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THE PLANNER

THE DECEMBER 2011 EDITION Volume 6, Issue 12

A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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IRA's And Qualified Retirement Plans For Wealth Transfer Planning

Coordinating retirement plans with wealth transfer planning can be challenging. This is primarily because retirement accounts are driven by income tax laws designed to encourage Americans to accumulate wealth for retirement, not for transferring wealth upon death.

In this edition of The Planner we will examine some of the critical rules in using IRAs and qualified retirement plans for wealth transfer planning, common misperceptions in this area, and why naming a trust as beneficiary may be the only way to accomplish some of the client's planning objectives. Completely covering these subjects requires volumes, so we will cover only the basics.

This topic is especially important now as the baby boomer generation begins retiring. At the end of 2010, IRAs and qualified retirement plans held nearly $17.5 trillion, accounting for 37% of all household financial assets. And because of how lifetime minimum required distributions are calculated, IRAs and qualified retirement plans may be the largest assets held at death.

The Fundamentals

Distribution Calendar Year: A distribution calendar year is a year in which the participant is required to take a distribution from the plan. The first distribution calendar year is the calendar year in which the participant reaches age 70 1/2 (for some employees under some qualified retirement plans, this may be the year in which the participant retires)

Required Beginning Date (RBD) A special rule applies to the first distribution calendar year. The required distribution for that year may be taken as late as April of the following year, which is called the required beginning date (RBD). Because all other required distributions must be made within their assigned year, the distribution for the second distribution calendar year must be made before December 31 of the year in which the RBD falls.

Minimum Required Distribution (MRD): In each distribution calendar year, the participant is required to take at least a prescribed distribution, called the minimum required distribution (MRD). The MRD for each distribution calendar year is determined by dividing the prior year-end account balance by a life expectancy factor for the participant that is supplied by the IRS. If the participant's sole beneficiary is his or her spouse who is more than 10 years younger than the participant, the MRD is calculated using the Joint and Last Survivor Table. Otherwise, the Uniform Lifetime Table, which assumes a joint life expectancy with someone presumed to be ten years younger, is used. Under the Uniform Lifetime Table, a participant who only takes the MRD each year cannot outlive his or her retirement benefits.

Planning Tip: Taking only the MRD also means that the account will probably grow for years past the RBD. For example, if an IRA is growing at a rate of 5.5%, at age 100, the participant will still have about 60% of the original account balance is still in the account. Planning for the beneficiaries, therefore, is very important.

Minimum Required Distribution for the Year of Death

If the participant has not yet taken the entire MRD for the year in which he/she dies, the beneficiary must withdraw the remaining amount of the participant's MRD by before the end of that year. If there are multiple beneficiaries, the MRD rules are satisfied as long as the beneficiaries, in the aggregate, take the balance of the year-of-death MRD and it does not have to be pro rata.

Minimum Required Distributions after Death

After the participant's death, MRDs apply to the beneficiary and normally begin the year after the year of the participant's death. The after-death MRD rules are more complicated than the lifetime MRD rules, and are based on three factors:

1) Whether death occurs before or after the participant's RBD for that IRA or qualified retirement plan;
2) Who, or what, is the beneficiary; and
3) For qualified retirement plans, what the plan allows.

Note: The rules are different if the spouse is the sole beneficiary; that will be covered later.

Planning Tip: If your client is a participant in a qualified retirement plan, make sure you review and understand what the plan will allow as a part of any planning, because, in many cases, plan rules trump the general rules.

Who is the Participant's Beneficiary? Is There a "Designated Beneficiary" (DB)?

Beneficiary means those who are entitled to the plan benefits upon the participant's death. Retirement benefits generally pass as non-probate property, by contract, to the beneficiary named in the participant's beneficiary designation form or, if there are none, as specified in the plan. The provisions in the participant's will or revocable living trust are irrelevant as to who receives the benefits, unless the plan or the participant's beneficiary designation provides otherwise.

"Designated beneficiary" does not mean the beneficiary designated by the participant. It is a legal term and understanding its meaning is crucial to planning and for compliance with post-death MRDs.

There is a Designated Beneficiary for an account if, on September 30 of the year following the year of the participant's death, there is no beneficiary that has to be considered in making the analysis that is not a human being or a qualified "look-through" trust and the plan administrator or custodian can know, with certainty, the oldest person who has to be considered in making the analysis.

