Estate Planning for Retirement Benefits: Selected Case Studies

What to do in real life

2013 Edition

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Parts of this seminar handout are excerpted from the 7th ed. (2011) of Natalie Choate's book *Life and Death Planning for Retirement Benefits* (Ataxplan Publications). The book can be ordered by calling 800-247-6553, or on line at www.ataxplan.com, for $89.95 plus shipping. See end of each Case Study for cross references to portions of the book that provide further explanation of some concepts.

CONTENTS

Introduction; Abbreviations and Symbols Used in this Seminar Handout . . . 2

CASE # I: Making Retirement Benefits Payable to a QTIP Trust: Ken and Karen . . . 2

CASE # II: Married Clients: How to Use the Federal Estate Tax Exemption . . . 11

CASE # III: Estate Taxes on Large Retirement Plan Balance: Dr. Della . . . 17

CASE # IV: Trio of Problems with One Solution: a Charitable Remainder Trust (CRT) . . . 20

CASE # V: Complying with the IRS's MRD "Trust Rules": Joseph and Jennie . . . 22

CASE # VI: Non-citizen Spouse: Pedro and Pepper . . . 24

CASE # VII: Pre-age 59½ Spousal Rollovers: Nancy . . . 26

CASE # VIII: Duncan: Estate Planning with Roth Accounts . . . 27

CASE # IX: Retirement: Rollover Considerations; Life Insurance; Payout Options: Ralph . . . 30

CASE # X: Larger Estates: MRD Planning vs. GST Planning: Dave Brick . . . 33

CASE # XI: A Tale of Two Families: Special Needs Beneficiaries . . . 36

CASE # XII: Providing for Minor Children . . . 38

Chart 1: The Uniform Lifetime Table . . . 41
Chart 2: Single Life Expectancy Table . . . 42
Chart 3: Choosing a Beneficiary for the Retirement Plan . . . 44

INTRODUCTION

Each case study describes a fact pattern, the planning problems presented by the case, the solution adopted, and other solutions considered, if any. The discussions assume you are familiar with the tax and other rules applicable to retirement benefits. At the end of some cases, the "Where to read more" section references parts of the author's book *Life and Death Planning for Retirement Benefits* (7th ed. 2011; Ataxplan Publications, www.ataxplan.com or 800-247-6553) that provide complete detail (and citations) on the issues discussed in summary fashion in that case study.

Federal income and estate tax exemptions and rates used are those in effect as of 2013.

Abbreviations and Symbols Used in this Seminar Handout

¶ Refers to a section of the author's book *Life and Death Planning for Retirement Benefits* (see above) which may be consulted for further detail on the point referenced.

§ Refers to a section of the Code unless otherwise indicated.

ADP	Applicable Distribution Period. ¶ 1.2.03.
ATRA	American Taxpayer Relief Act of 2012.
Code	Internal Revenue Code of 1986, as amended through March 2013.
DOL	Department of Labor.
ERISA	Employee Retirement Income Security Act of 1974.
IRA	Individual retirement account or individual retirement trust under § 408 or § 408A.
IRS	Internal Revenue Service.
IRT	Individual retirement trust (trusteed IRA). ¶ 6.1.07.
MRD	Minimum Required Distribution. Chapter 1, first paragraph.
PLR	IRS private letter ruling.
PT	Prohibited transaction. ¶ 8.1.06.
QRP	Qualified Retirement Plan. ¶ 8.3.12.
RBD	Required Beginning Date. ¶ 1.4.01.
REA	Retirement Equity Act of 1984 (Pub. L. 98-397). ¶ 3.4.
Reg.	Treasury Regulation.

CASE # I: Making Retirement Benefits Payable to a QTIP Trust: Ken and Karen

The Code provides special favorable treatment for retirement benefits payable to the surviving spouse as beneficiary. If a client wants to provide for his spouse, but does not want to make his retirement benefits payable outright to her as named beneficiary, what does the family lose if the client names *a trust for the spouse's benefit,* rather than the spouse herself, as beneficiary of his retirement plan?

This case discusses that question in a particular context: where the client's reason for wanting to name a trust as beneficiary is that his spouse is not the parent of his children—the so-called "second marriage" scenario.

In a second marriage situation where a client wants to leave assets for the life benefit of his spouse, but ultimately have the funds pass to his children by a prior marriage; or any situation in which a client wants to leave assets in a life trust for the spouse's benefit rather than outright to the spouse for tax or non-tax reasons; the usual solution is a "QTIP" trust.

Warning: This case study assumes that the spouse is a competent adult capable of handling his/her own financial affairs. Thus, the case assumes that the choice between leaving benefits "outright to spouse" versus "to a trust for spouse" is made solely on the basis of tax implications and choice of individuals to be benefitted. If the spouse's inability to handle financial affairs would put funds left outright to him/her at risk of loss, then it may be essential to leave benefits in trust for him/her, rather than outright to him/her, regardless of the tax consequences. This principle is not restated in every paragraph.

1. Facts

Ken Koslow is a 62-year-old executive. He has two children, ages 36 and 33. His children are competent adults. Both of them have very low incomes. His wife, Karen, is, like Ken, a high-income executive. She is 55. Ken's assets consists of:

House (joint with spouse)	$ 725,000
Non-plan investments	225,000
Life Insurance	500,000
Qualified plan	1,200,000
IRA	600,000
Total	$3,250,000

Ken's plan is to leave his life insurance and other "non-retirement-plan investments" to his children, the house to his wife (it is already in joint ownership), and all of his retirement benefits to a QTIP marital deduction trust. The trust would pay income to Karen for life and on her death the principal of the trust would pass to his children. Ken's stated goal is that "all of my family should benefit from my retirement plans, as these are my largest asset."

2. Drawbacks of leaving benefits to a QTIP trust rather than outright to spouse

Here are the tax drawbacks of leaving benefits to a QTIP trust for the spouse, compared with leaving the benefits outright to the spouse who then rolls them over to her own IRA:

A. **Distributions start immediately instead of being deferred until spouse reaches age 70½.** When the beneficiary is a trust, the minimum distribution rules generally require that distribution of the benefits begin in the calendar year after Ken's death (for exception, see #3(B), below). When benefits are left outright to the surviving spouse, she can roll them over to an IRA and then defer the commencement of distributions until she reaches age 70½. Karen Koslow is an executive who already has a high income. She will probably have no need for money from this IRA until her own retirement 10 years from now. Thus, commencing distributions immediately following Ken's death wastes a deferral opportunity.

B. **Distributions during spouse's life will be based on a single life expectancy rather than the more favorable Uniform Lifetime Table.** Because the benefits are paid to a trust for Karen, instead of to Karen personally, the benefits will have to be paid out over a *single* life expectancy, namely, Karen's, because she is the oldest beneficiary of the trust. If the benefits were paid to Karen personally and she rolled them over to her own IRA, then, when she started to take distributions at age 70½, she could take them out over a longer period: the Uniform Lifetime Table, which is based on the *joint* life expectancy of herself and a hypothetical 10-years-younger designated beneficiary. She would not be limited to just her own life expectancy. This is another reason why making benefits payable to a trust for the life of the spouse produces much less deferral, even during the spouse's lifetime, than making payments payable to the spouse personally.

C. **Marital deduction requires that spouse be entitled to distribution of all income annually.** The trust for Karen may or may not need to qualify for the "estate tax marital deduction" depending on the size of Ken's estate at the time of his death relative to the size of the federal estate tax exemption ($5.25 million as of 2013) and any applicable state estate tax exemption. Qualifying for the marital deduction adds another income tax disadvantage to the drawbacks of leaving retirement benefits in trust for (rather than outright to) the surviving spouse. The marital deduction rules generally require that the surviving spouse be entitled to distribution of all income of the IRA annually. This could result in accelerated distributions from the IRA if the income of the IRA exceeds the minimum required distribution. Distribution of IRA income in excess of the MRD is wasteful because Karen does not need or want this additional income for current spending. She would much prefer that the income be accumulated for later distribution to her. Sending her distributions *now* not only results in a loss of deferral, but also causes the benefits to be taxed in a higher bracket; Karen expects to be in a lower bracket after she retires than she is now. Although Rev. Rul. 2000-2 confirms that the income would not actually have to be distributed annually to Karen, as long as she had the right to demand that it be distributed, adding such a demand feature would substantially complicate the drafting and administration of the trust.

D. **Loss of the ability to distribute benefits over the relatively long life expectancy of the participant's children.** If benefits were paid directly to Ken's children as beneficiaries, their life expectancies would be the Applicable Distribution Period to measure required distributions of those benefits under the minimum distribution rules. This would maximize income tax deferral, since they are the youngest individuals in the family and have the longest life expectancies. When the benefits are paid to a trust of which they are only the remainder beneficiaries, however, the Applicable Distribution Period is *Karen's* (shorter) life expectancy, because she is the oldest trust beneficiary. The ability to use the long life expectancies of the children to measure the required payout of the benefits is *forever lost*.

E. **Benefits will be subject to higher income taxes.** The fifth drawback of making benefits payable to a marital trust has to do with the tax brackets applicable to trusts. To the extent distributions of "principal" are made from the retirement plans into the marital trust, they must be retained in the marital trust (to fulfill Ken's intent of preserving the principal for his children); see ¶ 6.1.02 of *Life and Death Planning for Retirement Benefits*. Distributions of "income" are distributed outright to the surviving spouse, of course. Even though some distributions from the retirement plan to the trust are considered "principal" for purposes of trust accounting, and thus must be retained in the trust, they are still "taxable income" for purposes of the federal income tax. See ¶ 6.5.01 of *Life and Death Planning for Retirement Benefits*. Thus, these benefits will be subject to the very high trust tax rates, resulting in an income tax rate of 39.6 percent on most of the distributions (a trust hits the top bracket of 39.6% at just $11,950 of income (2013 rates)). Ken's children are not in the highest tax bracket; humans do not hit the top bracket until they have more than $400,000/$450,000 of taxable income. But the only way to take advantage of that is to make some benefits payable directly to them, rather accumulating income for them in a trust for their later benefit. Similarly, Karen, although she's in a high income tax bracket now, expects to be in a lower bracket once she retires. Thus, paying benefits to a trust often results in their being subjected to a higher rate of income tax than if they were paid to family members.

F. **Children probably have a long wait for a little money.** Ken and Karen Koslow are not close in age. Karen is only 19 years older than Ken's oldest child. Thus it is quite likely that Ken's children themselves will be "old" before they see anything from the marital trust. Karen's life expectancy is currently about 30 years, according to the IRS tables. See Chart 2 at the end of this seminar handout.

3. <u>Solutions offered for this problem</u>

So we now know that leaving retirement benefits to a QTIP trust for Karen's life benefit would involve substantial income tax drawbacks, compared with leaving the benefits outright to Karen or outright to the children. We review with Ken other possible ways to achieve his goal:

A. **Leave the benefits outright to Spouse rather than to a QTIP trust (and buy life insurance as a "replacement asset" for the children).** Some clients, upon learning all the drawbacks of leaving benefits to a QTIP trust, would decide to forget the trust idea and simply leave the benefits to the spouse outright. The decision depends on whether the advantages the client is trying to achieve by using a QTIP trust outweigh the tax drawbacks. For example, if the client's reason for desiring a QTIP trust was a vague concern about a potential future disability of his currently healthy spouse, he might decide to take that risk and leave the benefits outright to the spouse rather than incur the definite drawbacks of naming a QTIP trust. On the other hand, if the spouse is a drug addict or compulsive gambler, it is worth incurring the tax drawbacks of a QTIP trust in order to prevent the funds' being dissipated by the spouse. In Ken Koslow's case, he does not want to leave all the benefits outright to Karen because he wants his children have some rights to the benefits. Thus, "Solution A" is suitable for him only if he wants to take an extra step and buy life insurance to benefit the children, so they would receive the insurance in lieu of any interest in the retirement benefits.

