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The Home Stretch

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By Philip J. Kavesh

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A new IRA beneficiary trust maximizes the income tax stretch-out while protecting beneficiaries

There's a boom on its way: over the next 20 years, the money now in company retirement plans that will roll over into IRAs may very well exceed the total amount now invested in the stock market, according to Ed Slott, the IRA expert. This represents a huge opportunity for financial advisors to assist in managing large investment assets.

Proper IRA investing will be more important than ever due to recently issued IRS required minimum distribution (RMD) rules. The new rules expand the period over which the IRA owner and his spouse may take RMDs, and greatly lengthen the period over which a non-spouse beneficiary (such as a child) may take RMDs after the owner's death. A non-spouse beneficiary may now stretch out RMDs over his own life expectancy. For example, under the old law, if Dad died and Mom rolled over his IRA into her own name and then died at age 76, her beneficiaries would have had to withdraw the entire IRA and pay all the taxes in as little as six years—her remaining life expectancy. Now, if a beneficiary is age 38, she may stretch out the RMDs over her life expectancy of about 46 years. This new stretchout of RMDs results in longer tax-deferred compounding inside the IRA and much greater potential family wealth accumulation.

The results of proper RMD stretchout are staggering. Let's assume Mom is age 65 and has a total of \$250,000 in her IRA, including any money she rolled over from her deceased spouse or from her own company retirement plans. Let's also assume that, over time, she enjoys 8% annual growth of the account. At age 70½, the account will be worth about \$396,000. If she begins taking minimum distributions at age 70½, the IRA will continue to grow because the RMD is only about 4%. When she passes away at age 80, the IRA inherited by her son is worth about \$541,000, despite his mother's RMDs. If that child is age 45 and annually takes only the required minimum distribution, by the time he is 80 he will have taken RMDs totaling about \$2.9 million but will still have over \$700,000 remaining in the IRA to potentially pass down to the next generation (the original owner's grandchildren). In other words, Mom's original \$250,000—with proper RMD and investment planning—may be worth over \$3.5 million to her family over time.

Many parents, and their financial advisors, believe that merely naming the children as IRA beneficiaries is sufficient to assure the stretchout. They assume the children will properly take only RMDs (and use other inherited assets if they need more), or expect the children will seek the assistance of the parents' financial advisor to make sure the stretchout happens. However, as an estate planning attorney, I've handled thousands of estates and found that many beneficiaries unfortunately decide to cash out the inherited IRA earlier than required, and blow the stretchout entirely.

When such a "blowout" occurs, it can be a huge family disaster. In the above example, if the 45-year-old

child cashes out the IRA in one year, about one third of the future value of that account to the family—\$1.5 million—will be lost.

Problems With a Trust as Beneficiary

One solution to the problem is to use a trust as beneficiary instead of the IRA being paid directly to individual beneficiaries. The trustee could then assure proper stretchout of RMDs. However, even if a stretchout is not a major concern, there are a number of other estate and financial planning reasons why using a trust as IRA beneficiary makes good sense.

For example, a trust may provide the individual beneficiary with greatly enhanced protection against loss of the inherited IRA to a spouse after a divorce; protect against the beneficiary's own poor spending habits or money management skills; and may preserve a beneficiary's needs-based government benefits, such as supplemental or disability income and Medicaid. A trust may also reassure the original account owner that the right people will eventually inherit his IRA assets, rather than simply allow the owner's (or the beneficiary's) surviving spouse to pass them on to a future spouse or children of another marriage. Finally, a properly structured trust may provide generation-skipping benefits so the IRA will not be estate taxed when passed down from child to grandchild.

Unfortunately, the IRS rules make it difficult for a trust to take advantage of the maximum stretchout based on each trust beneficiary's life expectancy. Should the trust fail to meet these rules, the IRS may force all trust beneficiaries to use the shortest life expectancy (of the oldest beneficiary) or even cash out the entire IRA in just 5 years.

