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THE PERFECT HOLIDAY GIFT:
Passing on Wealth to Grandchildren
BY GARY ALTMAN, ESQ.

In my last contribution, I discussed why the holiday season is a great time to discuss estate planning with your family. In keeping with the holiday theme, today I'm zeroing in on gifting – specifically, passing on wealth to grandchildren.

Many grandparents want to leave a significant bequest to their grandchildren. The simplest way is to leave a specific dollar amount or a specific percentage of their estate to their grandchildren. However, this simple approach is not the most tax or economically efficient method of leaving a bequest to grandchildren. This article explores two alternative techniques that can provide significantly more benefits than just a simple bequest.

Getting an IRA – Is it a Good Idea?

The first technique is for grandparents to leave their IRA (or other qualified retirement account) to their grandchildren. IRA assets are generally included in the owner's estate and are potentially subject to federal estate taxes and generation skipping transfer tax [when an individual has assets greater than $2,000,000]. These taxes are further compounded by the fact that IRA distributions are included in a beneficiary's income and therefore subject to income tax. Consequently, although qualified plans and IRAs are undoubtedly one of the best ways to accumulate dollars for retirement, they are not necessarily good vehicles for passing money to future generations. The best solution is to leave IRA assets to grandchildren in a technique commonly referred to as IRA stretch planning.

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IRA Stretch Planning

IRA Stretch Planning slows down distributions from an IRA and allows pre-tax dollars to continue to grow tax deferred through multiple generations. Naming the right beneficiary is the first step in the plan. When the IRA holder is married, the first choice should be the surviving spouse. But, for a single or widowed individual (i.e. the surviving spouse), the youngest individuals available should be named as the primary beneficiaries. For example, if a grandparent names his son, age 43, as the beneficiary, he will have 40.7 years to withdraw the IRA that he inherited from his parent. If the starting account balance is $300,000, the first year distribution would be only $7,370. If the son died at age 80, after taking almost 2 million in distributions over his lifetime, there would only be $450,000 left in the IRA for his descendants (assuming an 8% annual return). By contrast, if a granddaughter is named as the beneficiary of a grandparent's IRA and is 10 years old when the grandparent dies, she will have 72.8 years to withdraw the IRA that she inherited from the grandparent. If the starting account balance is $300,000, the first year distribution would be only $4,121. If the granddaughter died at age 80, after taking almost $14 million in distributions over her lifetime, there would still be over $2.3 million left in the IRA for her descendants (again, assuming an 8% annual return).

The next step in the plan is to postpone payout of the IRA until the IRA holder reaches the required minimum distribution age – generally age 70 ½. Then, required minimum distributions should be taken over the participant's life if possible and not accelerated, leaving a larger IRA balance for the surviving spouse, and eventually for younger generations. At the IRA holder's death, the surviving spouse should roll over the inherited IRA into one or more IRAs, depending on the number of grandchildren, naming each grandchild as the beneficiary

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of each separate IRA account. The ability to roll over and delay distributions until age 70 ½ is available only to a surviving spouse, which is why separate IRA accounts are generally not created until the death of the second spouse. The surviving spouse's ability to roll over an IRA account provides a window of opportunity to delay further any distributions from the decedent's IRA, thus stretching out tax deferred growth over another lifetime before distributions are made.

When the surviving spouse dies, each grandchild will receive distributions from his or her separate IRA over his or her own remaining life. The younger the beneficiary, the longer the payout period. By choosing younger beneficiaries and extending the deferral period, it is possible to accumulate and grow funds from an inherited IRA over multiple generations.

Now that you have made the decision to leave your IRA to your grandchildren, you must complete your plan. Besides changing the beneficiary, you have to consider the following items:

- First, if you have a taxable estate, determining which assets pay the estate tax. Most Wills and Revocable Trusts would require the IRA to pay its fair share of any estate taxes. Since paying estate taxes from IRA assets would defeat the purpose of maximizing wealth transfer to grandchildren, a grandparent may want to change the "tax clause" in his or her Will or Revocable Trust.

- Second, some grandparents will replace some or all of the value that is now not going to their children by purchasing a life insurance policy which the children will receive. If the life insurance policy is owned correctly, it will not be subject to estate taxes.

- Finally, since many grandchildren are minors, IRAs can not be left directly to the grandchildren, but instead must be held in a trust for the grandchild's benefit. These are very special trusts that are designed to be the beneficiary of an IRA and allow for the IRA distributions to be stretched over the grandchild's lifetime. Without the properly structured IRA Trust, the distributions may be wasted by a young beneficiary, controlled by a court, or the IRA stretch defeated by an impulsive grandchild who withdraws the whole IRA at a very young age.

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Creating a Perpetual Trust

The second technique is to create a perpetual trust (or one that lasts as long as your state law allows) that will pay for your grandchildren's and other descendants' education and medical expenses. If structured properly, this special type of education and medical trust will never be subject to generation-skipping transfer taxes and will be an available pool of money that future generations can use to pay for the ever-rising costs of college and medical expenses. Many grandparents decide to leave, in their Wills or Revocable Trusts, a percentage of their estates, such as twenty percent, this type of trust.

The Bottom Line

Grandparents take comfort in knowing their wealth will benefit generations to come and there's more than one avenue to do so. In the interest of maximizing and protecting what's passed on, and making it easier on the beneficiary, it's imperative to have done your due diligence and had things structured accordingly.

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