B. **"Conduit" Trust (trust is required to pass out to Spouse all retirement plan distributions as they are received by the QTIP trust) or Trusteed IRA (IRT).** Under a so-called "conduit trust," the trustee is obligated, each time it receives a distribution from any retirement plan, to pass that distribution out, immediately, to the life beneficiary of the trust, in this case the spouse. See ¶ 6.3.05 of *Life and Death Planning for Retirement Benefits*. With a conduit trust that is also a QTIP trust, the spouse-beneficiary is entitled to receive, each year, the income of the retirement plan for that year, or the entire plan distribution for that year, whichever amount is greater. See ¶ 3.3.08 of *Life and Death Planning for Retirement Benefits*. The advantages of a conduit-QTIP trust, compared with a "straight" QTIP trust, are: A conduit-QTIP is guaranteed to pass the IRS's minimum distribution trust rules (and qualify as a see-through trust); and the spouse is considered the sole beneficiary of the trust for purposes of two MRD-rule spousal rights. Specifically, the conduit-QTIP can postpone the start of MRDs until the deceased participant would have reached age 70½; and the spouse's life expectancy is recalculated annually in computing MRDs to the trust, instead of being a fixed period as would be true for a nonconduit trust. Thus, a conduit-QTIP gets a slightly better "MRD deal" than a nonconduit QTIP trust. Also, the high trust income tax rates applicable to distributions paid to a nonconduit trust as principal are avoided by having the trust distribute out to the spouse all distributions the trust receives from the retirement plan, as the trust receives them: retirement plan distributions will be taxed to the spouse at her (typically, lower) rate, rather than to the trust at its (high) rate.

One more MRD point to consider: If the participant and spouse *both* die before the end of the year the participant would have reached age 70½ (not a very common scenario) the subsequent distributions to the younger-generation remainder beneficiaries would be based on their life expectancy, not the spouse's, if and only if the trust still qualifies as a see-through at that time and the trust's remainder beneficiaries are considered the "spouse's beneficiaries" for MRD purposes under § 401(a)(9)(B)(iv)(II). However, in PLR 2006-44022 the IRS ruled that a trust's remainder beneficiaries would NOT be considered the "spouse's beneficiary" under those circumstances. If the IRS position in PLR 2006-44022 holds, this would be a significant *disadvantage* for the conduit-QTIP trust, because it would mean the five-year rule would always apply if both spouses died before the end of the year in which the participant would have reached age 70½.

The advantages of the conduit trust come at a price: With a conduit trust, the bulk of the retirement benefits will be distributed out of the plan to the trust, and thence immediately out to the spouse, over the spouse's life expectancy. There will be little left in that retirement plan or in the trust when the spouse dies, assuming she lives for all or most of her IRS-defined life expectancy. Thus the conduit-QTIP trust is suitable only for some unusual situations. For example, it might appeal to a client who is concerned that her spouse is not able to handle a large lump sum, but who is comfortable with giving the spouse control of annual distributions, provided the trustee retains control of the rest of the money.

All the tax effects of the conduit trust can be achieved even more efficiently by using a "trusteed IRA." What we call an "individual retirement account" can legally be in either one of two forms: a trust (§ 408(a)) or the more common custodial account (§ 408(h)). Both are treated identically for income tax purposes. The **trusteed IRA** (or **individual retirement trust or "IRT"**) can combine the tax advantages of an IRA with trust features (such as the ability to control distributions after the participant's death, within the constraints of the minimum distribution rules). By using an IRT rather than an IRA, Ken can avoid the need to draft a stand-alone conduit-QTIP trust to be named as beneficiary of a custodial IRA. The IRT agreement is the trust document, and it can require the trustee (after Ken's death) to pay Karen the greater of the account income or the minimum required distribution each year. It can even give the trustee discretion to pay Karen more than that, if Ken wishes the trust to include that provision.

Depending on the IRT provider's rules, the participant may be able to totally customize the trust instrument as if he were having a lawyer draft a trust just for him. Alternatively the IRT-provider may offer standard trust provisions available to take care of routine situations such as a marital deduction (QTIP) conduit trust, or a conduit trust for minors. Someone planning to leave his IRA to a trust should consider whether an IRT would serve instead. The only thing an IRT can NOT offer (that could be offered by a nonconduit trust named as beneficiary of an IRA) is the ability to accumulate distributions from the retirement plan for distribution to a future beneficiary; because the "IRT is the IRA," it must make annual MRDs directly to the individual beneficiary.

Ken Koslow rejects the conduit trust solution. Under a conduit trust (including a trusteed IRA), it is likely that most of the retirement benefits will be distributed outright to the spouse during her lifetime; thus, the children will probably not receive a substantial share of the retirement benefits unless the spouse dies prematurely. Thus the conduit trust approach does not achieve Ken's goal.

C. **Name Spouse as outright beneficiary, but on the condition that she will name Participant's children as beneficiaries of her rollover IRA.** Ken hears this idea from his golfing buddy and asks what you think. It sounds like a neat solution, because it enables the surviving spouse to roll over the inherited benefits (thus obtaining the deferral benefits of the spousal rollover), while still protecting the children of the prior marriage, right? Wrong. This idea is a non-starter. First, the children are not at all protected by the spouse's assurance that she will name them as beneficiary of her rollover IRA. Unless they force the spouse into some kind of court proceedings, how will they know if she complied? But even if she complied, she has agreed to basically nothing, since she can withdraw all funds from the rollover IRA without anyone's consent or knowledge. Once the funds have been withdrawn from the IRA she can spend them (or leave them to anyone she chooses if she does not spend them) and the children will get nothing. If Ken leaves the benefits to Karen on the conditions that (A) she will *not* spend them, and that (B) she must leave either the benefits themselves or the proceeds thereof to Ken's children, then he has created a terminable interest that will not qualify for the marital deduction. He has also probably eliminated the possibility of a spousal rollover (thus defeating the point of the exercise): Reg. § 1.408-8, A-5(a), provides that a spouse can elect to treat an inherited IRA as her own only if she is the sole beneficiary of the IRA *and* has an unlimited right to withdraw amounts from the IRA. Ken decides not to use this "solution," and agrees not to seek tax advice on the golf course.

D. **Leave the benefits to a traditional QTIP trust.** As noted, leaving benefits outright to a spouse who rolls them over is usually more tax-favored than leaving benefits to a QTIP trust. However, there are cases in which long-term deferral of distributions from a traditional retirement plan is not the best way to minimize income taxes. If the best form of distribution of the benefits is a lump sum distribution, not rolled over (for example, if the entire plan balance consists of low-basis employer stock), it may make no difference income tax-wise whether the distribution is paid to the spouse or a QTIP trust. See discussion of "NUA" stock distributions at ¶ 2.5 of *Life and Death Planning for Retirement Benefits*. Ken considers this point; however, none of his retirement plans qualifies for any special favored tax treatment for lump sum distributions. Thus, there is no known tax advantage to accelerating the distribution of these benefits, and the QTIP vs. outright-to-spouse dilemma remains.

E. **Leave some benefits outright to spouse and some outright to the children.** This is the solution Ken adopts. It is a sensible compromise between leaving all the benefits to a QTIP trust or all to the spouse outright. It gives each of the beneficiaries (spouse and children) a substantial financial benefit. The substantial tax savings (compared with leaving benefits to a QTIP trust) allows all the beneficiaries (spouse *and* children) to receive more money than they would receive as beneficiaries of a QTIP trust.

If adopting Solution E, how do you decide how much of the retirement benefits, and which specific plans, should be left to which beneficiary?

One approach to the "how much" question is to determine the value of what would have been the beneficiaries' respective interests in a QTIP trust. With a QTIP trust, the spouse has a life interest and the children have a remainder interest. The total value of their respective interests equals 100 percent of the value of the trust. These relative values can be determined using the IRS's tables for valuing life estates and remainder interests (or some other set of actuarial tables). The most recent edition (June 2, 2010) of the IRS's tables for valuing life estates, remainders, etc., can be found at http://www.irs.gov/retirement/article/0,,id=206601,00.html. Examples of how to use the tables can be found in IRS Publications 1457, 1458, and 1459.

For example, if the relative value of the spouse's life interest is 65 percent of the total value of the trust assets, and the children's remainder interest, at the outset, is worth 35 percent of the total trust value, the participant might consider leaving 65 percent of the benefits outright to the spouse and 35 percent outright to the children (or to a trust for their exclusive benefit). (As the years go by, the relative value of the spouse's life estate declines as she gets older, and the value of the remainder interest increases to the same extent.) If the spouse takes full advantage of the spousal rollover for her share, and the children take full advantage of the life expectancy payout option for their shares, both spouse and children should end up with substantially more dollars in their pockets than they would if they received theoretically the same relative amounts as life and remainder beneficiaries of a QTIP trust.

The relative amounts left to the respective beneficiaries need not be exactly what their relative interests would have been in a QTIP trust; it can be whatever percentage the participant wishes. Regarding which plan to leave to whom, consider such factors as spousal rights under REA (the spouse has a right, under federal law, to all or part of the death benefit under any qualified plan) and any state law rights (the spouse may have a community property right to an IRA).

Sometimes when this solution is offered the client's response is "But if I leave some of my plans directly to my children, my spouse won't have enough to live on." If that is true, and the client's primary goal is to assure the spouse's financial security, then the client should not leave any of the benefits to the children—and the client should certainly not leave benefits to a QTIP trust! The QTIP trust will *dramatically* erode the value of the benefits during the spouse's lifetime. The only way to assure her financial security is to leave the retirement benefits to her outright.

4. <u>How Ken implements Solution E</u>

Note: The numbers and tax brackets in this case study solution were based on the pre-ATRA tax code. There is no reason to believe ATRA's income tax changes would change the overall result in this case though the actual numbers would change.

Here is how Ken Koslow implements Solution E.

Using software, his planner projects the eventual value of the benefits to the family under "Scenario 1," which is leaving all benefits to a QTIP trust. The planner assumes that all income of the retirement plans is distributed annually to the QTIP trust and thence to Karen, where it is taxed at 39.6 percent. To the extent the MRD exceeds the income each year, the excess is retained in the trust and also taxed at 39.6 percent. Assuming Karen dies at the end of her 30-year life expectancy, there would be nothing left in the retirement plans at her death. At that time, the marital trust would contain essentially the date-of-death balance of the plans, as increased by capital gains (if any) and reduced by the income taxes the trust had to pay on the plan distributions. This net amount would pass to Ken's children. Karen's estate (which she could leave to her own beneficiaries) would consist of the after-tax accumulations of income from the marital trust.

This proposed scenario was compared with another alternative, "Scenario 2." Under Scenario 2 there would be no marital trust. The $1.2 million of qualified plan benefits would be made payable to Karen personally, and the $600,000 IRA would be payable directly to Ken's children. Ken would make sure his life insurance and investments outside the plan were sufficient to pay any estate taxes on the benefits passing to the children.

This scenario has many advantages over the QTIP scenario. Each beneficiary would have total control of his or her own share of the benefits, without having to compete for the attention of the trustee of the marital trust. Karen would take the plans payable to her out as a lump sum and roll them over to her own IRA. She would then defer all distributions until she reached 70½, at which time she would start withdrawing benefits using the Uniform Lifetime Table. She would name her nieces as her designated beneficiaries on the rollover IRA.

No benefits would be subject to the high income tax bracket of a trust.

Benefits paid to the children would be distributable over their long life expectancies and taxed at their low tax brackets. One of Ken's children is a social worker and the other one is a ballet dancer. They are in low income brackets. There would be annual minimum distributions required from the inherited IRA, which would be small in the early years. Each child's income from this source would gradually increase. By the time the children reach their 60s, each should be receiving substantial distributions from the inherited IRA fund. It could be a major source of retirement funding for them.

The children would have their inheritance immediately at Ken's death, and would not have to sit around for 30 (or more?) years waiting for Karen to die. Karen would not have to feel the children are looking over her shoulder with regard to the investments of the marital trust.

Another advantage of this approach has to do with the practicalities of plan distribution options. Qualified retirement plans (QRPs) often do not permit an installment payout to any beneficiary. Thus, if QRP benefits are made payable to a marital trust, the plan may not permit the trust to draw those benefits out gradually over the life expectancy of the oldest trust beneficiary. The trust can avoid taking a taxable lump sum by using the nonspouse beneficiary rollover to an "inherited IRA," if the trust qualifies as a see-through trust; see ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits*. If these benefits are made payable to Karen personally, by contrast, even if the plan forces her to take a lump sum distribution, she can roll the benefits over to an IRA in her own name which has whatever payout options she wants, without the worry over whether a trust qualifies as a "see-through."

