MorganStanley SmithBarney

Dialogues » WEALTH STRATEGIES FOR DISCUSSION

» Consolidating and reviewing your IRA
» Using the Roth IRA in estate planning
» Making a charitable bequest
» Planning for the unexpected

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IRA Beneficiary Reviews: Saving Your Life Savings

Your IRA is designed to provide you with retirement income, but it can also be a powerful way to pass assets to your heirs or charity. Steps you take now could dramatically reduce the taxes your heirs will pay in the future. More importantly, the actions of those heirs at the time of inheritance can determine how much of your wealth will keep working for the next generation. Let's talk today about designating appropriate beneficiaries, and educating them on how to preserve your assets for the future.

Here are some of the ways we can help:

» Consolidating scattered retirement accounts (IRAs, 401(k)s, pensions) so you have a complete picture of your retirement savings and how it's invested.

» Identifying the named beneficiaries on your IRAs and ensuring they are still the ones you want. We can explain the many ways you can customize your beneficiary designations to fit your situation. Note that your beneficiary designation forms—not your will—determine who will inherit your retirement account.

» Explaining the estate planning benefits of an IRA and how converting to a Roth IRA enables you to pass the assets to heirs tax-free, and whether this might be an appropriate strategy in your case.

» Determining if naming a charity as your IRA beneficiary can help you fulfill your charitable bequests. ■

By Morgan Stanley Smith Barney LLC.

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Your Retirement Accounts

The Importance of Consolidation and Periodic Reviews

If you maintain a hodgepodge of accounts, you simply may be driving your investment costs up, reducing the effectiveness of your asset allocation, and making financial planning more difficult to do—not to mention incurring a steady blizzard of account forms, statements and other records.

Consolidating your retirement accounts can simplify your life and give you more information about what you own. For instance, you may discover that having several accounts results in investment overlap, where you actually own more of the same investments or types of investments than you realized, thus increasing your risk. We may suggest reallocating your assets to reflect your risk tolerance and well-defined goals.

IS YOUR BENEFICIARY DESIGNATION CORRECT?

What changes have occurred in your life since you originally opened your IRA? You and your family may have experienced the joy of births and marriages, or the grief of divorces and deaths. It's unlikely you're still employed by the same company that hired you out of college. You may or may not be living in the same state where you bought your first house. All these events can impact your choice of IRA beneficiaries from legal, emotional and tax standpoints.

We can help you bring your IRA beneficiary designation up-to-date. This is a critical step if you want your final wishes to be carried out correctly. For instance, out-of-date beneficiary forms could result in former spouses inheriting retirement accounts meant to support a current family. If children are involved, survivors might be left wondering why one set of children inherited all the retirement assets, while the others were left with nothing. If your beneficiary predeceases you and you named no secondary or contingent beneficiaries, your IRA assets may go to someone you didn't expect would inherit them.

While your IRA may not be at the top of your to-do list when a life event occurs, reviewing your account periodically can help you catch mistakes. Talk with us about scheduling a review and make it part of a yearly process, possibly at year-end or after tax season.

WHICH BENEFICIARY DESIGNATION FITS YOUR NEEDS?

Before you automatically name your spouse as your IRA beneficiary, talk with us about how it could affect your family's overall tax burden or your long-term estate plans. You may learn that it's more advantageous to name your children or grandchildren, or other younger relatives, who could stretch payouts from the account over their lifetime. Also, proper assignment of beneficiary designations could help you accomplish some of your philanthropic goals.

WHAT IF YOU WANT TO NAME YOUR SPOUSE AS YOUR BENEFICIARY?

Naming your spouse as your beneficiary makes sense if your spouse will need those assets for lifetime financial support. A spouse can roll your account assets into an existing or "fresh start" IRA. Done correctly—and the process can be tricky—your spouse can avoid paying current income and estate taxes on the transfer. Your spouse will then have the opportunity to name a child or other beneficiary, which may allow the IRA to stretch payouts and continue growing tax-free over the lifetime of this second beneficiary.

WHAT HAPPENS WHEN A NONSPOUSE IS YOUR BENEFICIARY?

If you are not married, or simply choose to leave your IRA to someone other than your spouse, you may designate one or more nonspouse beneficiaries.* Leaving your IRA to a much younger person, for example, can be an effective way of reducing your family's tax liability. That person may keep your IRA intact and take lifetime distributions. This avoids the tax hit that would occur if the inherited account were distributed in a lump sum, and it preserves the IRA's tax-deferred status.

*In some states with community property laws, your spouse may have to agree in writing to this designation.

WHAT IF YOU DESIGNATE A MINOR CHILD AS YOUR BENEFICIARY?

We have the ability to customize beneficiary designations that would ensure that minor children and others who are unable to manage retirement funds are properly taken care of if they inherit your IRA. We can give you more information on the type of beneficiary designation. ■

Using the Roth IRA as a Powerful Estate Planning Strategy

Any estate worth more than a certain amount will subject the heirs to estate taxes, and possibly income taxes, when they inherit your IRA. One of the keys to a successful estate plan is reducing those taxes as much as possible ahead of time. A Roth IRA can help.

Currently, if you have a Traditional IRA and your income is under $100,000, you can convert all or part of the assets in this account to a tax-free Roth IRA. A Roth IRA conversion opportunity will soon be possible for higher income earners. In 2010 and beyond, a special tax provision will allow anyone to convert Traditional IRA assets to a Roth IRA regardless of income. Income taxes will be due on the amount converted, and they would have to be paid for with money outside of the converted funds. Those who convert their IRA assets in 2010 may spread any taxable income that results from the conversion over 2011 and 2012.