Planning Tip: During this period of at least nine months, clean-up strategies can be used. These include removing non-qualified beneficiaries and division into separate shares (discussed below).

Planning Tip: Most IRAs and qualified retirement plans have printed beneficiary designation forms they expect the participant to use. Most, but not all, will accept attachments. Some will accept a separate instrument. Due to the limited space on most forms, it will probably be necessary to add an attachment. When drafting beneficiary designations, make sure the plan permits what you are trying to accomplish.

Keys to Achieving "Designated Beneficiary" Status: Only an individual or a qualified "look through" trust can be a Designated Beneficiary. Estates, partnerships, corporations, LLCs, other trusts, and charities do not qualify. If there are multiple beneficiaries, all must be individuals and the oldest must be identifiable.

Determining the MRD for the Beneficiary after the Participant Dies.

When determining the MRD for years after the participant's death, the critical questions are: (1) Is there a Designated Beneficiary; (2) Did the participant die before or after the Required Beginning Date? and (3) What does the plan provide?

If there is a Designated Beneficiary, regardless of when the participant dies, each beneficiary may use the Designated Beneficiary's age factor as shown in the Single Life Table to determine his or her MRD unless the plan requires more rapid distribution. Using the Designated Beneficiary's age is commonly known as a "stretch-out," and, in most cases, maximum stretch-out results in significantly more wealth passing to the beneficiary.

Using the Life Expectancy Rule, the beneficiary calculates the MRD for the first year by dividing the account balance by the Designated Beneficiary's life expectancy. Each subsequent year, calculate the MRD by dividing the remaining account balance by the prior year's divisor minus "1." Thus, using this method, a beneficiary will withdraw all of the retirement benefits by the life expectancy of the Designated Beneficiary, even if taking only the MRD each year.

Death before Required Beginning Date

If the participant died before his or her RBD and there is no Designated Beneficiary, distributions must comply with the Five-Year Rule unless the plan requires more rapid distribution. Under the Five-Year Rule, the entire plan balance must be distributed by December 31 of the year containing the fifth anniversary of the participant's death. Annual distributions are not required. If there is a Designated Beneficiary, use of the Five-Year Rule is optional unless the plan provides otherwise.

Planning Tip: The Five-Year Rule only applies if the participant dies before his or her RBD.

Death after Required Beginning Date

If the participant died after his or her RBD, unless the plan requires more rapid distributions, the beneficiary's MRD is determined using the Single Life Table factor for the longer of the life expectancy of a person the same age as the participant and the life expectancy of the Designated Beneficiary, if any.

Planning Tip: Because a Roth plan has no RBD, the Five-Year Rule applies to Roth plans with no Designated Beneficiary, even if the participant has reached his or her RBD for other IRAs or qualified retirement plans. Also, distributions from a Roth plan cannot satisfy MRD requirements for non-Roth plans.

Multiple Beneficiaries

If there are multiple beneficiaries, there is no Designated Beneficiary unless all of the beneficiaries are individuals. If all of the beneficiaries are individuals, the Designated Beneficiary is the oldest beneficiary and it is his or her life expectancy that sets all MRDs. There are, however, two "escape hatches:"

1) The ability to remove a beneficiary through disclaimer or distribution of that beneficiary's share. This must be done by September 30 of the year following the year of death.

Example: If the beneficiary designation is to a trust that distributes a specified sum to a charity and splits the balance between Child 1 and Child 2, you can make the distribution to charity prior to the critical date. That would leave you with the two individuals, Child 1 and Child 2, and the older of the two would be the Designated Beneficiary.

Example: If the beneficiary designation is to a trust that distributes one-third to the participant's mother and one third each to Child 1 and Child 2, if the beneficiary's mother disclaims her interest prior to the critical date, the beneficiaries would be Child 1 and Child 2 and the older of the two would be the Designated Beneficiary.

2) The separate accounts rule: If the participant's benefits under a plan are divided into separate accounts with different beneficiaries, the post-death MRD rules apply separately to each account. This allows multiple beneficiaries to each use their own life expectancy in determining post-death MRDs. (The separate account rule is not applicable to multiple beneficiaries who take their interests through a trust that is named as a beneficiary of the plan.)

