Price & Farrington's Estate and Tax Planning *Fast*Faxts

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Estate, Tax and Wealth Planning for Advisors and Clients

Price & Farrington, PLLC
Attorneys and Counselors at Law
12501 Bel-Red Road, Suite 215
Bellevue, Washington 98005
425-451-3583
Email: contact@pricefarrington.com

The *Right* and *Wrong* Way to Leave Your IRA and 401(k) to Your Heirs

For many clients, IRAs and 401(k) plans are a large part of their estate. Yet few people understand how to go about leaving these assets to their beneficiaries. The following Q&A should help you and your clients better understand the rules.

1. Can I direct the inheritance of these assets under the terms of my will?

Yes and no. IRA and 401(k) plan benefits that pass according to a beneficiairy designation form are *nonprobate assets.* This means that the terms of your will cannot affect who inherits them. Only if your IRA and 401(k) accounts name your *estate* as beneficiary can your will dictate who inherits what share of the accounts.

Caution: Leaving your IRA and 401(k) to your estate usually isn't advisable from an income tax and asset protection standpoint. Since an estate has no life expectancy, the benefits are taxable at an accelerated rate. Protection from the decedent's creditors will also be lost. When individuals inherit an IRA, they can keep the funds invested and spread the required minimum distributions over their life expectancy.

Note: Most 401(k) plans don't permit long-term payments. But if a spouse is the beneficiary of a 401(k), he or she should immediately do a *spousal rollover* into an IRA and then select heirs. But if the decedent didn't take his required distributions, they can't be rolled over by the spouse.

Here's the key: Leaving funds directly to an estate wipes out years of continued tax-deferred compounding and could cost your beneficiaries thousands of dollars.

2. What happens if the person I've named as my beneficiary dies before I do and I don't complete a new beneficiary designation form?

A number of scenarios might apply, depending on which financial institution holds your account…

☑ Some financial institutions have "default" provisions that will pay out benefits to a surviving spouse if there is no other named beneficiary. Otherwise, funds will be paid directly to your estate, with the consequences discussed above.

☑ If you've named multiple beneficiaries on the beneficiary form—for example, your three kids - and one dies, your IRA usually is divided equally among the surviving named beneficiaries. Most people don't realize that. If you would like the children of the deceased child to inherit, you should have an advisor help you modify the form to reflect your wishes.

3. I have a large IRA rollover account and three children. Should I name them as beneficiaries on the one account or split the account into three, one for the benefit of each?

The choice is yours as long as the beneficiary designation form provides properly for contingent beneficiaries. Separate accounts will make it easier to ensure that each child's family is protected. It will also spare your children having to do the legal paperwork after your death. Your younger children will want to divide the account in order to continue deferral for their longer life expectancies. If the account stays whole, distributions must be calculated using the shortest life expectancy – the oldest child's — which will compress the deferral period unnecessarily.

"Yes, I enjoy the concept of wealth, but I really love the actual money, too."

4. I want to have my IRA payable to my children, who are now ages 10 and 12. Can I do this?

Yes. You can have your IRA payable to minors, but be careful how you do it. Don't have the IRA payable directly to them or a court will have to appoint a guardian to oversee management of the IRA after you're gone. Instead, have the IRA payable to:

☑ **A custodial account under the Uniform Transfers to Minors Act (UTMA).** This lets the custodian of the IRA manage the funds for the minors until they reach majority age. The custodian should use the IRA stetch-out payment rules after your death.

☑ **A trust for the benefit of the minors.** This is more costly to set up and manage than the UTMA account, but it is usually a much more effective strategy where there are substantial funds involved. The trustee should take advantage of the stretch-out payment rules.

5. Must I keave my IRA and 401(k) benefits to my spouse?

☑ **IRAs.** There is no law requiring

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"Investor confidence is a perishable commodity."

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"Blessed are the young, for they shall inherit the national debt."

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"Judge a man not by his clothing, but by his portfolio."

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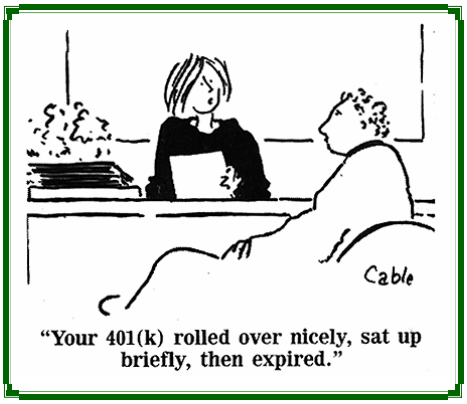
"It's difficult to save money when your neighbors keep buying things you can't afford."



"Your 401(k) rolled over nicely, sat up briefly, then expired."

you to pass on an IRA to a spouse. Under most state law, though, a spouse can elect to receive a set portion of your estate, which includes your IRA.

☑ **Benefits under qualified retirement plans including 401(k)s:**

Federal law requires these plans to provide a survivorship annuity to a spouse, which the spouse can waive in writing. But don't rely on a waiver in a prenuptial agreement. Since a fiance isn't a spouse, the waiver isn't valid for federal law. A waiver *after* the marriage is required. Faulty planning here can lead to a very messy situation.

6. Can I leave my IRA to charity?

Yes. Doing so is a smart strategy if you're plannning to leave something to a tax-exempt organization. The reason is that the charity doesn't pay income tax on receipt of your IRA and neither does your estate, so the account effectively escapes income tax forever – as well as estate taxes. You can leave other (nontaxable) assets, such as stocks and bonds, to your relatives and leave your IRA, which is taxable, to charity.

7. If I become incapacitated, what happens to my beneficiary designations?

They remain in place until your death. In some states, though, an agent working under a durable power of attorney can change beneficiary designations, even appointing himself as the beneficiary of your accounts. You should consult a qualified estate planning attorney to make sure your power of attorney limits this authority according to your wishes.

8. What happens if the beneficiary I name becomes incompetent?

Incompetency is not a bar to inheritance. But everyone should have a durable power of attorney which authorizes an agent to take action with respect to inherited IRA accounts.

9. I have a large estate that will owe estate taxes. Are my IRA beneficiaries liable for this tax?

This is a complicated area which involves *income in respect of a decedent* and Section 691(c) of the Internal Revenue Code. Your attorney and other advisors should carefully analyze your circumstances to avoid litigation problems with your beneficiaries and the IRS. (See our November, 2000 *Fast*Faxts, downloadable from the *Fast*Faxts archive on **www.pricefarrington.com**.

Closing note: It is extremely important to work with an attorney who has expertise in the proper drafting of beneficiary designations to help you review your forms and avoid costly planning errors. The stakes are high. Any changes that need to be made should be done immediately. We advise our clients to keep copies of all beneficiary designation forms with their important papers. Don't rely on financial institutions to provide your heirs with copies of the forms, which can easily be lost.

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For more insights into IRA beneficiary planning with community property, including several planning examples, see our **February, 2002 FastFaxts**: ***"Smart Tax Planning in Community Property States: Proceed with Caution"***. See also our **June, 2000 FastFaxts: *"IRA Rules Can Stump the Pros"***. Both are available on our new website, **www.pricefarrington.com**, in our complete FastFaxts archive. ■

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Our e-mail addresses have changed! Please update your address book or contact management software:

Glenn D. Price, J.D.
glenn@pricefarrington.com

Charles P. Farrington, J.D., LL.M.
chuck@pricefarrington.com

Doug Farrar, Firm Administrator:
doug@pricefarrington.com

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