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TAX & TRANSACTIONS BULLETIN

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- U.S. Families have accumulated significant wealth in their IRA accounts
- Family goals are to preserve this IRA wealth
- Specific Family goals for IRAs include:
  - keep assets within the Family
  - protect assets from creditors
  - reduce income and estate taxes
  - avoid probate and guardianship proceedings
- A Family should carefully plan its IRA beneficiary designation
- The beneficiary designation controls distribution of all IRA monies after the Account owner's death
- The beneficiary designation may be specially drafted to accomplish Family goals

THE OPTIMAL BENEFICIARY DESIGNATION FOR THE FAMILY IRA AND 401(k)

Many U.S. Families have accumulated significant wealth in their Individual Retirement Accounts and 401(k) Plans (collectively "IRAs"). Family goals and objectives often focus on preserving this IRA wealth. Specifically, Family goals and objectives for IRA's include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate taxes; and (d) avoid probate and guardianship proceedings.

To accomplish these goals for IRA assets, a Family must carefully plan its IRA beneficiary designation. The beneficiary designation controls distribution of all IRA monies after the Account owner's death. With advance planning, a Family may design a beneficiary designation which accomplishes its goals.

A primary benefit of an IRA is that certain assets in the Account are exempt from bankruptcy creditors.[1] Another benefit of an IRA is that the Account owner may designate a Trust as beneficiary. Yet another benefit of an IRA is deferral of income tax until assets are distributed out of the IRA. Effective January 1, 2003, IRS issued[2] Final Regulations on the income taxation of Individual Retirement Accounts.[3] These Final Regulations allow Families additional opportunities to reduce both income tax and estate tax. With careful advance planning, the IRA owner may reduce tax on his Account and increase wealth for the Family.

The Final Regulations provide a highly-favorable "Life Expectancy Rule." Under this new Life Expectancy Rule, IRA cash distributions to each recipient are based on that recipient's remaining life expectancy. Unlike prior rules which required

[1]For bankruptcies filed after October 17, 2005, federal law generally provides the following exemptions: (a) an unlimited exemption for qualified retirement plans; and (b) a $1 million exemption for traditional IRAs and Roth IRAs. IRA assets above the $1 million ceiling are included in the bankruptcy estate. The $1 million ceiling, however, does not apply to rollovers from qualified retirement plans or to simplified employee pension plans. Account owners may want to keep separate their regular and rollover IRAs, since a rollover IRA from a qualified plan should have an unlimited exemption from bankruptcy. (See *The Bankruptcy Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 11 U.S.C.A. Section 522*). Additionally, Illinois law protects qualified retirement plans and IRAs from the claims of judgment creditors outside of bankruptcy. There is no ceiling on the Illinois protection from non-bankruptcy creditors, although there are exceptions for child support payments and other strong public policy matters (e.g. tax debts). See *735 ILCS 5\12-1006.*

[2]The Final Regulations were published in the Federal Register on April 17, 2002, and apply for calendar years beginning on or after January 1, 2003.

[3]The Final Regulations apply to individual retirement accounts, 401(k) plans, and all other defined contribution plans which maintain an individual account for the owner. These retirement vehicles are collectively referred to as "IRAs". Regulation 1.401(a)(9)-5 Q&A-1; 1.408-8 Q&A-1. (The Final Regulations do not apply to defined benefit plans which pay an annuity to the owner).

fast IRA payouts, the Life Expectancy Rule permits slower IRA payouts stretched over a longer period of time. Slow payouts reduce current tax liability and allow IRA principal to compound tax-free. The Life Expectancy Rule[4] thus favors growth of the IRA Account, which benefits the owner's entire Family.

Typically an owner will contribute to his IRA Account during his working years. After the owner attains age 70½, the IRA must begin making cash distributions to him.[5] The IRA will continue to make these payouts annually during the owner's lifetime. After the owner's death, the IRA must make payouts to the beneficiary. Although IRA principal grows tax-free, each cash distribution is taxable to the recipient. Income tax planning for IRAs thus focuses on reducing the annual payout. By reducing the payout and retaining principal within the IRA, tax liability is deferred and the Account compounds tax-free. The following examples illustrate planning techniques for the IRA beneficiary designation.

Example 1: Mom Elects to Treat Inherited IRA as Her Own. Assume Dad is age 70. Mom is 64. Child is 38. Grandchild is 2. Dad contributes to his IRA over much of his lifetime, and the Account grows to a value of $1 Million. In the year he attains age 70 ½, Dad must begin receiving cash distributions from his IRA. These mandatory cash payouts to Dad are favorably based on his remaining life expectancy. Dad designates Mom as primary beneficiary of his IRA. Dad's Revocable Trust is contingent beneficiary. When Dad later dies at age 72, Mom can rollover the IRA to <u>her own IRA</u>.

