

**ESTATE PLANNING FOR
RETIREMENT ACCOUNTS**

*The Collision of Income Tax,
ERISA , and Estate Tax Laws*

**CHICAGO
ESTATE PLANNING COUNCIL**

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**ESTATE PLANNING WITH
RETIREMENT ACCOUNTS**

**Estate & Income Tax Changes*

**Distributions When Retired*

**Bequest of Retirement Assets,
especially funding a spousal trust*

**Retirement Assets and Portability*

FUTURE OF ESTATE TAX ?

<u>Year</u>	<u>Threshold</u>
2001	\$ 675,000
2002-2003	\$ 1,000,000
2004-2005	\$ 1,500,000
2006-2008	\$ 2,000,000
2009	\$ 3,500,000
2010	REPEALED ! [* <i>carryover basis</i>]
2011-2012	\$ 5,000,000 !
2013	\$ 1,000,000

Federal Estate Tax Returns Filed

2011 <small>[exclud portab]</small>	8,300 <small>(estim)</small>	26% charit
2007	38,000	20%
2004	62,700	18%
2001	108,000	17%
1998	97,900	17%
1995	69,780	19%
1992	59,200	19%

OTHER TRANSFER TAX CHANGES

	<u>2011</u>	<u>2012</u>	<u>2013</u>
■ \$5 million Gift Tax	*	*	
■ \$5 million GST	*	*	
■ 35% tax rate	*	*	
■ Portability for married couples	*	*	

Income Tax Changes

	<u>2011</u>	<u>2012</u>	<u>2013</u>
■ Social Security tax to 4.2%	*		
■ Bush tax rates –		*	*
-- 15% long term capital gain		*	*
-- no phaseout itemized deductions		*	*
■ AMT relief & “extenders”	*		
■ New health taxes - 3.8% /0.9%			*

**THE YEAR 2012:
The “Perfect Storm” for Taxes**

- The “Bush Tax Cuts” expire in 2012
 - Return to Clinton-era tax rates in 2013
- New Health Care Tax in 2013 if income over \$200,000 (\$250,000 joint returns)
 - 3.8% investment income surtax
 - 0.9% earned income (wages, etc.)

FUTURE INCOME TAX RATES

<i><u>Highest tax rates</u></i>	<u>2011-12</u>	<u>Otherwise</u>	<u>2013</u>
■ Investment income	35%	39.6%	43.4%
■ Earned income (wages – 1.45% health)	36.4%	41.0%	41.9%
■ Dividends	15%	39.6%	43.4%
■ LT Capital Gains	15%	20%	23.8%

THREE STAGES

- **Accumulate Wealth**
- **Retirement Withdrawals**
- **Distributions After Death**

Accumulate Wealth

- Tax deduction at contribution
 - Accumulate in tax-exempt trust
 - Taxed upon distribution
- = Tax Deferral**
- *COMPARE:*
Roth IRA, Roth 401(k) & Roth 403(b)

**Objective of Tax Laws:
Provide Retirement Income**

Consequently, there are laws to:

- **Discourage** distributions before
age 59 ½
- **Force** distributions after
age 70 ½

TYPES OF QRP_s

- 1. Sec. 401 – Company plans
- 2. Sec. 408 – IRAs
-- SEP & SIMPLE IRAs
- 3. Sec. 403(b) & 457 – Charities
- 4. Roth IRAs & 401(k)/403(b)

RETIREMENT ACCOUNTS

ESTATE PLANNER'S DILEMMA:

- Cannot* make a lifetime gift of retirement assets, like stock or land
 - * exception: "Charitable IRA"
- Can make a bequest of retirement assets, but usually taxable income to recipient

THREE STAGES

- Accumulate Wealth
- Retirement Withdrawals
- Distributions After Death

RETIREMENT

TAXATION

General Rule – Ordinary income

Exceptions:

- Tax-free return of capital
- NUA for appreciated employer stock
- Roth distributions are tax-free

