



# “TRUSTWORTHY”

A Free Estate Planner's Email Newsletter by Lawrence J. Robertson, P.C.  
Attorney at Law

September 2009

Volume 5, Number 3

## In This Issue

- Retirement Benefits and Estate Planning
- Please **NOTE** the address, phone and email below

## AVOID PROBATE AND SAVE TAXES WITH LIVING TRUSTS

### Contact Us

We're on the Web:

[www.ljrobertson.com](http://www.ljrobertson.com)

Email:

[larry@ljrobertson.com](mailto:larry@ljrobertson.com)

Address:

Lawrence J. Robertson  
13321 North Outer Forty  
Road  
Suite #300  
Chesterfield, MO 63017  
636-532-9933

## A Note on This Topic - Retirement Benefits and Estate Planning is Complicated

Retirement benefits constitute a large portion of many estates. The rules governing contributions to and distributions from qualified plans and IRAs can be complicated. Often there is a tension between the best planning from an income tax standpoint and the best planning from an estate tax standpoint. How to plan is often not an obvious choice.

There is NO “one size fits all” rule. Individual planning choices must be made for each client’s own situation.

*Larry Robertson*

---

## 10 ERRORS COMMONLY MADE WITH RETIREMENT BENEFITS PLANNING

The list below is not exclusive. Other errors occur frequently in dealing with retirement benefits. I practice in Missouri, where revocable trusts are commonly used. This list however does not include only those errors that are peculiar to revocable trusts.

Of course, what is an error in one case, or even in most cases, is not necessarily an error in *every* case.

### **ERROR #1 - NOT MAXIMIZING CONTRIBUTIONS**

Qualified plans and IRAs allow tax-free compounding of income and gains over long periods of time. At an 8% annual return, a single \$5,000 IRA contribution will grow to over \$100,000 over 40 years. Contributions of \$5,000 per year will grow to nearly \$1.3

million over 40 years. Contributions to pension, profit-sharing and 401(k) plans can be substantially greater than the \$5,000 per year limit for IRA contributions.

A common misconception is that by contributing to a retirement plan, you are converting capital gains to ordinary income, or giving up the opportunity to take advantage of the 15% tax rate on qualified dividends and capital gains. But the effective tax rate on income and gains in an IRA is zero. For example, suppose you contribute \$5,000 to an IRA. Over some period of time, it grows to \$50,000. If you are in a 30% tax bracket, and you withdraw the \$50,000, you will have \$35,000 remaining after income taxes. If you instead paid \$1,500 tax at the beginning, and invested the remaining \$3,500 in your taxable account, you would need a zero tax rate on your investment income for your \$3,500 taxable account to grow to the same \$35,000.

## **ERROR #2 - NOT CONVERTING TO A ROTH IRA**

Converting to a Roth IRA is generally advantageous. It is effectively the same as making a substantial additional contribution to your IRA.

For example, suppose you have a \$100 IRA and \$30 of other money. You convert your IRA to a Roth IRA, and use your \$30 of other money to pay the income tax on the conversion. You now have a \$100 Roth IRA. Over some period of time, it grows to \$200, which you can withdraw free of income tax.

Over the same period of time, if you did not convert to a Roth IRA, your \$100 IRA will grow to \$200. If you withdraw the \$200, you will pay \$60 tax, and will have \$140 after income taxes. You would need a zero tax rate on your investment income and gains in order for your \$30 taxable account to grow to the same \$60.

The Roth conversion offers other tax benefits as well.

There are no required distributions from a Roth IRA during lifetime. Since many people (or their surviving spouses) live well beyond age 70 1/2, the ability to avoid required distributions during lifetime can be significant.

The proceeds from a traditional IRA are subject to estate tax in the IRA owner's estate. Then, when the beneficiary receives the

benefits, they are generally subject to income tax. To avoid the double tax problem, Section 691(c) allows an income tax deduction for the Federal estate tax on the IRA benefits.

However, this deduction only covers the Federal, but not the state estate and inheritance taxes. This can be a problem in states that still have estate or inheritance taxes. By converting to a Roth IRA, the IRA owner removes all of the income tax from the estate for estate tax purposes, while preserving the ability to stretch out the IRA distributions.

A Roth IRA is also a more valuable asset with which to fund the credit shelter trust or a GST exempt disposition.

