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Stretch-Out Trusts: Good for Clients. Good for Advisors.

By Salvatore J. LaMendola, Esq.

Good For Clients

Stretch-out trusts can be good for clients. How? This is best answered by looking at how outright bequests of retirement plans (hereafter "outright bequests") can be bad for clients. This happens when an outright bequest frustrates any one or more of the following estate planning goals: first, to make maximum use of all tax breaks available; second, to restrict the enjoyment of inheritances to family members only; and third, to prevent the loss of inheritances to creditors (including ex-spouses).

How Outright Bequests Are Flawed

How do outright bequests frustrate these goals? First, outright bequests allow beneficiaries to "cash-out" inherited retirement plans. If the beneficiary does so (and many do), the "stretch-out" tax break that allows the bulk of the inherited funds to remain in the plan for decades after death is wasted. Result: goal one frustrated.

Second, outright bequests allow beneficiaries to name their own successor beneficiaries. These can be persons whom the original owner never would have wanted to benefit or persons whom the original owner never even knew. Result: goal two frustrated.

Third, looking at all of the cases so far (including appellate decisions), non-spouse beneficiaries have lost their inherited IRAs to their creditors 71% of the time (10 losses out of 14 cases). Thus, outright bequests routinely fail to protect inherited IRAs from creditors. Result: goal three frustrated.

The Stretch-Out Trust Solution

In contrast, with a stretch-out trust, the "stretch-out" is assured, and therefore, the tax break is maximized. This is done in the trust by directing the trustee to take only each year's required minimum distribution (RMD) and to distribute the same to the trust beneficiary. Result: goal one accomplished.

Again, with a stretch-out trust, all successor beneficiaries

are chosen by the original plan owner. This is done by naming the successor beneficiaries in the trust. Thus, there is no chance of undesirable or unknown beneficiaries coming into the picture. Result: goal two accomplished.

Finally, with a stretch-out trust, because the trust is a separate legal entity, creditors (including ex-spouses) can never get the inherited retirement plan, just the RMDs when paid. Result: goal three accomplished.

Good For Advisors

Stretch-out trusts can be good for advisors. How? As before, this is best answered by looking at how outright bequests can be bad for advisors – at least for those advisors whose goals are: first, to reduce their vulnerability to client loss; and second, to reduce their vulnerability to loss of assets after a client's death.

Reduced Vulnerability to Client Loss

As shown above, because outright bequests are more likely to frustrate client goals than to further them, those advising outright bequests leave themselves vulnerable to attack. How? Envision this scenario. After reviewing your client's beneficiary form, your competitor asks your client, "So, Mr. Client, after your death, do you want your daughter to be able to liquidate your retirement plan and pay all the tax at once?" Mr. Client: "Absolutely not! I've worked a lifetime to build up that retirement plan!" Competitor: "Well then why did you name your daughter as the beneficiary outright?" Mr. Client: "Because my advisor told me to." Competitor: "And, Mr. Client, if your son dies prematurely after your death, do you want your

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retirement plan to go to your daughter-in-law?" Mr. Client: "Absolutely not! I want my grandchildren to inherit it." Competitor: "Well then why did you name your son as the beneficiary outright?" Mr. Client: "Because my advisor told me to." Competitor: "And, Mr. Client, after you die, do you want your children's creditors to be able to get your retirement plan?" Mr. Client: "Absolutely not! I didn't work and save all those years for them." Competitor: "Well then why did you name your children as the beneficiaries outright?" Mr. Client: "Because my advisor told me to." Get the picture?

In contrast, when stretch-out trusts are recommended, vulnerability to client loss is reduced. The conversation described above just can't happen when "Mr. Client" already knows about stretch-out trusts. In addition, there need be no concern about a counter attack since the stretch-out trust described in this article is, except for the "RMDs only" limitation, the same pre-approved trust found

in the IRS's own regulations. Result: goal one accomplished.

Reduced Vulnerability to Asset Loss

And, with stretch-out trusts, vulnerability to a post-death loss of assets can be dramatically reduced. How? Through the inclusion of trust provisions that obligate the trustee to continue to use the asset management services of the advisor who recommended the trust. Such provisions would come in at the client's direction when the trust is drawn up and could apply to a certain time frame or over the full course of the stretch-out period. Result: goal two accomplished.

Stretch-out trusts. How good for clients? How good for advisors? Now you know.

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Charitable Giving Ideas for Roth IRA Converters

By Salvatore J. LaMendola, Esq.

A conversion of a traditional retirement plan to a Roth IRA is treated as a distribution from the traditional plan followed by a contribution of the same to the Roth IRA. For 2010 Roth IRA conversions, the distributed amount will either be added entirely to the converter's 2010 income (by election) or half will be added to each of the converter's 2011 and 2012 incomes (by default). The lower the income tax incurred on such income, the higher the likelihood of the ultimate success of the transaction. Since the charitable contribution deduction can help reduce income taxes, it should not be overlooked in this regard.

