Estate Planning for IRAs & Qualified Plans

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Keebler & Associates, LLP
Outline

• Foundation Concepts
• 401(a)(9) Regulations
• Estate Planning Issues
• Stretch Out IRAs
• Paying IRAs to Trusts
• IRA-ILIT Strategy
• Charitable Planning with IRAs
Foundation Concepts

Importance of Planning

- Federal Estate Tax, 40%
- Federal Income Tax, 24%
- Net to Family, 36%
Foundation Concepts

Importance of Planning

- Maximize use of Unified Credit (where needed)
- Maximize use of GST Exemption (where needed)
- Coordinate estate plan under will or revocable trust
- Generally, the IRA or qualified plan is the largest asset of the estate
- To minimize income tax on distributions and thereby maximize deferral
Foundation Concepts

Disposition After Death

• Beneficiary designation form, as opposed to a will, controls the property owner after death.
• State property law preempted by ERISA or REA
• Income tax consequences will vary substantially depending how the beneficiary form is completed.
Estate Planning Issues

Disclaimer Planning

• Disclaimer must be “qualified.”
  • In writing
  • Within 9 months
  • No acceptance of the interest or any of its benefits,
  • Interest passes without any direction on the part of
    the person making the disclaimer

• A disclaimer of plan benefits or IRA is neither a
  prohibited assignment or alienation. GCM
  39858.

IRC § 2518
Estate Planning Issues

Disclaimer Planning - Example

• Alex dies at age 70. Alex’s wife disclaims amount of Alex’s unified credit to bypass trust for benefit of herself and their children
  • Disclaimer must occur within nine months from date of death
  • Disclaimer must be served to the IRA custodian
  • Disclaimer must be fractional to avoid immediate income taxation
Estate Planning Issues

Disclaimer Planning - Example

- Disclaimer must be Qualified Disclaimer
- Life Expectancy of Oldest Beneficiary of Trust

Spouse Disclaims

Spouse Disclaims Again

Trust FBO of Spouse & Children

IRA

Trust FBO Children
Stretch Out IRAs

“Inherited” IRA

**Objective**: Prolong IRA payments over longest possible period of time, thus increasing wealth to future generations
TRADITIONAL IRA DISTRIBUTION FLOWCHART

SPECIAL NOTE
Pursuant to §629 of the Pension Protection Act of 2006, beginning in tax years after December 31, 2006, non-spousal qualified retirement plan beneficiaries (e.g., children, siblings, friends, etc.) will be permitted to make trustee-to-trustee transfers from qualified retirement plans to Inherited IRAs.

Is the IRA owner living?

Yes → Is the spouse the “sole beneficiary”? → Yes → Is the spouse more than 10 years younger than IRA participant?

→ Yes → Calculate using Joint and Last Survivor Table

No → Calculate using Uniform Lifetime Table

No → Spouse

→ Rollover or inherited IRA?

→ Spouse

→ Trust

Trust by disclaimer

Did owner die before RBD?

→ Yes → Children or grandchildren by disclaimer

→ No → Children or grandchildren

→ Charity

→ Estate

Did you create separate accounts by Dec. 31st of year following the year of death?

→ Yes → Life expectancy of each beneficiary

→ No → Life expectancy of oldest beneficiary

→ Rollover (take RMD, if applicable, then go to step one treating survivor as new owner)

→ Inherited IRA

→ Possible life expectancy of each beneficiary if separate trust share is in existence on the date that a person dies and the BDF specifically names each separate share as beneficiary. See PLR 200537044.

→ Were separate shares created by Dec. 31st of year following the year of death?

→ Yes → Remaining life expectancy of decedent as of death based on Single Life Table

→ No → Life expectancy of oldest beneficiary OR the owner’s life expectancy if the owner is younger than the oldest trust beneficiary

Please email us for more information on this chart and for other education products: contactus@keeblerandassociates.com

Stretch Out IRAs

“Inherited” IRA

• An IRA is treated as “inherited” if the individual for whose benefit the IRA is maintained acquired the IRA on account of the death of the original owner.