Furthermore, most qualified retirement plans are subject to the Retirement Equity Act of 1984 (REA), meaning that the benefits cannot be distributed to someone other than Karen (the surviving spouse) without her consent. By making the qualified plan benefits payable to Karen personally, you avoid the need for obtaining her consent, which would be required to make the benefits payable to a marital trust or some other beneficiary. Since REA does not apply to IRAs, Ken can make the IRA payable to his children without Karen's consent (subject to any requirements of state law or prenuptial agreements they may have signed).

Last but definitely not least, it is probable that through the combination of substantially increased deferral and somewhat lower income tax rates *both* Karen *and* the children would end up with *more dollars*. On Karen's death, she would still have a substantial portion of the plan she inherited still *inside* her rollover IRA; she could leave to her family her rollover IRA (to be paid out to her family over the oldest beneficiary's life expectancy) plus the after-tax fund of accumulated MRDs she took from the rollover IRA. The children, at Karen's death, would own their own after-tax fund of accumulated MRDs they took from their inherited IRA plus they would still have substantial funds inside the inherited IRA (since their life expectancy extends beyond Karen's).

5. Where to read more

Matters mentioned in this case study are discussed in full detail in the following sections of *Life and Death Planning for Retirement Benefits* (7th ed., 2011):

Qualifying for the estate tax marital deduction: ¶ 3.3

Special income-deferral rights granted to a surviving spouse named as beneficiary of a retirement plan, including spousal rollover: ¶ 1.6 and ¶ 3.2

Income tax, trust accounting, and MRD-rule aspects of naming a trust as beneficiary of a retirement plan: Chapter 6

Explanation of conduit trusts: ¶ 6.3.05

Comparison of MRD rules applicable to surviving spouse as beneficiary, with those applicable to trust for the benefit of spouse: ¶ 3.3.02

Uniform Lifetime Table and Single life expectancy table: ¶ 1.2.03 (see Chart #1 and Chart #2 at end of this seminar handout)

Recalculation of life expectancy annually versus fixed-term method: ¶ 1.2.04

Federal spousal rights to inherit benefits under qualified plans: ¶ 3.4

CASE # II: Married Clients: How to Use the Federal Estate Tax Exemption

Each and every American receives an exemption from federal estate tax. In recent years, the size of the exemption has ranged from $600,000 (for deaths in years 1987–1997) to $5 million adjusted for post-2011 inflation (this has grown to $5.25 million for deaths in 2013).[1] A key element of estate tax planning for married couples has always been making sure that each spouse made use of his/her exemption. The rule prior to 2011 was always "use [your exemption] or lose it." Since 2011, we have had a new estate tax regime, with larger exemptions, lower rates, and an exciting new concept: "Portability" of the estate tax exemption. Portability can create problems and issues, and is not "the right answer" for every married couple, but it has a huge and favorable impact on married couples who have substantial retirement assets.

A. Summary of the federal estate tax, post-ATRA

Following enactment of the American Taxpayer Relief Act of 2012 in January 2013, we have the following federal estate tax system for deaths after 2010. The federal estate tax is continued in effect largely as it applied to deaths in 2001–2009 (including "stepped up basis" for income tax purposes; see ¶ 4.3.08 and ¶ 4.6.03 of *Life and Death Planning for Retirement Benefits*), but for the following significant changes:

✓ There is a federal estate tax exemption (the "basic exclusion amount") of $5 million per person. § 2010(c)(2)(A). This new exemption is significantly LARGER than the exemption applicable in any prior year (the old maximum was $3.5 million, applicable to deaths in 2009).

✓ The basic exclusion amount is automatically indexed, in $10,000 increments, for years after 2011, for inflation occurring after 2010. § 2010(c)(2)(B). As of 2013, the exemption has grown to $5.25 million.

✓ The tax rate applicable to the taxable estate (after all exclusions and deductions etc. have been applied) is 40 percent. § 2001(c). This rate is LOWER than the rates applicable in other years (45% or even more).

✓ The gift tax exemption is again "unified" with the estate tax exemption: The full $5 million estate tax exclusion can be used during life by making gifts. § 2505(a)(1). This contrasts with the pre-2010 rules, under which the gift tax lifetime exclusion was capped at $1 million regardless of the size of the estate tax exemption.

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[1] For a fascinating chart showing the changes in the size of the estate tax exemption, top estate tax rate (and threshold at which it applies), and gift tax annual exclusion, see *Steve Leimberg's Estate Planning Email Newsletter* Archive Message #1762 (January 19, 2011), available to subscribers to Leimberg Information Services (www.leimbergservices.com).

- ✓ A surviving spouse can add to his or her own "basic exclusion amount" the unused exemption amount of her or his "last deceased spouse" (the deceased spousal unused exclusion amount, or "DSUEA"), provided such last deceased spouse died after 2010 and provided that the executor of such last deceased spouse timely filed an estate tax return for the estate of such last deceased spouse, computing (and irrevocably electing to allow the surviving spouse to use) the DSUEA. § 2010(c)(2)(B), (4), (5)(A). This is called "**portability**" of the estate tax exemption, because the exemption can essentially be transferred to the surviving spouse by the estate of the first spouse. Unlike with the basic exclusion amount, the DSUEA amount is frozen at the first death—it does not increase with inflation.

The case studies in this seminar handout focus on federal estate tax credit planning for married couples who have substantial retirement benefits in light of the above regime.

B. Background: Credit Shelter Trust Planning for Married Couples Pre-2011

Even though it has "always" been true that each spouse was entitled to his or her own federal estate tax exemption, it has also always been true that careful planning was needed to avoid wasting one spouse's exemption. If the first spouse to die ("first spouse") left all of his or her assets outright to the surviving spouse ("second spouse"), then there would be no estate tax on the first death, because the marital deduction for assets left to the surviving spouse meant there would be a 100 percent deduction, and no taxable estate. No taxable estate meant there was nothing for the first spouse's exemption to apply to. Now the second spouse owned all the assets (his/her own, plus those inherited from the first spouse) but had only one estate tax exemption (i.e., his or her own).

So Step #1 in basic estate tax planning for married couples, pre-2011, meant having the first spouse leave assets equal to the exemption amount to a beneficiary OTHER THAN the surviving spouse or charity…such as directly to the children, or (more commonly) to a trust that would benefit the second spouse for life but not be included in the second spouse's estate upon his/her later death (because he/she was only a life beneficiary of it). This type of trust is usually called a "credit shelter trust" (because it makes use of the first spouse's federal estate tax credit or exemption equivalent), "bypass trust" (because it "bypasses" inclusion in the second spouse's estate), or "family trust" (because that is the name often given to it in estate planning documents). This seminar handout uses the term **credit shelter trust**.

Even though the credit shelter trust estate plan is only needed at the first spouse's death, *both* spouses had to create credit shelter trust estate plans—because you never know which spouse will die first. And then the couple also had to arrange their assets to make sure that EACH spouse owned assets equal to the exemption amount (or equal to half the couple's assets, if less), so that (regardless of which spouse died first) the correct amount of assets would flow into the deceased spouse's credit shelter trust and be sheltered from estate tax, both on the first death (by the first spouse's exemption, which would apply to it) and on the second death (by being excluded from the second spouse's taxable estate because he/she didn't own the assets).

Portability of the estate tax exemption will make much of this planning (document drafting and asset-rearranging) unnecessary for many married couples.

C. Portability makes estate planning easier for benefits-heavy couples

"Standard" credit shelter planning created a very difficult choice for married couples (1) whose total wealth was large enough to make them concerned with federal estate taxes and (2) who had a substantial portion of their wealth in IRAs or other retirement plan benefits. The difficulty involved choosing between the *income tax benefits* of the "spousal rollover" (obtainable only by leaving the retirement benefits outright to the surviving spouse) and the *estate tax benefits* of the credit shelter trust estate plan (obtainable only by giving up on the spousal rollover, and accepting a faster rate of distribution of the benefits, and income taxation at a higher rate) by making the retirement benefits payable to a credit shelter trust.

For a detailed discussion of the income tax advantages of leaving retirement benefits outright to the surviving spouse and the income tax drawbacks of making benefits payable to a trust for the life benefit of the surviving spouse, see the *Ken Koslow* case study earlier in this seminar handout and ¶ 3.2.01 and ¶ 3.3.02(B) of *Life and Death Planning for Retirement Benefits*. Because of portability of the estate tax exemption, couples no longer have to choose between saving estate taxes and saving income taxes. They can save both.

We will look at how the new estate tax landscape impacts planning for three couples: Peter and Penny Poore (combined assets $4 million); Ron and Rita Rich (combined assets $30 million); and Mark and Mary Middle (combined assets $10 million). In each case, assume the following:

- ♦ This is a first marriage for both spouses.
- ♦ All the couples are in their 60s.
- ♦ Each couple has three adult children.
- ♦ In each case, the couple's only asset is a traditional IRA in the name of the wife.
- ♦ The spouses and the children are all happy, healthy, financially responsible individuals who have no concerns about creditors, divorce, substance abuse, state taxes, or any other unpleasant eventuality.
- ♦ Each couple's only goal is to minimize federal taxes for their children without impairing the financial security of the surviving spouse, but they do not want to make lifetime gifts.
- ♦ At the time they come to see you, each couple's estate plan consists of simply "I love you" wills leaving everything outright to the surviving spouse if living, otherwise outright to the children, and the beneficiary designation for the IRA is the same.

Note: The federal estate tax exemption is $5 million adjusted for inflation after 2011; as of 2013 it has increased to $5.25 million. For ease of discussion, these case studies use an exemption of $5 million, rather than the actual inflation-adjusted exemption and rather than referred constantly to "$5 million adjusted for inflation."

D. Peter and Penny Poore

Peter and Penny are truly poor, because their combined assets of only $4 million (all in Penny's IRA) are less than the federal estate tax exemption of $5 million. The question is *whether there is any reason for them to change their estate plan*. Is there any reason we should advise Penny to leave some or all of her IRA to a beneficiary other than Peter (such as directly to the children, or to a credit shelter trust for Peter's life benefit)? Is there any reason we should advise her to cash out some of her IRA and put some of the resulting after-tax cash in Peter's name to equalize the estates?

My answer would be no. Under the current estate tax regime, regardless of which spouse dies first the survivor would have a federal estate tax exemption of $5 million, which is more than their combined assets. Thus, even without "portability," they don't have to worry about federal estate taxes. If the executor of the first spouse to die (regardless of whether that is Peter or Penny) takes the step of timely filing a federal estate tax return and electing to leave the first spouse's DSUEA to the surviving spouse, then the surviving spouse will have a $10 million exemption.

There are arguments why the Poores should consider adopting a "traditional" credit shelter plan. One could speculate that the surviving spouse will win the lottery or by some other means grow the estate beyond its current $4 million of value, beyond $5 million, even beyond $10 million, and thus benefit from credit shelter planning on the first death.

But for them to do credit-shelter type planning, they would have to sacrifice some of the income tax deferral benefits that their estate plan now incorporates. For example, Penny would have to cash out some of her IRA *now* to get assets to put in Peter's name so he can leave assets to a credit shelter trust if he dies first. At the very least she would have to leave some of the IRA to a credit shelter trust for Peter's benefit, or directly to the children, rather than leaving the whole IRA outright to Peter as she does now. Leaving the IRA direct to the children would impair Peter's financial security. Leaving it to a credit shelter trust would cause accelerated distribution of the IRA (compared with the long-term deferral available with the spousal rollover) and taxation of the IRA distributions at a higher tax rate (the trust would be in a higher tax rate than Peter personally). See discussions in the *Ken Koslow* case study, earlier in this handout, regarding the drawbacks of making retirement benefits payable to a trust for the life benefit of the surviving spouse. While these alternatives could be discussed with Mr. & Mrs. Poore, it seems unlikely that they would want to pay a high income tax price for speculative estate tax savings.

