Estate Planning with Retirement Assets

Trusts, Taxes, and Other Common Issues

By Christopher M. Brown and Christopher J. Caldwell

Introduction

As more individuals save for retirement through qualified plans and individual retirement accounts (IRAs), it is becoming more common for retirement funds to be a client's primary asset. Thus, proper planning with retirement assets is an increasingly important area for attorneys to address. Unlike most other estate assets, however, consideration must be given not only to the client's goals regarding distribution, but also to the potential income tax consequences of those distributions.

This article first addresses basic issues relevant to planning with retirement assets. However, the primary focus will be on designating trusts as beneficiaries of retirement assets and the consequences of such designations. Much of this article discusses how to achieve the maximum deferral of minimum required distributions (MRDs) from a retirement account (and, as a result, the maximum deferral of income tax liability on the MRDs). However, it is also important to realize that a retirement account owner (also referred to as "owner") may have other goals or concerns (e.g., protecting assets for a spendthrift beneficiary or for children from a prior marriage) that outweigh the tax benefits associated with maximum deferral of MRDs. Therefore, this article also discusses naming beneficiaries, such as trusts, when achieving income or estate tax benefits is *not* the retirement account owner's primary concern. An excellent supplemental resource for these and a wide variety of other planning issues is Natalie Choate's book, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners.*[1]

Basic Issues

Planning for retirement assets begins with recognition of the fact that, with few exceptions (e.g., a Roth IRA), all distributions from retirement accounts are subject to income tax. If the retirement account owner dies, distributions to any beneficiary other than a charity will be subject to income tax as what is known as "income in respect of a decedent" (IRD).

Generally, an individual cannot plan for the receipt or administration of certain types of IRD (e.g., a dividend received after death). However, a retirement account owner will often plan for the maximum deferral of the imposition of income tax on the post-death distributions of the retirement assets. By planning for maximum deferral of the required distributions, the assets inside the retirement account will continue to grow on a tax-deferred basis.

Minimum Required Distribution (MRD) Rules

All plans require the retirement account owner or the beneficiary to eventually take MRDs. An owner must begin taking MRDs, calculated using the owner's life expectancy,[2] no later than April 1 of the year after attaining age 70½—the required beginning date (RBD).[3] MRD rules for beneficiaries vary depending on the owner's age and whether a designated beneficiary is identified, as illustrated below (although a surviving spouse named as an outright beneficiary can roll over any retirement plan to its own IRA and avoid application of the rules on the death of the first spouse).[4]

Did decedent die *before* RBD?	Is there a designated beneficiary?	Period for Distribution
Yes	Yes	Beneficiary's life expectancy
Yes	No	Five years from owner's death
No	Yes	Longer of (1) beneficiary's life expectancy or (2) deceased owner's life expectancy
No	No	Deceased owner's life expectancy

Naming Beneficiaries

A retirement account owner who names an individual or a small class of individuals as the primary beneficiary should always name a contingent beneficiary. If the owner does not designate a beneficiary, the plan will determine the default beneficiary, which may be inconsistent with the owner's wishes. If the default beneficiary is the estate, the retirement plan will not have a designated beneficiary.[5] Absent non-tax considerations (e.g., a second marriage or spendthrift tendencies), the owner's spouse typically should be the primary beneficiary because the survivor can roll over the account and defer imposition of income tax.[6] In fact, for the owner of a qualified plan to name a beneficiary other than his or her spouse, the spouse must consent to the alternative designation; otherwise, the owner (and beneficiaries) will lose the favorable tax treatment associated with qualified plans.[7]

MRD Withdrawals

The attorney should assist the retirement account owner in deciding how much he or she should withdraw when MRDs begin. Often, owners are inclined to take no more than the MRD for any given year. However, it may not be wise for an owner with a modest estate to consume other assets on which he or she relies to only take the MRD from the retirement account. For example, if the

Fast Facts:

The tax issues associated with retirement account assets are some of the most complicated issues an attorney must address when assisting clients with estate planning. The use of trusts as beneficiaries of retirement account assets can be appealing in many respects, but can also have negative tax consequences. Therefore, it is important to address a client's ultimate goals when determining the proper beneficiary for retirement account assets.

owner's only significant assets other than retirement account assets are a house, a modest bank account and a small investment account, he or she may be better off taking more than the MRD required in any given year—even with the increased income tax liability—to preserve other assets of his or her estate.