Planning Tip: In order to satisfy compliance for the separate accounts rule, there must be pro rata sharing in gains and losses, which is normally done by fractional or percentage division. A pecuniary gift would not meet the definition unless (under local law or beneficiary designation) the gift shares in post-death gains and losses pro rata with the other beneficiaries' shares. However, you can eliminate the recipient of a pecuniary gift from being included in the Designated Beneficiary determination by distributing that gift before September 30 of the year following the year in which the participant died.

Planning Tip: Separate accounts must be established by December 31 of the year following the year of the participant's death to use separate life expectancies. If established later, the separate accounts are still effective for all other purposes.

Critical Dates

September 30 of the year following the year of death
- Beneficiaries must be identified.
- Non-designated beneficiaries eliminated by disclaimer or satisfaction of bequest.

October 31 of the year following the year of death
- Trust documentation must be filed with the plan administrator if a trust is named a designated beneficiary.

December 31 of the year following the year of death
- First distribution to beneficiary must be made.
- Separate accounts must be created to be able to use individual life expectancies.

Surviving Spouse as Sole Beneficiary

Special rules apply if the surviving spouse is the sole beneficiary. For example, if the surviving spouse is more than ten years younger than the participant and the sole beneficiary, the participant's MRDs are determined by using the Joint and Survivor Table.

If the surviving spouse is the only beneficiary, he or she can roll over the inherited benefits into his or her own retirement plan or elect to treat an inherited IRA as his or her own IRA. There is no deadline by which the spouse must make the rollover decision, but until the rollover is made, MRDs would have to be under the inherited IRA rules based on the spouse's age unless the plan requires more rapid distributions.

Planning Tip: A spouse who is under 70 1/2 can postpone distributions until reaching his or her own required beginning date, and can take MRDs using the recalculation method from the Uniform Lifetime Table. In addition, after rollover the spouse can name his or her own beneficiaries who can then use their own life expectancies after the surviving spouse dies, resulting in the maximum stretch-out.

Planning Tip: If the surviving spouse is under 59 1/2, special care must be taken in deciding whether and when to do a rollover. This is because distributions taken from the account after rollover and before the survivor reaches age 59 1/2 are subject to the 10% early withdrawal penalty.

If the participant dies before his or her RBD and the spouse does not do a rollover (i.e., treats the plan as an inherited plan), annual distributions to the surviving spouse can be postponed until the end of the latter of the year following the year in which the participant died or the year in which the participant would have reached age 70 1/2. If, after rollover, the surviving spouse dies before his or her RBD, the MRDs for her beneficiaries will not be based on the participant's remaining life expectancy. For them, MRDs will be based on either the five-year rule or, if the spouse has a Designated Beneficiary, the life expectancy of that Designated Beneficiary.

While the surviving spouse remains the beneficiary and has reached his or her RBD, following the surviving spouse's death, distributions may be stretched over the surviving spouse's hypothetical remaining life expectancy under the fixed-term method (life expectancy rule).

Trust as Beneficiary

There are two common myths about estate planning for qualified retirement plans and IRAs:

1) You cannot name a trust as beneficiary and get a stretch-out; and

2) Naming an individual as beneficiary will result in a stretch-out.

The problem with naming an individual as beneficiary is that he or she is likely to cash out the IRA or plan account, thus negating the participant's careful planning for long-term tax-deferred growth. Example: A 25-year-old inherits a $100,000 IRA. Will he choose a $60,000 automobile (the amount after cashing in the IRA and paying the income tax) or $400,000 in after-tax income over his or her life expectancy (based on 5% growth and combined state and federal income tax of 35%)? If the client's goal is to preserve tax-deferred growth, it is advisable to have a trustee involved who will ensure that happens.

Normally a trust is a non-individual and cannot qualify for Designated Beneficiary status, but it is possible to name a trust as beneficiary and still have a Designated Beneficiary for purposes of determining MRDs. Special rules allow a "see-through trust" that lets you look through the trust and treat the trust beneficiaries as the participant's beneficiaries, just as if they had been named directly as beneficiaries by the participant.

Planning Tip: If a trust is made the beneficiary, neither the spousal rollover nor the special accounts treatment is available. However, if the trust states that property can be distributed out to the spouse, then the IRA could be distributed to the spouse and the spouse could roll over the IRA.