USUAL OBJECTIVE:

Defer paying income taxes in order to get greater cash flow

	<u>Principal</u>	<u>10% Yield</u>
■ Amount	\$ 100,000	\$ 10,000
■ Income Tax		
on Distribution (40%)	<u>40,000</u>	
■ Amount Left to Invest	\$ 60,000	\$ 6,000

REQUIRED MINIMUM DISTRIBUTION (“RMD”)

BACKGROUND: 50% penalty if not
receive distribution from IRA, 401(k), etc:

#1 – lifetime distributions from own IRA:

→ beginning after age 70 1/2

#2 – an inherited IRA, 401(k), etc –

→ beginning year after death *

REQUIRED MINIMUM DISTRIBUTIONS

LIFETIME DISTRIBUTIONS

Age of Account Owner Required Payout

70 1/2	3.65%
75	4.37%
80	5.35%
85	6.76%
90	8.75%
95	11.63%
100	15.88%

THREE STAGES

- **Accumulate Wealth**
- **Retirement Withdrawals**
- **Distributions After Death**

Distributions After Death

- > **Income taxation**
- > **Mandatory ERISA distributions**
- > **Estate taxation**

Collision of three tax worlds at death

INCOME IN RESPECT OF A DECEDENT - “IRD” – Sec. 691

- No stepped up basis for retirement assets
- After death, payments are *income in respect of a decedent* (“IRD”) to the beneficiaries
- Common mistake in the past: children liquidate inherited retirement accounts.

Distributions After Death

After death, must start liquidating account

- Tax planning for family members who inherit: *DEFER* distributions as long as possible – greater tax savings
- “Stretch IRA” – make payments over beneficiary’s life expectancy

Distributions After Death

“life expectancy“

Oversimplified: Half of population will die before that age, and half will die after

Implication: For the 50% of people who live beyond L.E. date, an inherited IRA will be empty before they die.

REQUIRED MINIMUM DISTRIBUTIONS *LIFE EXPECTANCY TABLE*

<u>Age of Beneficiary</u>	<u>Life Expectancy</u>
30	53.3 more years
40	43.6
50	34.2
60	25.2
70	17.0
80	10.2
90	6.9

**REQUIRED MINIMUM
DISTRIBUTIONS
*LIFE EXPECTANCY TABLE***

<u>Age of Beneficiary</u>	<u>Life Expectancy</u>	<u>Life Expectancy</u>
30	1.9%	53.3 more years
40	2.3%	43.6
50	2.9%	34.2
60	4.0%	25.2
70	5.9%	17.0
80	10.0%	10.2
90	14.5%	6.9

**REQUIRED MINIMUM
DISTRIBUTIONS**

*** DEFINITIONS ***

- **Required Beginning Date (“RBD”)**
April 1 in year after attain age 70 ½
- **Designated Beneficiary (“DB”)**
A human being. An estate or charity can be a beneficiary of an account, but not a DB.
- **Determination Date**
September 30 in year after death.

**HOW TO ELIMINATE
BENEFICIARIES BEFORE
DETERMINATION DATE**

- Disclaimers
- Full distribution of share
- Divide into separate accounts

**REQUIRED DISTRIBUTIONS
IF NOT
DESIGNATED BENEFICIARY**

Death Before RBD

FIVE
YEARS

Death After RBD

Remaining life
expectancy of
someone who is
decedent's age at
death

**REQUIRED DISTRIBUTIONS
IF ALL BENEFICIARIES ARE
DESIGNATED BENEFICIARIES**

Death Before RBD *or* Death After RBD

- Maximum term is the life expectancy of the oldest beneficiary of the account. *
- * Exception if DB is older than decedent
- If establish *separate accounts, each account*

**SURVIVING SPOUSE:
EXTRA TAX ADVANTAGES**

- ROLLOVER
 - to a new IRA of surviving spouse
 - treated same as spouse's other IRAs
- LEAVE IN DECEASED SPOUSE'S ACCOUNT (an "inherited IRA")? If surviving spouse is sole beneficiary of the account, there are three tax breaks.

