Estate Planning: Going Beyond The Basics To Cover Yourself & Benefit Your Family

Articles

11.10.2015

Many people make the mistake of believing that if they have created a proper will, power of attorney and an advance directive for healthcare, they have satisfied their estate planning needs. These are the basic requirements, but they must be supplemented with appropriate retirement planning, if applicable, since a significant portion of many client's assets, their tax deferred retirement accounts—traditional IRA's, 401(k)'s and 403(b)'s—are not covered by their wills.

People should discuss with their estate planning attorney the following issues regarding their Retirement Accounts:

1) Who will be the primary and contingent beneficiaries?

2) How long can the beneficiary defer withdrawals from the account and the attendant income tax liability?

3) Is there a compelling reason to name a trust as a beneficiary and how should it be done?

4) What is the most tax efficient source of payment for estate taxes on the retirement account?

The designation of your primary beneficiary or beneficiaries and those to succeed them if they predecease you is both a "family planning decision" and a "tax planning" decision. The tax planning component involves a basic understanding of the internal revenue code. The required minimum distribution (RMD) rules specify how long a taxpayer (and after the taxpayer's death, the beneficiary) may defer withdrawal from a retirement account.

A taxpayer can obtain the most favorable income tax results for retirement accounts by naming the taxpayer's spouse as the primary beneficiary. A surviving spouse is the only person who has the option of rolling over the retirement account into his or her own IRA.

Often the simplest way to accomplish the rollover is to retitle the account into the surviving spouse's name. By rolling over the account, the surviving spouse can defer withdrawals from the account until the spouse turns 70 ½ years of age; any other non-spouse beneficiary must begin taking withdrawals the year after the taxpayer's death.

In addition, the spouse can name his or her own beneficiaries of the “rollover” IRA. Those beneficiaries may use a life expectancy payout; when other beneficiaries of a retirement account die, the RMD continues to be based on the deceased beneficiary’s life expectancy.

If someone other than the spouse is the beneficiary, the beneficiary’s RMD depends on whether there is a “designated beneficiary” of the account as that term is specifically defined in the treasury regulations.

The term “designated beneficiary” does not just refer to the individual or entity named by the taxpayer to inherit the account after death; rather, it is a specific tax concept. Although individuals and certain qualified trusts can be “designated beneficiaries”, estates, charities and business entities are not “designated beneficiaries”.

If there are multiple beneficiaries of a retirement account, then the RMD is based on the life expectancy of the oldest beneficiary. However, if separate accounts are established for each of the beneficiaries, then the RMD rules will apply separately to each separate account and will be calculated based on the individual beneficiary’s life expectancy.

To establish separate accounts, the beneficiaries’ interests in the account must be fractional (not pecuniary). In addition, some affirmative act must establish the separate accounts—for example, a physical division of a single account into completely separate accounts or the use of separate account language on the beneficiary designation form. Whenever possible, it is best to create the separate accounts with appropriate language directly on the beneficiary designation form.

Because of the complexity associated with using a trust as a designated beneficiary, a revocable trust should be avoided as the beneficiary of retirement accounts in most cases. Before naming a trust as a beneficiary of a retirement account, the attorney and the client should confirm that the reasons to name a trust as a beneficiary outweigh the time and costs associated with establishing a qualified trust.

The client may decide that the protection provided by a trust is more important than the potential lost ability to plan for income tax deferral that often can occur by naming a trust as beneficiary. A trust may be more attractive if a life expectancy payout option or spousal rollover is not important to the client or not available.

There are a number of reasons to use a trust as a beneficiary of a retirement account. A trust can limit the beneficiary’s control over the trust assets. Trusts can potentially provide the beneficiary with creditor protection, including protection from division in the event of the beneficiary’s divorce. Finally, a trust can be used to exclude the trust assets from the estate tax at the beneficiary’s death.

If one of these reasons is more important than allowing the beneficiary to defer withdrawals from the retirement account in order to defer income taxes, then a traditional trust can be named as the beneficiary of the retirement account.

The taxpayer should be aware, however, that the beneficiary will lose possible income tax deferral opportunities. If a taxpayer qualifies a trust as a designated beneficiary, then the trust may make withdrawals from the account based on the life expectancy of the oldest beneficiary of the trust—that is, the trust’s RMD is based on the age of the oldest beneficiary.

Naming a trust is crucial in certain circumstances. For example, if the beneficiary is a disabled child who relies on government benefits, a special-needs trust should be used. Clients often use trusts when the beneficiary is a second spouse and the client wants the spouse to have limited access to the trust principal. Additionally, in order to increase the likelihood that the client's children will receive an inheritance, a parent may wish to use a trust if the beneficiary is a minor, is a spendthrift, or has substance abuse problems. Finally, retirement account assets can fund a credit shelter trust for estate planning purposes.

In these situations, the client may decide that the reason for the trust may outweigh the possible lost income tax deferral.

Fortunately, the regulations do describe a type of safe harbor trust that the IRS will treat as designated beneficiaries. Such trusts are often referred to as "conduit trusts." A conduit trust requires a trustee to distribute all of the retirement account withdrawals by the trust to the beneficiary.

As the trust may not accumulate any assets withdrawn from the retirement account, the IRS allows the beneficiary to be treated as the oldest beneficiary. Although conduit trusts have the advantage of certainty because they are specifically described in the treasury regulations, they also have major disadvantages.

For example, a conduit trust cannot accumulate retirement account withdrawals inside the trust. This is often contrary to the intent of the client, who is often specifically using a trust to prevent the retirement account assets from being distributed to the beneficiary for one reason or another.

A trust that allows accumulations of retirement account withdrawals (an "accumulation trust") should qualify as a designated beneficiary if certain provisions are added to the trust, the details of which you should discuss with your attorney since they may require careful drafting. If properly drafted, an accumulation trust can help coordinate a taxpayer's retirement account with his or her estate plan.

Retirement accounts are not only subject to income tax when distributed to the beneficiary, but they are also subject to estate tax at the death of the owner. For the year 2015, the combined effect of the 40 percent federal estate tax, a top federal income tax rate of 39.6 percent, and a possible state income tax can be debilitating.

This heavy tax burden makes tax-deferred retirement accounts an interesting source for charitable bequests at death, as charities are exempt from the income tax.

These taxes may be payable from the taxpayer's probate estate or a trust, or they may need to be paid by a withdrawal from the IRA. A client's estate planning documents should be drafted to ensure, to the extent possible, that any tax due is paid from nonretirement assets as the withdrawal of retirement assets to pay taxes will cause additional income tax.

The portion of one's estate planning that includes retirement documentation planning, because of the IRS Regulations that apply to them, results in certain complexity that you can work though with your estate planning attorney. If done properly, this can provide meaningful and productive family planning, as well as tax planning, for those who will benefit from your retirement documentation for years—and possibly decades after your demise.

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