



The Wealth Counselor

A monthly newsletter for wealth planning professionals

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Planning for Tax-Qualified Plans

Planning for tax-qualified plans, which includes IRAs, 401(k)s and qualified retirement plans, requires a careful examination of the potential taxes that impact these assets. Unlike most other assets that receive a "basis step-up" to current fair market value upon the owner's death, IRAs, 401(k)s and other qualified retirement plans do not step-up to the date-of-death value.

Therefore, beneficiaries who receive these assets do so subject to income tax. If the estate is subject to estate tax, the value of these assets may be further reduced by federal and perhaps state estate tax. And if your clients name grandchildren or younger generations as beneficiaries, these assets may additionally be reduced by the generation-skipping transfer tax at the highest federal estate tax rate. All told, these assets may be subject to 70% tax or more.

There are several strategies available to your clients to help reduce the impact of these taxes and to ensure that these assets meet each client's unique planning objectives. This issue of The Wealth Counselor examines some of the more common planning alternatives for tax-qualified plans, as well as the advantages and disadvantages of each.

Structure Accounts to Provide the Longest Term Payout Possible

Structuring tax-qualified plans to provide the longest term payout possible is the most common option. With this strategy your clients name beneficiaries in a way that requires the beneficiaries to withdraw the least amount possible as required minimum distributions (those distributions that the beneficiaries must take in order to avoid a 50% penalty).

Frequently, married clients name the surviving spouse as the primary beneficiary so that the survivor may roll over the account into his or her name and treat the account as his or her own. The surviving spouse then names younger beneficiaries for stretch-out purposes.

To achieve the maximum "stretch-out," your clients should name beneficiaries who are young (e.g., children or grandchildren, although there are special considerations when naming grandchildren or younger generations). The younger the beneficiary, the smaller the required minimum distributions. To achieve maximum income tax deferral, beneficiaries should take only their required minimum distributions.

Your clients can accomplish this strategy by naming the beneficiaries individually. Alternatively, if your clients are concerned about the loss of creditor or divorce protection that occurs when they name beneficiaries outright, they can name a beneficiary's share of a trust as the designated beneficiary of their tax-qualified plans.

Planning Tip: Structuring tax-qualified accounts for maximum "stretch-out" makes sense from an income tax perspective. However, naming a beneficiary outright may subject the account to the beneficiary's creditors or former spouse upon divorce. Consider naming a trust as designated beneficiary to ensure that the account passes to the client's intended beneficiaries and in the manner intended by the client.

Name a Retirement Trust as Beneficiary to Ensure the Longest Term Payout Possible

Naming a beneficiary outright to accomplish tax deferral with a tax-qualified plan has several disadvantages. First, if the beneficiary is very young, the distributions must be paid to a guardian; if the beneficiary has no guardian, a court must appoint one. Another disadvantage is the potential loss of creditor protection or bloodline protection, particularly where the named beneficiary is the surviving spouse.

A third, practical disadvantage is that many beneficiaries take distributions much larger than the required minimum distributions. In fact, studies show that beneficiaries consistently consume this "found money" in only a couple of years regardless of the amount in the account or the age of the beneficiary.

However, by naming a trust as the beneficiary of tax-qualified plans, your client can ensure that the beneficiary defers the income and that these assets remain protected from creditors or a former son- or daughter-in-law. A stand-alone retirement trust (separate from a revocable living trust and other trusts) can further help ensure that it accomplishes your client's objectives while also ensuring the maximum tax deferral permitted under the law. This trust can either pay out the required minimum distribution to the beneficiary or it can accumulate these distributions and pay out trust assets pursuant to the standards your clients set in advance (e.g., for higher education, to start a business, etc.)

Planning Tip: Consider naming a stand-alone retirement trust as beneficiary of tax-qualified plans to ensure that the account passes not only in the manner intended by the client, but while achieving maximum stretch-out if that is the client's objective.

Planning Tip: Naming a trust as beneficiary also ensures consistent account management - in the manner desired by the client, using the client's advisors - oftentimes over generations.

Give the Accounts to Charity at Death

Another relatively simple option is for your clients to name a charity as a designated beneficiary at their death or at the death of their survivor, if married. This strategy is particularly attractive for those clients who intend to make gifts to charity at death and the question is simply what assets should they select. As a tax exempt entity, a qualified charity does not pay income tax and therefore receives the full value of tax-qualified plans.

In other words, if the client's beneficiary is in a 35% tax bracket, a \$100,000 IRA is worth only \$65,000 in his or her hands, but is worth the full \$100,000 if given to charity. Therefore, it makes economic sense for clients to give these assets to charity and give to their beneficiaries assets that are not subject to income tax after death.

