

Elder Law: IRAs: What's your exit strategy?

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By Julian Gray and Frank Petrich

In our column last month, we discussed the structure and advantages of using an IRA as an investment vehicle for favorable tax treatment in the planning for Mr. and Mrs. Adams. However, the changing social and economic climate causes us to rethink traditional distribution strategies. While there are various options, we will examine two planning ideas for handling the distribution of an IRA. Both options utilize a trust and are geared towards tax savings as well as protection of the underlying funds.

Historically, clients who had concerns over the protection of their assets after death would utilize a trust to hold such assets for the benefit of their estate beneficiaries. However, it was difficult to fund trusts with IRAs because of the tax-sensitive nature of these accounts. Over the past few years, the Internal Revenue Service has adopted new rules and positions on this arrangement to allow people to continue tax beneficial growth of an IRA left to a beneficiary with the protection of a trust. These types of trusts can be used in addressing a variety of situations. Here are a few examples:

- If an outright beneficiary after the death of both Mr. and Mrs. Adams (such as the Adams' daughter, Elaine) receives the IRA and then names her spouse, Sam, (whom the Adams' never liked) as beneficiary, Sam may then receive the IRA in the event of Elaine's death, something that the Adams' would have detested. It even might eventually go to Sam's new spouse and not the Adams' grandchildren as they ultimately intended.
- An outright beneficiary may get divorced and may lose a portion of the IRA.
- The beneficiary may be disabled and have high medical costs which would exhaust the IRA or make that beneficiary ineligible for Medical Assistance or Veterans' benefits.
- The beneficiary may have poor spending habits and lack good investment decision making abilities.
- The beneficiary may not seek tax advice and thus accelerate income tax liability.

These are just a few common occurrences that can waste a lifetime of tax deferred growth of hard-earned money. Therefore, one option is to name a trust as the beneficiary of an IRA so that the IRA owner can dictate the terms under which funds will be distributed from the IRA during the lifetime of the beneficiary.

Because of the strict IRS rules on distributions, this trust must be carefully drafted to accomplish both protection of the investments while still utilizing the measuring life of the trust beneficiary in order to continue to "stretch" the IRA. In addition, when naming a trust as an IRA beneficiary, the IRA must have carefully drafted beneficiary designation language. Normally, the drafting attorney will provide the financial adviser with the appropriate language to place on the IRA agreement so that the funds go to the trustee in a way that promotes tax favorable treatment.

Another option is available through the use of a life insurance trust. Consider that an IRA is someday going to be subject to at least two different levels of taxation (Pennsylvania inheritance tax and federal income tax). And, depending on the upcoming change to the federal estate tax rules set to take effect on Jan. 1, an IRA may be subject to this third tax at death.

To replace the IRA funds that may be exposed to triple taxation, Mr. or Mrs. Adams (or both of them) could purchase a life insurance policy that basically "replaces" the IRA with tax-free cash upon their deaths.

If the life insurance policy is owned by a properly drafted life insurance trust, then the insurance proceeds will not be subject to the aforementioned taxes and they can be distributed over the lifetime of the intended beneficiaries as the Adams' desire. In addition, the life insurance policy held in the trust during Mr. and Mrs. Adams' lifetimes could be protected from long-term care costs in the event either of them needed expensive care at home or in a facility.

How can this be done? The required minimum distributions from the IRA and additional IRA funds could be used to fund the premiums on the life insurance held in trust. In this way, the IRA funds are systematically being transferred from a high tax exposure situation to a non-tax exposure situation during the lifetime of the IRA owner.

If there are IRA funds still remaining at the IRA owner's death, these will be in addition to the tax-free life insurance trust funds, resulting in greater estate preservation. Since life insurance requires medical underwriting, it is important to determine the IRA owner's insurability prior to engaging this option.

So, if you own an IRA, it's just as important to plan for the exit strategy as well as the investment strategy. While an IRA trust or a life insurance trust may not be appropriate for all people, an IRA owner should investigate appropriate options before simply naming an individual beneficiary.

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