• Under the tax law the IRA assets can be distributed based upon the life expectancy of the beneficiary.

IRC Sec. 401(a)(9)
Stretch Out IRAs

“Inherited” IRA

- Post-death RMDs based on whether a “designated beneficiary” exists:
  - Only “individuals” with quantifiable life expectancy can be “designated beneficiaries”
  - If trust qualifies, look through to underlying trust beneficiaries
  - Distribution out of trust to beneficiary does not make the beneficiary the “designated beneficiary”
Stretch Out IRAs

“Inherited” IRA

• Permissible “designated beneficiaries:”
  • Individuals
  • Certain Trusts

• Non-permissible “designated beneficiaries:”
  • Estates
  • Distribution out of estates to estate beneficiaries does not make the beneficiary the “designated beneficiary”
  • Charities
  • Most Trusts
  • LLCs
Stretch Out IRAs

“Inherited” IRA

• Two Strategies
  • Spousal Rollover
  • Inherited IRA
Stretch Out IRAs

401(a)(9) Regulations

• Post-death critical questions:
  • Did the participant die before his RBD?
  • Is the spouse the sole beneficiary?
  • Are there multiple beneficiaries?
  • Are all beneficiaries “designated beneficiaries”?
  • What does the IRA/qualified plan allow?
# Stretch Out IRAs

## 401(a)(9) Regulations

<table>
<thead>
<tr>
<th>Designated Beneficiary</th>
<th>Death Before Required Beginning Date</th>
<th>Death On or After Required Beginning Date</th>
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<tbody>
<tr>
<td><strong>Life Expectancy Rule</strong></td>
<td></td>
<td><strong>Life Expectancy Rule</strong></td>
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<tr>
<td><strong>Non-Designated Beneficiary</strong></td>
<td><strong>Five-Year Rule</strong></td>
<td><strong>Owner’s “Ghost” Life Expectancy Rule</strong></td>
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</tbody>
</table>
Stretch Out IRAs

Key Issues in Making It Work

- Beneficiary Designation Forms
- Tax Apportionment
- Irrevocable Life Insurance Trust (ILIT)
Stretch Out IRAs

Common Mistakes to Avoid

• Incorrect titling
• Failure to take RMDs
  • Before death
  • Year of death
  • After death
• Failure to utilize disclaimers when appropriate
• Failure to analyze contingent beneficiaries when utilizing disclaimers
• Taking a lump-sum distribution
Stretch Out IRAs

Common Mistakes to Avoid

• Spousal rollover before age 59 ½
  • Will cause pre-59 ½ distributions to be subject to the 10% early distribution penalty. *Sears v. Commissioner*, TC Memo 2010-146.
  • If no rollover occurred, pre-59 ½ distributions can be taken penalty free.

• Solution
  • Do not perform spousal rollover until spouse reaches age 59 ½.
Stretch Out IRAs

“Inherited” IRA - Case Study

• **Benefits**
  
  • Effectively shows the additional wealth generated by naming a qualified designated beneficiary of an IRA
  
  • Provides a framework as to how to structure the IRA Trust
  
  • Serves as a guide for post-mortem distributions
Stretch Out IRAs

“Inherited” IRA - Case Study

• Scenarios
  • Immediate distribution
  • IRA payable to non-qualified beneficiary (five-year rule)
  • IRA payable to surviving spouse (no spousal rollover)
  • IRA payable to surviving spouse (spousal rollover)
  • IRA payable to child
  • IRA payable to grandchild
Stretch Out IRAs

“Inherited” IRA - Case Study

• Assumptions
  • IRA owner’s age - 65
  • Spouse’s age – 60
  • Child’s age – 35
  • Grandchild’s age - 10
  • IRA balance - $1,000,000
  • Brokerage account balance - $0
  • Pre-tax growth rate – 8%
  • Ordinary income tax rate – 40%
  • Capital gains tax rate – 20%
# Stretch Out IRAs