There are at least <u>four (4) major tax advantages</u> to Mom's rollover strategy. <u>First</u>, the IRA will qualify for the marital deduction and will pass to Mom free of estate tax. <u>Second</u>, Mom is not required to take distributions from <u>her own IRA</u> until she attains age 70 ½. Since Mom is only 66, she can defer income taxes on the IRA for over 4 years. <u>Third</u>, when Mom does attain age 70 ½, she must begin receiving cash payouts. However, Mom's required annual payouts as IRA owner are smaller than if she were a beneficiary, permitting additional tax deferral.[6] <u>Fourth</u>, as owner Mom can designate <u>new</u> beneficiaries for the IRA. For instance, Mom can divide her IRA into two (2) equal $500,000 Accounts. The first Account names Child as beneficiary. The second Account names Grandchild as beneficiary. After Mom's death, each IRA pays out over the life expectancy of its respective beneficiary.

[4]<u>During the Account owner's lifetime</u>, required distributions are made annually based on the <u>longer</u> of: (a) the joint life and last survivor expectancy of the owner and a hypothetical beneficiary ten (10) years younger; and (b) the joint life and last survivor expectancy of the owner and his spouse (in cases where the owner's sole designated beneficiary is his spouse and that spouse is more than ten (10) years younger than the owner). This distribution period is considerably longer than if based solely on the owner's remaining life expectancy. The Life Expectancy Rule thus permits slow IRA payouts over a long period of time. Regulation 1.401(a)(9)-5(A-4). <u>After the Account owner's death</u>, required distributions generally are made annually based on the remaining life expectancy of the beneficiary. Specifically, where the owner dies <u>before</u> his "required beginning date," required distributions are made annually based on the remaining life expectancy of the beneficiary. Regulation 1.401(a)(9)-5 Q&A-5(c)(1); PLR 200432027. Where the owner dies <u>after</u> his "required beginning date," required distributions are made annually based on the <u>longer</u> of: (a) the life expectancy of the beneficiary; and (b) the life expectancy of the owner. Regulation 1.401(a)(9)-5(A-5); PLR 200248030. Thus, the owner can designate a Grandchild as beneficiary and stretch IRA payouts over an extended period. Again, the Life Expectancy Rule permits slow IRA payouts over a long period of time.

[5]The IRA must make payouts due to the "required minimum distribution rules." These rules require that payouts begin on the owner's "first distribution calendar year," which is the year the owner attains age 70½. These payouts must continue to be made each year during the owner's lifetime. Although the owner may defer his first year's payout until April 1 of the calendar year following the calendar year in which he attains age 70½ (the owner's "required beginning date"), this deferral will cause two payouts in that following year, possibly affecting the owner's tax bracket. Regulation 1.401(a)(9)-5(A-1(b)).

[6]Required distributions <u>to the owner</u> are actuarially based on the joint life and last survivor expectancy of the owner and a hypothetical beneficiary ten (10) years younger. This distribution period is considerably <u>longer</u> than if based on solely the owner's remaining life expectancy. Contrarily, required distributions <u>to the beneficiary</u> are actuarially based on the beneficiary's remaining life expectancy (or the owner's life expectancy, if the owner was younger than the beneficiary). Regulations 1.401(a)(9)-5(A-4), and 1.401(a)(9)-5(A-5). [Stated differently, if Mom failed to rollover the IRA account, her payouts as a beneficiary would be larger and would accelerate income tax liability].

Example 2: Spousal Fractional Disclaimer of Inherited IRA to Fund Credit Shelter Trust. Assume Dad is age 70. Mom is 64. Son is 38. Daughter is 32. Dad's IRA is worth $4 Million on Dad's death. Dad designated Mom as primary beneficiary of his IRA. Dad's Revocable Trust is contingent beneficiary. Dad's entire estate consists of his IRA. If Dad's IRA is distributed entirely to Mom, then Dad will <u>fail</u> to use his $2 Million estate tax credit. Upon Mom's subsequent death, her estate may incur tax. To avoid this tax, Mom <u>disclaims</u> a fraction of the IRA.[7] The fraction equals $2 Million. The <u>disclaimer</u>[8] treats Mom as if she predeceased Dad. Therefore, a $2 Million IRA sub-account is distributed to Dad's Revocable Trust as contingent beneficiary. The Revocable Trust creates a "credit shelter trust."[9] The $2 Million IRA sub-account is distributed to this credit shelter trust.[10] The $2 Million IRA sub-account will make cash payouts[11] to the credit shelter trust.[12] Upon Mom's later death, the $2 Million IRA sub-account is <u>excluded</u> from her taxable estate. The family enjoys an estate tax <u>savings</u> of approximately $1 million.

