Genworth Financial

CASE STUDIES

Charitable Stretch IRA

Participants in retirement plans—including IRAs—often face a difficult question. "How do I get the most money to my family if I die early?" This question becomes even more difficult if you think you might use that money to provide financial help to a member of your extended family.

Issued by

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The strategy discussed in this case study may interest those who:

- Are charitably inclined.
- Have an estate valued at less than $2 million ($4 million if married).
- Have an IRA worth a third or more of the value of the estate.
- Want to take care of a spouse or children.
- Are concerned about providing financial help to a sibling or other member of the extended family who is older than the spouse. It is useful if you want to pay income to "John for life, then to Mary for life" when John is older than Mary. A conventional stretch IRA cannot do that.

THE FACTS, THE WHOLE FACTS AND NOTHIN' BUT THE FACTS

Dad (age 59) and Mom (age 58) have an estate worth about $4 million. Of that, about half is in Dad's IRA. The rest is in other investments they expect to use for retirement income, their home, furnishings, a couple antique cars, some purebred hamsters, etc. They expect that Dad's pension and those investments will take care of most, if not all, of their retirement income needs. They have three children, the youngest of whom is 30.

Dad has a sister, Petronella, who is ten years older than him. Petronella's sole source of income is a small Social Security check. Her health is running on the bad side; that is one reason she usually runs out of money before she runs out of month. As long as he is alive, Dad knows he can help her financially. However, he worries about what will happen if he dies before Petronella. He knows that outside of his investments, his IRA is his most liquid asset. He's not sure how to make sure it's available to take care of his sister as long as she is alive.

Mom and Dad also worry about estate taxes. Until the federal estate tax exemption increases to $3.5 million in 2009, their children could face a $920,000 estate tax bill.[1] They currently have a will with a credit shelter trust (CST).[2] The trust lets both Mom and Dad use their $2 million estate tax exemption so the children don't have to pay the $920,000. However, as we'll see, because the IRA is such a large part of their estate, it may be hard for both Mom and Dad to use their exemption.

They also worry about income tax on the IRA after they die. They've heard about "stretch IRAs" and understand that one of the benefits of "stretching" distributions from an IRA is that money not yet paid out continues to grow tax-deferred. That effectively increases the investment yield on IRA assets compared with taking money out of the IRA, paying tax on it and investing what's left.

TYPICAL STRATEGIES

Mom and Dad's legal and tax advisers have suggested five strategies for them to think about.

- Mom becomes owner of Dad's IRA
- Mom takes income as the sole beneficiary of Dad's IRA
- Mom cashes out the IRA
- Dad names Mom and Petronella as beneficiaries of his IRA
- Dad names the credit shelter trust as beneficiary of his IRA

PROBLEMS WITH THE TYPICAL STRATEGIES

Let's first look at how each strategy works and consider the issues they raise before we talk about the Charitable Stretch IRA.

Mom moves Dad's IRA into her own

When Dad dies, Mom could elect to make the IRA her own; she would become the owner. If she doesn't need the money, she could let the IRA grow tax deferred until she turns 70½. When she does begin taking required minimum distributions (RMD), she'll use the life expectancy table for owners, not the table for beneficiaries. The owner's table has RMD factors going out to age 115. That's important because it lets Mom receive income as long as she lives. If she had to use the beneficiary table, she could take income only for her life expectancy in the year after Dad died, which would be less than 115.

If Mom needs to tap the IRA before turning 70½ in order to help Petronella, she may take what she needs and give it to her sister-in-law.

Mom will pay income tax on the money she takes but, if she's older than 59½, she won't have to pay the additional 10% tax on early withdrawals. Mom's "gifts" may also be taxable and she may have to file annual gift tax returns.

Beyond the financial considerations, there are personal considerations as well. It's one thing for Petronella to accept money from her brother. Family is supposed to help family. However, it's something else for Petronella to depend on her <u>sister-in-law</u>. The gift makes it awkward. Both Mom and Dad worry about how this may affect Petronella's dignity and independence.

