



## Inside-Out IRA Estates

By Robert L. Moshman

Over the past 10 to 15 years, Individual Retirement Accounts (IRAs) have become super-sized in a growing number of estates. When large pools of wealth accumulate in an IRA, there are competing income and estate tax consequences that will influence how those funds will be distributed.

But super-IRAs raise additional issues. What may initially be assessed as a benign passage of assets outside of the probate process may result in the majority of an individual's wealth passing outside of the supervision of the executor and the testamentary guidelines of the IRA owner's will. This can turn a traditional estate plan inside out.

What is causing these super-IRAs? Based on the current contribution and distribution rules, will they continue? What strategies should be considered?

### The Way Things Were

For most of the 20th century, the stock market was neither attractive nor accessible to individuals. The Dow Jones industrial average peaked at 386 in 1929. After the stock market crashed, it took 25 years for the market to recover. It was not until 1966 that the Dow reached 1,000, but that proved to be a psychological barrier around which the market wavered until 1982.

Prior to that time, those determined to invest did not have the benefit of discount brokers, online information, or mutual funds. The family home was the biggest asset in most households.

Meanwhile, retirement benefits during most of the 20th century were typically for corporate executives. Any retirement benefits an individual had were small and precious enough to be entirely excluded from estate tax. Then, in 1974, ERISA ushered in the era of retirement plan inclusion.

"Top-heavy" retirement plans favoring upper management were restricted. Participation rules were democratized. Subsequent laws placed the means of retirement plan participation directly in the hands of individuals with 401(k) plans and SEPs for small-business owners.

Individual Retirement Accounts (IRAs) were liberalized in 1981. By 1986 alone, there were \$40 billion of deductible contributions. By 1990, total IRA assets had reached \$637 billion. This had grown to \$2.3 trillion by the end of 2002, down from a peak of \$2.7 trillion at the peak of the stock market in 1999.

In 1970, there were about 360 mutual funds with \$48 billion of assets. In 1980 there were about 600 mutual funds. Today, there are more than 8,200 funds. There are 53.3 million households investing in mutual funds. They held about 80% of the assets invested in these funds or about \$5.5 trillion of the \$6.9 trillion invested as of 2000. In March, 2004, the total assets in mutual funds reached \$7.5 trillion.

Granted, some of those trillions have been swelled by several decades of inflation, including several years with double-digit inflation: 1973, 1974, 1979, and 1980. The generational flow of some \$10 trillion of assets from the Greatest Generation to the Baby Boomers has also begun. Economists will want the global economy and greater productivity through technology to be given their due in this discussion as well.



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So where does that leave us? With a great deal of personal wealth being invested in stocks and mutual funds held in IRAs and other retirement accounts. By the end of 2001, the U.S. retirement market had reached \$10.9 trillion, \$2.4 trillion of which consisted of mutual funds. IRAs are owned by 45.2-million households (36.4-million households owned traditional IRAs with median amount of \$30,000). Some \$1.9 trillion is invested in 401(k) accounts for 42 million workers. (Sources: Investment Company Institute, Federal Reserve Board.)

## Supersizing The IRA

Although contribution limits for traditional Individual Retirement Accounts were increased from \$2,000 per year and now are at \$3,000 (or more if qualifications are met), that alone certainly doesn't explain the phenomenon of super IRAs. It is the happy confluence of several factors that are at work here.

- Given enough time, tax-deferred growth of assets is exponential
- Assets distributed from other retirement plans end up being rolled over into IRAs to extend the time that they can remain sheltered from taxation.
- IRA owners will exhaust other resources rather than withdraw assets from a tax-sheltered retirement plan.

After enough time, an estate can be left with a house and a giant IRA. With so much emphasis on the IRA, estate planners should study this wild animal with great care.

## The Modern IRA

Contributions for traditional IRAs are \$3,000 for 2004. Contribution limits will be raised to \$4,000 in 2005 and to \$5,000 in 2008. A "catch up" contribution of an additional \$500 may be made by qualified persons who are age 50 or older for 2004 through 2005, and by \$1,000 in 2006 and thereafter.