E. Ron and Rita Rich

The estate tax planning picture is completely different for the Riches, with combined assets of $30 million (all in Rita's IRA). Regardless of any foreseeable scenario for the federal estate tax law, their estate will be subject to a substantial federal estate tax bill no later than the death of the surviving spouse. They agree that the surviving spouse could live well on just a $10 million IRA, so they can accept some acceleration of income taxes and diversion of assets to the next generation without impairing the surviving spouse's financial security in order to save estate taxes.

For a couple in this position, the focus is on making maximum use of each spouse's federal estate tax exemption. One goal is to use the exemption as early as possible, so that post-transfer appreciation on the exemption amount can be removed from the couple's estate. That factor would often prompt a suggestion that the couple should make lifetime gifts to use up their estate tax exemptions. At the very least, this would indicate that the first spouse's exemption should be used to transfer the exemption amount to the next generation at the first death, so that subsequent growth in the value of the assets (through income or appreciation) does not increase the size of the second spouse's estate.

The Riches should consider the following steps to get the most use out of their two $5 million estate tax exemptions.

First, Rita should consider leaving the exemption amount directly to the children rather than leaving her whole estate plus her exemption amount outright to Ron. Leaving all to Ron would mean leaving him her "frozen" $5 million exemption amount plus an asset that would continue to grow in value after her death. Her DSUEA in other words would not shelter the whole asset from estate tax, because of the growth in value that would be expected to occur after her death.

But leaving a $5 million traditional IRA to the children does not maximize the value of her exemption. Some of her exemption will be "wasted" when the children have to pay income tax on distributions from that traditional IRA. She should consider, instead, leaving them a $5 million Roth IRA. She can convert $5 million of her IRA to a Roth and name the children as beneficiaries of the Roth IRA. That way they will inherit the full $5 million, not $5 million minus income taxes, and they can spread out distributions from the Roth IRA tax-free over their life expectancies. To pay the income tax on the Roth conversion Rita will need $1,980,000 million of cash (39.6% income tax bracket times $5 million). By cashing out about $3,278,146 of her traditional IRA, she will get enough cash to pay the income tax on the conversion and on the $3,278,146 distribution itself. Now her estate consists of a $21,721,854 traditional IRA and a $5 million Roth IRA.

Next, Rita needs to transfer some assets to Ron to make sure he has $5 million of assets to leave direct to the children in case he dies first. In order to get $5 million of cash to give to Ron, she needs to cash out another $8,278,146 of her IRA. This costs her $3,278,146 of income tax, leaving her exactly $5 million to give to Ron. Now the couple's assets are: Ron, $5 million of cash; Rita, $5 million Roth IRA plus $13.4 million traditional IRA. The surviving spouse will own the $13.4 million traditional IRA plus the $5 million cash (Ron) or $5 million Roth IRA (Rita).

This plan works even if portability ceases to exist for some reason (which seems unlikely), because it does not use portability at all. Portability is for poor and middle class people. Rich people shouldn't use it anyway, so they don't care if it goes away.

F. Mark and Mary Middle

Planning is sometimes hardest for the people in the middle. Mark and Mary, with $10 million of assets (all in Mary's IRA) don't have the luxury of leaving money to the children on the first death because they agree the entire estate should remain in the hands of the surviving spouse for his/her financial well being.

For Mark and Mary, portability is a godsend. Prior to portability, they would have had to make that tough choice: Either to—

- Leave all assets outright to the surviving spouse, to maximize income tax deferral, at the cost of wasting one spouse's estate tax exemption and incurring a projected $2,000,000 of "unnecessary" federal estate tax (40% X $5 million) at the second death; or

- Try to split assets between the spouses, and between the surviving spouse and a credit shelter trust, so each spouse's estate would be within the $5 million exemption, thereby giving up on the spousal rollover, paying high trust income tax rates, and giving up on a payout over the life expectancy of the children.

Under portability, they don't have to make that unpleasant choice. If Mark dies first, his executor can leave his DSUEA to Mary, and her $10 million IRA will then be sheltered by a $10 million exemption (Mary's own exemption plus the DSUEA from Mark). If Mary dies first, she can leave her IRA outright to Mark as beneficiary and her executor can leave her DSUEA to Mark, and the $10 million IRA will still be sheltered by a $10 million exemption (Mark's own exemption plus the DSUEA from Mary). The couple and their children get income tax savings AND estate tax savings.

Portability of the estate tax exemption creates many thorny issues when a surviving spouse who possesses "DSUEA" from a deceased spouse proposes to remarry. Remarriage risks losing the DSUEA (a surviving spouse can use DSUEA only from her "last" deceased spouse). Another portability issue is the necessity of timely filing an estate tax return for the first spouse. That step will be missed in many cases where the first spouse's estate is too small for a federal estate tax return to be required, and thus many potential DSUEAs will be lost. These problems are not covered in this handout because they apply to all estate plans, not just retirement benefit-heavy estates.

G. Exemption planning alternatives

Here are some other ideas that might be considered when a client is facing the dilemma that he wants to make use of his federal estate tax exemption, but the only asset he has to fund a "credit shelter gift" is a retirement plan:

- **Make the credit shelter trust a conduit trust (or trusteed IRA).** Conduit trusts and trusteed IRAs are explained at Case # I(3)(B), above. The drawback of using a conduit trust as a credit shelter trust is the same as the drawback of using a conduit trust as a QTIP trust: most of the retirement benefits will be paid out to the surviving spouse over her lifetime, assuming she lives to or beyond her normal life expectancy. Thus, there will be little left in the trust on her death, unless she dies prematurely. If a conduit trust is being used as a credit shelter trust, therefore, the trust will not save estate taxes unless the spouse dies prematurely, because all the money in the retirement plan will be back in her estate as a result of the conduit distributions.

- **Disclaimer-funded credit shelter trust**. A client may choose to name his spouse as primary beneficiary of the IRA, and names a credit shelter trust as contingent beneficiary if the spouse predeceases him or disclaims the benefits. The disclaimer estate plan does not eliminate the problem of funding a credit shelter trust with retirement benefits; if the situation hasn't changed when the participant dies, activating the credit shelter trust by having the surviving spouse disclaim the IRA will have exactly the same drawbacks as naming the credit shelter trust as beneficiary in the first place. However, the surviving spouse might choose to disclaim if something has changed: for example, if her financial situation has improved (she won the lottery), or if her life expectancy was severely shortened, or the tax laws, at the time of the participant's death, had changed so that having the

IRA pass to the credit shelter trust would no longer have a negative effect on her financial security.

H. Where to Read More

Matters mentioned in this case study are discussed in full detail in the following sections of *Life and Death Planning for Retirement Benefits* (7th ed., 2011):

Special income-deferral rights granted to a surviving spouse named as beneficiary of a retirement plan, including spousal rollover: ¶ 1.6 and ¶ 3.2

Income tax, trust accounting, and MRD-rule aspects of naming a trust as beneficiary of a retirement plan: Chapter 6

Comparison of MRD rules applicable to surviving spouse as beneficiary, with those applicable to trust for the benefit of spouse: ¶ 3.3.02

Explanation of conduit trusts: ¶ 6.3.05

Uniform Lifetime Table and Single Life Expectancy Table: ¶ 1.2.03 (see Chart #1 and Chart #2 at end of this seminar handout)

CASE # III: Estate Taxes on Large Retirement Plan Balance: Dr. Della

Dr. Della is 68. She has a $10 million IRA, a home worth $2 million and few other assets. She wants to leave all her assets to her three children, and save taxes. Among her concerns are the large minimum distributions she faces in a few years, when she reaches age 70½.

Before considering ways to reduce taxes, we first face the question of how estate taxes will be paid if she dies with this asset picture. Assume a $5.25 million estate tax exemption and 40 percent tax rate on assets in excess of $5.25 million. If she leaves the IRA directly to her children, the executor of the estate will be liable for $2.7 million of estate taxes and no assets with which to pay that tax other than the $2 million home. The executor might have to sue the children to try to collect their share of the estate taxes, or somehow forfeit the estate to the IRS and let the IRS figure out how to collect from the children.

To avoid putting the executor in this difficult position, make sure the person who is primarily responsible for paying the estate taxes also has control of the money! For example, make the IRA payable to a trust, and make sure the trustee is the same as the executor of the estate. That way, the executor can be sure the friendly trustee (himself) does not run away with the IRA money before taxes are paid. Or, make the three children co-executors as well as beneficiaries, so they are primarily as well as secondarily liable for the estate taxes.

Another approach is for Della to buy life insurance to assure the availability of funds to pay estate taxes. Again, she must make sure that the life insurance proceeds end up in the hands of the person who will need them to pay the estate tax.

Next Della invites everyone she knows to send her ideas for how to reduce the estate tax value of her IRA (and/or how to reduce the income tax impact of required minimum distributions). Here are the ideas she has received so far:

A. Roll the IRA back into a corporate retirement plan, then buy life insurance inside the plan, then distribute the policy out of the plan after a few years when the policy value is lower than the sum of premiums paid.

The idea here is that, for the first several years of its existence, a life insurance policy is worth less than you paid for it, and it takes many years for the cash value to catch up to what it would have been had you invested in (say) bonds rather than life insurance. An IRA cannot hold life insurance, so the possibility of using this scheme depends on having a qualified retirement plan (QRP) you can roll the IRA into. In Della's case, she would have to go to work for a company that had a plan that would permit her to roll her IRA into it and also would permit the purchase of life insurance in the plan. Because of abuses in the valuation of plan-owned life insurance (basically, schemes designed to lower the value of the policy, artificially and temporarily, to reduce the income tax impact of distributing the policy), the IRS will no longer accept "cash surrender value" as the proper valuation of a policy. See Reg. § 1.402(a)-1(a)(2) and Rev. Proc. 2005-25, 2205-17 I.R.B. 962 (April 2005). Incredibly, some insurance agents are still pushing this plan and claiming that (even with the new IRS valuation standards) a policy can be fairly valued at 50 percent of what the plan paid for it.

B. Invest in a venture capital (or real estate development) partnership or other form of investment that temporarily reduces the value of the plan.

The idea is to invest the IRA in something that the client believes is a good investment over the long term, but that actually declines in value right after the investment is made. The decline is due to a lack of transferability or lack of marketability of the investment during a lockup phase while the venture investments are still in the start-up stage (or while the real estate development is still just a hole in the ground). The key to success is that the client must either (a) die or (b) withdraw the investment from the plan *while the investment is still in its reduced-value stage* in order to capture the benefit of the low value for purposes of achieving lower estate taxes or lower income taxes.

C. Make IRA assets subject to a "Restricted Management Agreement" (RMA).

Some practitioners argue that an investment manager should be hired for a fixed term such as five years, rather than on the more customary at-will terms. An investment manager who knows he has a five-year time horizon will produce better investment results, the theory goes, because he will not have to focus on producing short-term quarter-by-quarter results. By promising your investment manager that you won't fire him for five years, and that you won't even LOOK at his investment returns until the five years are up, you will supposedly benefit from the superior investment results produced by a long-term investment horizon. Oh, incidentally, proponents argue, your account will be entitled to valuation discounts for estate and gift tax purposes because of the lack of marketability created by your restrictive contract with the investment manager. The proponents add that the RMA is a superior vehicle to other "discount" entities (such as the family limited partnership) because it requires fewer state law formalities and no business purpose. There are as yet no cases or IRS pronouncements dealing with the RMA as a discount-generator.

If the RMA works for assets outside a retirement plan it should work for assets inside a retirement plan. One concern is the fiduciary investment standards applicable to trustees of QRPs;

however, if the "superior investment results" argument is demonstrably true, then the RMA approach should pass muster here. The fiduciary requirements are not applicable to IRAs.