Dad also worries about what could happen if Mom becomes the owner of his IRA. He's heard horror stories about widows who remarry and how the new husband (and <u>his</u> children) end up with what was supposed to be an inheritance for Dad's children. Unlike other property, Dad cannot control what Mom does with the IRA if she becomes the owner.

If Mom wants to use this strategy, $2 million of <u>other</u> assets must go into Dad's credit shelter trust in order for Dad's estate to take advantage of the $2 million estate tax exemption. Mom may have to put everything else she then owns into that trust—the home, the antique cars, even the purebred hamsters. There may be other tax considerations that make that less than ideal.

Mom becomes beneficiary of Dad's IRA

Under the second strategy, when Dad dies Mom becomes a beneficiary of Dad's IRA instead of becoming the owner.

If Dad is younger than 70½ when he dies, Mom may wait until the year Dad would have turned 70½ before she starts taking required minimum distributions. Otherwise, she begins taking RMDs, based on her life expectancy, the year after Dad dies. Because she is a surviving spouse, she gets to recalculate her life expectancy every year. However, she uses the table for beneficiaries, not the table that owners use. That means she must take out more each year and it may not last as long.[3]

The tax concerns (income, gift and estate) are the same as before. The concerns about remarriage still exist because Mom would have the right to take everything out of the IRA any time after Dad dies, negating any contingent beneficiaries Dad might name.

Mom cashes out Dad's IRA

Mom could cash out Dad's IRA, pay the income tax and invest what's left. She could then use the earnings to help Petronella. Although there may be no 10% penalty tax[4], adding $2 million to her taxable income in a single year would hurt a lot—and not just because of the size of the tax bill. That money, if not paid to the IRS, could be invested to earn more income. Those earnings alone could be more than enough to take care of Petronella's needs for a long time.

This strategy does nothing to take care of the estate and gift tax concerns. It doesn't take care of the remarriage concerns. It is probably the least attractive strategy.

Dad names Mom and Petronella as beneficiaries of his IRA

Dad could name Mom and Petronella as beneficiaries of his IRA. For example, he could name his sister as beneficiary of a quarter of the IRA and Mom as beneficiary of the rest. If done properly, after Dad dies Mom could use either of the first two strategies for her share.

Petronella, on the other hand, must begin taking at least the RMD before the end of the year after Dad dies. (If she needs more than the RMD amount, she may take more.) If Dad dies this year, her first RMD is based on her life expectancy next year, when she will be 70. Her RMD will be the account balance divided by 17. This is her life expectancy in the beneficiary table divided by 17. Each year after that, the life expectancy part of the equation goes down by 1.

The entire IRA must be paid to her within 17 years. In other words, the last distribution would be before Petronella is 87, if she is still alive then. If she dies before then, whatever is left will be paid at the same rate to any contingent beneficiaries Dad might name.

Because Petronella's needs vary from month to month, it's impossible to know with any certainty how much of his IRA Dad should leave to his sister. Whatever he decides, the RMDs will be different from what she needs. If she's not left enough, Mom must be willing to continue to make up the difference.

This strategy may address the concerns Mom has about having to make gifts to Petronella. And Petronella may be in a lower income tax bracket than Mom, so it takes care of at least part of that issue. Whatever share he gives to Petronella does help Dad use part of his $2 million exemption. However, it still leaves the rest of his IRA exposed to estate taxes when Mom dies.

And, more importantly, because Petronella will receive income no longer than 17 years, it does not take care of Dad's desire to take care of Petronella no matter how long she lives. If Dad's only concern was to provide that lifetime income, she could take her share as a Genworth Life & Annuity (or in New York, Genworth Life of New York) SecureLiving℠ single premium immediate annuity (SPIA) IRA. She would have a lifelong income. That could, however, create a conflict with Dad's other desire to be charitable. It also means there is no discretion to take less than the SPIA payments.

Dad makes a trust the beneficiary of the IRA

The final strategy calls for Dad to make his credit shelter trust the beneficiary of his IRA. Mom and Petronella would then be beneficiaries not of the IRA but of the trust. After Dad dies, the trust would receive RMDs from the IRA and Mom and Petronella would receive income from the trust.

