ESTATE PLANNING WITH IRAs AND RETIREMENT BENEFITS

POLK COUNTY BAR ASSOCIATION

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Des Moines, Iowa

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I. Introductory Comments

A. Retirement account benefits often comprise a large percentage of an individual's personal wealth and need to be accounted for in planning the estates of our clients.

B. The disposition of an individual's retirement account at death is determined by: (i) a beneficiary designation form provided by the retirement account's trustee/custodian; and/or (ii) the default provisions of such forms.

C. Potential pitfalls of beneficiary designation forms:

   i. There is a risk that the beneficiary designation form will not be properly completed by the individual-participant.

   ii. There is a risk that the beneficiary designation form will not be updated in light of changed circumstances of the individual-participant, e.g. death of a designated beneficiary.

   iii. There is a risk that the individual-participant is never made aware of the default provisions of the applicable form.

D. In counseling estate planning clients, it is often a compromise between optimal tax deferral and getting the funds to the right person in the desired manner.

II. Inherited Retirement Accounts: Some Basic Rules

A. Under the tax laws, if certain requirements are met, an inherited retirement account can be distributed based upon the life expectancy of the beneficiary. This is sometimes referred to as a "stretch payout." The advantage of the "stretch" is relatively greater tax deferral as contrasted with five-year payment if "stretch" rules are not followed.

B. Stretch payout rules require benefits to be payable to a "designated beneficiary" ("DB") under the required minimum distribution rules.

  i. Only an individual may be a DB.

  ii. If a trust qualifies as a "see-through trust," its individual beneficiaries qualify as DBs.

  iii. An estate or other non-individual beneficiary does not qualify as a DB.

C. If the beneficiary of an inherited retirement account is a non-DB or a non-see-through trust, then, generally, the inherited retirement account must be paid to the beneficiary over 5 years or the remaining life expectancy of the participant (where participant died on or after age 70½ (required beginning date or "RBD").

D. Note: A surviving spouse may roll over an inherited retirement account. If rollover is chosen, his/her age is used to determine when required minimum distributions must begin.

III. Leaving Retirement Benefits in Trust: Some Basic Rules

A. The "See-Through" Trust, Generally.

  i. If retirement benefits are left to a "see-through" trust, the benefits can be distributed in annual installments over the life expectancy of the oldest trust beneficiary, i.e., the trust beneficiary with the shortest life expectancy.

  ii. A trust qualifies as a see-through trust if it meets the following requirements:

    1. The trust is valid under state law;

    2. The trust is irrevocable or will, by its terms, become irrevocable upon the death of the participant;

    3. The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the participant's retirement

account are identifiable from the trust instrument, i.e., my children living at my death.

4. Certain documentation must be provided to "the plan administrator." With an IRA this is generally the IRA custodian; and

5. All trust beneficiaries must be individuals (Note: there is an exception to this general rule: "mere potential successors" may be disregarded – see discussion under Paragraph B below).

B. The Conduit Trust (Viewed as a Safe Harbor to Achieving See-Through Trust Status).

i. A "conduit trust" is a trust under which the trustee has no power to accumulate retirement account distributions in the trust. The IRS regards the conduit beneficiary as the sole beneficiary of the trust; all other beneficiaries are considered mere potential successors and are disregarded. *See* Treas. Reg. § 1.401(a)(9)-5, Q&A-7(c)(3), Example 2.

ii. Note: the "conduit" provision of a trust must come into effect immediately upon the participant-individual's death.

C. See-Through Trusts: Planning Considerations.

i. If a participant wants a life expectancy payout to be available for each of multiple beneficiaries based on each such beneficiary's own life expectancy (or for each of multiple separate trusts based on the life expectancy of the oldest beneficiary of each such trust), the participant should name the individuals (or trusts) directly as beneficiaries in the beneficiary designation form, rather than naming a single funding trust as beneficiary of the retirement plan.

ii. If left to a single funding trust, separate retirement accounts can be established for each beneficiary thereof, provided that the life expectancy of the oldest beneficiary governs the term of the life expectancy payout for each trust beneficiary.

D. Advantages of Trust Beneficiary.

i. The trustee rather than the beneficiary determines if and when amounts in excess of the required minimum distribution ("RMD") are withdrawn.

