LEE R. PHILLIPS

TOOLS OF WEALTH

USING THE LAW TO MAKE MONEY

THREE

LEE PHILLIPS SHARES THE LEGAL TOOLS OF WEALTH WITH YOU

STRETCHING YOUR IRA FOR MORE MONEY

By Lee R. Phillips, JD

Not all assets in your estate are created equal. In past issues I have shown you how devastating taxes are on your investment growth. It almost doesn't matter how astute you are as in investor, the tax imposed on your investment will make all the difference in how much money you actually end up accumulating.

You might remember that a dollar doubled 20 times will yield over $1 million. However, if you impose a 40% tax on each double, you end up with a lot less. (One dollar doubled doesn't equal two dollars, because you have to tax the increase. If you tax it at 40% you only end up with $1.60. Then double the $1.60 to get $3.20, but you tax the $1.60 increase so you actually end up

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LIFE ESTATE TRUSTS

By Kristy S. Phillips, JD

More and more people who have assets tied up in Life Estate Trusts, are calling my office. When they want to access their property and cannot, it is a serious concern. People put assets in these trusts thinking that they are getting protection from liability exposure, when in fact all they are doing is opening the door for even more people to sue them. Life Estate Trusts are valid legal tools, but when they are misused, there can be disastrous consequences. Before I get into that, I need to explain what a Life Estate Trust is.

When you own property, under the law you actually own a group of property rights. The best example that people are most acquainted with is that if you own land, you may or may not own the mineral rights with the land. You have one property right (land), but that doesn't mean you have all the property rights (someone else might have the mineral rights). You can divide up property rights in just about any way you want to under the law. If I am renting out a house, I am breaking up my property rights. Where I once had the ability to do anything I wanted to the property, with a tenant my rights are more limited. I am, essentially, selling the rights to occupy and use the property to my tenant for a monthly payment. This transfer of partial property rights is what you do when you rent your real estate.

You can also break up your property rights in time as well as in location. This is where a Life Estate Trust comes in. If I say to you, I will sell you my house now for $100k, but I get to live in the house rent free as long as I live and your property rights don't come into effect until I die, then I have separated the property rights into two parts. I kept the property rights to live in the house while I am alive (this is called a "life estate"), and I have sold to you the property rights after I die (this is called the "remainder").

People who use Life Estate Trusts are selling or giving away the remainder interest in the property to family members, businesses, other trusts, or any number of possible "remaindermen." They do this because they know that a creditor is not as happy about chasing a life estate as they are about chasing assets with "no strings attached." If I am your creditor and I take your life estate in your house, I get to live rent free in your house. But when you die, I have to immediately move out – I have no more right to be there. As your creditor, I can't get the remainder interest, because you don't own that property right.

There are other asset protection values to Life Estate Trusts. Because someone else owns a property interest (the remainder) the property can't be damaged because I don't own it all. Damaging a piece of property that someone else has a future interest in is called "waste," and it is the subject of significant litigation. Creditors can't just take your house and demolish it to build an apartment complex when it is in one of these trusts, because demolishing the house would change the essential characteristics of the remainder interest. Even improvements can be a "waste" of the property – and the remainder holder has the right to demand that the property pass to

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GOT QUESTIONS?

What are your needs, concerns, or challenges?

Email Lee with questions you would like to see answered in this newsletter.

Email: info@legalees.com

STRETCHING YOUR IRA FOR MORE MONEY, CONT.

with only $2.56. You get the picture.) The "lot less" that you end up with is only $12,086 – not $1 million. The tax is a huge loss.

You can't find anyone who says their broker made them rich. Everyone who has played the stock market game with a broker has lost. You can find people who have made money in their retirement accounts and IRAs, but you can't find people who have made money in their general accounts. Their broker hasn't been any more astute at investing the IRA funds than they were at investing funds in the general account. The tax advantages of the IRA and retirement accounts have simply "out run" the investment returns.

The "taxed advantaged" investments you have may be your most valuable asset, and they are almost certainly the most valuable thing you can leave to your loved ones. You will be shocked when you see just how valuable they are. You'll see what I mean at the end of this article.

Tax advantaged investments come in a number of different forms. Obviously, your retirement accounts and IRAs are the ones you would think of first, and they're the ones this article is about.

As a side note, your cash value life insurance is also tax advantaged to you while you are alive, but not to your family after your death. In planning for your retirement, you can make a life insurance policy act almost exactly like a Roth IRA. In some ways the life insurance acting as a "nonqualified retirement plan" is better than a Roth IRA. For example, there are no contribution limits, required withdrawals, discrimination rules, adjusted gross income regulations, or other regulations that restrict your use of a Roth IRA.