A skeptic would suspect that RMAs are entered into only to obtain the supposed valuation discounts, not to obtain the supposed superior investment results. If I were advising a client proposing to enter into an RMA, I would ask the investment manager these questions: Are you really saying that you invest most of your clients' money only to produce the best quarter-to-quarter results? Is it true that I must lock my money up for five years to get the benefit of your best investment wisdom? Is that what your advertising brochures say? Can you show me some portfolios that have and have not used RMAs, to demonstrate that the RMAs have had superior investment results? Can you show me two typical client portfolios, one that is subject to an RMA and one that isn't, and show me how they are invested differently? If the investment manager cannot show any difference between the investment processes and choices applied to RMAs and those used for other accounts, the entire argument (for both investment and tax results) falls apart. The articles that have appeared on RMAs do not address this point.

In Rev. Rul. 2008-35, 2008-29 I.R.B. 116, the IRS announced that it would not recognize any alleged reduction in value based on a restricted management agreement: "The fair market value of an interest in an RMA for gift and estate tax purposes is determined based on the fair market value of the assets held in the RMA without any reduction or discount to reflect restrictions imposed by the RMA agreement on the transfer of any part or all of the RMA or on the use of the assets held in the RMA."

<u>Where to read more</u>: David A. Handler and David Sennett, "Avoid FLPs: Try restricted management accounts instead," *Trusts & Estates*, Vol. 142, No. 5 (May 2003), p. 30; Owen Fiore and David A. Handler, "FLPs vs. RMAs," *Trusts & Estates*, Vol. 142, No. 8 (Aug. 2003), p. 24; Randy A. Fox and Scott Hamilton, "Experts Discuss the Transfer Tax Benefits of Restricted Management Accounts Owned by FLPs," *Insights & Strategies*, Vol. 14, No. 5 (May 2003), p. 2**.**

D. Transfer IRA assets to family limited partnership.

The idea here is to form a family partnership (FLP) among the IRA (which contributes all its investments to the FLP), the IRA owner (as general partner, perhaps) and (say) the client's children. The goal is to get the same "valuation discounts" for the investments inside the IRA as clients get for their outside-the-IRA investments that are held in FLPs. The main obstacle is whether having the IRA enter into a partnership with the IRA owner and other related parties constitutes a "prohibited transaction" under § 4975. This is a subject for analysis by an ERISA lawyer. Department of Labor Advisory Opinion #2000-10a gives an example of the analysis to be followed when determining whether a transaction of this type is a prohibited transaction. In that opinion, the DOL stated that there were three separate prohibited transaction rules that could potentially be violated by investment of IRA assets in a FLP. The DOL found that the particular transaction in question was not a violation of *one* of those rules, and might or might not later violate the other two rules. To read the opinion, go to the DOL website www.dol.gov./dol/ebsa, click on "Laws and Regulations," and select Advisory Opinion 2000-10a.

In analyzing whether a proposed transaction is a "prohibited transaction"(PT), do not be lulled into thinking that all you have to do is pass certain mechanical and numerical tests. § 4975 and the DOL regulations convey the impression that as long as your transaction does not involve certain specified categories of relationships (such as parent-child), and/or stays below certain percentages of cross ownership (such as 50%), there is no PT problem. This impression is false. There is a catch-all category of PT under § 4975 under which a court can find that the transaction is a PT because it indirectly benefitted the participant by benefitting someone he cared about, even though none of the listed categories of relationships was involved and none of the specified percentages was exceeded.

So, when you are trying to determine whether something is a prohibited transaction, you have two separate tests you must pass. First is the mechanical by-the-numbers test: if you flunk that, there is no need to go on to the second test—you have a prohibited transaction. But if you pass the first test that does not mean you are home free. You still must pass the second test under § 4975(c)(1)(E): is there any possible *indirect* benefit to the fiduciary/disqualified person?

CASE # IV: Trio of Problems with One Solution: a Charitable Remainder Trust (CRT)

For use of a CRT to benefit a handicapped child, see the "Dingle" case at XI(1).

A. Keeping a lump sum distribution out of children's hands.

Felicia Fallon is 66. She has $8 million in total assets: $3 million in the qualified retirement plan (QRP) of her employer, and another $5 million of liquid investments and residential real estate. She has two children, ages 48 and 45, and several grandchildren. The children are well provided for financially. While her children are to be the principal beneficiaries of her estate, Felicia has some interest in charitable giving. She does not want her children to cash out the retirement plan on her death, but she is afraid they will do just that. She reviews several options.

1. Annuity option under the plan.

One is to force the children to take an annuity distribution from the retirement plan. The plan offers her the option of restricting her beneficiaries to an annuity payout. The drawback of that is that the children are left at risk if the employer and/or the plan itself gets into financial troubles. Also, the plan offers only fixed annuities, which Felicia considers too vulnerable to inflation.

2. Leave benefits to see-through trust, rely on beneficiary rollover

Another possibility is to leave the benefits to a Conduit Trust or other see-through trust for the benefit of her children. Although the plan offers a lump sum distribution as the only form of benefit, the trustee could direct the plan to transfer the lump sum to an "inherited IRA" payable to the trust as beneficiary. See ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* for details on such nonspouse beneficiary rollovers.

There are two drawbacks to relying on the nonspouse beneficiary rollover.

First, drafting a see-through trust is a complicated and perilous undertaking, in view of the IRS's problematic regulations. See ¶ 6.2–¶ 6.3 of *Life and Death Planning for Retirement Benefits*. If the trust for some reason does not qualify as a see-through (for example, because the trustee forgets to send required documentation to the plan administrator by October 31 of the year after the year of the participant's death) the nonspouse beneficiary rollover to an inherited IRA is not available (it's available only to "designated beneficiaries"). IRS Notice 2007-7, A-16.

Second, there is the risk that the lump sum benefits, instead of being transferred by direct rollover to an inherited IRA as instructed by the trustee-beneficiary after the participant's death, will by mistake (either of the plan trustee or the IRA provider) be transferred to a taxable account, causing immediate income taxation of the entire lump sum, with no ability to correct the mistake by rolling the money back into the plan or into an IRA. Transferring intended rollover distributions into a taxable account is one of the most common mistakes made in the retirement benefits area. See, *e.g.*, PLRs 2007-03036, 2007-04038, 2007-27027, 2007-09068, 2007-17027, 2007-22030, 2007-27022, 2007-27025, and 2007-32025. When this mistake happens after the participant's death it cannot be corrected (unless the beneficiary happens to be the participant's surviving spouse).

3. Roll benefits to an IRA while living

Another approach is to roll the benefits over to an individual retirement trust (IRT, or "trusteed IRA") while Felicia is still living; the IRT can then provide for a restricted payout to her children over their life expectancies. However, Felicia cannot withdraw money from the plan (to roll it over to an IRT) until after she has retired, which is still several years away. See ¶ 6.1.07 of *Life and Death Planning for Retirement Benefits* for more explanation of IRTs.

4. Leave benefits to a charitable remainder trust

Finally, Felicia considers leaving the benefits to a charitable remainder trust (CRT). The CRT that would pay a six percent unitrust payout to the children for their joint lifetime and for the life of the survivor. The advantage of this scenario is that the CRT pays no income tax on the $3 million lump sum distribution it receives. The children would then receive, for life, the 6 percent income stream from the entire $3 million fund. Their income distributions would fluctuate depending on whether the CRT's investments grew at more or less than 6 percent per annum. The children would have to pay income taxes on these distributions. On the death of the surviving child all funds remaining in the CRT would go to Felicia's favorite charity.

In addition to eliminating income taxes on the lump sum distribution, this approach produces an estate tax charitable deduction to Felicia's estate for the value of the remainder interest. The value the children receive (in the form of a lifelong stream of income from the CRT, plus decreased estate taxes) is not significantly less than the net value they would receive if they were outright beneficiaries of a lump sum distribution of the entire plan balance on Felicia's death.

Also, the CRT scenario assumes that at least one child lives for 44 years. If both of them die before the 44 years are up, the entire trust at that point moves to the charity. Thus, in case of premature death, the value to the family of the CRT scenario would be much lower. The children can overcome this risk by buying decreasing term insurance on their lives; or, Felicia could decide that this risk is not of concern to her.

B. Multiple beneficiaries.

Ogden is single, age 45. He has worked for several companies and as a result he has money in several different qualified plans, 403(b)s, and IRAs. His estate planning goals are: to provide for his parents' needs, if they both survive him and need additional funds; to provide something for his siblings; and to benefit charity. He creates a CRT which will pay a five percent unitrust payout in equal shares to the living members of the group consisting of his parents (who are in their 70s) and two siblings (ages 42 and 48). His estate has other assets to pay the estate taxes applicable to his other assets and to the noncharitable interests under the CRT.

C. Older beneficiary.

Hilda, age 68, has a $3 million IRA. Her goal is to provide a life income to her sister Justine (age 71) and remainder to a charitable foundation. Leaving the benefits to a trust that provided life income to Justine and remainder to charity would require a rapid fully income-taxable distribution of the account after Hilda's death. Such a trust would not qualify as a see-through (because of its nonindividual remainder beneficiary, the charity), so the IRA would have to be entirely distributed within five years after Hilda's death. Even if the trust were a conduit trust (so it qualified as a see-through despite the charitable remainder beneficiary), the benefits would have to be entirely distributed (and taxed) over Justine's relatively short life expectancy (16 years). Assuming the income stream from a CRT would provide sufficient funds for Justine, Hilda should leave her IRA to a CRT for Justine's life benefit. Then there would be no income tax on distribution of the benefits from the IRA to the CRT, and an estate tax deduction for the value of the charitable remainder. This solution assumes there are other assets available to pay any applicable estate expenses and taxes.

<u>Where to read more</u>

Regarding charitable giving with retirement benefits, see Chapter 7 of *Life and Death Planning for Retirement Benefits*. See ¶ 7.5.04–¶ 7.5.07 regarding making retirement benefits payable to a charitable remainder trust.

CASE # V: Complying with the IRS's MRD "Trust Rules": Joseph and Jennie

1. <u>Facts and solution: Joseph</u>

Joseph and Jennie are a husband and wife, both age 69. This is a second marriage for both.

Joseph's assets are his $1 million IRA and $500,000 of municipal bonds. His four children are well off financially. He wants to leave his IRA to his 11 grandchildren who range in age from 3 to 21 years old. He is anxious to extend the life of his IRA as long as possible both during his life and after his death. He wants to be sure the grandchildren do not cash out the IRA immediately upon his death; he wants a wise trustee to take advantage of the long term payout of the account (over the oldest grandchild's life expectancy) permitted by the minimum distribution rules.

Joseph names as beneficiary of his IRA a "conduit trust," under which the trustee will invest the IRA and withdraw from it, each year, the "minimum required distribution" (MRD) amount based on the oldest grandchild's life expectancy. The trustee also has discretion to withdraw more than the MRD in any year. The trustee must distribute all amounts withdrawn from the IRA outright to the grandchildren in equal shares *per capita* (or to the grandchild's parent as custodian for the grandchild under the Uniform Transfers to Minors Act, in the case of a minor grandchild). Any estate taxes and expenses of administration, debts, etc., are to be paid from the assets of Joseph's probate estate; what's left of the probate estate, if anything, will pass to Joseph's children.

Since the primary goal of the trust for Joseph's grandchildren is to assure extended payout of the IRA, the trust must be carefully drafted to comply with the IRS trust rules. It is expected that the trustee would take out of the IRA each year only the MRD, and that this would be a small amount each year per grandchild. The risk with this "conduit trust" is that, if the MRD rules change, so that the trustee is forced to withdraw more than the small annual MRDs required under today's rules, the trust will end up dumping out more money to the grandchildren, at younger ages, than the donor really wanted them to have.

Joseph's is an ideal situation for use of a trusteed IRA (IRT) instead of an IRA payable to a conduit trust; see discussion under *Koslow* case study, #I(3)(B), above.

2. Facts and solution: Jennie

Jennie's estate planning goals are completely different. Her $20 million estate includes a family business, extensive personal real estate, liquid investments, and a $400,000 IRA representing the rollover of retirement plans she had acquired through her work for the family business.

