How to Handle the Beneficiary Designation of Your Client's

IRA in a Second Marriage

By

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Last month, I wrote about IRA beneficiary designations for the "Leave it to Beaver" family, where neither the husband nor the wife remarries as a consequence of death or divorce. When children are involved, estate planning for the "Beaver" family is fairly straightforward. But a second marriage introduces complications that need to be handled with a bit more finesse. How can you help your client, in this case a Dad who has remarried, provide for both his second spouse and his children from the first marriage?

This is where attorneys jump up and down and shriek "Do a QTIP trust." The QTIP is also known as the marital trust, and it is also the "A" in an A/B trust. In a nutshell, the trust provides the second spouse with an income for life, but at his or her death the principal reverts to the children of the first marriage.

Many Dads like this solution because they are providing for their second spouse but they know that the money will eventually go to their children. In reality, trusts for surviving spouses are usually losers in the IRA world.

Don't get me wrong. It is natural to want to protect your second spouse and then have the money revert to your children. For after-tax assets (non-IRA or retirement assets) QTIP trusts, though far from a perfect, are often the best solution. For IRA owners, however, in my mind, using a QTIP trust as the beneficiary of an IRA begs the question: who will be most unhappy—the surviving spouse, the children of the first marriage, or the poor trustee?

This type of trust accelerates income taxes by forcing both the surviving spouse and the children of the first marriage (generally the ones who inherit the remainder of the trust at the second death) to take minimum required distributions (MRD) based on the surviving spouse's age. Furthermore, the life expectancy table that is used to calculate the spouse's remaining life expectancy is less favorable than the table used to calculate an IRA owner's life expectancy. Consequently, while the surviving spouse is alive, minimum distributions are greater than if the surviving spouse had been named outright. When the surviving spouse dies (assuming the surviving spouse predeceases the children), the children will also have an accelerated minimum required distribution schedule based on the life expectancy of their stepparent, not their own life expectancy.

What is an Alternative to the QTIP?

Instead of setting up a QTIP trust, help the IRA owner make an explicit decision to divide the IRA between his spouse and his children from the first marriage; giving *x* percent to the spouse and *y* percent to the children.

For example, if the value of an income stream for a 65-year-old surviving spouse based on a 6 % rate of return is worth roughly 58 % of the principal of the IRA (based on the life expectancy of the surviving spouse and depending on what tables you use), then it is simpler and preferable in the vast majority of cases to leave the surviving spouse 58 % of the IRA and the remaining 42 % of the IRA to the children. The income tax savings that can be harnessed through the "stretch," for both the spouse and the children, is enormous.

By bequeathing *percentages* of the IRA, when the IRA owner dies, each of the inheriting parties assumes complete control over their portion of the IRA. The surviving spouse takes her share and rolls it into an IRA. There will be no MRD until she reaches age 70 ½ so she can opt to wait to take distributions or not as she sees fit, and the distributions will be based on the advantageous Uniform Life Table. The children take their shares as an inherited IRA and stretch distributions based on their own life expectancies. Clean. Simple. Cheap. No trusts, no fuss, no muss. This solution almost always saves thousands and often millions of dollars for both the surviving spouse and the children.

So, what's the hitch? For some of my clients, even King Solomon could not pick an appropriate percentage for the second wife and the children of the first marriage and make all parties happy.

The best solution for many if not most families in this situation is life insurance. For larger estates, I think the best solution is to create an irrevocable life insurance trust with the children as beneficiaries. Dad makes regular gifts to the trustee and the trustee uses those gifts to purchase life insurance owned by the trust. "When the policy matures" (i.e., Dad dies), the children get the death benefit of the policy free of income tax and free of estate tax.

If life insurance is not an acceptable option, for whatever reason, another compromise might be to bequeath after-tax assets to the spouse outright and leave the IRA to the children of the first marriage to fully capitalize on the benefits of the stretch.

Perhaps there are other excellent solutions that you will devise based on the individual circumstances of your client. But please, no QTIPs as beneficiaries for IRAs or retirement plans.