Roth IRAs have comparable contribution limits, but they are preferable as long-term tax shelters. Roth IRA contributions are made with after-tax dollars and do not qualify for an income tax deduction. Over time the Roth will catch up and surpass the traditional IRA. Roth distributions are not subject to income tax while distributions from a traditional IRA certainly will face income tax.

Other retirement plans have higher contribution limits. The Simple IRA contribution limit for 2004 is \$9,000 (with a \$1,500 catch-up provision for those who qualify), but that amount rises to \$10,000 (with a \$2,000 catch-up) in 2005 and so remains far higher than the IRA. A company's 401(k) plan's contribution limits are \$13,000 (with a \$3,000 catch-up provision) for 2004 and then rise to \$14,000 (with a \$4,000 catch up) in 2005 and so on.

Distributions must begin when a plan participant turns 70 ½ and must be received by April 1 of the following year. There are some critical rules and terms of art to be aware of.



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Example: Marv owns an IRA worth \$500,000. Marv was born November 3, 1934. He will turn 70 on November 3, 2004. He will turn 70 ½ on May 2, 2005. That is his "required beginning date," or RBD. Therefore, he turns 70 ½ in 2005. He must receive his first retirement plan distribution for 2005 on April 1, 2006. Subsequent distributions must be made each year by December 31. So for 2006, Marv must receive his distribution by December 31, 2006.

Mandatory distributions must be at least as large as the Required Minimum Distribution (RMD), an amount based on the life expectancy of the beneficiary. To reduce the size of the RMD, IRA participants took advantage of the former rules by having multiple beneficiaries, including grandchildren or younger people with longer life expectancies.

Distributions that are too small will be penalized. Failure to make sufficient distributions, i.e., distributions smaller than the RMD, are subject to an excise tax of 50% on the amount that should have been distributed.

Techniques for extending distributions over longer periods of time have been limited in number by the establishment of regulations establishing a Uniform Lifetime Table that is generally beneficial. The table sets the same life expectancy for all IRA owners of the same age. Where a spouse is named as beneficiary, the new rules utilize a hypothetical spouse who is no more than 10 years younger than the plan owner.

With higher contribution limits and the Uniform Lifetime Table allowing smaller distributions in general, super-IRAs will continue to grow larger than ever.

## Strategic Responses

Although there is now less maneuverability in naming beneficiaries in an effort to minimize distributions as a result of the Uniform Tables, this is a positive development that has actually given IRA owners greater lifetime freedom to change beneficiaries without affecting the required distributions.

**Testamentary Intentions:** Where an estate is becoming lop-sided with the majority of wealth being concentrated in an IRA, the most obvious concern is the testamentary plan, i.e., the IRA owner's intentions for how his or her wealth will be inherited, supervised and used.

**Tax Impact:** Although IRAs are superb vehicles for the accumulation of wealth, as a general rule it is better not to die with them; they are not well equipped to soften the double blow of income tax and estate tax.

*Example:* If a traditional IRA with \$1 million is taxed at a top income tax rate of 35% and is then subjected to a top estate tax rate of 47%, more than two-thirds of the IRA will be lost to taxation and the beneficiary will receive \$344,500. Several measures can be used to avoid this result.

**Charitable Gifts:** If possible, a pool of revenues that would otherwise be subjected to significant taxation should be utilized to fulfill the testator's charitable bequests. A charitable gift of IRA assets would keep those assets free of income tax and out of the taxable estate for estate tax purposes. It is



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advisable to use separate trusts to isolate IRA funds that are to be used for charitable purposes from those that are not.

**Earlier Payouts:** Once assets are distributed from an IRA and subjected to income tax, there are opportunities to transfer them to beneficiaries utilizing the annual gift tax exclusion. Funds could also be used to finance a child's college education. Because the distribution of IRAs is controlled by the terms of the IRA contract, the language of the beneficiary designations on the IRA needs to be amended. But note the restrictions on payouts. The rules are designed to have retirement funds last throughout retirement. In the case of an enormous IRA, it may not be possible to distribute appropriate amounts in an accelerated manner; advance planning and distributions over a number of years may be necessary.

**Tax Apportionment:** Note the impact on the estate's liquidity when large tax liabilities from assets that pass outside of the estate are involved. Will IRA assets be available to the executor of the estate? Which assets will be used to pay the taxes on IRA assets? These are issues to be dealt with prior to death while the will and IRA contract can still be amended.

