000 IRA becomes the property of Susan. That means Susan will always retain the right and power to designate the IRA account beneficiaries as she desires. Obviously, this will raise the possibility (if not the likelihood) that Susan will thereafter name Sam and Sally - her own children – as beneficiaries and Ron and Rhonda will never see a penny of their father's $1,000,000 IRA.

So what could Paul have done to prevent this? He could have structured an IRA Inheritance Trust – either within his Revocable Living Trust or as a "Standalone IRA Inheritance Trust" and designated the trust (and not his spouse) as the beneficiary of the IRA account. If properly drafted, the trust would allow incremental "minimum required distributions" (based on the age of the spouse) to be made from the IRA to the trust each year. Upon Susan's death, the IRA funds would then be paid to Paul's children, and Susan would not have the ability to prevent that from happening.

Thus, it is possible to enable a surviving spouse to benefit from your large IRA (as beneficiary under a trust) without having the IRA pass to the spouse as owner. However, it must be noted that having a spousal trust as beneficiary means you will be giving up the "spousal rollover" option, which almost always will achieve a better result from strictly an income tax standpoint.

Additionally, where beneficiaries are under age or immature, or where the client wants to provide protection from creditors, lawsuits or failed marriages, a trust is necessary. Clearly, when your children are minors, a trust is imperative. But also note that if you know your child is irresponsible with money, and you want to avoid having your hard-earned retirement savings squandered, you wouldn't want to name him as beneficiary under your IRA because if you died that money would be his to do with whatever he wanted. Or if your daughter had creditor problems, naming her as beneficiary may result in your IRA going to her creditors and not to her.

The alternative is to have your IRA pass to some form of trust. The trust would provide that someone other than your child would be Trustee. The Trustee would be smart enough to know to take only the minimum required distributions, so as to preserve the tax benefits of the "stretch out." Of course, if there were some emergency or extraordinary need for more than the minimum distributions, the Trustee could take out more. The point is that someone you trust will be making the distribution decisions, rather than the irresponsible child.

For many years there has been widespread confusion over the ability to achieve the benefits of the “stretch out” of retirement benefits when a trust is named as beneficiary. However, it is beyond dispute and well established by IRS regulations and rulings that when properly structured under the so-called “trust rules”, a trust can qualify for stretch out treatment, thus preserving all of the tax benefits while also protecting those assets from being squandered or taken in a divorce or lawsuit.

There are some very important technical guidelines that must be followed in drafting a trust which is designed to be designated as a beneficiary under an IRA or other qualified retirement plan in order to comply with the “trust rules.” Thus it is imperative that you make sure the attorney who prepares your trust is well qualified and versed in those rules.

In addition, there is no question that designating a trust as beneficiary as opposed to an individual creates some additional complexities in administration in order to avoid a higher level of income taxation if not administered properly. However, in many cases the additional complexity is far outweighed by your ability to make sure your retirement assets are protected from those dangers discussed above.

The point is that it is important to know there are options to simply putting someone’s name into that beneficiary box when you designate beneficiaries under your retirement plan. A properly designed trust can help you take advantage of income tax planning benefits of the “stretch out” while also enabling you to better protect your hard earned retirement savings.