As suggested earlier, when retirement assets like an IRA are a big part of the estate, getting enough into a credit shelter trust to use the entire $2 million exemption can be hard. If Mom has "too much" control or "too many" rights over the trust, the trust assets will be included in her estate when she dies—which defeats the purpose of the trust. Typically she can receive any income the trust produces, but she may use principal only if needed for her "health, education, maintenance and support." While those standards may seem fairly broad, they are not unlimited. The trust may also include language to let her take, for any reason or for no reason at all, the greater of $5,000 or 5% of the trust principal every year.

That gives her some flexibility—but not as much as she would have as either owner or beneficiary of the IRA. We'll assume that Mom and Dad are willing to trade those limitations to save $920,000 in federal estate taxes.

The problem may get worse when the estate tax exemption rises to $3.5 million in 2009. More well-off families may face the choice of giving their IRA to a credit shelter trust, putting things into the trust that don't "fit" well, or making the family pay more estate taxes than they would otherwise have to pay.

There are various other tax considerations that go into deciding what should go into a credit shelter trust. They are beyond the scope of this case study.

One of the concerns with using a credit shelter trust as beneficiary of an IRA is that a trust reduces flexibility to stretch IRA distributions. IRS regulations say the trust can stretch distributions only as long as the oldest beneficiary is expected to live (using IRS tables, of course). That is, the trust must use the shortest life expectancy when it calculates RMDs. Petronella's life expectancy applies to the entire IRA, not just her part of it. If Dad died this year, the trust can stretch distributions only 17 years.

Petronella may still be alive in 17 years. Mom probably will be and income from the IRA may well end just when Mom needs it to continue. If Mom had been the only trust beneficiary, the trust could stretch the IRA as long as she lives. This strategy doesn't provide any opportunity to continue payments to Mom (or the kids) after those 17 years. Mom will be only 75 then and the youngest child will be only 47. Mom doesn't have the alternative of waiting and letting her share continue to grow tax-deferred if she doesn't need the money before then.

RMDs from the entire IRA must begin the year after Dad dies. It doesn't matter that Mom is a beneficiary of the trust or that if she was the beneficiary of the IRA she might be able to wait before taking RMDs.

If Dad's goal is just to stretch payments, he will succeed. If however, he wants to provide income as long as Petronella is alive, he may fail. Here a single premium immediate annuity would not be a solution. If the trust is the beneficiary, RMDs must be based on the life expectancy of the oldest beneficiary.

Based on Petronella's life expectancy, the first year's RMD is $117,647 ($2 million divided by 17). Since this RMD will be more than Petronella needs, the balance could either go to Mom or stay in the trust. Keeping it in the trust, however, can be expensive. In 2007, a trust is in the top 35% income tax bracket after just $10,450 of income whereas Mom, filing as a single person, would not be in that bracket until she has $349,700 in income. And the trust, unless it must pay all its income every year, has a standard deduction of only $100; Mom's standard deduction would be $5,150 (or $6,400 if she is then over 65).

By making the credit shelter trust the beneficiary of his IRA, Dad does effectively address the estate tax concerns. As long as Mom has no more than $2 million in other assets when she dies, the kids will pay no federal estate taxes. And it does take care of those nagging concerns about Mom's new husband's children. Because she's now a trust beneficiary, it's not Mom giving money to Petronella. That may help with the concerns for how Petronella feels about having to go to her sister-in-law when she needs help; asking a trustee may be easier for her.

Dad faces a Hobson's choice. While each of the most common strategies have advantages, each also has disadvantages that may make them unsuitable. Dad wants to take care of everyone. If he names anyone other than Mom as beneficiary of his IRA, the rules don't allow a stretch longer than the life expectancy of the oldest beneficiary. If Petronella lives longer, the money in the IRA may run out on her.

There is a strategy that Mom and Dad's advisers probably haven't talked about. It is our final strategy—the Charitable Stretch IRA.