Be very, very careful though. The insurance companies can burn you in a New York minute. We have read hundreds of life insurance policies and only seen one or two good ones. Those are bad odds, so call me if you try to play the life insurance cash value game and actually try and use your cash value as a source of retirement funds.

IRAs, 401(k)s, and life insurance policies are all contracts. In each one of them, you will name a beneficiary. They are not subject to probate, because the terms of the contract determine where the asset will go after your death. They actually supersede your will and living trust. Your will has no effect on them. In these cases the contracts determine what happens, not the will, so don't even bother talking about them in your will.

You should not make your living trust the beneficiary of your life insurance, 401(k), or IRA. In each case make your spouse the primary beneficiary. ALWAYS name a secondary beneficiary. Your spouse may die 10 minutes before you at the scene of the automobile accident, and if you haven't named secondary beneficiaries, your IRA will end up going to your estate.

You do not want your IRA going to your estate. BIG MISTAKE!

Name your spouse as first beneficiary and your kids as secondary beneficiaries. If you don't have a spouse, just name the kids as primary beneficiaries. (If you don't have children, name the person or persons you want to inherit your IRA.) Always say how the IRA will be split amongst the kids. If you are going to leave it equally to the kids, just put: "To my issue in equal shares per stirpes." (Per stirpes means if one child is dead leaving issue [your grandkids], then the dead child's share will go to his or her children equally.)

I ran into a bank that wouldn't let me use the "per stirpes" language. (Banks can be idiots.) I had to put: "My issue in equal shares by representation." That means the same thing as per stirpes, but they didn't know that.

You want your IRA(s) to go to your living heirs. If an IRA goes to a living person, that person can "stretch" the IRA over his or her lifetime. "Stretch an IRA" is actually the term of art used amongst the professionals. Stretching an IRA is a huge deal, because the money could stay in the IRA growing tax free for decades.

The tax free growth compounding over decades is unbelievable. You may have heard that compounding interest is the 8th wonder of the world. It's amazing! Tax free compounding is compounding on super steroids. A modest IRA can turn into millions of dollars for your family.

The IRA has to be left to a live person. If it is left to a trust, the trust can't stretch it. If it is left to your estate, it can't be stretched. You have to name people on your IRA beneficiary form. Get a copy of your "beneficiary designation form" for you IRA, and make sure you get it right. I'll help if you have ques-

There are no contribution limits, required withdrawals, discrimination rules, adjusted gross income regulations, or other regulations that restrict your use of a Roth IRA.

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STRETCHING YOUR IRA FOR MORE MONEY, CONT.

tions. This is a big enough deal that if you need help and your bank or broker doesn't seem to know, then get help.

For example, a $500,000 IRA growing at 6% left to a 40 year old son or daughter will deliver over $2.5 million to the child during their lifetime. If the money is in a Roth IRA, it is even more valuable. After tax, the child can have millions of extra dollars to spend during their life.

Of course, there are rules that have to be followed. The money has to be in an IRA. Therefore, it might be a good idea to roll your money from your retirement account into an IRA. If you've retired, you have the right to do that. However, never "roll" retirement money into an IRA that you already have established and have been making your annual contributions to. If you comingle the retirement money with existing IRA money, you lose options, such as being able to "roll" the money back into another retirement plan.

You can have multiple IRAs. It is sometimes a good idea to break up your IRA into a number of IRAs and designate just one person as the primary beneficiary on each account. If there is a large age difference (more than about 10 years difference) in the beneficiaries, you definitely want to divide up your IRA now and create multiple IRAs. Name each child or intended recipient as the primary beneficiary of one of the pieces of your IRA.

The reason you want to create different IRAs for each recipient is because when the beneficiary gets the IRA, they have to start withdrawing minimum required distributions from the IRA based on their life expectancy.

However, if there is a group of beneficiaries, the required minimum distribution calculations have to me be made on the life expectancy of the oldest member of the group. The younger members of the group won't get the benefit of having their IRA share grow during their entire lifetime.

Obviously, you would never name your children and grandchildren as joint primary beneficiaries to your IRA. If you actually want your children and grandchildren to benefit from your IRA, you'll need to create at least two IRAs – one for the kids and one for the grandchildren. Remember, always name secondary beneficiaries.

Because the IRA money is so valuable in your heirs' hands, make sure that you use your other money to live on and spend your IRA money as a last resort in your retirement. Yes, you'll have to take required minimum distributions, but don't take out any more than you have to.