**Trust Benefits:** With so many assets concentrated in an IRA, all of the goals and benefits of trust planning make a compelling case to make one or more trusts beneficiaries of the IRA. But beware of the potential adverse effect on the taxation of IRA distributions.

## Many Possibilities

The phenomenon of large IRAs will only continue. Recognizing the potential for a super-IRA to develop in a given estate is the most important first step. Understanding an IRA owner's testamentary objectives can then guide the selection of appropriate strategies.

## No Discount of Retirement Accounts

Because the distribution of retirement accounts to decedent's beneficiaries would trigger large income tax liabilities, the estate sought a 30% valuation discount. The District Court reviewed this matter of first impression and applied a "willing buyer/willing seller" analysis of Reg. §20.2031-1(b).

The Court determined that a willing buyer would not take the potential income tax liability into consideration. The retirement accounts were valued based on the market value of the securities within the accounts. *Smith Estate, DC Tex., 2004-1.*

## Trusts as IRA Beneficiaries

Several important issues arise when an IRA's beneficiary is a trust. When is it appropriate to look through the trust? Who are the beneficiaries for purposes of establishing life expectancies to determine the minimum required distribution amounts? A series of recent Letter Rulings has provided some guidance (though not to be relied upon as legal precedent).

A 63-year-old IRA owner was survived by three children, B, C, and D. His IRA's beneficiary was trust



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"T." The trust instructs the trustee that upon the death of the Grantor, the trust is to pay expenses of a last illness and burial and to pay any probate expenses and estate taxes that exceed the probate estate.

The trust names the Grantor's three children as beneficiaries. The trustee proposed dividing the IRA into three sub-IRAs for the three beneficiaries. Each of the three beneficiaries applied for a Letter Ruling from the IRS.

Under Code §408(a)(6), the minimum required distribution rules of §401(a)(9) apply to the interest of an individual for whose benefit the trust is maintained. Under §401(a)(9)(B), the IRA must be distributed within five years of the employee's death. However, an IRA interest for a beneficiary can be distributed over the life expectancy of the beneficiary. Would those rules apply where the IRA interest passes through a trust?

Yes. The criteria are established by Question 5 of Reg. §1-401(a)(9)-4. The trust must be valid under state law, the trust is irrevocable (or becomes irrevocable upon the death of the employee/owner), the beneficiary is identifiable, and documentation of the trust has been provided to the plan administrator.

Here, the criteria for a pass-through trust were met, all estate administration costs required from the trust had already been paid by September 30 of the year following the year of death. The payments from the trust for estate administration were made before the beneficiaries of the trust were designated. Therefore, the estate was not a beneficiary of the trust and the three beneficiaries were treated as the sole beneficiaries of the trust for purposes of minimum distribution rules. However, the separate account rules of Reg. §1-401(a)(9)-8 did not apply. Therefore, minimum distribution rules apply to the trust beneficiaries, but all of the beneficiaries would have to use the life expectancy of the eldest beneficiary, i.e., with the shortest payout. *Letter Rulings 200432027, 200432028, and 200432029.*

## Conclusion

It is possible to carefully draft a trust that can accomplish multiple goals, such as payment of estate administration expenses while still qualifying individuals as the sole beneficiaries of the trust after that date for purposes of applying the minimum distribution rules. However, it required prompt action on the part of the trustees to satisfy these obligations prior to the beneficiary designation date to avoid having the estate as a beneficiary of the trust. And the IRS is not bound by prior Letter Rulings. A safer course of action is to create separate trusts from the outset. This would isolate the source of payments to the estate and establish separate beneficiaries, each with his or her own life expectancy and required distribution schedule for each of the trusts. Note also that in the situation discussed, the trust terminated at the employee's death. The children could have been named as beneficiaries of the IRA directly.

In other circumstances, designation of a trust as an IRA beneficiary may backfire if the primary beneficiary dies. This approach may also not be desirable if it prevents an IRA from being rolled over to a surviving spouse. Naming a trust as an IRA beneficiary remains a complex endeavor that should be executed with great care.



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