THE CHARITABLE STRETCH IRA

The IRS discussed this strategy in a 2001 private letter ruling.[5] A private letter ruling is not binding on the IRS except for the person who sought the ruling. It does NOT apply to you and me. However, such rulings are useful in understanding what the IRS is thinking, the direction in which it may be moving, or what it might be receptive to.

The strategy itself is simple.

- Dad creates a charitable remainder trust (CRT) in his will. He decides who will receive income from the trust (Mom and Petronella) and chooses the charity.
- He makes the CRT the beneficiary of his IRA.
- When Dad dies, the entire IRA is paid to the trust.
- The trust invests that money and pays income as directed.

Although we call it a "stretch IRA", you can see it really isn't. Because not all the beneficiaries of the CRT are individuals (it is a charitable trust), the stretch rules we talked about earlier for trusts don't apply. When Dad dies, the entire IRA must be paid to the CRT. It is the charitable trust, not the IRA that provides the benefits of the stretch by paying income to Mom and Petronella. As we'll see, it has benefits that a regular stretch IRA cannot offer.

Benefits to the family

The CRT doesn't pay income tax when it gets the IRA. You'll remember we talked about the heavy tax hit Mom or a regular trust would take if she cashed out the IRA. The CRT, because it is a charitable trust, doesn't have that problem. Nor will Dad's estate, the beneficiaries of his estate or the trust's income beneficiaries.

Because it doesn't have to pay income tax, the trust gets to invest the <u>entire</u> $2 million. If it's suitable and state law allows it, the trust could buy a combination of annuities and life insurance that can provide a guaranteed lifetime income for Mom and Petronella and, at the same time, help make sure the charity gets a sizable gift. For example, it could buy a RetireReady℠ Choice Variable Annuity with an optional living benefit income rider from Genworth Life & Annuity (in New York from Genworth Life of New York). The annuity would provide a guaranteed income for life and the life insurance could help assure a significant gift to charity after both Petronella and Mom die.

Dad can set up the beneficiaries of the CRT however he thinks will work best. Mom could be the sole beneficiary and she could use part of that income if Petronella needs her help. Both Mom and Petronella could be beneficiaries. Or just Petronella could be the beneficiary. He could even set it up so the CRT pays income to his credit shelter trust which then decides how much Mom should get and how much his sister should get.[6] He could also set up separate charitable trusts, one for Mom and one for his sister. The trust for his sister would pay income to her as long as she is alive and, after Petronella dies, continue paying income to Mom for the rest of her life. Dad need only figure out what will best meet everyone's needs.

The result? Instead of only 17 years, income can last as long as <u>either</u> Petronella or Mom lives—assuming, of course, the trustee makes wise investments and has income to distribute. Income is not based on life expectancy but can continue as long as the person lives, up to age 115.

What does it cost the family?

What does this cost the family? Remember the TINSTAAFL rule. (Don't know what the TINSTAAFL rule is? Check the bottom of this case study.)

The Charitable Stretch IRA is a charitable gift—something must go to charity. <u>What goes to charity cannot go to family.</u> Dad has effectively disinherited the kids from his IRA. If that is a concern (for some people it is not), Mom and Dad may want to buy a Lifetime Provider℠ SUL survivorship universal life insurance policy from Genworth Life & Annuity (in New York from Genworth Life of New York) to replace what they've given to charity. If set up properly, the kids will receive the life insurance policy death benefit free of either income or estate tax—unlike what would most likely happen if they get the IRA.

With an IRA or even a credit shelter trust, beneficiaries might be able to dip into principal for emergencies or, perhaps, even for things that are not an emergency. The CRT principal is off limits unless the trustee needs it to make required income payments. Using principal to pay income could, depending on the trust design, mean less income in future years. The proper trust design and the use of annuities as a trust investment could mitigate some of that risk by providing guaranteed payments.

There is also the cost of setting up the charitable trust. These are not simple trusts. Although the IRS has provided "sample" documents, few attorneys use them unchanged because they slant everything in favor of the IRS and don't make use of some terms that clearly favor the donor. Sometimes a charity will pay part of that cost; the cost of that "free service" may, however, be a requirement that Mom and Dad give up the right to change the charity that will eventually get the trust.

