

How IRA millionaires can maximize tax savings



By Faith Read Xenos, CFP

Sam and Sally Smith are in their mid-60s and retired. Sally has a \$3½ million individual retirement account (IRA) and \$250,000 of other assets. The \$350,000 house is in Sams name. Sally has been withdrawing \$80,000 per year from her IRA, paying the income taxes on it, and living on the rest. Neither Sam nor Sally has sufficient individually owned assets to fully use both spouses unified credits. Sam and Sallys goals are simple: 1) have the entire estate available to benefit the surviving spouse for life, then pass the assets to the children; 2) defer estate taxes until the second death; and 3) take advantage of both spouses federal estate tax exemptions so they can maximize their tax savings.

The goals appear to be good ones, but they raise two major issues:

1. Who should be the IRA beneficiary on the death of the first spouse? A credit shelter trust? The surviving spouse? A qualified terminable interest property (QTIP) trust?

2. Should Sally withdraw more than \$80,000 per year? Can she? How much should she withdraw? Who should be the beneficiary?

While the IRA is a great way to accumulate assets during life, without proper planning, it can be one of the worst assets on death, even with the repeal of the excise taxes on excess distributions and accumulations. Why? On death, the

assets are subject to both income taxes and estate taxes, leaving little for the family. Different types of trusts for different beneficiaries will allow Sam and Sally to accomplish all their objectives.

Make a Credit Shelter Trust the IRA Beneficiary

To allow Sam and Sally to fully use both of their unified credits, Sally could name her credit shelter trust as IRA beneficiary if she dies first, to the extent necessary to fully fund the credit shelter amount. (Beginning in 1998, this amount will increase from \$600,000 until it reaches \$1½ million in 2006. See 1997 Tax Law Change Highlights on page 7 for more information.) Assuming Sam is the beneficiary of the balance, no estate tax will be incurred.

Naming the credit shelter trust will, however, result in increased and accelerated income tax liability. First, benefits paid to the credit shelter trust may be taxed at the higher trust income tax rate. Second, benefits payable to the trust must begin (and the resulting income taxes be paid) within one year of Sallys death. However, because income taxes are still lower than estate taxes, Sam and Sallys children will still be better off.

Make a QTIP Trust the IRA Beneficiary

If Sally designates a qualified terminable interest property (QTIP) trust as the primary IRA beneficiary, she will be able to provide for Sams lifetime needs and can be assured that the assets remaining on Sams death will pass to their children. The QTIP trust can qualify for the estate tax marital deduction.

To qualify for the marital deduction, certain steps must be taken. The trust must provide that the spouse is to receive the greater of all income earned by the IRA in a given year or the minimum amount required to be distributed. The trustee should be permitted to require such distributions. Similarly, the IRA distribution elected should provide

that the trust receive at least annually the greater of 1) the income generated by the IRA assets, or 2) the minimum required distribution.

Make the Surviving Spouse the IRA Beneficiary

Sally can name Sam as beneficiary, and the credit shelter trust or the children as contingent beneficiary if he predeceases or disclaims. If Sam rolls over the IRA assets, more tax will be deferred, but Sam will be able to distribute the assets away from the children. Sam can also disclaim to the extent necessary to fund the credit shelter.

Withdrawing More Than \$80,000 Per Year

In general, Sally should withdraw enough to transfer additional assets to Sam so he can use his unified credit. Sally may wish to withdraw even more each year, however.

Increasing the non-IRA portion of their balance sheet offers several benefits. It:

1. Provides funds for the unforeseen,
2. Makes cash available for annual exclusion gifts, allowing estate reduction,
3. Increases assets available to fund the credit shelter trust, and
4. Leaves fewer assets subject to the restrictions and changing rules regarding retirement plan assets.

Remember that Sam and Sallys situation is unique, so these solutions may not be right for you. Careful analysis is necessary before you make a decision.

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