IRA BENEFICIARY TRUSTS: To Stretch or not to Stretch?

BY BEN KINIRY, ESQ.T

No, the title is not referencing a question for your exercise routine, rather a retirement planning tool you should be utilizing to protect the next generation from themselves and others. The tool is called an **IRA Beneficiary Trust** and may be one of the best investments you will ever make for your loved ones.

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RETIREMENT PLANS

In modern times, retirement plan savings make up a larger percentage of a retiree's portfolio than any other time in history. This is due in part to significant tax benefits provided by such plans. By "Retirement Plan" I mean an account that is subject to the minimum distribution rules (RMDs) of section 401(a)(9) of the Internal Revenue Code, such as 401(k) and IRA plans.

REQUIRED MINIMUM DISTRIBUTIONS AND THE TAX STRETCH

If you have such a retirement plan, then you must take required minimum distributions (RMDs) starting in the year after you attain the age of 70 ½ years or face severe penalties. These RMDs are based on your life expectancy under the uniform lifetime table and the amount of your retirement plan holdings at the end of each calendar year. For example, under the uniform lifetime table a 72 year old has a divisor (looks like a life expectancy) of 25.6 and given $100,000 account balance as of December 31 of the prior year is required to take a RMD of $3,906.25. It is important to note that these accounts are not available to most creditors, such as those involved in a bankruptcy (these assets are available for the purposes Medicaid, a fact that shocks many of my clients).

Like any asset in your portfolio, you should have named a beneficiary to receive the retirement account upon your death and, as you can imagine, there is another set of rules that apply to the RMDs of the named beneficiary (for the sake of brevity this article does not discuss the complex issue of the "designated beneficiary" rules).

Upon your death, your named beneficiary has the right to request all funds in the retirement plan be distributed to him over a relatively short period of time, such as one to five years. If your named beneficiary chooses the short period pay out, then she will incur a substantial tax bill and, at the same time, be giving up substantial tax deferred (or tax free) growth. Unfortunately, a very high number of retirement plan named beneficiaries (perhaps as high as 80%) are giving up the Tax Stretch option as well as the compounding of interest. This is a result that, in my opinion, you should find rather upsetting, especially given that your named beneficiary may very well need the inherited retirement income for their own retirement security.

The ***smart tax option*** is for the named beneficiary to ***receive the RMDs over his life expectancy*** and thereby continue the tax deferred status of the retirement account. When an individual defers the taxes over many years, the growth can be significant. Following is an example from Fidelity Investments: Should you leave your 45 year old beneficiary the sum of $100,000, with a given life expectancy of 38.8 years (pursuant to the appropriate table) and assuming a 7% rate of return and a 25% federal tax bracket, as well as reinvestment of income dividends and capital gains distributions, would result in the following: 10 years - $145,760; 20 years - $275,889; 30 years; $508,006; and 40 years – $905,958. This example illustrates the power of tax deferral and compounding of interest over a beneficiary's lifetime.

We can imagine why some of these named beneficiaries are not taking advantage of the Tax Stretch. I'm sure many would state they "need" the money now due to life circumstances. We all know that "need" is a relative term. There are, of course, many other possibilities. Perhaps the named beneficiary is not sophisticated enough to understand the financially devastating decision they are making or is a spendthrift and couldn't wait to get his hands on *your money* to buy an expensive car, truck, boat, cruise… (honestly, how would finish this sentence?). Another possibility is the pressure from an overbearing spouse to cash it in for immediate gratification (after all it is not your child that is doing the spending, it's that person they married). Unfortunately, we are all aware of the problems of drug and substance abuse, as well as gambling, in our society.

Whatever the rationale, we all can agree that in many cases it isn't necessary and ***the financial cost of taking early distributions is way too high***.

A GOLDEN OPPORTUNITY: RETIREMENT TAX STRETCH/ ASSET PROTECTION TRUST

In my opinion, one of the best planning opportunities in recent times is the use of a Retirement Tax Stretch/Asset Protection Trust (a.k.a. IRA Trust). I don't say this as an Elder Law Attorney, rather as an individual who understands the time value of money and the instant gratification credit card society we live in.