When do you not want to use this strategy?

First and foremost, if you do not want to benefit a charity, this strategy is not for you.

Your heirs will probably receive less income from the charitable trust than they might get as beneficiaries of the IRA. It is, after all, a charitable trust and there must be something for the charity. Your desire to help the charity must be strong enough to outweigh this reduced income if that happens. Otherwise, a conventional stretch IRA may be a better choice for you.

If you cannot buy life insurance and it is important that you not disinherit your children, this strategy may not work for you.

When Dad dies, his estate must include the present value of income the CRT will pay to Mom and Petronella.

> Example: Dad names the CRT as beneficiary of his IRA with instructions that the trust pay 70% of the annual trust payments to Mom and the rest to Petronella. (As an alternative, if he has an independent trustee, he can give that trustee the ability to divide the income so Petronella only gets as much as she needs; Mom gets the rest.)
>
> He dies and $2 million is paid to the IRA. The value of the income interest payable to Mom and Petronella, depending on exactly when Dad died, might be about $1.35 million. Mom's interest doesn't qualify for the marital deduction because she is not the only one receiving income. Dad's estate may deduct the other $650,000 as a charitable deduction. If Dad has already used his $2 million exemption, the $1.35 million income interest is fully taxable and could generate an extra $600,000 in estate taxes. Because the cash needed to pay that tax cannot come from the charitable trust, Mom must use other property to pay it. That reduces how much she has to live on.
>
> If Dad has not used his estate tax exemption, this means that Mom must use almost a third of "her" $2 million estate to make sure that Dad's credit shelter trust is "fully" funded.

If Dad decided to add the kids to the list of charitable trust beneficiaries (to "stretch" payments to them), he faces another issue. To qualify for a charitable deduction, the charitable trust must satisfy some "tests" to make sure that, after all those income interests, there is "enough" left for charity. If the income beneficiaries are under 40, or if there are too many of them, the CRT may not pass those tests.

Special warnings

Combining IRA distributions and charitable trusts makes this strategy complicated. Add estate taxes, income taxes, and everything else and you have a mix that requires an expert. This is not the realm of your average lawyer. Find someone who knows what he or she is doing.

If retirement savings are in a qualified retirement plan (such as a 403(b) tax-sheltered annuity, 401(k), profit sharing plan, etc.), when the plan participant dies, the surviving spouse generally receives 100% of the account balance. The only way someone else can get that money is if the spouse agrees. That could destroy a well-designed plan. Different rules govern IRAs so that consent may not be required.

If there is no surviving spouse, the Pension Protection Act of 2006 now allows nonspousal beneficiaries of other qualified plans to roll their interest into an inherited IRA. Special rules apply and an inherited IRA may not work as part of a Charitable Stretch IRA, so make sure you talk with your tax adviser.

IN SUMMARY

Is a Charitable Stretch IRA for everyone? Certainly not. But if it fits, it can help meet needs very well.

- It avoids the income tax hit on outright distributions to a beneficiary.
- It creates an estate tax deduction for the present value of the gift to charity.
- Income can continue as long as income beneficiaries are alive, not the arbitrary life expectancy imposed by required minimum distributions.

Talk with your financial representative today.

Finally, the TINSTAAFL rule – There Is No Such Thing As A Free Lunch.

[1] Technically the exemption amount is called the “applicable credit amount” and used to be called the “unified credit.” However, it’s easier to think of the equivalent amount that is “sheltered” by the credit, so we’ll use that.
[2] Credit Shelter Trusts are also called “Bypass Trusts” or the “B” trust in an “A-B Trust.”
[3] For example, at age 71, her life expectancy is 16.3 under the beneficiary table and 26.5 under the owner’s table. The larger the number, the less that must be distributed as an RMD. The beneficiary table goes to age 111. The owner’s table goes to 115.
[4] Because it’s a distribution caused by death.
[5] PLR 200150019 available at http://www.irs.gov/pub/irs-wd/0150019.pdf .
[6] However, that trust can last only a maximum of 20 years.

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