

ESTATE PLANNING NEWS



CONTENTS

Retirement Accounts
Announcements
Tip of the Month
Entertainment

Retirement Accounts: 4 Special Considerations

As you know from last month's article, Revocable Living Trusts ("RLTs") are a popular estate planning technique. To be effective, RLTs must be funded. Assets must be retitled in the trust's name, and life insurance policies should designate the trust as beneficiary.

But different rules apply to retirement accounts. First, retirement accounts are owned by individuals, not by trusts, and retirement accounts usually designate individuals as beneficiaries. Second, retirement account distributions may be subject to income tax. Third, certain retirement accounts qualify for a tax-efficient wealth transfer strategy known as the Stretch IRA. Fourth, tremendous caution must be used when designating a trust as beneficiary of a retirement account.

(continued on page 3)

Law Office of Nicole A. Davidson

1092 Gardenia Ln., Concord, CA 94520-4485

Tel/Fax: 925-689-6890 • Cell: 510-919-8389

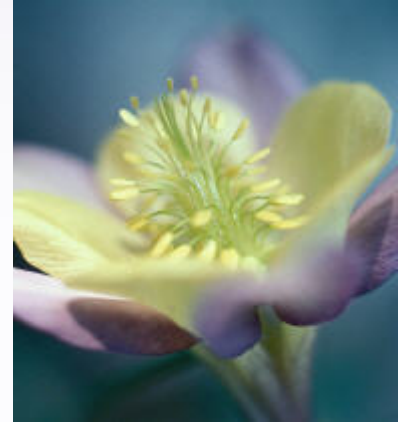
E-mail: californiaattorney@hotmail.com



Estate Planning News

Announcements

Thank you for all your suggestions regarding the website that is in progress. I will implement as many of your ideas as I can.



Tip of the Month

Safekeeping your Estate Plan

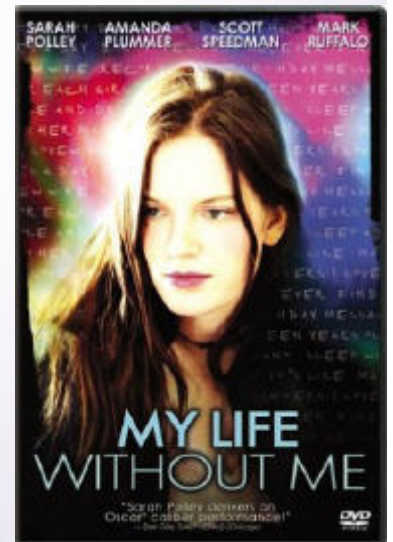
- 1) Your original estate plan should be kept in:
 - a) A bank safe deposit box; or
 - b) A fire-resistant home safe.
- 2) If you keep the documents at the bank, ensure that your successor trustees or your executors will have access in the event of your death.
- 3) Tell your successor trustees or executors where they will find the original documents.



Entertainment

My Life Without Me (2003)

Winner of the Goya (Spanish Academy Awards) for Best Screenplay, this film is about a 23-year-old mother who learns that her life will be cut short. Instead of falling to pieces, she develops a list of "things to do" before she dies and then systematically accomplishes them.



Estate Planning News



If anyone counts upon one day ahead or even more, he does not think. For there can be no tomorrow until we have safely passed the day that is with us still.

-- SOPHOCLES
The Women of Trachis

Retirement Accounts

(continued from page 1)

1. Individuals Own Retirement Accounts

Trusts can own property, but they don't own retirement accounts. Retirement accounts stay in your name. Remember "IRA" stands for *individual* retirement account.

Like life insurance policies, retirement accounts include beneficiary designations. People often name their spouse as primary beneficiary and children as contingent beneficiaries. When a RLT is created, life insurance policies are updated to name the trust as beneficiary. Similarly, retirement accounts can designate certain qualifying trusts as beneficiaries. However, as discussed in section 4, be sure to consult with your attorney before you do so.

2. Distributions May Incur Income Tax

When you contribute pre-tax dollars to a retirement account, such as a 401(k) or traditional IRA, you accept that subsequent distributions will be subject to income tax at ordinary income tax rates. Distributions are taxable whether they are paid to you or to your beneficiary. In this respect, retirement accounts are different from other assets, which pass to beneficiaries without income tax consequences.