The credit shelter trust also provides <u>non-tax benefits</u>. <u>First</u>, IRA payouts remain in the trust. Since trust assets are generally protected from creditors, Son or Daughter will retain these assets following divorce, bankruptcy, or adverse judgment. <u>Second</u>, if Son dies the trust can provide that Son's share of the assets are paid to his children. A standard IRA "form" beneficiary designation, however, might provide that all IRA monies are paid to Daughter as surviving beneficiary. By designating a trust as beneficiary of an IRA, Dad ensures that IRA proceeds are distributed according to his intended estate plan. <u>Third</u>, if IRA proceeds were distributed to an estate, or to an individual who is either a minor or incompetent, probate and/or guardianship proceedings might be required. By using a trust as beneficiary, Dad may avoid the extra fees and delays associated with probate and guardianship.

Example 3: Unmarried Person Maximum Income Tax Savings Strategy. Assume Mom is age 64 and unmarried. Son is 38. Grandchild is 8. Mom's IRA is worth $1 Million on her death. Mom designates Son and Grandchild as equal (½) primary beneficiaries of her IRA.[13] Following Mom's death, Grandchild can establish a separate $500,000 IRA in Mom's name f/b/o Grandchild. Grandchild's separate IRA would pay out over his own life expectancy.[14] Since Grandchild is only 8 years old when Mom dies, Grandchild's IRA will pay him cash each year for the next 75 years. Effectively, Mom has created a lifetime annuity for Grandchild.

There are several drawbacks to Mom's strategy of naming Son and Grandchild as outright beneficiaries. <u>First</u>, as beneficiary Grandchild may have the right to withdraw <u>all</u> funds from his IRA.[15] <u>Second</u>, if either Son or Grandchild dies, the IRA Custodian's standard "form" beneficiary designation may dictate who receives the deceased

[7] See PLR 8922036. See also PLR 200521033.

[8] The disclaimer must qualify under Code Section 2518. See PLR 8922036.

[9] The "credit shelter trust" is also known as the family trust. Its purpose is to receive assets equal to Dad's remaining estate tax credit upon his death. Assets in the family trust are <u>outside</u> of Mom's taxable estate, and thus <u>avoid</u> estate tax upon Mom's subsequent death.

[10] Division of the IRA into sub-accounts is generally an <u>income tax-free</u> event. PLR 200235038; Revenue Ruling 78-406.

[11] These payouts would generally be made over the life expectancy of the eldest beneficiary of the credit shelter trust, pursuant to the required minimum distribution rules. PLR 200432027; PLR 200235038. Mom may consider also disclaiming her beneficial interest in the credit shelter trust, which could permit IRA distributions to be paid over the life expectancy of Son. Since Son is considerably younger, annual IRA distributions would be much smaller resulting in income tax savings.

[12] The credit shelter trust can then distribute to its beneficiaries the IRA proceeds.

[13] Mom may prefer to divide her IRA into two (2) equal accounts while she is living.

[14] PLR 200248030.

[15] Under most IRA Custodian Agreements, the owner has the right to withdraw all monies from the IRA during his lifetime. After the owner's death, the beneficiary has the right to withdraw all monies from the IRA.

person's IRA. Mom's estate plan may be frustrated if she intended a different result. Third, the IRA's required distributions are made outright to Son and Grandchild, so there is no creditor protection for these dollars. Fourth, Grandchild is a minor, so that probate and/or guardianship proceedings may be required.

Mom may use Trusts to eliminate these drawbacks. Trusts generally ensure that beneficiaries may withdraw funds only upon attaining prescribed ages, that Mom's intended distribution pattern is respected, that inherited dollars receive protection from creditors, and that probate and/or guardianship will be avoided. In short, designating a Trust as IRA beneficiary often helps accomplish Family goals and objectives.[16]

Example 4: Dad Designates QTIP Marital Trust for 2nd Wife as Beneficiary of his IRA. Assume Dad is age 70. Dad has children from prior marriage to 1st Wife who is deceased. Dad is currently married to 2nd Wife with whom he has no children. Dad's IRA is worth $3 Million. Dad wants to provide income for 2nd Wife during her lifetime. Upon 2nd Wife's death, Dad wants the principal to be distributed to his children. Dad does not want 2nd Wife to consume the principal. Dad wants to minimize income and estate tax. Therefore, Dad's Revocable Trust creates a QTIP Marital Trust ("QTIP Trust") for 2nd Wife.[17] The QTIP Trust satisfies all of the following requirements:[18]

