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

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In our last column, we stressed the importance of having a will and what it can and cannot do for you, especially when you have assets that are "beneficiary designated" such as Individual Retirement Accounts.

Individual Retirement Accounts are a very popular investment tool that originated in 1974 with the enactment of the Employee Retirement Income Security Act. IRAs are attractive to many people such as our Mr. and Mrs. Adams about whose wills we last wrote, because "traditional" IRAs may provide for an income tax deduction upon their establishment as well as tax deferred growth of the investment(s). And, in the case of Mr. and Mrs. Adams, their IRAs represent a significant portion of their wealth.

There are many rules surrounding IRAs, but the major issue revolves around planning for eventual distribution of the IRA, which is when income taxes are due on each dollar received from the IRA by the IRA owner or beneficiary.

IRAs are predominantly established through individual contributions as well as "rolling" other tax deferred plans, such as a 401K plan, away from a previous employer. Now that investors have had a few decades to take advantage of income tax deferred growth in their IRA's, the question is, "How do I access my IRA or plan for its distribution while minimizing taxes and protecting it from other negative consequences?"

While the IRS allows a person to invest the IRA in various types of investments, sooner or later the taxes must be paid. As a wise colleague once stated, "If you don't have a plan for the distribution of your IRA, the IRS has a plan for you." In fact, the IRS rules force the taxpayer to eventually take distributions from an IRA, thus triggering income tax on such distributions. This is generally around age 71.

These mandatory distributions are called Required Minimum Distributions and there are severe penalties for failing to take them. The penalty can be 50 percent of the amount of the Required Minimum Distribution that should have been taken. However, one does not have to wait until age 71 to begin taking distributions. Normally, around age 59, a person can start taking voluntary distributions from their IRA without any penalty, although income taxes are still required to be paid on each distribution. If the IRA owner takes a distribution prior to age 59, there is a 10 percent early withdrawal penalty unless certain exceptions apply.

The common advice is to defer taking IRA distributions for as long as possible to avoid incurring the income tax and to allow, hopefully, continued growth in the IRA. While this is one facet of planning, it is weighted on tax consequences.

The first issue to recognize is that an IRA can and should be set up so that it travels to a designated beneficiary in the event of the IRA owner's death. However, care should be taken to also designate one or more contingent beneficiaries. It is always surprising to us to see married IRA owners who have named each other as beneficiaries yet failed to name their children as the contingent beneficiaries.

This can be a tax nightmare in the event of a simultaneous death of the spouses or simply the failure of a surviving spouse to update her/his IRA beneficiary designations. While the IRS rules allow a beneficiary to "stretch" the IRA distributions under certain circumstances, if the IRA has no named beneficiary at death, the IRS rules require the IRA to be paid to the decedent's estate, thus subjecting the IRA funds to probate. More devastating is that the IRA must then be completely withdrawn over a five year period, which means that the entire amount in the IRA will be counted as income to the beneficiary over a very short period of time and significantly increase the beneficiary's marginal income tax rate.

While a surviving spouse who inherits an IRA can continue to enjoy tax deferred growth, a beneficiary such as adult child must consider "stretching" the IRA over her/his life expectancy so that only small distributions are taken out of the IRA annually, thus continuing to defer as much income tax as possible while continuing to grow the underlying investments. This "stretch" is not automatic, and an IRA owner should discuss this option with a financial planner to avoid any surprises.

Assuming the IRA owner has appropriately addressed the beneficiary and stretch opportunities, what other issues are there to consider?

Well, times and the economy have changed. The majority of marriages end in divorce and medical and long-term care costs have spiraled to new heights. Many people are concerned that they have accumulated a significant portion of their savings in an IRA and do not want to see it squandered by poor decisions of a beneficiary or the designs of a child's ex-spouse.

In our next column, we'll examine ways to plan for the distribution of an IRA to maximize protection of the asset while still providing for the beneficial use of the funds without sacrificing the inherent tax advantages.

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