The attorney should also assist the retirement account owner in determining whether maximum deferral after death is important. An individual's unique circumstances may make deferral irrelevant. For example, it may be that no beneficiary is going to inherit enough retirement account assets to justify maximum deferral. On the other hand, in larger estates where the retirement account assets make up a significant portion of the available liquid assets, it may be necessary for the owner to plan for the use of the retirement account assets to pay estate taxes by naming his or her trust or estate as the beneficiary.

Early Withdrawals

A retirement account owner generally should not withdraw retirement plan assets before age 70½, unless necessary to meet living expenses. Although the 10 percent penalty for early withdrawal does not apply after age 59½,[8] any distributions will be subject to income tax,[9] depleting the fund to the extent of the income tax liability. Although assets left in the retirement account will also be subject to income tax liability upon withdrawal at a later date (e.g., when MRDs begin), the assets left in the plan will continue to grow without the immediate imposition of income tax. The result is that when distributions become mandatory, the retirement account will usually be larger than the fund of assets withdrawn and reinvested. Even after the payment of income tax on the MRDs, the owner generally will be better off not making early withdrawals because of the difficulty in "catching up" after paying the income tax on those withdrawals.

Similarly, it is usually unwise to incur the income tax burden necessary to convert a traditional IRA to a Roth IRA, unless the owner is relatively young. However, it typically is beneficial to roll over substantial qualified plan assets (e.g., a 401(k)) to an IRA because of the ability to defer MRDs and income tax liability, and because of the added flexibility in designating beneficiaries (although new legislation adds flexibility after death, allowing the beneficiaries of a qualified plan account to roll over plan benefits to an inherited IRA).[10]

Charitable Beneficiaries

Retirement assets are an excellent source of charitable gifts. A charity receiving retirement plan assets will not be subject to income tax liability on any distributions it receives, thus maximizing the benefit to the charity. Moreover, new legislation also permits direct charitable IRA distributions without including the assets distributed in the owner's gross income.[11] In addition, although any retirement account assets passing to charity must be included in a decedent's gross estate, the decedent's estate also receives a corresponding charitable deduction for those distributions. The result is that a decedent's estate will have no estate tax liability for any retirement assets passing to charity. Accordingly, charitably inclined individuals should always consider the use of retirement assets to fund such gifts.

Common Issues Regarding Trusts as Beneficiaries

Revocable Trusts as Beneficiaries

Often, a retirement account owner wants to name a revocable trust as the beneficiary of a retirement plan because of the convenience and certainty associated with naming a trust (although married individuals generally should name each other as primary beneficiary, with the trust as a contingent beneficiary). In addition, a trust also often provides a superior management vehicle for minors or other beneficiaries who are too young or unsophisticated to properly manage the retirement benefits.

Potential Consequences

However, the retirement account owner must be aware of certain pitfalls associated with naming a revocable trust. First, assets may be unnecessarily entrusted for a beneficiary who can manage the distribution without assistance. Second, there are potentially negative income tax consequences. Income in excess of $9,750 taxed to a trust is taxed at the maximum marginal rate of 35 percent.[12] Moreover, a trust that does not have a clearly identifiable individual beneficiary or that includes *any* provisions for charity will

Retirement assets are an excellent source of charitable gifts. A charity receiving retirement plan assets will not be subject to income tax liability on any distributions it receives, thus maximizing the benefit to the charity.

result in the retirement account having no designated beneficiary, likely accelerating the imposition of income tax on any retirement account assets passing to a non-charitable beneficiary.[13]

As previously discussed, a retirement account must have a designated beneficiary to achieve extended deferral of MRDs. Trusts usually cannot be designated beneficiaries. However, a "see-through trust" will qualify as a designated beneficiary if the following are true when MRDs are determined:

1. The trust is valid under state law;
2. The trust is irrevocable;
3. The trust beneficiaries and their ages are identifiable; and
4. Trust documentation is provided to the plan administrator by October 31 of the year following the participant's death.[14]

If the four-part test described above is satisfied, each beneficiary's MRDs are calculated using the oldest trust beneficiary's life expectancy (separate account treatment, in which each beneficiary's MRDs are based on his or her own life expectancy, generally is not

A trust that does not have a clearly identifiable individual beneficiary or that includes *any* provisions for charity will result in the retirement account having no designated beneficiary.

available to separate trust beneficiaries).[15] For example, if a trust contains provisions for the grantor's 40-year-old son and 20-year-old daughter, the 40-year-old son's life expectancy will determine each beneficiary's MRDs. Consequently, the 20-year-old daughter will have to withdraw the retirement assets over a shorter period of time, which will result in fewer distributions and greater income tax liability than had the assets been withdrawn over the daughter's lifetime.

