

# Estate planning strategies for your IRA

One of the major goals in estate planning is to minimize taxation, allowing you to leave as much as you can to your loved ones.

Planning in today's environment is especially difficult. Why? Because estate tax law changed in 2001 and could change again. Congress voted to repeal the tax, but only for people who die in 2010. Until then the amount exempt from federal estate tax will grow slowly to \$3.5 million. And still it gets more complex, with a drift downward in tax rates from 55% to 45% in 2009. In 2011 the estate tax exemption falls back to \$1 million, unless Congress acts before then.

## **Distribution rules**

By following the rules for payout and beneficiary designation, along with alternatives available to IRA owners, individuals with large balances can use one or both of the following key strategies: (1) passing on the undistributed portion of a traditional IRA to a spouse tax free (through the use of the "marital deduction") or (2) passing all gains to their heirs completely free from income tax through conversion of an IRA to a Roth IRA.

Distribution rules for IRAs are the starting point. Traditional IRA owners must begin taking a distribution from their plans by April 1 following the year that they turn age 70 1/2. To help keep as much money as possible in an IRA, the IRS provided a minimum distribution table that takes life expectancy into account. If the surviving beneficiary is a spouse who is more than ten years younger than the IRA owner, the joint life expectancy of both spouses is used. The point is that these solutions minimize taxable income when you do not need it and have the opportunity to achieve more gains prior to death.

Of course, IRA funds withdrawn by an owner or a beneficiary are taxed at normal rates with no preferential rates for capital gains. It may occur to some owners upon retirement simply to cash out the entire balance of the traditional IRA and invest in a way that alleviates heirs' responsibility for any federal income tax.

## **The Roth IRA alternative**

The Roth IRA is one of the best vehicles for tax-smart investment and estate planning. Because Roth IRAs only have been available since 1997, it is unlikely that balances are at sufficient levels for those near retirement to provide a lifetime income and an inheritance to pass on.

However, those with significant balances in traditional IRAs can convert (i.e., transfer or roll over) such funds to a Roth IRA. The conversion privilege is limited to those whose adjusted gross income doesn't exceed \$100,000 (whether single or married filing jointly). Income tax is due on the conversion, and it should be paid from sources outside the IRA for the strategy to make the most financial sense. Also, the conversion to a Roth IRA may be staged over a number of tax years. When the funds are safe inside the Roth IRA, there is no need for the owner to take any unwanted distributions during life.

The annual contribution limit to a Roth IRA will increase to \$5,000 by 2008 (\$3,000 in 2003 and 2004), with cost-of-living adjustments thereafter. The contribution limits for higher-income taxpayers are phased out between \$95,000 and \$110,000 for single filers, and between \$150,000 and \$160,000 for married persons filing jointly.

## **Who's the beneficiary?**

*Traditional IRAs:* If a spouse is the sole beneficiary upon the IRA owner's death, he or she may roll over the funds to his or her own IRA. Distributions will be made as if the spouse owned the IRA. Spouses also may name their own beneficiaries.

When the spouse is not the sole beneficiary, or when a nonspouse beneficiary is named, distribution will occur over a period not to exceed the beneficiary's single life expectancy. The first life expectancy factor used is the age of the beneficiary in the year following the year of death, reduced by one for each subsequent year.

*Roth IRAs:* When spouses are the sole beneficiaries, no distribution need be taken at all. In all other cases, payout is required within five years of the Roth IRA owner's death, or over the single life expectancy of the beneficiary, provided such method begins by December 31 of the year following the year of death.

*Trusts as beneficiaries:* Trusts named as beneficiaries generally must be valid under state law, benefit a living person, and be irrevocable at death. It also is wise to name the trustee/custodian and successors in a will. Otherwise, the appropriate local court or the

institution holding the IRA may have the right to name someone to serve in these capacities. The same goes for funds that are left to beneficiaries who are minors at the time of the owner's death.

*Qualified Terminable Interest Property (QTIP) Trusts as beneficiaries:* By making your beneficiary a QTIP trust, you leave your IRA (or any other assets) in trust for your spouse as beneficiary of the trust. They pass to the surviving spouse through the trust with no estate tax. With a QTIP trust you choose the beneficiary of the trust should funds remain after your spouse dies. This ensures that funds pass on to those whom you want to be the rightful heirs, making a QTIP trust a useful vehicle for those who have been married more than once and want to provide for children from previous marriages.

### **Seek professional guidance**

Understanding all of the tax and other ramifications of estate planning for IRAs—and taking the best approach in your circumstances—requires the knowledge and experience of legal, tax and trust specialists.

May we be of assistance? One of our estate planning specialists would be pleased to meet with you and your other advisors to develop a strategy that suits your needs.

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