First, she plans to use her generation-skipping (GST) exemption by creating a long-term dynasty trust for her descendants. This trust will receive $5 million worth of assets at her death, probably all funded with stock of the family business, and a major goal of this trust is to avoid estate taxes in perpetuity. She wants to leave a certain amount in trust to provide for Joseph's support; whatever remains in this trust at Joseph's death is to pass to Jennie's private foundation. The rest of her estate will pass, after multiple pecuniary bequests to charities and friends (total amount of these bequests is about $1,500,000), in trusts for her children. Her children will have general powers of appointment over their shares (to avoid generation-skipping tax), but these general powers will be as circumscribed as it is possible to make them while still causing estate inclusion at the level of the children's generation. Also, it is important to Jennie that her children have the power to appoint principal from their shares to charity during their lifetimes.

Clearly, Jennie's proposed trusts for Joseph and for her children will not comply with the IRS's "trust rules" with the terms as above described, because both trusts have charitable beneficiaries. Is it worth creating a separate "subtrust" within either of these two trusts for the sole purpose of holding $400,000 of retirement plan benefits? The advantage of creating such separate subtrusts (which could provide, for example, that distributions from the subtrust could be made only to the individual family members, not to charities) would be that the retirement benefits could be paid out, after Jennie's death, to the trusts gradually over the life expectancy of the oldest individual beneficiary; if the trust does not qualify as a see-through trust required distributions could be more rapid after her death.

In my judgment, it is not worth creating a small separate subtrust for this relatively minor asset. It would be worth exploring whether the IRA could be used directly to fund a particular charitable bequest; for example, perhaps her foundation could be named directly as beneficiary and then the foundation's bequest in her will could be reduced accordingly. It would be worth exploring whether Jennie has any interest in naming Joseph individually as beneficiary, and reducing the size of the marital trust bequest accordingly, because of the tax advantages of naming the spouse. But if these ideas do not seem amenable or easy to implement, Jennie may well decide that the added complications and administration expenses of a separate subtrust (in an already complex estate plan) are not worth the benefit of additional tax deferral on this minor asset.

3. Where to read more

For how to qualify as trust as a see-through trust under the minimum distribution trust rules, see ¶ 6.2–¶ 6.3 of *Life and Death Planning for Retirement Benefits* (7th ed., 2011). Regarding conduit trusts, see ¶ 6.3.05.

CASE # VI: Non-citizen Spouse: Pedro and Pepper

1. Facts and problem

Pedro has a defined benefit plan and a $500,000 profit sharing plan through his employer, and a $600,000 IRA. He would like to leave all of these assets to his wife, Pepper, and have them qualify for the estate tax marital deduction. Pepper is a U.S. resident, but not a U.S. citizen. Assets left to a surviving spouse who is not a U.S. citizen do not qualify for the federal estate tax marital deduction, unless the assets are left to a "qualified domestic trust" (QDOT) (or transferred to such a trust by the surviving spouse).

For non-retirement plan assets, Pedro can simply leave the asset to a marital deduction trust that is also a QDOT. However, there are income tax drawbacks to leaving retirement plan benefits to a marital trust (see the *Ken Koslow* case study, above). Also, the only death benefit provided by the defined benefit plan is a non-transferable life annuity payable to the surviving spouse individually; benefits under this plan cannot be left to a trust, because the spouse is the only permitted beneficiary.

Pedro wants to make sure, to the extent he can do so, that all the benefits will qualify for the marital deduction, while at the same time minimizing negative income tax effects.

2. IRA: name QDOT as primary beneficiary, wife as contingent

On his IRA, Pedro names a QDOT-marital trust as beneficiary of the IRA, with Pepper as the contingent beneficiary. The QDOT gives Pepper the right to withdraw all assets from the QDOT at her discretion (subject only to the right of the U.S. trustee of the QDOT to withhold estate taxes, as required by the Code). For income tax purposes, if she is a U.S. resident, she should be deemed the owner of the trust's assets under § 678(a)(1) and § 672(f). Thus IRA distributions to the trust will be taxed to Pepper at her personal tax bracket which is expected to be lower than the trust rates.

Also, as the surviving spouse and deemed "owner" of the IRA held in the trust (under § 678), she would be able to defer any distributions from the IRA until Pedro would have reached age 70½. However, the regulations say that a trust cannot exercise the spouse's election to treat the IRA as her own even if the spouse is the sole beneficiary of the trust. Thus, although this asset will qualify for the marital deduction without the necessity of any post-death actions by Pepper, it apparently will not be eligible for the most favorable income tax treatments.

If it appears (after Pedro's death) that the income taxes would be more favorable by having the IRA pass outright to Pepper, the QDOT can disclaim the IRA and let it pass to Pepper outright as contingent beneficiary. However, she will then have to transfer it to a QDOT if she wants to preserve the estate tax marital deduction.

3. Profit sharing plan: name wife as primary, QDOT as contingent

Regarding the profit sharing plan, there is less flexibility. The plan's only form of death benefit payment is a lump sum in cash. The plan has been known to balk at permitting disclaimers, saying these are "prohibited by ERISA."

On this plan, Pedro decides to name Pepper as primary beneficiary, with his QDOT as contingent beneficiary. Pepper can roll the benefits over to her own IRA, and assign ownership of her IRA to a QDOT she creates that is a 100 percent "grantor trust" as to Pepper under § 676, if she is a U.S. resident. This way she will get the income tax deferral benefits they are seeking, and also the gift will qualify for the marital deduction, though such qualification depends on post-death action by Pepper.

If Pedro wants to eliminate the uncertainty of depending on Pepper to take action after his death, he could make the profit sharing plan payable to the same QDOT as the IRA. Possibly, Pepper (as surviving spouse and deemed "owner" of the trust's assets under § 678) could direct the QDOT trustee to exercise her right to roll over the plan distribution to an IRA. However, this step would probably require an IRS ruling, because there is no precedent establishing use of § 678 to effect a spousal rollover of benefits payable to a trust.

Theoretically, Pepper could withdraw the distribution from the QDOT and transfer it to a rollover IRA and transfer the IRA to another QDOT; but that would involve a withdrawal from the QDOT, which normally triggers deferred estate taxes. There is no exception that permits a spouse to take money out of the QDOT estate tax-free just because she is going to put it right back in. Thus the rollover must either be done entirely within the QDOT (which may not be possible) or else by Pepper before the plan distribution gets into a QDOT in the first place.

4. Defined benefit plan: Leave to Pepper, who will sign contract with IRS

Regarding the defined benefit plan there is even less flexibility. Marital deduction qualification must be left up to Pepper who, after Pedro's death, would have to enter into an agreement with the IRS. Under such an agreement (the details of which are spelled out in the regulations) Pepper would promise that, as she received payments from the defined benefit plan, she would transfer the "principal" portion of such payments to a QDOT (alternatively, she could promise to pay estate taxes on such principal payments as received).

5. Where to read more

The QDOT rules are found in IRC § 2056(d) and § 2056A, and Treas. Reg. § 20.2056A-1 *et seq.* These rules, and their planning implications for retirement benefits, are the subject of Chapter 4 of the 5th edition (2003) of *Life and Death Planning for Retirement Benefits*. This subject is NOT covered in the 6th edition (2006) or 7th edition (2011), but can be purchased as a Special Report, "Retirement Benefits and the Marital Deduction (Including Planning for the Noncitizen Spouse)," at www.ataxplan.com.

CASE # VII: Pre-age 59½ Spousal Rollovers: Nancy

Nancy is age 48. Her husband Ned recently died at age 51, leaving her as beneficiary of his 401(k) plan ($500,000) and his IRA ($100,000). As the surviving spouse, she is entitled to roll over all these benefits to an IRA in her own name. The problem is, once the benefits are in her own IRA, she cannot withdraw from them without paying a 10 percent penalty under § 72(t) (unless one of the 13 exceptions applies), because she is under age 59½.

At first it appears that she should just leave the plans in Ned's name for now. As the surviving spouse and sole beneficiary, she is not required to take any distributions until the year he would have reached age 70½ (20 years from now). If she needs money to live on, she can withdraw funds as needed from Ned's retirement plans without paying a penalty because death benefits are not subject to the 10 percent penalty (of course she will have to pay income taxes). Once she reaches age 59½, she could roll over the remaining benefits to her own IRA and after that she can withdraw money as needed without penalty because she will be over 59½. However, there are several drawbacks of leaving money in the plans:

1. She does not like the limited investment alternatives in the 401(k) plan.

2. Under the minimum distribution rules, if Nancy dies before she takes the money out of Ned's plans, and if her death occurs before Ned would have reached age 70½, the "five year rule" is applied as if *she* were the participant: all benefits would have to be distributed within five years after Nancy's death unless payable to her designated beneficiary, in which case the benefits could be distributed over the life expectancy of the designated beneficiary. See ¶ 1.6.05 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). That's fine for the IRA, which allows Nancy to name a designated beneficiary; but the 401(k) plan does not allow Nancy to name a beneficiary for her rights in the plan. The 401(k) plan provides that if Nancy dies before withdrawing Ned's benefits, the account belongs to Nancy's estate. Since (according to the IRS) an estate cannot be a designated beneficiary, all the benefits would have to be distributed within five years after *Nancy's* death in that case.

3. Other factors may affect the rollover decision, such as the vulnerability of the different types of plans to claims of Nancy's creditors (if she has any concerns on this issue), and any state law differentiation between IRA and 401(k) benefits.

How much weight should be given to factor # 2? If Nancy strongly favored the investment options in the 401(k) plan, or if other factors (such as vulnerability to creditors' claims) favored leaving money in the 401(k) plan, factor #2 could be considered unimportant; after all, Nancy is unlikely to die in the next 20 years, and the risk of her premature demise could easily be insured against. Since Nancy does not like the investment options in the 401(k) plan, however, factor # 2 adds to the reasons to move the benefits out of that plan.

How likely is it she will really want to take money out and spend it? If she is financially needy, and maximum flexibility to take penalty-free death benefits is her highest priority, she could roll over Ned's 401(k) plan to an IRA still in Ned's name. Reg. § 1.408-8, A-7; see ¶ 3.2.07 of *Life and Death Planning for Retirement Benefits*. That way she can name her own beneficiary for benefits remaining in the IRA at her death, and get the investment options she wants, without giving up the right to take penalty-free death benefits.

On the other hand, if she is extremely concerned about factor # 2, and/or if she does not think she will need much if any of the money to live on prior to age 59½, she could simply roll over everything right away to an IRA in her *own* name. Then, if she later *does* need money to live on prior to age 59½, she can start taking a series of substantially equal periodic payments (SOSEPP) penalty-free from her own IRA at that later time.

Another problem that *formerly* existed in the young-widow situation has disappeared. Although neither the Code nor the IRS regulations contains any indications of such an election, at least one IRS ruling *had* hinted that the spouse must elect: either she takes the benefits as penalty-free death benefits, or she rolls them over to her own account. The final minimum distribution regulations eliminated any concern about such a forced either-or election; the regulations now clearly allow the spouse to elect to treat an inherited IRA as her own even after she has taken some distributions as beneficiary, so she can do some of each.

4. <u>Where to read more</u>

See Chapter 3 of *Life and Death Planning for Retirement Benefits* (7^{th} ed. 2011) regarding spousal rights in retirement plans and spousal rollovers. See Chapter 9 regarding the 10 percent penalty on pre-age 59½ distributions, and ¶ 9.2–¶ 9.4 regarding the SOSEPP and other exceptions.

CASE # VIII: Duncan: Estate Planning with Roth Accounts

"Roth" retirement plans are encountered with increasing frequency among estate planning clients, especially since (beginning in 2010) the availability of Roth "conversions" was extended to high-income individuals.

Naming the "right" beneficiary for a client's retirement plans is always a very important step in creating an estate plan. Failing to name the right beneficiary for a traditional retirement plan can cause loss of the "stretch" life expectancy payout for the benefits, and the resulting acceleration of income taxes (loss of deferral) can be financial detrimental.

Some planners mistakenly conclude that naming the right beneficiary is *less* important for a Roth plan than for other plans, because the Roth distributions are income tax free. Therefore if the benefits are "dumped" out of the Roth plan shortly after the client's death due to a faulty estate plan there is no great harm, because there is no acceleration of income tax.