**REQUIRED DISTRIBUTIONS
IF SOLE BENEFICIARY
IS SURVIVING SPOUSE**

- *SPOUSE CAN RECALCULATE LIFE EXPECTANCY*
- *IRAs ONLY: CAN ELECT TO TREAT IRA AS HER OWN*
- *DECEDENT DIE BEFORE 70 ½?
CAN WAIT FOR DISTRIBUTION*

FUNDING TRUSTS

General Rule: Trust is not DB

Exception: “Look-through”
trust if four conditions

Types:-- “*accumulation trusts*”
-- “*conduit trusts*”

FUNDING TRUSTS

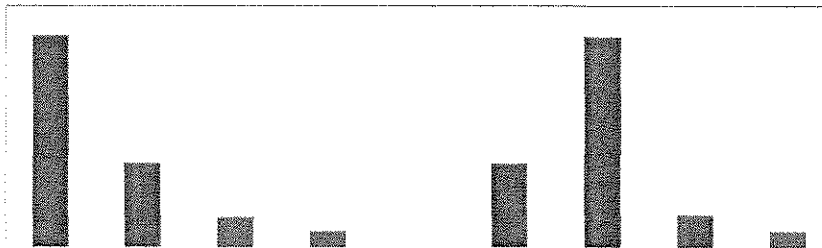
Multiple beneficiaries of a single IRA?

Must liquidate over life expectancy of oldest.

That is a problem when an IRA is payable to a credit shelter/ QTIP trust that has both older (surviving spouse) and younger beneficiaries (children).

AGE AT DEATH

MARITAL STATUS AT DEATH



MANDATORY DISTRIBUTIONS

[Assume surv. spouse inherits IRA at age 70]

<u>AGE</u>	<u>Own IRA</u>	<u>Accumulation Trust</u>	<u>AGE</u>	<u>Own IRA</u>	<u>Accumulation Trust</u>
70	3.65%	5.88%	82	5.85%	20.00%
			83	6.14%	25.00%
75	4.37%	8.33%	84	6.46%	33.33%
			85	6.76%	50.00%
80	5.35%	14.29%	86	7.10%	100.00%
			87	7.47%	empty

MANDATORY DISTRIBUTIONS

[Assume surv. spouse inherits IRA at age 70]

<u>AGE</u>	<u>Own IRA</u>	<u>Conduit Trust</u>	<u>AGE</u>	<u>Own IRA</u>	<u>Conduit Trust</u>
70	3.65%	5.88%	82	5.85%	11.00%
			83	6.14%	11.63%
75	4.37%	7.46%	84	6.46%	12.35%
			85	6.76%	13.16%
80	5.35%	9.80%	86	7.10%	14.08%
			87	7.47%	14.93%

MANDATORY DISTRIBUTIONS

[Assume inherit IRA at age 80 and die at 92]

<u>AGE</u>	<u>Own IRA</u>	<u>Accumulation Trust</u>	<u>Conduit Trust</u>
80	5.35%	9.80%	9.80%
85	6.76%	19.23%	13.16%
90	8.78%	100.00%	18.18%
91	9.26%	empty	19.23%
92	9.81%	empty	20.41%

2-GENERATION CHARITABLE REMAINDER TRUST

- Can operate like a credit-shelter trust for IRD assets
- Like an IRA, CRT is exempt from income tax
- Typically pays 5% to elderly surviving spouse for life, then 5% to children for life, then liquidates to charity

2-GENERATION CHARITABLE REMAINDER TRUST

- Can be a solution for *second marriages* when estate is top-heavy with retirement assets. Example:
 - Half of IRA to surviving spouse
 - Other half of IRA to a CRT for 2nd spouse and children from 1st marriage