This article will cover three basic charitable giving techniques: cash gifts, qualified charitable distributions (QCDs), and gifts of capital gain property. But before proceeding, four items should be noted. First, because the tax break for a charitable contribution is a deduction and not a credit, charitable giving can only lower income taxes, not total out-of-pocket costs. For example, though a gift of \$100 will save \$28 in tax for a donor in the 28% tax bracket, the donor will nonetheless be net out-of-pocket \$72 rather than \$28 without the gift.

Second, while Roth IRA conversions are revocable, charitable gifts are not. Thus, a 2010 Roth converter can "unconvert" by as late as October 17, 2011, but a 2010 donor can never "ungift".

Third, while for 2010 conversions there is a choice as to the year(s) in which conversion income will be recognized, there is no choice as to the year in which a charitable

contribution will be deducted. Thus, a Roth converter who makes a gift in 2010 thinking that she will include all of her conversion income in 2010 but then later opting for the 2011/2012 income spread, must nonetheless deduct the gift in 2010.

Fourth, an income tax deduction could also be had through the use of a split-interest gift. Such would be appropriate if meeting a second objective, such as the reservation of a life income (CRTs and charitable gift annuities) or wealth transfer (CLTs), were desired.

Cash Gifts

Cash gifts are the best for reducing current income taxes because the deduction ceiling for cash gifts is the highest. Cash gifts can be used to either shelter current conversion income or to free up more income within a given bracket to allow more to be converted therein. For example, a single taxpayer with \$100,000 of 2010 Roth IRA conversion income added to \$100,000 of other ordinary income would be in the 33% tax bracket with respect to \$17,400. However, with a \$100,000 cash gift, no income would be taxed in the 33% bracket and an additional \$75,500 could be converted without a return to that bracket. In this case, such a large gift might be made to a donor advised fund to buy time to decide who the ultimate recipient(s) of the gift will be. Still larger gifts might be made to the donor's own private foundation (though a lower deduction ceiling would apply).

Qualified Charitable Distributions

If cash gifts directly to charity from the plan itself (IRAs only) return, such QCDs could be used by Roth IRA converters age 70½ or older to not only satisfy an unconvertible 2010 required minimum distribution (RMD) obligation and avoid all income tax thereon, but also to lower the cost of conversion by “carrying out” pre-tax money only. For example, a donor in the 33% tax bracket who is faced with a \$15,000 2010 RMD from an IRA currently worth \$343,500 (and with \$100,000 of basis) would not only save \$3,509 in income taxes on the RMD by a QCD of the same, but would also save an additional \$1,441 in income taxes upon the later conversion of the balance of the IRA. This is because with a QCD the \$4,367 of basis that would otherwise have been “carried out” by the RMD remains in the IRA to offset conversion income. Unlike cash gifts, QCDs to donor advised funds and private foundations are not allowed.

Capital Gain Property

Though donors of capital gain property are allowed to “realize” the appreciation in the donated property for deduction purposes (subject to a lower deduction ceiling), they are not required to realize such appreciation for capital gains tax purposes, thereby saving two taxes with one gift. Going back to the first example, if the \$100,000 gift were instead one of capital gain property having a cost basis of \$50,000, the \$50,000 of appreciation would be

deductible for income tax purposes (as would the \$50,000 of cost basis) but such appreciation would not be considered realized upon donation for capital gains tax purposes. Therefore, it would never be taxed. When choosing which capital gain property to give, assets for which poor or no cost basis records have been kept are the best candidates. This is because brokers (starting in 2011) and mutual fund companies (starting in 2012) must begin reporting cost basis to the IRS on all sales. By giving away capital gain property with poor or no cost basis records, the future time-consuming problem of trying to reconstruct cost basis can be avoided. Such problems might be increased for those inheriting this year since, with some exceptions, there is no step-up in basis for assets inherited in 2010. On the charity’s side, the lack of records is of no concern, since even with zero cost basis the charity pays no tax on the sale.

Life Insurance

Any of the gifts described above can be leveraged by means of a life insurance policy on the donor. (In Michigan, the only insurable interest requirement is that the donor give the charity written consent to the purchase of the policy on his or her life.) Life insurance would be especially useful if the Roth converter had originally intended to leave the traditional retirement plan to charity. In that case, the death benefit paid to the charity would replace the value of the now Roth IRA, which is better left to heirs.

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Long-Term Care Riders Inside an ILIT

By Julius H. Giarmarco, Esq.

In recent years, some insurers have begun to offer long-term care (LTC) coverage in the form of riders to life insurance policies. These riders are often referred to as “Living Benefit” or “Living Needs” riders. The LTC benefits offered under these riders are similar to those found in an LTC policy. The benefits may be defined as a specific daily amount or as a percentage of the face amount of the policy (up to a specified maximum). Under an “independent” program, the LTC rider will not affect the policy’s death benefit (or cash value), but in an “integrated” program, any LTC rider benefits paid will result in a reduction of these values.