1. Dad executes a beneficiary designation naming the "QTIP Marital Trust" as beneficiary of his IRA.[19]
2. 2nd Wife has the right (directly or through the trustee of Trust) to compel the investment of the IRA in assets productive of a reasonable income;
3. The QTIP Trust requires the trustee annually to withdraw all income from the IRA and to distribute to 2nd Wife at least that income;[20]
4. The IRA document does not prohibit withdrawal from the IRA of amounts in excess of the annual required minimum distribution amount under Code Section 408(a)(6);
5. Under QTIP Trust's terms, all income is payable annually to 2nd Wife for her lifetime;[21]
6. Under QTIP Trust's terms, no person has the power to appoint any part of Trust principal to any person other than 2nd Wife during her lifetime;

[16] For income tax purposes, however, it may be difficult to have Grandchild's IRA pay out to a Trust for Grandchild over his favorable life expectancy. The IRS has not yet fully endorsed such a technique. See PLR 200228025; Regulation 1.401(a)(9)-5 Q&A 7(b),(c).

[17] Dad's Revocable Trust also creates a Family Trust for 2nd Wife and his children. Dad's Family Trust will be funded with Dad's additional assets equal to his Tax Credit of $2 Million. These additional assets are allocated to the Family Trust because they are rapidly appreciating, and Dad wants to eliminate all estate tax on them at both his and 2nd Wife's death. Contrarily, the IRA is allocated to the Marital Trust because it will not rapidly appreciate (due to the requirement to pay minimum distributions annually, which increases the tax/compliance/administration costs), and therefore the estate tax on the IRA – which is merely deferred until 2nd Wife's death – will be comparatively less than if the rapidly appreciating assets were allocated to the Marital Trust. Furthermore, since IRA will not rapidly appreciate, and since 2nd Wife's estate tax credit will apply on her subsequent death, the estate tax on the IRA may be reduced or even eliminated. [Note: the allocation of assets to the Family Trust and Marital Trust, respectively, is case specific and depends on many factors.]

[18] By satisfying each requirement, the IRA qualifies for the marital deduction under Code Section 2056(b)(7), which defers estate tax until the death of 2nd Wife. Furthermore, 2nd Wife's Tax Credit will apply on her subsequent death, meaning that the estate tax on the IRA may be reduced or even eliminated. *See Revenue Ruling 2006-26.*

[19] These same principles which apply to an IRA also apply to naming the QTIP Trust as beneficiary of Dad's interest in some other qualified retirement plan described in Code Section 4974(c) that is a defined contribution plan. *See Revenue Ruling 2006-26.*

[20] Alternatively, 2nd Wife may be granted the power, exercisable annually, to compel the trustee to withdraw from the IRA an amount equal to all income of the IRA for the year and to distribute that income to her.

[21] The income of the IRA, and the income of Trust excluding the IRA, are determined separately and without taking into account that the IRA distribution is made to Trust. In order to avoid any duplication in determining the total income to be paid to 2nd Wife, the portion of the IRA distribution to Trust that is allocated to trust income is disregarded in determining the amount of trust income that must be distributed to 2nd Wife. *See Revenue Ruling 2006-26.*

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7. 2nd Wife has the right to compel the trustee to invest the (non-IRA) Trust principal in assets productive of a reasonable income;
8. On 2nd Wife's death, Trust principal is to be distributed to Dad's children, who are younger than 2nd Wife;
9. Under the Trust Agreement, no person other than 2nd Wife and Dad's children has a beneficial interest in Trust (including any contingent beneficial interest);
10. The trustee of QTIP Trust elects to receive annual required minimum distributions over a distribution period equal to 2nd Wife's life expectancy;[22] and
11. The executor of Dad's estate files a QTIP Election to treat both the IRA and Trust as QTIP.[23]

This strategy permits Dad to accomplish the following goals and objectives: (1) Dad provides income from IRA for 2nd Wife during her lifetime; (2) upon 2nd Wife's death, all principal of IRA is allocated to Dad's children; (3) 2nd Wife cannot consume IRA principal; (4) Dad minimizes income tax by paying IRA distributions over 2nd Wife's life expectancy; and (5) Dad minimizes estate tax by carefully allocating assets to his QTIP Marital Trust and Family Trust, respectively.

[22] Based on the Single Life Table in A-1 of Reg. 1.401(a)(9)-9, using 2nd Wife's age as of her birthday in the year immediately following Dad's death, reduced by one for each calendar year that elapses after such year. On 2nd Wife's death, the required minimum distributions with respect to any undistributed balance of the IRA will continue to be calculated in the same manner and be distributed to Trust over the remaining distribution period. [Note: both 2nd Wife, and Dad's children as remainder beneficiaries, must be taken into account as designated beneficiaries in order to determine the shortest life expectancy and whether solely individuals are designated beneficiaries. If an entity (e.g. a Charitable Organization or an Estate) is a current or a contingent beneficiary, then the required distributions may be accelerated.]

[23] Dad's executor must make a QTIP Election for both the IRA and the Marital Trust. *See Revenue Ruling 2006-26.*

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