2-GENERATION CHARITABLE REMAINDER TRUST

TECHNICAL REQUIREMENTS

- Minimum 10% charitable deduction
 - all children should be over age 40
- CRUT – minimum 5% annual distrib
- Not eligible for marital deduction
(see 2002 article on topic)

MANDATORY DISTRIBUTIONS

[Assume inherit IRA at age 80 and die at 92]

<u>AGE</u>	<u>Own Accumulation IRA</u>	<u>Trust</u>	<u>Conduit Trust</u>	<u>CRT</u>
80	5.35%	9.80%	9.80%	5.00%
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YEARS OF TAX DEFERRAL

ROLLOVER – Actual Life + Life Expect kids

ACCUM CST – Life Expect of surviving spouse

CONDUIT CST – Actual life + few more years

CRT – Actual life of spouse & actual lives of kids

RETIREMENT ASSETS: THE CROSSFIRE OF:

- > Income taxation
- > Mandatory ERISA distributions
- > *Estate taxation*

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RETIREMENT ACCOUNTS AND PORTABILITY

**For a surviving spouse,
rollovers and portability
will usually be
your first choice**

PORTABILITY

* Temporary law that gives a married couple a potential combined \$10 million exemption – double the \$5 million exemption available to others.

Section 2010(c)

* When 2nd spouse dies, estate can claim DSUEA from estate of first spouse

RETIREMENT ACCOUNTS AND PORTABILITY

■ EXAMPLE: Male physician's only assets: \$9 million in 401(k)/IRAs, \$1 million house in joint tenancy with spouse [spouse has no assets]

■ PORTABILITY

-- Poorer spouse dies first? -- physician dies first?

■ PRIOR LAW – Poorer spouse dies first?

-- physician dies first? (credit shelter trust)

ESTATE PLANNERS PREFER CREDIT SHELTER TRUST

1. Portability requires the administrative cost and hassle of filing a federal estate tax return, even when the estate is under \$5 million.
2. Law expires at the end of 2012

ESTATE PLANNERS PREFER CREDIT SHELTER TRUST

3. Growth in value of the assets in a credit shelter trust is excluded from estate of 2nd spouse to die. For example, a growth stock worth \$2 million when the first spouse died might be worth \$20 million when the second spouse dies.

**ESTATE PLANNERS PREFER
CREDIT SHELTER TRUST**

4. DSUEA is not indexed for inflation.
5. DSUEA from a particular predeceased spouse might be lost with remarriages in the future.
6. Other standard benefits of trusts, including asset protection, investment management, etc.

**ESTATE PLANNERS PREFER
CREDIT SHELTER TRUST**

#3. "Growth in value of the assets in a credit shelter trust is excluded from estate of 2nd spouse to die."

**APPLICATION TO
RETIREMENT ACCOUNTS:**

A. No growth! B. In spouse's estate!

**IRA PAYABLE TO A
CREDIT SHELTER TRUST**

A. For typical spouse who survives to life expectancy, the retirement account will be fully (or nearly) liquidated [accumulation or conduit trust rules]. Instead of growth, there is shrinkage after paying income taxes.

**IRA PAYABLE TO A
CREDIT SHELTER TRUST**

B. For typical spouse who survives to life expectancy and used conduit trust, all retirement account distributions will have been paid to surviving spouse and (after income taxes) will be included in her estate.

MANDATORY DISTRIBUTIONS

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RETIREMENT ACCOUNTS AND PORTABILITY

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rollovers and portability
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RETIREMENT ACCOUNTS: PORTABILITY IS 1st CHOICE

- **EXAMPLE:** Male physician's only assets: \$9 million in 401(k)/IRAs, \$1 million house in joint tenancy with spouse [spouse has no assets]
- **PORTABILITY** – permits rollovers
 - Poorer spouse dies first? -- physician dies first?
- **COMPARE** – outcome of credit shelter [CRT?]

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