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Trusts and Estates

Estate Planning With Qualified Retirement Benefits

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For most of our clients these days, qualified retirement benefits form a significant part of their asset base. Accordingly, careful attention must be paid to properly incorporating those benefits into their estate plans.

Qualified retirement benefits include benefits in employer-sponsored Employee Retirement Income Security Act-qualified tax deferred plans, such as 401(k) plans, 403(b) plans, profit-sharing plans, money purchase plans and defined benefit plans. They also include IRAs, which can be composed of rollovers from these retirement plans or direct annual contributions.

IRAs and 401(k) benefits can be "traditional" or "Roth." Those that are traditional are merely tax-deferred, and an income tax deduction was generally available for the contributions. By contrast, those that are Roth are generally tax-exempt and no income tax deduction was available for the contributions. The Roth accounts have the greatest future value since, unless the applicable laws are changed in the future (which is possible but unlikely), not only are those funds exempt from tax while in the Roth account, but also all distributions from the accounts to the account owner after age 59-and-a-half, or to a beneficiary after the account owner's death, will be completely exempt from income tax.

It is a generally accepted principle that in nearly all cases tax-deferred growth (and in all cases the tax-exempt growth of Roth accounts) will produce more value over time than a taxable account because of the opportunity for tax-deferred compounding (or in the case of Roth accounts, completely tax-exempt investment returns). Accordingly, it is extremely worthwhile to allow heirs to benefit from these "tax shelter" features for as long as possible.

The statutory structure that governs qualified retirement benefits only allows the tax shelter features to remain in place for a limited period. The policy behind the tax shelter opportunity is to encourage people to gradually save for retirement—both for their own good and to prevent them from being a burden on society. Accordingly, as the creators of accounts reach their retirement years, the required minimum distribution (RMD) rules come into play and annual minimum distributions are required to be distributed to the account creators once they are in their 70s. Notably, the rules allow a balance to remain in the tax-sheltered account until after the account creator reaches the age of 115, so, unless the account creator needs to spend all of the funds during his or her lifetime, in most cases a portion of the funds will remain for beneficiaries.

When there is a surviving spouse, it nearly always makes economic and practical sense for the surviving spouse to be the primary beneficiary of the qualified retirement benefit so he or she can roll over the account to his or her own IRA, which is treated the same way as an IRA that he or she funded personally for the purposes of the RMD rules. However, in many instances, it can instead be appropriate to either leave the benefits outright to children (or grandchildren), in trust for them, or in trust for the surviving spouse. The main factors that come into play in these decisions is whether the surviving spouse has enough other resources for his or her support after the first spouse's death, and whether or not both spouses have the same children or whether they may each have different "objects of their bounty." It used to be important to also consider using the funds to utilize the federal estate tax exemption available to the first spouse to die in a bypass trust structure, but that is no longer a significant factor, in most cases, due to the availability of the portability election for the exemption of the first spouse to die.

When qualified retirement benefits pass to beneficiaries other than the surviving spouse, the RMD rules generally provide that distributions must commence under one of the following three methods: (1) the "five-year rule," where the entire account must be distributed by the end of the year containing the fifth anniversary of the account owner's death; (2) the "stretch-out rule," where the distributions must be made over the life expectancy of the beneficiary with the shortest life expectancy (generally the oldest beneficiary) and the first distribution must occur by end of the first year after the account owner's death; or (3) the "at least as rapidly rule," where the distribution must be made over the remaining life expectancy the account owner would have had if he or she was still alive and taking distributions. It is important to note that there have been recent proposals in Congress to require that all distributions to non-spouse beneficiaries be made using the five-year rule, so stay tuned on that front.

When clients are interested in leaving more than a token gift to grandchildren, we often suggest that they consider using qualified retirement benefits to fund those gifts because that allows for the longest continuation of the tax deferral (or exemption in the case of Roth funds). Also, when the intended beneficiaries have a large range of ages (i.e., generally more than a five-year difference between oldest and youngest), it can be worthwhile to ensure that each beneficiary receives a "separate share" of the qualified retirement benefit so that the youngest beneficiary will not be stuck with a reduced payout period attributable to the life expectancy of the oldest beneficiary. When trust structures are used to receive the benefits, it is important that they are carefully designed so that the life expectancies of the intended beneficiaries may be used for determining the payout period. If the trust does not qualify as a "conduit" or "see-through" trust, the payout period will likely be of a reduced duration and thus the tax deferral (or exemption) benefits may be partly wasted.

Unfortunately, for the purposes of the stretch-out rule, an estate or a charity is considered to have a "zero" life expectancy, so, if a stretch-out is desirable for noncharitable beneficiaries, in no event should an estate be named as beneficiary for a retirement benefit, and if a charity is named as partial beneficiary, the situation must be managed carefully. Notably, although a revocable trust can serve the same function as an estate as a "clearinghouse" for sorting out a decedent's assets among beneficiaries and creditors, unlike an estate, it is not automatically ascribed a zero life expectancy, so it can usually be named as a beneficiary without jeopardizing the maximum duration of the stretch-out period. When a charity is the recipient of part of the qualified retirement benefits, its interest should be structured as a "separate share" of the account to avoid its zero life expectancy from impacting the payout period for other beneficiaries. Alternatively, if the charity's interest is satisfied before the "beneficiary determination date" on Sept. 30 of the year after the year of the account owner's death, it may be disregarded when identifying the beneficiary with the shortest life expectancy, so that is another potential approach for maximizing the stretch-out period for the other beneficiaries.

As a final note, it's important for clients to recognize that because of the stretch-out opportunities for beneficiaries, qualified retirement benefits may offer greater value for beneficiaries than taxable accounts (particularly in the case of Roth accounts, but, sometimes for non-Roth accounts too). For that reason, when considering how to fund significant charitable gifts at death, it is not always the case that the tax-deferred funds are the most optimal funding mechanism merely because the charity is tax-exempt. That may usually be the case if it is anticipated that the noncharitable beneficiaries would otherwise immediately withdraw the tax-deferred funds and be subject to income tax on them, but, if they will stretch them out over a relatively long deferral period, it may be more valuable to provide them with the opportunity to do so and use other assets to fund a charitable gift.

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