Requirements for a See-Through Trust

To qualify as a see-through trust, the trust must meet certain criteria:

1) The trust must be valid under state law.

2) The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the participant. (While it is not necessary to include this wording in a revocable living trust or testamentary trust under a will, WealthDocxTM does so out of caution and for the benefit of the plan provider. Also, a trustee's power to amend the administrative provisions of the trust should not be considered a power to revoke. See PLRs 200537004 and 200522012.)

3) Certain documentation must be provided to the plan administrator by October 31 of the year after the year of the participant's death.

4) Trust beneficiaries who are to be included in the Designated Beneficiary determination must be identifiable from the trust instrument and all must be individuals.

A Designated Beneficiary need not be specified by name as long as the individual who is to be the Designated Beneficiary is identifiable under the plan. Thus, the members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. For example, "my descendants" is a class that can be identifiable even if they are not individually named.

Which trust beneficiaries are to be included in the Designated Beneficiary determination? The general rule is that contingent and successor beneficiaries count, unless the beneficiary is a "mere potential successor to the interest of one of the beneficiaries upon that beneficiary's death." What is a "mere potential successor" beneficiary is demonstrated by an examination of "conduit" and "accumulation" trusts.

Conduit Trusts

These specifically require that any distributions that come from the IRA and go into the trust must be immediately distributed to the identifiable current beneficiaries. The IRS regulations say that, with a conduit trust, the Designated Beneficiary analysis has only to look at the current beneficiaries because all others are mere potential successors. Thus, with a conduit trust remainder beneficiaries could be charities and older beneficiaries.

Planning Tip: With conduit trusts distributions cannot accumulate in the trust, so there is no asset protection for those distributions. Also, if there is a special needs beneficiary, required distributions could result in the loss of government benefits.

Accumulation Trusts

The advantage of these trusts is that distributions can accumulate and do not have to be immediately distributed to the beneficiaries, so they provide asset protection for plan distributions. However, these trusts are more difficult to draft so that there will be a Designated Beneficiary. All potential remainder beneficiaries must be identifiable and they must all be individuals. This is not possible, for example, when the remote contingent beneficiaries are someone's heirs at law.

Stand-Alone Retirement Trust (SRT)

Using an SRT to receive retirement plan benefits is often the best solution. As you have seen, qualified retirement plans and IRAs are special assets with unique tax rules that provide well for accumulating wealth for retirement but do not work so well when trying to pass this wealth on to the next generation. It is always best to transfer property to the next generation in trust rather than outright. When the facts are such that an accumulation trust is best, it is difficult to draft it in a revocable living trust.

An SRT is an inter vivos trust created by the participant as grantor; it can be revocable or irrevocable. It is nominally funded during the grantor's life and will receive retirement plan benefits upon the death of the participant by means of properly drafted beneficiary designations.

Planning Tip: Using an SRT can ensure stretch-out (if that is the client's objective) while also allowing the financial professional to maintain the assets under management.

Conclusion

Understanding retirement planning helps the planning team help clients pass more wealth to their loved ones, integrate a client's IRA with their overall wealth plan, maximize continued tax-deferred growth, protect and grow IRA savings for their families, and take advantage of the rules applying to separate accounts governing IRAs and qualified plans so that each beneficiary can control his or her own inheritance.

Like other aspects of planning, it is helpful to review client retirement planning objectives and beneficiary designations frequently to ensure they coordinate with the client's planning.

The Top News Stories in 2011

There were many newsworthy events this year that affected or could affect many of the seniors and special needs clients we serve. This issue of the Planner looks at some of the top stories that made headlines this year

Proposed Cuts to the Federal Budget

Much of the news this year has been dominated by talks of the debt our country faces. As a result, much of the focus has been on cutting spending, particularly in the areas of Medicare, Medicaid and Social Security.

An agreement was reached for the first round of cuts earlier this year, and a super committee was appointed to meet and come to an agreement on an additional $1.2 trillion in cuts over the next ten years. The super committee, made up of six Republicans and six Democrats from Congress, is to reach an agreement by late November, and Congress is to approve the recommendations by December 23, 2011. If the super committee does not reach an agreement or Congress fails to approve any agreement proposed, then automatic cuts will occur.

