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Wealth Management

Funding a Trust With Retirement Assets

The use of IRAs to fund bypass trusts has significant income tax ramifications

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Many people today have a large concentration of their owned wealth in their IRA accounts and/or retirement plans, such as pension, profit-sharing and 401(k) plans. As a result, for married couples, it may be necessary to utilize these assets to fully fund the first spouse to die's applicable exclusion amount. This article will highlight the income tax disadvantages associated with using such assets in this regard.

Under current law, the federal estate tax applicable exclusion permits taxpayers to transfer up to $2 million at death to anyone other than a spouse without incurring a federal estate tax. The estate tax applicable exclusion is scheduled to increase to $3.5 million in 2009. In 2010, the federal estate tax is scheduled to be repealed, but only for one year. Starting in 2011, estates will once again be subject to estate tax at 2001 rates (top rate of 55 percent) with only a $1 million exemption available.

Generally speaking, to maximize the applicable exclusion of the first spouse to die, wills and/or revocable trusts are drafted to provide that a trust is created automatically or via a disclaimer approach for the benefit of the surviving spouse and the decedent's children and grandchildren and funded with the decedent's then-remaining applicable exclusion amount, taking into account any transfers the decedent may have made during his lifetime. These trusts are typically called bypass or disclaimer trusts. The balance of the decedent's estate in most instances would pass to the surviving spouse.

If IRAs and/or retirement assets are used to fund the trusts as described above, there are significant income tax ramifications for the decedent and his family. If the surviving spouse is the beneficiary of the IRA and/or retirement assets, the surviving spouse has the ability to roll over these assets to his own IRA and treat it as a new IRA. Consequently, the surviving spouse is able to designate his own beneficiary. The new beneficiary designation means that at the surviving spouse's death, the beneficiary can take required minimum distributions over that beneficiary's life expectancy. In most circumstances, the beneficiaries of the surviving spouse's IRA will be the next generation (i.e., children), so that the required pay-out period will be based on the life expectancies of the children, which typically is a longer period of time.

While the surviving spouse is alive, required minimum distributions need to begin to be paid as of April 1 of the calendar year following the surviving spouse's attainment of the age of 70 1/2. After that date, in most cases, the required minimum distributions are based on IRS tables, which factor in the life expectancy of the surviving spouse and a hypothetical beneficiary who is 10 years younger than the surviving spouse.

The required minimum distributions are significantly accelerated if the beneficiary of the decedent's IRA and/or retirement assets is the bypass or disclaimer trust under the decedent's will, as opposed to the surviving spouse. First, during the surviving spouse's life, assuming the surviving spouse is the oldest beneficiary of the trust, distributions during the spouse's

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life must be taken over the spouse's life expectancy, as opposed to the surviving spouse waiting until April 1 of the year following the attainment of age 70 1/2. In this event, the surviving spouse is not able to roll over the IRA and/or retirement assets and treat the IRA as his own IRA because he is not the beneficiary.

Second, at the surviving spouse's death, while the beneficiaries are usually the younger generation, the required minimum distributions remain based on the surviving spouse's life expectancy. The decedent's family is not able to use the younger generation's longer life expectancy to significantly delay distributions.

This is the major reason why IRAs and retirement assets should be the last resort to fund a bypass trust or a disclaimer trust to maximize the decedent's applicable exclusion amount. Generally speaking, the longer period of time a taxpayer can defer the payment of the income tax due from the IRA and retirement assets, the more the taxpayer will benefit.

There are a couple of important points to consider. If the surviving spouse has not attained age 59 1/2 and he rolls over the inherited retirement assets to his own IRA, subject to a few exceptions, distributions cannot be taken out by the surviving spouse without a 10 percent penalty until the surviving spouse attains age 59 1/2. If the surviving spouse wants access to the IRA without being subject to penalty, he should not roll over the IRA but rather retain it in an inherited IRA account and take advantage of special spousal required minimum distribution rules that are available until he attains age 59 1/2. Upon attaining age 59 1/2, the surviving spouse could then roll over the amount.

The special spousal required minimum distribution rules provide that the surviving spouse can wait until the decedent would have attained age 70 1/2 to then start taking distributions over the surviving spouse's life expectancy. Thus, if the decedent was 60 at death, and surviving spouse is age 55, and the surviving spouse is the beneficiary, the surviving spouse can maintain the IRA in the decedent's name in an inherited IRA account and wait until he attains 59 1/2 to roll over the IRA to his own IRA. During the time period from age 55 to 59 1/2, there are no required minimum distributions because decedent would still have not attained age 70 1/2. With a trust designated as a beneficiary, however, the surviving spouse is not able to take advantage of this favorable rule.

Another potential problem with the trust being designated as the beneficiary is that if the surviving spouse is not the oldest beneficiary of the trust, or if there are contingent beneficiaries who are not deemed to be "designated beneficiaries" pursuant to special IRA rules, then the surviving spouse may not even be permitted to use his life expectancy as the basis for calculating the required minimum distributions. If there is a possibility that an older beneficiary will receive any portion of the retirement assets under the bypass or disclaimer trust, you are required to use that older person's life expectancy as the basis for the required minimum distributions, thus accelerating further the payout period. For example, if the decedent's parents are contingent beneficiaries under the trust and there is a possibility that they would receive retirement proceeds, you are required to use the oldest living parent's life expectancy as the basis for the required distributions. Because this could significantly accelerate the required minimum distributions, attention should be paid to the identity of the contingent beneficiaries.

If there is a possibility that a charity or the decedent's estate will receive the retirement assets, and the decedent dies prior to 70 1/2, the payout period is limited to only 5 years. If the decedent dies after 70 1/2, and a charity or his estate is a potential beneficiary, the payout period will be based on the decedent's life expectancy. In either case, the deferral period is considerably shortened if a trust with these beneficiaries is designated as the beneficiary of the retirement asset.

It is also important to ensure that the beneficiary designations of the retirement assets are coordinated with the decedent's estate plan. For example, if a married couple utilizes QTIP trusts, the retirement plan assets also should be coordinated with this planning. A QTIP trust is a special marital trust for the benefit of the surviving spouse, which qualifies for the unlimited marital deduction, and which enables the first spouse to die to determine where the assets will pass at the surviving spouse's death. If this planning is implemented, in most cases it makes sense for the surviving spouse not to be designated as the outright beneficiary. Otherwise, the surviving spouse would be able to designate the beneficiaries of these assets at his death.

Instead, the QTIP trust created under the decedent's will and/or revocable trust should be the beneficiary. While achieving consistency in the disposition of the decedent's assets is very desirable from an estate planning point of view, there are adverse income tax consequences to this designation. Naming the QTIP Trust as the beneficiary will prevent the surviving spouse and the children from stretching the payments over the younger generation's life expectancy.

Clearly, the estate tax savings associated with funding the first spouse to die's applicable exclusion are dramatic. However, the use of retirement assets to accomplish this results in an income tax cost that must be considered when implementing an estate plan. ■