Example: A 30-year-old beneficiary of a $1,000,000.00 IRA need only withdraw $18,740 as his/her RMD. With no conduit trust, the beneficiary decides whether to take more rather than the trustee making the decision.

ii. These trusts, as beneficiaries of the IRA, often enjoy creditor protection not available to individual beneficiaries.

iii. When the beneficiary dies, the trust designates the identity of the successor beneficiary and benefits continue to be paid out over the life expectancy of the deceased beneficiary. In our example, with a 30-year-old beneficiary, if s/he dies at age 36, the payout to the successor beneficiary continues on the basis of the 30-year-old beneficiary who was 36 at death. Thus, the payout for the first year would be based on 47.3 years (53.3 – 6 years) with an additional year subtracted each year. It makes no difference how old the successor beneficiary is.

E. Separate Conduit Trust or Family Trust as Beneficiary.

i. Easier to deal with IRA or plan assets through the use of a separate trust ("Conduit Trust"), than with a single pot family trust, e.g. avoid need of segregating distributions, less chance of violating esoteric IRA distribution rules.

ii. With a single pot trust, must use age of oldest beneficiary in class for determining all RMDs. With a conduit trust for each child, each child's age determines payout for that child. **[N.B. May not be practical with smaller IRA balances.]**

iii. Another option is to avoid the trust and distribute to a UTMA for the designated beneficiary or beneficiaries. The main drawback of this approach is that the beneficiary becomes the account holder at age 21 (18 in some states), a younger age than many parents and grandparents desire. Also, state law dictates use of distributions to UTMA.

IV. Surviving Spouse Alternatives

A. Advantages of a Spousal Rollover to a Plan in his/her name include the following:

   i. Spouse may use Uniform Lifetime Table rather than single life expectancy of beneficiary meaning s/he will never run out of IRA benefits and may take less in early years.

   ii. Spouse can name his/her own beneficiaries and they can take benefits over their life expectancies after death of spouse.

   iii. Spouse need not begin distributions until 70½ if s/he is younger than deceased spouse.

B. Disadvantages to Spousal Rollover

   i. Benefits may be subject to claims of creditors of spouse if rolled over in his/her name.

   ii. If surviving spouse is older than the Participant, s/he may want to leave benefits in the deceased spouse's account until the year deceased spouse would have reached age 69½ so s/he can begin taking distributions in following year.

   iii. If spouse rolls over and is under age 59½, spouse cannot take distributions penalty free until year in which s/he reaches age 59½.

C. Deadline for Completing Spousal Rollover

   i. There is no deadline, but once distributed, funds must be rolled over in 60 days.

   ii. If spouse dies before initiating the rollover, an intervening death of the spouse will greatly complicate or even eliminate rollover option.

   iii. Spouse must complete rollover by close of year in which fifth anniversary of Participant's death occurs. Spouse has no withdrawal obligations until close of fifth year but after that there is no rollover option.

D. As far as recipient rollover plans are concerned, the spouse may roll over to any plan the participant could have, which would include IRAs and Qualified Retirement Plans.

E. Surviving Spouse Under Age 59½

   i. For a spouse under age 59½, consider leaving benefits in deceased spouse's plan until s/he reaches age 59½. Surviving spouse can take distributions without penalty as beneficiary. Once surviving spouse reaches age 59½, s/he can roll over to spousal IRA and postpone mandatory distributions until age 70½.

   ii. Another option for surviving spouse under age 59½ is to roll over and then take series of substantially equal period payments (SOSEPP) until age 59½, at which time benefits can be rolled over. Alternatively, surviving spouse can roll over some to his/her plan and leave balance available in inherited plan.

F. Where benefits are left to an estate or trust by beneficiary designation, rollovers to a spousal IRA may still be possible.

   i. A long series of IRS Private Letter Rulings have allowed spouse to roll over where s/he is only beneficiary of an estate or trust. (See, for example, PLRs 200210066 and 200242044.)

   ii. Spousal rollovers have been allowed where spouse has the right to the benefits because s/he has the rights to the benefits to fulfill the spousal share rights from an estate or trust.

G. Spousal Rollovers Denied by IRS

   i. If spouse's rights in trust are limited to ascertainable standard distributions (e.g., health and support), IRS has denied rollover right. (PLR 200618030)

   ii. Only partial rollover allowed to spouse if s/he was only the beneficiary of a portion of the IRA. Also, if a portion of IRA was left to marital trust and part to credit shelter trust, only marital trust portion could be rolled over. (PLR 200449040)