Contingent beneficiaries are generally included in determining the ages of the "identifiable" beneficiaries. The Treasury regulations state that potential successor beneficiaries may be ignored, but provide little additional guidance.[16] The only guidance in this area is a recent private letter ruling (PLR), which suggests the beneficiaries who have attained the age of outright distribution (e.g., at termination of the trust or separate portion) specified in the trust and who would receive assets at the termination of the trust are the only beneficiaries to be considered for the MRD calculation.[17] Although this PLR does not discuss lifetime trusts, the MRD period for such trusts will not be affected (regardless of the type of trust) if the contingent beneficiaries are younger than the primary beneficiary.

Solutions

Satisfying Beneficiaries

Any beneficiary whose interest is satisfied by September 30 of the year following the owner's death is not considered in determining the designated beneficiary.[18] Therefore, the problems previously described in "Potential Consequences" can be resolved by satisfying that beneficiary's interest before that date.

Drafting Solutions

Conduit Trusts and "Individuals-Only" Trusts

If maximum deferral of MRDs and income tax liability is important, the goal is to achieve "separate account treatment" so each beneficiary may use his or her own life expectancy to determine the withdrawal period. Naming individual beneficiaries can accomplish this goal. Alternatively, and although separate account treatment is generally not available when a trust is named as a beneficiary, certain drafting can allow the retirement account owner to name a trust and still achieve separate account treatment.[19]

The owner could use a "conduit trust," in which the trustee is required to distribute all retirement account assets received by the trust to the beneficiaries. If the trust contains this requirement, the beneficiary of each separate portion will be treated as the oldest trust beneficiary and each beneficiary's MRDs will be based on his or her own life expectancy.[20] However, including conduit trust language should be a case-by-case determination, as requiring distribution of all retirement account assets may be contrary to the owner's intent.

On the other hand, the owner could create an "individuals-only" trust. At least one PLR has approved of separate account treatment for such a trust.[21] An individuals-only trust requires all retirement account assets paid to a beneficiary's separate trust to be allocated to a sub-trust. The beneficiaries of the sub-trust must be individuals and must be younger than the primary beneficiary. If the trust is properly drafted, MRDs are calculated using the primary beneficiary's life expectancy. Because of the added administrative complexity, this type of trust should only be included if a retirement account owner has significant retirement account assets and maximum deferral of the income tax liability outweighs other retirement asset planning considerations.

Drafting the Beneficiary Designation

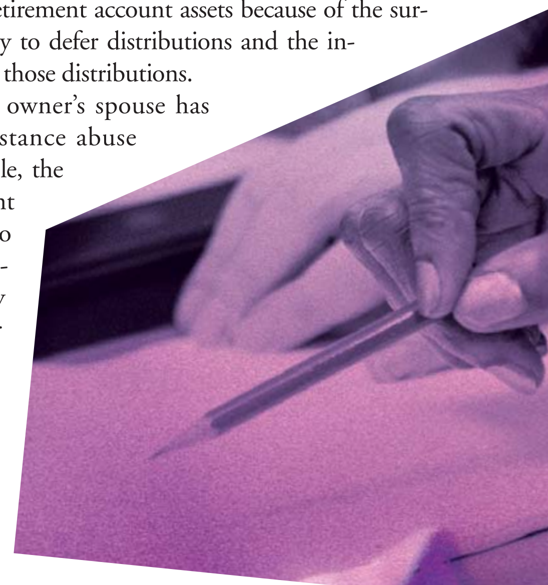
Drafting the beneficiary designation is equally important. When using conduit or individuals-only trusts, the designation should name *each separate trust* created by the funding trust, rather than the funding trust itself. Otherwise, either the retirement account owner will be treated as having no designated beneficiary or the life expectancy of the oldest beneficiary will control. If there is no concern with a mature beneficiary receiving the retirement assets outright, the best designation might name each individual beneficiary, provided that any portion for a beneficiary who has not attained the trust's specified age for outright distribution be distributed to that beneficiary's separate trust.