If an IRA owner intends to leave the IRA in trust rather than outright, the benefits are subject to the compressed income tax brackets for trusts to the extent they are retained in the trust. Since Roth IRA benefits are generally not subject to income tax, this is not an issue with a Roth IRA.

In order to be able to convert to a Roth IRA, an IRA owner's modified adjusted gross income cannot exceed \$100,000, without regard to the income from the conversion. Required distributions from an IRA do not count for this purpose. Beginning in 2010, the \$100,000 income cap will no longer apply. This will enable more IRA owners to convert to Roth IRAs.

### **ERROR #3 - NOT KEEPING THE ASSETS IN THE RETIREMENT PLAN OR IRA AS LONG AS POSSIBLE**

Qualified plan participants and IRA owners must generally begin taking benefits at age 70 1/2. However, the benefits can be stretched out over a long period of time.

Participants and IRA owners should generally use their other assets first, so as to take advantage of the income tax benefits of keeping as much money as possible in the retirement plan or IRA.

On the other hand, participants and IRA owners should give consideration to utilizing their lower income tax brackets. An IRA owner in a low income tax bracket can utilize his or her lower income tax brackets while keeping the assets in the IRA by converting some or all of the IRA to a Roth IRA.

## **ERROR #4 - NOT COORDINATING THE BENEFICIARY DESIGNATION WITH THE ESTATE PLAN**

Many participants and IRA owners have sophisticated Wills or Trusts, containing detailed provisions disposing of their assets, as well as detailed administration provisions. Consideration is often given to income tax, estate tax and asset protection.

An IRA is often someone's largest single asset. It passes in accordance with the beneficiary designation, not the Will. Often very little thought is given to the beneficiary designation. This can result in additional estate tax, the loss of the ability to stretch out the benefits, and the loss of asset protection.

Participants and IRA owners should coordinate their beneficiary designations with the rest of the estate plan. They should consider naming contingent beneficiaries where appropriate.

## **ERROR #5 - NOT LEAVING THE RETIREMENT BENEFITS TO THE SPOUSE WHERE APPROPRIATE**

There are income and estate tax benefits to leaving qualified plan and IRA benefits to the spouse. The benefits qualify for the estate tax marital deduction. The spouse can roll them over into his or her own IRA, name new beneficiaries, possibly convert to a Roth IRA, and obtain a longer income tax stretchout.

A QTIP (marital) trust provides control over the principal, but gives up substantial income tax benefits. A QTIP trust can at most stretch distributions over the spouse's life expectancy.

So, in most cases, even if the marital share of the estate otherwise passes in a QTIP trust, participants or IRA owners should consider whether it would be acceptable to leave the retirement benefits to the spouse outright. This will more likely be the case if the IRA is relatively small in comparison to the size of the estate, or in states where the elective share cannot be satisfied by a bequest in a QTIP trust.

The Internal Revenue Service takes the position that, in order to qualify for the marital deduction, the IRA itself (in addition to the

QTIP trust) must qualify for QTIP treatment. The spouse must be entitled to all of the income of the IRA. If the income of the IRA exceeds the required distribution, the spouse may be able to roll the excess over into his or her own IRA.

### **ERROR #6 - NOT COORDINATING WITH THE CREDIT SHELTER DISPOSITION**

Some participants and IRA owners do not have enough other assets to fill up the credit shelter trust, and want to leave some or all of the IRA to their credit shelter trusts. In this way, the assets will be available for the spouse if he or she ever needs them, but will not be included in the spouse's estate. This situation is more common now that the estate tax exempt amount has increased to \$2 million.

If retirement benefits are payable to the credit shelter trust, they must be paid out over the spouse's life expectancy (at most). The participant or IRA owner must choose between the income tax benefits of leaving the IRA to the spouse and the potential estate tax benefit of fully funding the credit shelter trust.

One way to do this is to provide on the beneficiary designation form that the credit shelter trust is to receive the amount necessary to fully fund it, after taking into account the participant or IRA owner's other assets. Another approach is to leave the retirement benefits to the spouse, who can disclaim them to the extent necessary to fill up the credit shelter trust (or to whatever extent, if any, the spouse chooses).

### **ERROR #7 - LEAVING THE RETIREMENT BENEFITS TO CHILDREN OR GRANDCHILDREN OUTRIGHT INSTEAD OF IN A DISCRETIONARY TRUST**

There are a number of reasons to provide for children or grandchildren in trust rather than outright. Assets in a trust are better protected against the beneficiary's potential creditors (including spouses), and will not be included in the beneficiary's estate. Trusts also separate the control from the beneficial ownership, and provide greater income tax flexibility.