Note: Different rules apply to Roth IRAs.

Why should you be concerned whether your beneficiary will pay income taxes on distributions from your retirement account?

Consider the following hypothetical:

Aaron owns a home and an IRA, each worth \$500,000. Aaron has two adult children, Beth and Caty. To treat them equally, he leaves the house to Beth, while his IRA names Caty as beneficiary. Aaron dies, and Beth moves into the home, enjoying a full step up in basis and freedom from mortgage payments. Caty feels shortchanged when she learns that her inheritance will be subject to income tax.

III. Certain Retirement Accounts Qualify For A Stretch IRA

The tax-efficient wealth transfer strategy, known as the Stretch IRA, allows a younger beneficiary to extend the period of tax-deferred earnings on an inherited IRA.

How does this work?

Let's assume that Dylan, age 54, rolled his 401(k), worth \$400,000, into a traditional IRA in 1938. Dylan named his wife, Ellen, age 48, as beneficiary. Dylan waited until he was 70.5 years old to begin taking required minimum distributions ("RMDs"). Dylan died in 1969.

(continued on page 4)

Estate Planning News

Ellen rolled the IRA into her own IRA, taking RMDs based on her life expectancy. Ellen named her son, Fran, age 56, as beneficiary. Ellen died in 1973. Fran continued taking RMDs based on his life expectancy.

When the final distribution was made this year, Dylan's IRA had been stretched for 67 years. The total of all IRA distributions: \$4.32 million.

Why was this strategy so successful? Neither Dylan, Ellen, nor Fran needed the IRA for their retirement. They took RMDs, but never more. They wanted to let the IRA grow tax-deferred.

Not everyone can afford to take advantage of this strategy. But if it is an option, and you want to benefit younger generations, you should consider it.

IV. It Is Dangerous To Designate A Trust As Beneficiary Of A Retirement Account

Naming a trust as beneficiary of a retirement account is risky business.

The first risk is that the trust will not qualify. To qualify as a designated beneficiary, the most challenging of four criteria is that beneficiaries be identifiable human beings. A trust that names a charity or estate as a contingent beneficiary does not qualify. Not only is the Stretch IRA taken away, but the result will be a fully taxable lump sum distribution.

A second risk is that the trust will qualify as a designated IRA beneficiary, but the stretch-out will be significantly shorter than intended.

Consider this example:

Grandma set up a RLT, with separate trusts for her grandchildren. Since the oldest grandchild was only 12 years old, Grandma intended that the trusts provide for the grandchildren's needs until their 30th birthday. Grandma also made a backup plan. If a grandchild passed away before his 30th birthday, his share would go to Grandma's sister, Helen, age 67.

Grandma also had a few IRAs, on which she named her RLT as beneficiary. This seemed simple enough, until the IRS issued a private-letter ruling that the RMDs from Grandma's IRAs must be based on the life expectancy of a 67-year-old (Helen), not a 12-year-old (the oldest grandchild). This shortened the Stretch IRA period from 70.8 years to 19.4 years!

What could Grandma have done differently?

The simplest alternative was for Grandma to name her grandchildren as beneficiaries of her IRA. Each grandchild could take advantage of the Stretch IRA, watching his inheritance grow tax-deferred and taking the RMD (or more if needed) based on his life expectancy. In fact, the youngest grandchild, age 1, would have a Stretch IRA period of 81.6 years.

If Grandma feared her grandchildren would cash out the IRAs, she should have discussed the topic of "conduit trusts" with her attorney. Conduit trusts are created within a RLT to qualify younger persons as beneficiaries and force them to use Stretch IRAs. Importantly, RMDs would be taxed at the lower income tax rates applicable to individuals, as opposed to the higher income tax rates imposed on trusts.

Law Office of Nicole A. Davidson

1092 Gardenia Ln., Concord, CA 94520-4485

Tel/Fax: 925-689-6890 • Cell: 510-919-8389

E-mail: californiaattorney@hotmail.com