**“Inherited” IRA - Case Study**

**Summary**

<table>
<thead>
<tr>
<th>Year</th>
<th>Immediate Distribution</th>
<th>IRA Payable to Non-Qualified Designated Beneficiary (i.e. 5-Year Rule)</th>
<th>IRA Payable to Surviving Spouse (No Spousal Rollover)</th>
<th>IRA Payable to Surviving Spouse (Spousal Rollover)</th>
<th>IRA Payable to Oldest Non-Spousal Beneficiary</th>
<th>IRA Payable to Youngest Non-Spousal Beneficiary</th>
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<tr>
<td>2007</td>
<td>$643,200</td>
<td>$1,080,000</td>
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<td>$1,948,200</td>
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<td>2021</td>
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<td>2026</td>
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</table>
Paying IRAs to Trusts

Naming a Trust as a “Designated Beneficiary”

An IRA Can Be Payable to a Trust

IRA

Beneficiary Designation Form

Trust

IRA distributions over the life expectancy of the oldest beneficiary

Spouse

Children
Paying IRAs to Trusts

Benefits of Utilizing a Trust

• Spendthrift protection
• Creditor protection
• Divorce protection
• Special needs
• Investment management
• Estate planning
• “Dead-hand” control
Paying IRAs to Trusts

*Four Requirements for ALL Trusts*

1. Trust is valid under state law
   - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(1)

2. Trust is irrevocable upon death of owner
   - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(2)

3. Beneficiaries of the trust are identifiable from the trust instrument
   - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(3)

4. Documentation requirement is satisfied
   - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(4)
Paying IRAs to Trusts

Two Types of Trusts

- Accumulation Trusts
- Conduit Trusts
- Treas. Reg. § 1.401(a)(9)-4, Q&A 5 requirements apply to both types
Paying IRAs to Trusts

Separate Share Rule

Payable to single trust

No separate shares identified in the beneficiary designation form

IRA paid over oldest life expectancy
Paying IRAs to Trusts

*Separate Share Rule*

- IRA payable to multiple trusts
- Each trust named in beneficiary designation form
- IRA paid over each separate trust beneficiary’s life expectancy
Paying IRAs to Trusts

Revocable Living Trust as a “Designated Beneficiary”

• Problems
  – Proper apportionment language regarding payment of debts, expenses and taxes of estate (See PLR 9820021).
  – Recognition of income in respect of a decedent (IRD) if pecuniary funding clause is utilized.
  – Unanticipated loss of designated beneficiary due to the inclusion of power of appointment (general or limited).
  – Recent problems with custodians allowing the “in-kind” assignment of IRAs to subtrusts.

• Solution – stand-alone IRA trust such as “IRA Legacy Trust.”
Paying IRAs to Trusts

Revocable Living Trust as a “Designated Beneficiary”

• Revocable trust should use a fractional funding clause to determine the marital and bypass shares – PLRs in which pecuniary funding clause utilized and no IRD acceleration issue (PLRs 199912040, 9808043, 9744024).
## Paying IRAs to Trusts
### Protection Against Claims of Creditors

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<tbody>
<tr>
<td>Child</td>
<td>Estate(^3)</td>
<td>Typical Revocable Trust</td>
<td>Stand Alone Revocable IRA Trust</td>
<td>SubTrusts Under Stand Alone Trust</td>
<td>Irrevocable Trust</td>
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</table>

<table>
<thead>
<tr>
<th>Subject to claims of beneficiary’s creditors</th>
<th>YES</th>
<th>YES</th>
<th>NO</th>
<th>NO</th>
<th>NO</th>
<th>NO</th>
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<td>YES</td>
<td>YES(^1)</td>
<td>YES(^1)</td>
<td>Possibly NO(^2)</td>
<td>NO</td>
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</tbody>
</table>

\(^1\) Depends upon state law, however, see Commerce Bank v. Bolander, 2007 WL 1041760 (Kan. App. 2007) unpublished.

\(^2\) By naming a SubTrust that is irrevocable you may avoid the reach of the Commerce Bank Doctrine.