This idea is mistaken. The stakes are actually even higher with a Roth plan simply *because* distributions from the Roth plan are tax-free. Thus the longer the assets can accumulate inside the Roth plan, the more tax-free income the client and his beneficiaries will receive. If the benefits are "dumped" out of the Roth plan shortly after the client's death due to a faulty estate plan, then that future tax-free investment growth is gone forever.

When a traditional retirement plan gets distributed immediately after the client's death due to a faulty estate plan, the financial damages are a little speculative. It's true the income tax has been accelerated when it could have been deferred, but the beneficiaries would have had to pay that tax sooner or later anyway so maybe they are not really harmed so much. But when an account that was supposed to generate tax free distributions over the beneficiary's entire lifetime gets distributed prematurely, the damage is severe. Just compare the value of that tax-free life-long stream of payments with the present value of an investment fund that will generate taxable income forever and see the difference.

The moral is: Proper estate planning is even more important for Roth accounts than for traditional plans!

A. Duncan's problem

Duncan wants to leave some of his assets to charity, some to his wife, and some to his children. He has some assets in a traditional retirement plan, some in a Roth plan, and some in "outside" (nonretirement) investments. Which asset should he leave to which beneficiary?

Chart 3 at the end of this seminar handout, "**Choosing a Beneficiary for the Retirement Plan**," suggests that all three of these classes of beneficiary are "tax-favored" for the traditional plans:

- ♦ Charity is tax-favored because it receives the traditional retirement benefits totally free of the income tax that individual beneficiaries would have to pay as they withdrew funds from the traditional plan;

- ♦ The surviving spouse is tax-favored because she can roll over inherited benefits to her own IRA, thus: deferring all distributions until she reaches age 70½, taking distributions beginning at age 70½ using the favorable "Uniform Lifetime Table" (Chart 1) rather than the less favorable "Single Life Expectancy Table" (Chart 2) to determine her MRDs; and naming the children as her designated beneficiaries on the rollover IRA, so they can take a stretch life expectancy payout after her death; and

- ♦ The children are tax-favored (because, as young individuals, they can withdraw the benefits gradually, in annual instalments over their long life expectancies.

B. Who to name on the Roth

With the Roth plan, the picture changes. Charity is NOT a tax-favored choice of beneficiary for a Roth plan. Because distributions from a Roth plan are generally income tax-free, there is no advantage to leaving this asset to an income tax-exempt entity.

If federal estate taxes are a concern, there is a strong argument *against* making the traditional IRA payable to the children. By inheriting the traditional IRA, they would be inheriting an asset that has a built-in income tax "debt." Duncan does not get a marital or charitable deduction for leaving assets to his children; the only estate tax "shelter" there is for bequests to his children is the federal estate tax exemption. Part of that exemption is "wasted" if the children inherit an asset that they then have to pay income tax on. Part of the "exempt" amount goes to the IRS! See discussion under the "Ron and Rita Rich" case study, #I(F) above.

So the children should inherit either the Roth plan or the nonretirement assets; either way, they will owe no income tax on their inheritance.

We have figured out that the charity SHOULD inherit the traditional retirement, and the children should NOT inherit it; that leaves the Roth plan and the nonretirement assets to be divided somehow between the spouse and the children. The question is, what is the best income tax scenario for the Roth plan?

If a Roth IRA is left to the children, they can stretch it out via annual tax-free distributions over their life expectancies. That's a pretty darn good scenario.

But if the Roth plan is left to the surviving spouse she can get an even better scenario: She can roll the inherited Roth plan over to her OWN Roth IRA (only the surviving spouse has this right). Then she will be able to stretch out the tax-free distributions much longer than the children possibly could: She does not have to take *any MRDs at all* from the rollover Roth IRA during her lifetime. After her death it can be left to the children for gradual tax-free distributions over their life expectancy.

Duncan's choice is made: Leave the traditional retirement plan to the income tax-exempt charity, the Roth plan to the wife for her to roll over and keep accumulating tax-free, and the nonretirement assets to the children.

C. Practical problems

Duncan has one problem. His "traditional retirement plan" is an account in a 401(k) plan, and his "Roth retirement plan" is a designated Roth account (DRAC) in the very same plan. It is not clear whether plan administrators will sometimes, always, or never allow an employee to make a "split" beneficiary designation (traditional account to one beneficiary, DRAC to a different beneficiary). If the plan administrator of Duncan's plan balks at allowing his proposed split beneficiary designation, Duncan may have to roll his plan benefits over to individual retirement accounts (a traditional IRA and a Roth IRA respectively) to carry out the proposed estate plan.

Here are two other practical problems we are bound to see with Roth beneficiary designations:

❏ As discussed above, the tax-favored choice of beneficiary is not the same for a Roth plan as for a traditional plan. Unfortunately, with many individuals doing Roth conversions these days, it is to be expected that many clients will neglect to inform their estate planners about the conversion, and either neglect to prepare a beneficiary designation for the new Roth IRA or just carry over the beneficiary designation from the former traditional plan. This could have negative effects; for example, if a client who named charity as beneficiary of his traditional IRA converts the account to a Roth and keeps the same beneficiary designation. WE NEED TO IMPRESS ON CLIENTS THAT THEY MUST CONSULT WITH THE ESTATE PLANNER IF A ROTH CONVERSION IS DONE.

❏ The Roth conversion comes with the unique option to "undo" (recharacterize) the conversion at any time up until the extended due date of the return for the conversion year. If the client dies prior to the expiration of that period then the executor has the authority to undo the decedent's Roth conversion, according to the IRS. If the probate estate is liable for the decedent's income tax on the Roth conversion, and the beneficiary of the Roth IRA is not the same as the estate beneficiary, there will be a conflict regarding this election. The beneficiary presumably will want to keep his tax-free Roth IRA, while the probate estate beneficiaries will insist that the executor should recharacterize the conversion (so they don't get stuck paying the income tax on the account that went to someone else). Estate planners may want to consider putting some kind of guidance and/or exculpatory provisions for the executor into wills. See ¶ 4.1.02 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011).

CASE # IX: Retirement: Rollover Considerations; Life Insurance; Payout Options: Ralph

1. Facts and discussion

Ralph, who was born before 1936, comes to see you a few months before his retirement from Kramden Bus Co., where he has worked since 1970. He has three retirement plans with Kramden, a defined benefit plan, a money purchase pension plan (worth $400,000) and a profit sharing plan worth $1 million. The $1 million in the profit sharing plan includes $100,000 cash value of a $500,000 life insurance policy that the plan owns on Ralph's life.

Under the defined benefit and money purchase plans, Ralph can take a life annuity that provides a 50 percent survivor annuity to his spouse Alice; or (if Alice consents) he can instead take a single life annuity for himself alone or a lump sum distribution in cash. Regarding the profit sharing plan, the only option is a lump sum, but he can either take the life insurance policy with him or direct the plan to convert the policy to cash. He wants advice in evaluating the various payout options, and in deciding whether to cash out the plans, roll them to an IRA, or consider other alternatives.

To make sure we consider all factors that go into this decision, we need some more information about Ralph, such as:

What is the state of his and his wife's health? If their health is robust and they are from long-lived families, the plans' annuity options may become relatively attractive, and the life insurance policy may seem less attractive. An actuary should be engaged to advise whether the pension plans' annuity options are financially favorable and to analyze the terms of the life insurance policy to determine if it is worth keeping.

Often the retiree's decision is made complicated not merely by a variety of annuity offerings, but by the additional option of taking a lump sum distribution and rolling it over to an IRA instead of taking any annuity offered by the plan; and also by the issue of subsidized benefits.

Expert tip: Subsidized plan benefits

The late Ed Burrows, a pension actuary and consultant in Boston, and former President of the College of Pension Actuaries, used to remind me that a retirement plan may subsidize certain options. Typically, for example, a plan may subsidize the joint and survivor spousal annuity option:

Parker Example: Parker is retiring. His plan offers him three options: a life annuity of $1,000 per month; a lump sum cash distribution of $X (which is the actuarial equivalent of a life annuity of $1,000 per month for a person Parker's age); or a joint and survivor annuity with his wife. In order for the joint and survivor annuity to be actuarially equivalent to the straight one-life annuity, the payment to Parker should be reduced to something less than $1,000, to reflect the addition of the survivor annuity. However, this particular plan (like the plan discussed in PLR 2005-50039) provides that a 60 percent survivor annuity can be provided for the participant's spouse without any reduction of the participant's benefit if the spouse is not more than five years younger than the participant. In effect the plan is offering Parker a "free" survivor annuity for his wife.

An early retirement pension is another type of benefit a plan might subsidize. For example, if Parker is 60 years old, and is entitled to a pension of $1,000 a month for life starting at age 65, the plan might offer him the choice of $1,000 a month for life beginning at age 60 (subsidized early retirement benefit) or a lump sum of $Y (the actuarial equivalent of the $1,000-a-month pension starting at age 65). If he takes the lump sum, he is giving up $60,000 (five years' worth of $1,000-a-month payments) and getting nothing in return.

Does this mean the participant should always choose the subsidized benefit, to avoid wasting money? No. If the participant is in poor health, or if the plan is in poor financial shape, any life annuity would be a bad bet, even if it is subsidized. The point is not that one should always take the subsidized benefit; the point is that one should be aware which benefit forms, if any, are subsidized by the plan, in order to properly evaluate the choices. This point can be missed when (for example) a financial advisor who wants to manage the participant's money focuses only on the possibility of rolling over a lump sum distribution to an IRA, without evaluating the plan's annuity options.

More expert tips: How to evaluate choices

How can the retiree tell the relative values of different benefit options? Fred Lindgren, Vice President and senior actuary with Fidelity Investments, who reviewed parts of this chapter prior to publication, points out that (since 2006) pension plans are required to tell retirees the relative values of the different options the plan is offering them. See Reg. § 1.417(a)(3)-1(c). (This regulation, though it appears to deal with qualified annuity options that must be offered to married participants (see ¶ 3.4), also applies to unmarried employees.)

Unfortunately, Fred says, the plan's use of different interest and mortality assumptions to calculate benefits and/or display the "relative values" of benefits (all as permitted by the IRS regulations) may create additional confusion. Accordingly, the participant should still seek outside help. A professional advisor acting on the retiree's behalf can evaluate the options using "apples to apples" comparisons, and can also consider the individual's own health and financial needs, and the financial health of the plan, factors the plan does not take into account in its "relative value" analysis. Fred also warns:

❑ **If you delay the start of your pension** (for example, because you are still working), will you get an increased pension when you eventually start taking payments, or are you giving up current monthly payments and getting nothing in return?

❑ **If you want an annuity benefit:** Will the plan buy your annuity from an insurance company, or fund it directly from plan assets? If the latter, and your benefit exceeds the amount insured by the federal pension guaranty program, are you willing to take the risk of the plan's insolvency? Are you better off rolling over a lump sum to an IRA and buying the annuity in the IRA?

If the amount of benefits is not large enough to justify the fee for consulting a professional actuary, a "quick and dirty" method of evaluating the plan's annuity offerings is to compare the prices you would have to pay to purchase each option from an annuity company, *outside* the plan. You can obtain such annuity quotes (free) from the website www.annuityquotes.com.

What other assets do the spouses own—both inside and outside retirement plans? Suppose Alice has a $2 million 403(b) plan, and the spouses also own $1 million worth of personal residences, $1 million of life insurance and a $2 million investment portfolio. If Ralph takes all his benefits in lump sum form and rolls them all to an IRA, the couple will then have close to $4 million in retirement plans—and be facing huge distributions in a few years when Ralph reaches age 70½. With those facts, we would look for favorable ways to get money out of the retirement plans. For example, *if* Ralph could take a "lump sum distribution" (LSD) of the money purchase plan, it could qualify for 10 year averaging (because he was born before 1936) and for the 20 percent maximum tax on pre-1974 benefits (because he has participated in the plan since before 1974). These two "grandfather rules" Ralph is eligible for would produce a fairly low tax rate (under 25%) if applied *only* to the $400,000 money purchase plan.

It is probably not possible, however, to get a LSD of the money purchase pension plan because "all pension plans are considered as one plan" for purposes of determining whether he has taken a distribution of his entire interest in the plan in one taxable year; thus the defined benefit plan would be combined with the money purchase plan and the combined total would be large enough that the 10-year averaging would cease to be attractive. (The 10-year averaging tax rate is graduated.)