Whether you should take advantage of this Roth IRA conversion opportunity will depend on several factors, most notably:

» **Do you believe taxes will be lower today or tomorrow?**

» **Do you have the money to pay the taxes on the conversion from sources outside of your IRA?**

» **Will your spouse depend on your IRA as a source of income? Will a smaller tax-free amount or a larger taxable amount be more beneficial?**

» **Will your estate be subject to estate taxes?**

Since a Roth conversion could significantly increase your taxes in the year of conversion, you should discuss an appropriate strategy with your financial and tax advisors before you convert your Traditional IRA to a Roth IRA. ■

Are You Planning on Making a Charitable Bequest?

Are you planning to make a charitable bequest in addition to leaving assets to your heirs?

If so, it might make more sense to leave appreciated securities to your heirs and donate your Traditional IRA to a qualified nonprofit charity, since the charity is not subject to income taxes when the assets are distributed. Leaving your Roth IRA funds to a charity or other entity would fail to take advantage of the income-tax-free benefit of a Roth IRA. Also, when heirs inherit certain taxable assets, such as common stocks, equity mutual funds, business interests and real estate, they get a "step-up" in the original cost basis to current fair-market value. That effectively removes any income tax liability at the time of inheritance, and dramatically reduces the capital gains tax heirs will have to pay when they eventually sell the inherited assets. In contrast, heirs must pay income tax on the current market value of Traditional IRA assets as amounts are withdrawn. ■

Not All Bequests Are Equal

Passing Along Traditional IRA	Heir	Charity
IRA Value at Death	$100,000	$100,000
Ordinary Income Tax Rate	35%	0%
Net Bequest	$65,000	$100,000

If an IRA beneficiary in the 35% income tax bracket inherits a Traditional IRA with a balance of $100,000, he will keep only 65% of the balance. If the IRA were left to a charity instead, 100% of the balance would go to the charity due to its tax-exempt status.

Passing Along Taxable Assets	Heir	Charity
Taxable Assets at Death	$100,000	$100,000
Original Costs Basis	$20,000	$20,000
Capital Gains Tax (When Sold at Death)	0	0
Net Bequest	$100,000	$100,000

This example illustrates that because of the step-up in the cost basis of the inherited securities, a taxable portfolio is more valuable to an heir than an IRA, whereas either a taxable account or an IRA would yield the same $100,000 to the charity. Therefore, you should consider leaving the IRA to charity and the taxable portfolio to your heirs.

Planning for the Unexpected:

What Happens If One of Your Beneficiaries Predeceases You

You may designate more than one primary beneficiary for your IRA. However, if one of your beneficiaries predeceases you, the distribution of your IRA assets will depend on how you titled your beneficiary designations.

The following are some common designations and should be reviewed for state variations, since terminology and definitions may differ somewhat from state to state:

All My Children—If you use this term or name each child specifically, your IRA assets will be divided equally among your surviving children only.

Per Stirpes—If you indicate that death distributions will be *per stirpes* (or "Rights of Representation" in some states), the children of a beneficiary that predeceases you will share equally in that portion of your IRA originally left to the now-deceased child. For example, if you designate that your three children will share your IRA equally, but one son predeceases you, his one-third share will be divided equally among his surviving children.

Per Capita—This method divides your IRA assets equally among your beneficiaries and the descendants of any beneficiary who dies before you. For example, if you designate that your three children will share your IRA equally, but one son, who had two children, predeceases you, your IRA assets will be divided equally among five beneficiaries instead of three beneficiaries.

Contingent Beneficiaries—In addition to naming one or more primary beneficiaries, you may name contingent beneficiaries, who will inherit your IRA only if the primary beneficiaries predecease you, die simultaneously with you or disclaim their rights to your IRA assets.

WHAT HAPPENS IF YOU DON'T NAME A BENEFICIARY?

If you do not name a beneficiary on your IRA, the distribution of these assets upon your death will depend on the IRA plan document, which spells out the provisions of your account. You should periodically check the default beneficiary paragraph in the plan document that tells you who inherits your account if your beneficiaries predecease you or if you did not name a beneficiary. If your IRA is here, we can provide a current copy of this document so you can determine what will happen in these situations.

Be sure to regularly check the IRA beneficiary that your provider has on file and make sure that this designation accurately reflects your final wishes concerning how your IRA assets will be distributed. Ask your provider for a Change in Beneficiary form if you need to amend the information.

IRA Checklist

WE CAN WORK WITH YOU ON THE FOLLOWING:

- Ask your IRA custodian for a copy of your plan document that spells out the provisions of your account. Be sure to also get a written confirmation on the beneficiary(ies) who is on file. Check the default beneficiary paragraph in the plan document, which will determine who inherits your account if your beneficiaries predecease you.
- Discuss with your tax advisor the tax implications of your beneficiary designation, such as a spouse or nonspouse, or an entity such as a charity or a type of trust. Choose the primary and contingent beneficiary who is most appropriate for your current situation.
- Whenever you experience a major change in your life, such as a birth or death, marriage or divorce, or if you move to another state or start a new job, contact us to determine how these events might affect your IRA's beneficiary designation.

If you have needs beyond those covered by standard beneficiary forms, we can accommodate most customized beneficiary designations, such as those involving trust arrangements or charitable organizations. Working with your attorney, we can help implement a beneficiary designation arrangement that addresses your special needs.