Planning Tip: Naming a charity as beneficiary of a tax-qualified plan is particularly attractive for clients who intend to make gifts to charity at death and the question is simply what assets should they select.

Planning Tip: By purchasing life insurance owned by a Wealth Replacement Trust, clients can give beneficiaries the full value of a tax-qualified plan in a manner that is free from income and estate tax, and protected from creditors and predators.

Take Lifetime Withdrawals, Buy an Immediate Annuity (plus Wealth Replacement Insurance)

Another option is for your clients to withdraw their IRA or qualified plan and purchase an immediate annuity, which will generate a guaranteed income stream during their lives (or during their joint lives if married). Your clients can use this income stream to pay the income tax caused by the withdrawal, and also pay the premiums on life insurance owned by a Wealth Replacement Trust.

This strategy makes the most sense if your clients are in good health and are able to obtain life insurance at reasonable rates. Unlike with an IRA or retirement plan, the beneficiaries will receive the life insurance proceeds from the Wealth Replacement Trust free of income and estate tax and, under certain circumstances, free of generation-skipping transfer tax.

Alternatively, it may make sense to use other assets to purchase the immediate annuity, saving the IRA for family members. This alternative strategy makes the most sense when your clients can name a very young beneficiary, thereby deferring the income tax on the IRA or qualified plan for many years.

Planning Tip: For clients who desire a steady and known income stream, an annuity purchased with a lump-sum withdrawal from a tax-qualified plan can meet those objectives.

Planning Tip: In many instances, the annuity income will provide additional cash flow sufficient to purchase life insurance that can replace or increase what would have passed to the beneficiaries.

Take Lifetime Withdrawals, Gift Remaining Cash through Life Insurance Trust

Another option for your clients is to take the money out during their lifetime and pay the income tax, then gift the remaining cash either outright via lifetime giving or, better yet, through an Irrevocable Life Insurance Trust. If your clients desire to make the gifts through an Irrevocable Life Insurance Trust, this strategy makes the most sense when they are in good health and able to obtain life insurance at reasonable rates. Unlike the IRA or retirement plan, the beneficiaries will receive the life insurance proceeds free of income and estate tax and, under certain circumstances, free of generation-skipping transfer tax.

Planning Tip: By using withdrawals from a tax-qualified plan to purchase life insurance owned by a Wealth Replacement Trust, clients can pass the full value of the assets to their beneficiaries in a protected manner undiminished by income tax.

Name a Charitable Remainder Trust as Beneficiary

Yet another option is for your clients to name as beneficiary of the accounts a Charitable Remainder Trust, a type of trust specifically authorized by the IRS. These irrevocable trusts permit your clients to transfer ownership of assets to the charitable trust in exchange for an income stream to the person or persons of their choice, typically the client's spouse with tax-qualified plans. The term can be for life or for a specified term of up to 20 years.

The survivor receives income that will help maintain his or her lifestyle should the income stream from other assets be insufficient. At the survivor's death, the property passes to charity.

This strategy defers income tax until the survivor receives each income payment; there is no tax at the initial transfer to the trust. This strategy can also help reduce estate taxes for those clients subject to the estate tax.

With this option, your clients fund the Charitable Remainder Trust upon death. Therefore, it is only at death or incompetency that this aspect of the estate plan becomes irrevocable, giving clients the option to make changes in the future if their circumstances change.

Planning Tip: Naming a Charitable Remainder Trust as beneficiary of a tax-qualified plan can provide a steady income stream to a surviving spouse in a tax-deferred manner. Since the assets ultimately transfer to charity, this strategy also provides a charitable deduction for those clients subject to estate tax.

Give Up to \$100,000 from IRAs Directly to Charity in 2007

For clients who are at least 70 1/2 years of age, it may also make sense for them to transfer up to \$100,000 from IRAs to charity in 2007 to satisfy their charitable contributions. If the contribution is made by direct transfer from the IRA custodian to a public charity (for example, religious organizations, colleges and universities, etc.), the client need not report the distribution as taxable income. In other words, unlike a typical IRA distribution, the distribution will not appear as taxable income on the client's income tax return. However, because the distribution does not appear as income, the client will not get an offsetting charitable income tax deduction to reduce the income created by the IRA distribution.

Planning Tip: Giving up to \$100,000 from IRAs directly to charity is particularly attractive for clients who intend to make gifts to charity in 2007 and the question is simply what assets should they select.

Conclusion

These are only a few of the more common planning solutions for tax-qualified plans. The right solution for your clients will depend upon their particular goals and objectives as well as their particular circumstances.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.