Typically, in order for a trust to qualify for the maximum stretchout period for each individual beneficiary, RMDs must be immediately distributed from the IRA to the trust and then to each beneficiary. This may not appear to be a problem. However, when a trust is named as the IRA beneficiary and the trust is later divided into shares payable to more than one beneficiary—as is often the case—the IRS has denied maximum stretch-out for each. Furthermore, there may be, either now or in the future, a number of situations when protection is more important for a beneficiary than income tax stretch-out—such as when a beneficiary is undergoing a divorce or other lawsuit, is a spendthrift, or is receiving needs-based government benefits. It makes more sense in these circumstances to accumulate RMDs in the trust. Unfortunately, the IRS has said that if any secondary or contingent trust beneficiaries who may receive this accumulation are older than the primary beneficiary, the oldest life expectancy will need to be used, significantly reducing the stretchout.

Attempting to determine at the time a trust is created whether any particular beneficiary will have a greater need for income tax stretchout or protection years later when the IRA owner dies is at best only a guess and could prove wrong. A beneficiary may have no currently foreseeable asset protection problems, so immediate distribution of RMDs may seem appropriate. But what if that beneficiary later has a divorce, a lawsuit, or needs government benefits? On the other hand, a beneficiary who no longer has these issues will not want IRA distributions locked up in a trust, where they also may be subject to higher income taxes.

A Solution: the IRA Inheritance Trust

Some people have attempted to solve this problem by including special language in a client's living trust. From a technical standpoint, however, this greatly risks the loss of stretchout, and from a practical standpoint, it makes it much harder for a custodian to read, understand, and implement the trust.

My solution to the problem is a new type of standalone IRA beneficiary trust that has been federally service mark registered as the IRA Inheritance Trust. This Trust qualifies as a designated beneficiary trust (using a specially designed beneficiary designation form) so that each primary beneficiary may utilize his or her own life expectancy and maximize the income tax stretchout of RMDs. Second, this maximum stretchout may be obtained, in most cases, whether or not the primary beneficiary receives immediate distribution of RMDs or the money is accumulated in the Trust for protective purposes. Third, the trust attorney and financial advisor no longer must determine in advance which is better for any particular beneficiary—stretchout or protection—because the Trust builds in the flexibility after the IRA owner's death to determine whether a payout or accumulation trust best fits the needs and situation of each individual beneficiary.

I've successfully implemented this trust after an IRA owner's death, and it has been approved by the IRS in a Private Letter Ruling published September 16, 2005.

How the Client Benefits

The benefits of this approach can be summarized for a client in two words: stretchout and protection. The trust may help assure the income-tax stretchout, thereby maximizing family wealth accumulation. In addition, it can provide greatly enhanced protection for the client's beneficiaries against divorce, lawsuits, creditors, loss of government benefits, and additional estate taxes when the remaining IRA is passed down to the next generation.

Participants in 401(k) and other company retirement plans should be counseled about the benefit of rolling that money over into IRA accounts in order to have their non-spouse beneficiaries take maximum advantage of the income-tax stretchout (otherwise, those plans often force distribution in five years or less). If a client seeks to maximize potential family wealth accumulation through the IRA stretchout, the IRA investments should be reviewed and possibly repositioned to emphasize growth, even after the client retires. Variable annuities with both living benefit and enhanced death benefit safety features may be particularly attractive investment vehicles. Life insurance planning may also be warranted. The client may name grandchildren as IRA beneficiaries in order to maximize the stretchout even further—using their longer life expectancies—and the client's children can receive the insurance proceeds as a replacement of sorts. Finally, the client's IRA planning should be properly integrated with his overall estate plan and the attorney involved should be qualified to design, draft, and implement the IRA Inheritance Trust.

As a general rule of thumb, this Trust is appropriate if the client (and his or her spouse) has around \$200,000 or more in IRAs—including company plans that will be rolled over into IRAs—and you assume the client's beneficiaries will outlive him by at least 10 to 15 years.

Philip J. Kavesh, J.D., LL.M., CFP, ChFC, is an estate planning attorney in Torrance, California. He can be reached at phil.kavesh@kaveshlaw.com.

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