Revocable trusts can be appropriate beneficiaries of retirement account assets, especially when other planning concerns override the goal of maximum deferral. Even where deferral is important, however, a trust may be an appropriate beneficiary after thorough consideration of the alternatives and consequences of such a designation.

Funding the Credit Shelter Trust with Retirement Assets

As previously discussed, in most circumstances, a married retirement account owner should name his or her spouse as the primary beneficiary of any retirement account assets because of the surviving spouse's ability to defer distributions and the income tax liability on those distributions.

However, if the owner's spouse has spendthrift or substance abuse concerns, for example, the owner may not want his or her spouse to receive the assets outright. The same may be true for an owner in a second marriage if he or she has children from a prior



marriage who are not the present spouse's objects of bounty. Yet the owner may still want to ensure the retirement account assets are available for the surviving spouse's benefit after the owner's death.

Competing with this concern is the idea that in larger estates, where minimizing estate taxes is an important goal, the retirement account owner generally should avoid funding the credit shelter trust with retirement asset distributions. MRDs and the income tax liability on the distributions to the credit shelter trust will deplete these assets, wasting the opportunity to pass assets to the next generation free of estate tax at the surviving spouse's death.

Rather, if the owner does not have sufficient other assets to fund the credit trust (or does not properly fund his or her revocable trust during his or her life), a disclaimer by the surviving spouse of other assets (such as jointly owned assets or life insurance benefits) may provide assets for the credit trust. Recent rulings have also approved a technique allowing a husband and wife to rely on the same fund of assets to fund the credit shelter trust established by the first of them to die.[22]

If none of these options is viable or if there are sufficient reasons to justify not giving retirement assets to a surviving spouse outright (such as those previously discussed), the retirement account owner may still name the revocable trust as the beneficiary. Assuming the owner's other assets do not exceed the applicable exclusion amount, some retirement account assets will then be used to fund the credit shelter trust. Alternatively, the owner could name his or her spouse as the primary beneficiary and the trust as the contingent beneficiary. If, at the owner's death, the surviving spouse determines that the estate tax savings that may be realized by funding the credit shelter trust with retirement account assets seem more important than the immediate deferral of income taxes, the surviving spouse can disclaim the benefits to fund the credit shelter trust.

Although such a disclaimer will result in earlier imposition of income taxes on the distributions, the remaining retirement account assets will still be used to fund the credit shelter trust and will pass free of estate tax on the surviving spouse's death. However, the owner should avoid making the credit shelter trust a conduit trust, as the trustee of the credit shelter trust will then be required to immediately distribute all retirement benefits paid to the credit shelter trust.

As previously discussed, it is generally not favorable to name the credit shelter trust as the beneficiary of retirement account distributions because the distribution will result in the immediate imposition of income tax liability on the retirement account assets passing to the credit shelter trust. The income taxes paid will then reduce the amount of assets available to pass to the next generation on the surviving spouse's death. Yet, in situations such as those previously discussed, saving income taxes may *not* be the retirement account owner's primary goal. Nevertheless, if the owner is married, only in the situations previously described (and in other situations where entrusting the retirement account assets for a surviving spouse outweighs the negative income and estate tax consequences) should a retirement account owner consider naming the credit shelter trust as beneficiary of retirement plan assets.

Funding a Marital Trust with Retirement Assets

As previously stated, the owner's surviving spouse typically should be the primary beneficiary of the owner's retirement account. However, another alternative in situations in which the surviving spouse is not an appropriate primary beneficiary is to name a marital trust (either a qualified terminal interest property (QTIP) marital trust or a marital trust including a general power of appointment) for the surviving spouse. This is appropriate if a retirement account owner has sufficient assets to fund the credit shelter trust and does not want to give his or her spouse retirement benefits outright (e.g., if the owner is in a second marriage and has children from a prior marriage who are not the present spouse's objects of bounty).