\(^3\) If the Estate is the Beneficiary and an outright distribution follows, then the IRA is subject to the claims of both sets of creditors.
Paying IRAs to Trusts

Common Mistakes to Avoid

- Older or unidentifiable contingent beneficiary
- Estate as contingent beneficiary
- Powers of appointment
- Failure of beneficiaries clause
- Failure to provide trust document to custodian by October 31 of year following year of death
- Making lump sum distribution to trust
- Tax issues
- Asset protection issues
IRA-ILIT Strategy

*Inherited IRA “Tax Spiral”*

**ISSUE:** Perhaps the single biggest issue with an inherited IRA is that the IRA owner’s estate oftentimes needs to utilize the IRA to pay the applicable estate tax liability. The payment of the estate tax using IRA funds, in turn, causes additional income tax to be incurred at higher income tax rates. As a result, between 60% to 80% of IRA could be lost to taxes. (This is known as the “Inherited IRA Tax Spiral”.)
IRA-ILIT Strategy

Inherited IRA “Tax Spiral”

- Federal Estate Tax, 40%
- Federal Income Tax, 24%
- Net to Family, 36%
IRA-ILIT Strategy
Inherited IRA “Tax Spiral”

- **SOLUTION**: Establish an Irrevocable Life Insurance Trust (ILIT) to hold a life insurance policy whereby the death benefit proceeds can be used to provide liquidity to the IRA owner’s estate, thereby preserving the inherited IRA.
IRA-ILIT Strategy

*Irrevocable Life Insurance Trust (ILIT)*

- To the extent that the grantor’s estate has insufficient liquid assets cover the estate tax liability, trust assets can be lent to the estate or used to purchase assets from the estate.

- To the extent that the grantor does not hold any “incidents of ownership”, none of the trust assets will be included in his/her taxable estate.
IRA-ILIT Strategy

IRA-ILIT Strategy - Overview

IRA Owner (Insured) → ILIT (Beneficiary) → Life Insurance Company

Annual gifts to cover life insurance premiums

Discretionary distributions of income and principal during the lifetime of the trust’s beneficiaries

Assets outside of the taxable estates of beneficiaries

Payment of premiums

Payment of death benefit proceeds at death of insured

Children

* NOTE: Gifts to the ILIT will use IRA owner’s annual gift exclusion and/or lifetime gift exemption.
IRAs Payable to Charity

**Basic Overview**

- Available Options to Transfer IRD Assets of Charity
  - Name the charity as the designated beneficiary of the assets
  - Specific Bequest of IRD assets to charity under a will
  - Power of Executor to make a non-pro rata distribution to Residuary Beneficiaries
  - Assignment of IRD to charity of satisfy a Pecuniary Bequest
  - Recognition of income with § 642(c) charitable deduction
  - Recognition of income without § 642(c) charitable deduction
IRAs Payable to Charity

Basic Overview

§ 642(c)(1) General rule

In the case of an estate or trust, there shall be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c)
IRAs Payable to Charity

Basic Overview

§ 642(c)(2) Amounts permanently set aside

there shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c)

*Applies only to estates – not to trusts funded later than 1969

See the remainder of the statute for details.
Charitable Planning with IRAs

**CRT - Conceptual**

- **Taxpayer**
- **Highly appreciated assets**
- **CRT**
- **For life or a maximum fixed term of 20 years**
- **Charity**
- **At taxpayer’s death or end of fixed term**
Charitable Planning with IRAs

**CRT Comparison**
Charitable Planning with IRAs

**Taxation of CRTs**

- The CRT is a tax-exempt trust
- Tax on the income attributable to assets held in the trust is deferred until distribution.
- Distributions to beneficiaries are taxable to the beneficiary under IRC §664
- IRC §664 provides the **Tier Rules**
Charitable Planning with IRAs

Tier Rules

Step 1: Current Income
Step 2: Accumulated Income
Step 3: Current Capital Gain
Step 4: Accumulated Capital Gain
Step 5: Current Tax-Exempt Income
Step 6: Accumulated Tax-Exempt Income
Step 7: Return of Principal

 Tier Rules

Tier 1: Ordinary Income
Tier 2: Capital Gain Income
Tier 3: Tax-Exempt Income
Tier 4: Principal
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