For an in-depth explanation of the process and potential cuts if the super committee does not reach an agreement, please view the OMB Watch report at http://www.ombwatch.org/files/budget/debtceilingfaq.pdf.

CLASS Act Provisions Withdrawn

The Community Living Assistance Services and Supports (CLASS) Act was the government-operated long term care insurance program that was part of last year's Patient Protection and Affordable Care Act of 2010, commonly referred to as "health care reform." The CLASS Act provisions were to begin in January 2011 and required a working individual to be enrolled in the program for 5 years and maintain the minimal work requirements for 3 of the first 5 years of employment. Premiums would be deducted automatically from the individual's paycheck and were expected to range from $150 to $240/month depending on the age of the enrollee, with decreased premiums available to persons with low income. The $50/day minimum benefit could be used to pay for personal care needs, medical equipment, and care at home.

However, on October 14, 2011, the Department of Health and Human Services Secretary Kathleen Sebelius sent a letter to leaders of Congress stating that despite their best analytical efforts, the Department did not see "a viable path forward for CLASS implementation at this time." There are no plans to move forward with the CLASS Act as written in the health care reform law of 2010.

U.S. Supreme Court to Review Constitutionality of Health Care Reform Law

At the end of September, 26 states in the 11th Circuit, states in the 4th and 6th Circuits, and several private plaintiffs filed petitions asking the United States Supreme Court to review whether the health care reform law as passed in 2010 is constitutional, in particular the mandate requiring all individuals purchase and maintain health care insurance. If found to be unconstitutional, states are arguing that the individual mandate cannot be separated from the rest of the Act, and the entire Act should be declared unconstitutional.

The Supreme Court announced on November 14 that it would review the constitutionality of the health care reform law. A decision is not expected until 2012.

COLA Increase for Social Security and Certain Veterans Benefits

For the first time since 2009, Social Security recipients will receive an increase in their monthly checks. In October, the Social Security Administration announced a cost of living adjustment of 3.6% that will take effect December 1, 2011. Recipients will see the first increase in their January 2012 check. The standard Medicare Part B premium will only increase $3.50 to $99.90 per month, much lower than initially projected.

Veterans will also see an increase in Compensation and Pension benefits as a result of the Social Security increase. While an increase is not automatic with a cost of living adjustment, the House and Senate have both voted to increase Compensation and Pension benefits (including those payable to eligible survivors) by 3.6%. Senate Bill 894 was passed by the Senate in October and approved by the House in early November and is expected to be signed by the President shortly. Like Social Security, the increase in veteran's benefits is scheduled to begin in December 2011, with the first increase to appear in January 2012 payments.

More Caregivers are Proactive in Planning for Loved Ones with Special Needs

The MetLife Center for Special Needs Planning's 2011 Torn Security Blanket study polled 1,000 caregivers and included follow up interview with some of the respondents. The study, released in October, found that progress has been made in the area of special needs planning by caregivers, but there is still much progress to be made.

Some key findings include:

- 38% of caregivers have written a Will, compared to 32% in 2005.
- 36% of caregivers have planned for their dependent's future housing, up from 31% in 2005.
- 21% of caregivers have set up a special needs trust, nearly double the number in 2005.

As noted above, the study also showed where there is still much room for improvement when it comes to planning:

- Only 49% of caregivers have identified a guardian for their dependent should they no longer be able to care for them.
- More than half (56%) said they are unfamiliar with the steps needed to identify a trustee to watch over their dependent's financial holdings in the future.
- 55% weren't sure how to set up a plan for lifetime financial assistance for their dependent.

The full text of the study can be found at:
www.metlife.com/assets/investments/services/special-needs-children/Torn-Security-Blanket-Report.pdf.

Conclusion

The past year was a turbulent one with continued financial strain on much of the population. Adding to the stress of many families who have loved ones receiving government benefits was the continued talk of cutting government programs like Medicare and Medicaid. The next few months will prove critical in understanding how those programs will be affected.

Despite the turbulence around the economy, social security recipients and veterans' benefits recipients will receive the first cost of living adjustment since 2009. Other positive news was reflected in the 2011 MetLife Torn Blanket Study that showed more caregivers are being proactive in planning for loved ones with special needs.

If you have any questions or if we can help someone you know, please don't hesitate to contact our office.

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