According to a recent revenue ruling, however, if an owner names a QTIP trust as the beneficiary of a retirement plan, the retirement account *and* the QTIP trust must each qualify for the marital deduction.[23] While certain provisions of state law (e.g., statutes based on the Uniform Principal and Income Act) might affect the qualification of a retirement account for the marital deduction when using a QTIP trust, one way to assure the QTIP trust and the IRA will qualify for the marital deduction is to require the trustee to withdraw and distribute to the QTIP trust the greater of the MRD or the income from the IRA, and to distribute at least the income to the surviving spouse.[24] Presumably, the requirement that the marital trust and retirement plan each qualify separately for the marital deduction will also apply to marital trusts containing a general power of appointment, although the revenue ruling does not discuss this issue.

Although there are many general rules regarding retirement planning, it is important that the attorney understand the retirement account owner's goals. Certain planning might be favorable from an income tax perspective, but the result of that planning may be unacceptable for other reasons.

Conclusion

This article addresses basic and intermediate issues to consider when planning with retirement assets. The topics discussed should

provide attorneys an understanding of common issues that arise when assisting retirement account owners with retirement asset planning. Although there are many general rules regarding retirement planning, it is important that the attorney understand the retirement account owner's goals. Certain planning might be favorable from an income tax perspective, but the result of that planning may be unacceptable for other reasons. Thus, the attorney should always frame the issues surrounding retirement asset planning within the context of the retirement account owner's overall objectives. ◆

Christopher M. Brown offers a full range of estate planning, trust and estate administration, and guardianship services. He is a frequent author and presenter on related topics. His services are enhanced by his admission to practice in the United States Tax Court, his appointment to the State Bar of Michigan Unauthorized Practice of the Law Committee, and his membership in the Michigan Guardianship Association. Chris is a partner in Varnum's Estate Planning Group.

Christopher J. Caldwell is an associate in Varnum's Estate Planning Group. He works with clients to create estate plans tailored to their needs, within the general framework of minimizing tax liability and avoiding unnecessary probate procedures. Chris also assists clients with all aspects of trust and estate administration.

Footnotes

1. Choate, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners* (Boston: Ataxplan Publications, 6th ed, 2006).
2. 26 USC 401(a)(9)(A), (D).
3. *Id.* at 401(a)(9)(C).
4. *Id.* at 401(a)(9)(B)(iv).
5. Treas Reg 1.401(a)(9)-4, A-3.
6. 26 USC 401(a)(9)(B)(iv); 402(c)(9); 408(d)(3)(C)(ii).
7. *Id.* at 401(a)(11)(A); 417(a)(2)(A).
8. *Id.* at 72(t).
9. *Id.* at 402(a); 408(d)(1).
10. Pension Protection Act of 2006, H.R. 4, *available at* <http://thomas.loc.gov/cgi-bin/query/z?c109:H.R.4:> (accessed November 13, 2006). See also <http://waysandmeans.house.gov/media/pdf/taxdocs/072806charitable.pdf> (accessed November 13, 2006).
11. *Id.* See also <http://waysandmeans.house.gov/media/pdf/taxdocs/072806pensionsummary.pdf> (accessed November 13, 2006).
12. *Id.* at 1.
13. Treas Reg 1.401(a)(9)-3, A-3(a); 1.401(a)(9)-4, A-3.
14. *Id.* at 1.401(a)(9)-4, A-5, A-6.
15. *Id.* at 1.401(a)(9)-4, A-5(c); 1.401(a)(9)-5, A-7(a)(1).
16. *Id.* at 1.401(a)(9)-5, A-7(b)–(c).
17. PLR 200438044. See also Keith A. Herman, *Coordinating Retirement Accounts with Estate Planning 101 (What Every Estate Planner Needs to Know),* Probate & Property, Jan./Feb. 2006, at 52–58 [hereinafter Herman, *Retirement Accounts*].
18. Treas Reg at 1.401(a)(9)-4, A-4.
19. See PLR 200537044. See also Herman, *Retirement Accounts;* Harvey B. Wallace II, *Retirement Benefits Planning Update,* Probate & Property, May/June 2006, at 49–55.
20. *Id.* at 1.401(a)(9)-5, A-7(c)(3), ex 2.
21. PLR 200537044.
22. See PLR 200403094. See also PLR 200210051.
23. Rev Rul 2006-26.
24. *Id.*