LTC policies (including LTC riders) come in two base models: reimbursement plans and indemnity plans. A reimbursement plan pays the selected benefit, but only up to the actual cost of the service. In contrast, an indemnity plan pays the selected benefit amount – even if it exceeds the actual cost incurred. An indemnity plan provides more flexibility, but is also more expensive.

In deciding whether to buy a stand-alone LTC policy or an LTC rider to a life insurance policy, the purchaser should consider the following issues:

- Is there a need for the life insurance coverage?
- Will the LTC coverage be adequate, particularly where the carrier caps the amount that can go to LTC benefits as a percentage of the face amount of the policy?
- If LTC benefits are paid, will the reduced life benefits (under an integrated plan) be sufficient for the beneficiaries?
- Are the benefit options in an LTC rider comparable to those in a stand-alone LTC policy?
- How much more expensive is the cost of a stand-alone LTC policy compared to an LTC rider?

An analysis of LTC insurance policies is beyond the scope

of this article. But, let's assume that the decision is made to purchase a life insurance policy with an LTC rider. Let's further assume the insured has a taxable estate and, therefore, wants the life insurance policy to be owned by an irrevocable life insurance trust ("ILIT"). How best to structure this program for a married couple?

The insured will be the grantor and the insured's spouse (or child) will be the trustee of the ILIT. The insured/grantor cannot be a beneficiary of the ILIT without adverse estate tax consequences. Thus, the insured's spouse will be the primary beneficiary of the ILIT and, upon the spouse's death, the children will be the remainder beneficiaries. The trustee will be the initial owner and beneficiary of the policy. Finally, the ILIT will be designed as a "grantor" trust so that all items of income and deduction are taxed to (or deductible by) the grantor.

What are the tax consequences if the insured qualifies for LTC benefits? First, the LTC rider should not require the carrier to pay the benefits directly to the nursing home. If so, this will bring the trust assets back into the grantor's estate as a transfer with a retained interest. IRC Section 2036. As mentioned above, the grantor cannot benefit from the ILIT.

If the LTC benefits are paid directly to the ILIT, the trustee can distribute such amounts to the spouse (or the children after the spouse's death) as beneficiary of the ILIT as needed for "health, education, maintenance and support". Thus, the grantor/insured can "indirectly" benefit from the LTC benefits. But, the beneficiaries cannot be legally obligated to pay the grantor's LTC expenses and there cannot be a "prearranged" agreement between the parties to do so – without running afoul of IRC Section 2036. Finally, if the spouse or children pay the grantor's LTC expenses directly to the care facility, such payments are not considered taxable gifts. IRC Section 2503(c)(2)(B).

As a result of the Pension Protection Act of 2006 (PPA 2006), effective January 1, 2010, "tax qualified" LTC riders will be treated for tax purposes as separate contracts. LTC riders must clear these hurdles to be tax qualified:

- To receive benefits, the insured must be unable to perform at least two of these "activities of daily

living" (ADLs): eating, bathing, dressing, getting out of bed, toileting and continence.

- A health care professional must certify that these conditions will last at least 90 days.
- Alternatively, the insured will be eligible for benefits if he/she requires supervision to protect himself/herself from threats to his/her health and safety due to severe cognitive impairment and this condition has been certified by a licensed health care professional within the previous 12 months.

If these conditions are met, tax-qualified LTC riders offer two tax benefits: (1) the premiums may be deductible, and (2) the benefits will not be taxable. Generally, the premiums for a tax qualified LTC rider are considered a medical expense and are deductible (for itemizers) to the extent they exceed 7.5% of the insured's Adjusted Gross Income. But, the amount of the LTC premium that is treated as a medical expense is limited by IRC Section 213 (d), based on the insured's age. For example, in 2009 the limit is \$1,150 for insureds between ages 50 and 60; \$3,080 for insureds between the ages of 60 and 70; and \$3,850 for insureds over age 70.

Benefits from reimbursement riders are not taxable. And benefits from indemnity riders are only taxable if they exceed the beneficiary's total qualified long-term care expenses or \$280 per day (for 2009), whichever is greater. Finally, PPA 2006 allows the LTC rider to be funded through a partial cash surrender without taxation, so long as the investment in the life insurance policy is large enough to support the transaction. Thus, the LTC rider can be acquired with pre-tax dollars, but then benefits from such riders so acquired will not be deductible.

In short, the appeal of using an LTC rider is that someone will benefit from the combination policy. If LTC benefits are not needed, the death benefit will pay out in full. In contrast, with a stand-alone policy, if LTC benefits are not needed, the premiums are never recovered. But, the extra coverage comes with an extra cost (i.e., the cost of the life insurance). Thus, if life insurance is not needed, a stand-alone LTC policy should be used.

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