Educate your children on the IRA stretch theories. IRAs are easy money for the beneficiaries. Most children immediately withdraw any money they inherit in an IRA and blow the money on a trip. (That is really what happens. Yes, the kids can and usually do "cash in" the IRA as soon as possible – STUPID!) You've got to tell them not to take any money out of the IRA. If you think one child will take it out, don't leave IRA money to them. Give them other assets.

Your heirs may have to get "cash" to pay estate taxes. IRAs are part of your taxable estate. Educate your kids not to take the money out for any reason. The temptation is to take the "cash" out of the IRA to pay the estate tax. The IRA may be the most liquid asset in your estate.

It's a disaster when the kids take the IRA money to pay taxes (or for any other reason). In a traditional IRA, when the money is taken out, it is subject to income tax.

So when the child takes the money out to pay your estate tax, that generates an income tax – on the order of a 50% tax, because the amount he takes out goes right on top of all his other income and boosts him into the highest federal and state tax brackets. Well, with a huge income tax, the only place he can get the money to pay the huge income tax is to take more money out of the IRA, but that generates more income tax. This can go on until there is nothing left in the IRA. If this scenario starts to unfold, the child will actually lose 105% of the IRA in some states when the estate taxes and income taxes are stacked on top of each other.

If there will be an estate tax liquidity issue, buy life insurance on yourself to give the family money to pay the estate tax. (Use the *Accumulation and Preservation of Wealth* course and do some estate planning to eliminate the tax. At least use the irrevocable life insurance trust to make sure the life insurance goes estate tax free.)

I can't overstate how important it is to train yourself and your family on the IRA stretch. Because of the tax treatment, your IRA in the hands of your family can do incredible things, and your Roth IRA can be stunning. Remember the IRAs are asset protected in addition to being tax advantaged. If you have questions on what to do, please email and I'll help any way I can. ■

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USING THE LAW TO MAKE MONEY

LIFE ESTATE TRUSTS, CONT.

them in essentially the same form as it is currently held.

This does give Life Estate Trusts some degree of asset protection. And it is a valid tool for some purposes (if you have a family cabin that you plan to pass down through the generations, it may be a good idea to stick it in one of these trusts). But Life Estate Trusts are being used for some ridiculous purposes. Other people believe that they are accomplishing far more than they should. Here are some common problems:

1) <u>Life Estate Trusts are horrible for depreciating assets</u>. Think about what a life estate holder has an obligation to do. They have to pass the asset in essentially the same condition to the remainder holder. So if you put an asset that wears out into a Life Estate Trust, you have just prevented yourself from ever changing it. A common example of this kind of problem is when people put cars in a Life Estate Trust. Horrible idea! The remainder holder has the right to the asset in the condition it was in when the trust was created. This means if you drive the vehicle, you are wasting the asset. But that isn't all. Not only can't you drive the car, but you better not let it get rusted. You have the obligation to keep it up. Get ready to wax!

2) <u>Life Estate Trusts don't magically stop all creditors</u>. If you lack assets sufficient to satisfy your debts and you are obligated to file for bankruptcy, the bankruptcy courts are ready and able to assign a present day value to your assets in the life estate trust – and obligate either the sale of the asset or the remainder holder to purchase the asset at the price designated. There will be some discounting based upon your age and other factors, but don't think that just because you put an asset in a Life Estate Trust it is forever protected. It has some asset protection (the older you are and the worse health you are in, ironically, the better the asset protection).

3) <u>You don't own assets put in a Life Estate Trust</u>. This can cause some horrible moments for people who didn't realize they might need to get an asset out of the trust. When you put an asset in a Life Estate Trust, you have given up that asset – permanently. If your document says otherwise, the courts will not be bound by it. This means that if you ever need to sell the asset, you can't. Does your daughter need cancer treatment and the only asset you have is your house held in a Life Estate Trust? Sorry, you still can't sell it. It isn't yours. Period.

I can't emphasize this enough, because we get clients who have done things like putting their bank accounts in a Life Estate Trust, only to find that they don't have access to their life savings anymore. They come to us for legal help, and while we try to help them, the answer is almost invariably nothing can be done. We can only express our condolences. This is one of the reasons these trusts have the name Life Estate Trusts – they used to be called Remainder Trusts (the other half of the property right) but they acquired such a bad name that they are rarely marketed under that name today. After all, you want life not a remainder.

The Life Estate Trust is a valid legal tool with a limited scope of usefulness. It is not right for most people, but it can be a powerful tool for those people it is right for. If you think there is <u>any</u> chance you might need an asset (to sell, trade, or anything else) it does not belong in one of these trusts.■