The same reasons for leaving other assets in trust apply in the case of retirement benefits. However, the stretchout is limited to the life expectancy of the oldest beneficiary of the trust. In other words, no accumulated IRA benefits can ever go to anyone older than the

designated beneficiary. Even remote contingent beneficiaries are counted for this purpose. Unless the IRA owner is willing to subject the other assets to this restriction, this means that the IRA benefits must be segregated in a separate trust. The trust or trusts that receive the IRA benefits can be created either under the Will or in a separate trust instrument.

If the IRA benefits must be paid out each year, and cannot be accumulated, then subsequent beneficiaries can be disregarded. However, in that case, if the beneficiary lives to life expectancy, then nothing will remain in the IRA or the trust, and all of the protection of the trust will be lost.

### **ERROR #8 - COLLECTING THE BENEFITS UPON DEATH AND DESTROYING THE STRETCHOUT**

A beneficiary can generally stretch the benefits out over his or her life expectancy. The benefit can be significant for younger beneficiaries. However, sometimes a beneficiary collects the benefits before realizing that he or she could have stretched them out over his or her life expectancy.

There is no provision allowing a beneficiary other than a spouse 60 days to roll the benefits over into an IRA. Advisors should make sure that their clients' beneficiaries are aware of the potential stretchout before collecting the retirement benefits.

### **ERROR #9 - COLLECTING THE BENEFITS BEFORE CONSIDERING A DISCLAIMER**

As in the case of other assets, beneficiaries sometimes choose to disclaim (refuse to accept) retirement benefits. If the named beneficiary disclaims, the retirement benefits will go to the contingent beneficiaries, or if none then in accordance with the default provisions of the plan or IRA, or if none then to the participant's or IRA owner's estate.

A beneficiary may wish to disclaim retirement benefits to allow them to go to the spouse to obtain the marital deduction, and to permit the spouse to roll them over into his or her own IRA, name new beneficiaries, possibly convert to a Roth IRA, and obtain a longer stretchout.

A spouse may wish to disclaim retirement benefits to allow them to

go to the credit shelter trust, or to or in trust for the children, to save estate taxes in the spouse's estate.

A child may wish to disclaim retirement benefits to allow them to go to the grandchildren, so as to keep them out of the child's estate, and to obtain a longer stretchout.

In some cases, the Service will allow a beneficiary to disclaim even after beginning to receive distributions from an IRA.

### **ERROR #10 - NOT CONSIDERING A SPOUSAL ROLLOVER EVEN IF THE SPOUSE IS NOT THE NAMED BENEFICIARY**

As set forth above, there are significant benefits to naming the spouse as beneficiary. The spouse can roll the benefits over into his or her own IRA, name new beneficiaries, and possibly convert to a Roth IRA. But sometimes the spouse is not the named beneficiary.

The IRS has issued numerous private letter rulings allowing a spousal rollover where the spouse was not the named beneficiary. For example, the retirement benefits may pass to the spouse under the default provisions of the qualified plan or IRA. Or the IRA may go to the spouse as a result of disclaimer, by intestacy, by reason of the elective share, as community property, or through an estate or a trust in which no one other than the spouse can cause the retirement benefits to be payable to anyone other than the spouse.

So just because the spouse is not the named beneficiary does not mean that you can't get the retirement benefits to the spouse so as to permit a spousal rollover.

### **CONCLUDING OBSERVATION:**

The rules governing contributions to and distributions from qualified plan and IRA benefits are complicated, and there is often a tension between income tax and estate tax planning. However, retirement benefits offer substantial income tax benefits. Advisors should become familiar with the rules, as well as the planning opportunities and pitfalls.

---

**As always, I stand ready to assist your clients by educating them to all of their estate planning alternatives at a FREE consultation (my office or yours).**

And, as always, I very much appreciate your kind referrals.

Sincerely,

*Larry Robertson*

**ADDITIONALLY:** See [www.ljrobertson.com](http://www.ljrobertson.com)

*Please remember my website [www.ljrobertson.com](http://www.ljrobertson.com) to download this newsletter at anytime, from anywhere. Also, clients will likely enjoy reading about living trust benefits and FAQ's as well as download estate planning questionnaires and Medicaid planning questionnaires.*