These are revocable trusts (mostly) that you set up during your lifetime, in which you name the trust, rather than your child, as the beneficiary of all or a portion of your retirement account. For example: "50% to Abraham Lincoln, as Trustee of the Retirement Benefit Trust for George Washington."

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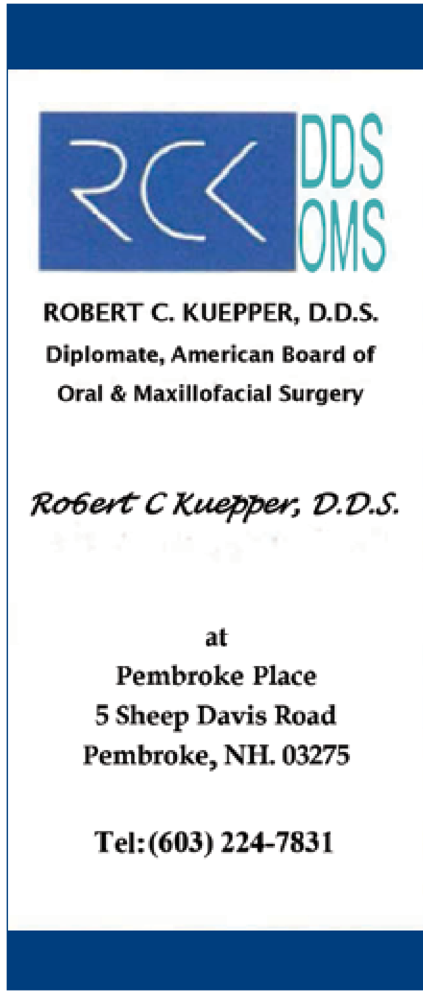
These trusts have two significant points of value that will help you sleep at night: *Tax Stretch and Asset Protection*.

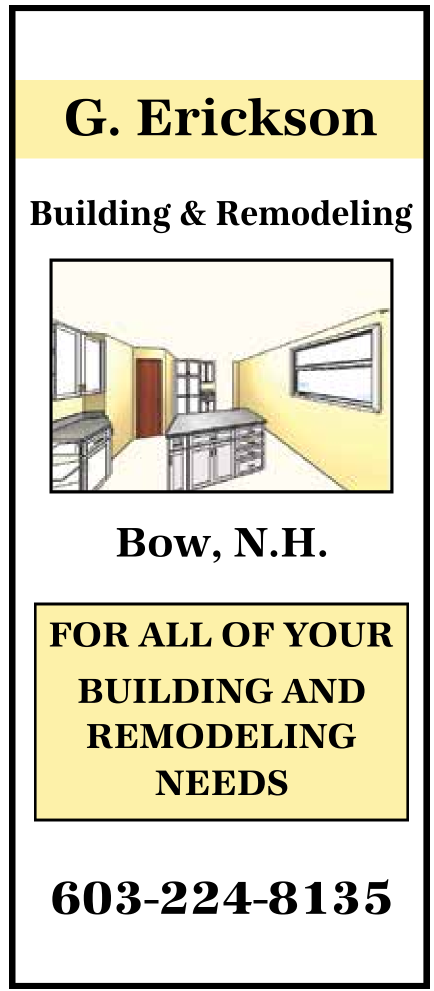
IN REGARDS TO ASSET PROTECTION, if you should choose to name your child directly, then the retirement plan will be owned by him. If your child has, or develops, a creditor issue then the account is available to such creditor. The most common creditor example is divorce, in which case approximately one-half of what was your retirement savings (the security you wanted to benefit your child with) now belongs to your ex-son or daughter-in-law. In contrast, if you should choose to name a properly drafted Retirement Tax Stretch/Asset Protection Trust as the beneficiary of your retirement plan, your child would NOT be the owner of the inherited retirement plan and therefore the funds held by the plan should not be available to your child's creditors. Did you just get goose bumps?

MY CHILD WILL ACT TAX SMART

In the case of a child who you firmly believe will make the tax smart decision and elect to take the RMDs over his life expectancy, you would still be wise to set up such a plan involving such trust in order to gain the asset protection element, unless you believe that your child will never get divorced, be sued, file for bankruptcy or have other creditor issues.

I urge you to come hold a conversation with me and learn more about this powerful planning tool, once you truly understand the long term security and value these trusts provide, you will be glad you did.





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