Nevertheless it would be worth investigating whether there is any way to split the plans for this purpose; for example, if Ralph took a distribution of his entire interest in the defined benefit plan by taking distribution of an annuity contract, prior to his retirement, then retired (separated from service), the money purchase plan perhaps could be considered on its own. This depends on whether Ralph wants to take an annuity from the DB plan and whether the DB plan would permit such a distribution prior to Ralph's separation from service (he has reached normal retirement age under the plan, though he is still working).

Ralph decides he wants to keep the life insurance policy in force; he also wants to roll over his profit-sharing plan to an IRA, maximize deferral of income taxes, and keep the life insurance out of his taxable estate. He cannot roll the insurance policy over to an IRA, since an IRA cannot hold life insurance. The plan could simply distribute the policy to him, and then he could give the policy to an irrevocable life insurance trust (ILIT). One drawback of this approach is that he loses future potential income tax deferral on the value of the policy, because he would have to pay income tax, when the policy is distributed to him, on the policy value (minus any portion of the premiums he paid income tax on over the years).

This current income tax can be avoided by having Ralph *buy* the policy from the profit sharing plan, before anything is distributed. Such a purchase can be done by complying with a detailed Department of Labor class exemption granted to these transactions (which otherwise might be "prohibited transactions"). The policy would be valued at "fair market value" for income tax purposes, so Ralph would have to pay the plan that amount to avoid income tax on the distribution of the policy. Determining fair market value may require an appraisal of the policy, unless the "safe harbor" valuation method in Rev. Proc. 2005-25, 2205-17 I.R.B. 962 (April 2005) is used.

The other drawback of giving the policy to an ILIT is that the gift triggers the three-year waiting period under § 2035 before the policy is removed from his estate; it may be possible to avoid the waiting period by distributing the policy to Ralph, then having a family partnership in which Ralph is a partner buy the policy from Ralph. Ralph must be a member of the buying partnership to avoid the adverse income tax consequences of a transfer for value under § 101(a)(2). If he sells the policy, it may be possible for him to roll over the sale proceeds tax-free to an IRA.

2. Where to read more

Special tax deals for lump sum distributions, including distributions of employer stock, are discussed in ¶ 2.4–¶ 2.5 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). For rollover rules, see ¶ 2.6. Choices under defined benefit plans and various aspects of life insurance in retirement plans are explained in the author's *Special Report: When Insurance Products Meet Retirement Plans*, downloadable at www.ataxplan.com.

CASE # X: Larger Estates: MRD Planning vs. GST Planning: Dave Brick

Generation skipping transfer (GST) tax planning poses a difficult problem when a client has a very large estate, including substantial retirement benefits, and does not want to leave assets outright to one or more of his children.

1. Facts: Dave & Dolly Brick example

Dave Brick has assets of $15 million, including a $3 million IRA and $500,000 401(k) plan. He creates a generation-skipping trust as part of his estate plan, to use up his GST exemption. Dave estimates that his retirement benefits will not be needed to fund the GST-exempt trust. He wants these benefits to pass to his children at his death.

However, Dave does not want to leave the benefits to his children outright as named beneficiaries. He is very concerned about their spending habits and present and future spouses. So, his estate plan calls for each child's share of his estate to be left to a life trust for that child. Each child's trust provides that the child receives all income of the trust for life, plus principal in the trustee's discretion in such amounts as the trustee deems advisable for the child's care, comfort, support, and welfare.

2. Dave's GST tax-avoiding estate plan

Dave would have liked his children's trusts to provide that, upon each child's death, the deceased child's share would automatically pass to the deceased child's issue, if any, otherwise to the shares of Dave's other children. However, Dave cannot write the trust that way without incurring substantial GST taxes, for the following reason. If a deceased child's share passes automatically to such deceased child's issue, then the child's death would cause a "taxable termination" under the generation-skipping transfer (GST) tax. The grandchildren who would inherit the share at that point are "skip persons" as to Dave Brick, the creator and "transferor" of the trust. Dave has already used up his entire GST exemption on other trusts. Accordingly, the deceased child's trust would be liable for GST taxes. Since GST taxes are assessed at whatever is the highest federal estate tax rate at the applicable time, this is a major drawback.

To avoid this result, Dave's trust provides that, as each child dies, if the child is survived by issue, the child has a power of appointment over his trust; the child can, in his will, "appoint" his trust to his own estate or creditors, or to any issue of Dave. This broad power is considered a "general power of appointment" under the federal estate tax, causing the deceased child's trust to be included in the deceased child's estate for federal estate tax purposes. Because the trust is included in the deceased child's estate, it is believed that the *child* becomes the transferor of the assets in that trust for GST tax purposes. Then, if the child appoints the trust assets to his own children (or the assets pass to the deceased child's children by default, through the child's failure to exercise the power of appointment), there is no generation-skipping transfer, because the deceased child is only one generation "above" his children.

This is a common method of avoiding GST tax when a donor (like Dave) wants to tie his children's shares of his estate up in trusts for their lifetimes. As with other common estate planning devices (such as QTIP and credit shelter trusts), this approach entails a major drawback when the asset in the trust is a retirement plan. *Because of each child's power to appoint to nonindividual beneficiaries (such as the child's estate), the trusts for Dave's children, as written, will not qualify as see-through trusts.*

3. Conflict between GST goal and MRD "stretch" goal

The minimum distribution rules of § 401(a)(9) allow retirement benefits to be distributed over the life expectancy of the beneficiary if there is a "designated beneficiary." A trust can qualify as a designated beneficiary provided it meets various requirements, one of which is that all of its countable beneficiaries must be individuals. If the trust passes the rules, the oldest trust beneficiary's life expectancy is the Applicable Distribution Period (ADP). A trust that provides income to child for life, with remainder to such person (including child's *estate*) as child appoints, "flunks" this test. The child's estate, as a potential appointee, is a countable beneficiary under this type of trust, and an estate is not an individual. For details on the minimum distribution rules, definition of designated beneficiary, and IRS minimum distribution trust rules, see Chapters 1 and 6 of *Life and Death Planning for Retirement Benefits*.

But if Dave does not give the child the power to appoint to the child's estate (or the creditors of the child's estate) then the child does not have a general power of appointment, meaning that Dave remains the transferor for GST tax purposes, and the child's death will trigger GST tax.

So Dave has a conflict between two goals: avoiding GST taxes (must give child power to appoint to child's estate/creditors); and stretching out retirement plan distributions over the life expectancy of the oldest trust beneficiary (cannot have a nonindividual as a countable beneficiary of the trust).

4. Five possible solutions

Here are possible solutions to Dave's dilemma.

Approach #1: Avoid GST tax, guarantee qualification for life expectancy payout, give child total control. One approach is to leave the children's shares of the retirement plans to them outright rather than leaving these assets in trust for the children. If the child is named as beneficiary personally, he is automatically entitled to use his life expectancy as the ADP (assuming the plan permits a life expectancy payout), without the need to worry about complying with the trust rules. Obviously, this solution conflicts with Dave's goal of not giving any child outright control of his/her share.

Approach #2: Avoid GST tax, keep all control away from child, give up on deferral. Another choice is to leave the trusts as is, and not worry about qualifying for the life expectancy payout, even if that means sacrificing the long term income tax deferral offered by the life expectancy or "stretch" payout. This choice might appeal to Dave if he is extremely reluctant to give his children any right to access trust principal and/or if he thinks the stretch is of little value or unlikely to be used.

Approach #3: Qualify for stretch payout, give child no control, incur GST tax. Another choice is to take away the general powers of appointment, in order to be able to keep the assets in trust but avoid having a nonindividual beneficiary. This approach makes the trust subject to GST tax. Because that tax is so punitive, this seems like an undesirable choice unless the child is so wild and wicked he cannot be trusted with any rights whatsoever, even a power of appointment.

Approach #4: Give child lifetime GPOA, requiring consent of nonadverse trustee. Another approach is to give the child the right, during his or her life, to withdraw all of the principal of the trust with the consent of an independent trustee (someone who does not have a "substantial interest" in the trust property that is "adverse" to the child's interest). This right of withdrawal is considered a general power of appointment (see § 2041(a)(2), (b)(1)(C)) and causes the trust property to be includible in the child's estate, thus causing the child to be the "transferor" for GST tax purposes, *even if* the child is given no power of appointment at death. This requires expert drafting and also requires care in the choice of trustee, as well as consideration of what standards the trustee is to observe if the child seeks to withdraw the benefits from the trust. The trust can then require distribution of the remaining principal, at the child's death, outright to the child's living issue (or, if none, to Dave's living issue), and so qualify as a see-through trust (as an "O/R-2-NLP"; see Appendix at the end of this document).

Approach #5: Conduit Trust: Avoid GST tax, qualify for life expectancy payout, give child some control. This solution calls for each child's share of Dave's trust to be a "Conduit Trust" as to the retirement benefits. Under a Conduit Trust, the trustee is obligated, each time it receives a distribution from any retirement plan, to pass that distribution out, immediately and in its entirety, to the life beneficiary of the trust, in this case the child. The advantage of a Conduit Trust is that the individual life or "conduit" beneficiary is considered the *sole beneficiary* of the trust for purposes of the MRD trust rules; remainder beneficiaries are disregarded. Thus, the trusts are guaranteed to qualify for the life expectancy payout method, and yet GST tax is still avoided because the child does retain a general power of appointment for what's left in the trust at the child's death. The drawback is that each child will receive outright control of his entire share of the IRA before he dies, if he lives to his life expectancy. However, the child cannot get a lump sum; he receives only the MRD each year, so (from the point of view of preserving the assets in the trust as long as possible) this is a compromise. (Note: The same result could be accomplished with "trusteed IRA" (IRT); see *Koslow* Case Study, Part I(3)(B).)

Dave opts for Approach #5. This solution gives each child outright control of such child's share of the retirement benefits, but does so only gradually, one MRD at a time, over the child's life expectancy. Dave is willing to give them that much control in order to achieve the two goals of avoiding GST tax and qualifying for the life expectancy payout.

Where to read more

Regarding trusts as beneficiaries of retirement benefits, see Chapter 6 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011). See ¶ 6.4.07 regarding leaving benefits to a generation skipping or dynasty trust.

CASE # XI: A Tale of Two Families: Special Needs Beneficiaries

Mr. and Mrs. Dingle have three children, ages 23, 18, and 16, one of whom, Daisy (the 18-year-old), is severely handicapped and will need lifelong care. Mr. and Mrs. Ringle also have three children, ages 35, 25, and 23, one of whom, Ronnie (age 25), is severely handicapped. Both the Dingles and the Ringles have $1 million in IRA funds among their other assets, and both seek to use the IRA asset to help their respective disabled children. However, there the similarity ends.

1. Supplemental needs trust for family of modest means

The Dingles have no other assets they will be able to leave for Daisy's benefit. Daisy Dingle qualifies for government-provided medical care and other need-based welfare-type benefits. Thus, the Dingles want the IRA to be held in a trust to provide for Daisy's needs that are not covered by the benefits programs she qualifies for, and they want to be sure that after their deaths the trust and the IRA it holds are not considered "countable assets" that would disqualify Daisy for the benefits she now receives. They similarly do not want trust distributions for Daisy's benefit to disqualify her for need-based assistance.

Mr. and Mrs. Dingle will name each other as outright beneficiary of their IRAs, with a supplemental needs trust for Daisy's benefit as contingent beneficiary. They hire a Medicaid specialist-attorney to draft the trust.

The Dingles cannot name a Conduit Trust as beneficiary of their IRAs. Because a Conduit Trust mandates that all distributions from the IRA to the trust be paid to the individual trust beneficiary, such a trust would disqualify Daisy from the various need-based benefits programs. The minimum required distributions from the IRA would become countable income to Daisy. Thus the trust must be an accumulation trust, not a Conduit Trust.

However, even though the trust cannot be a Conduit Trust, it is important that the trust qualify as a "see-through trust," so the trustee is not forced to withdraw funds from the IRA more rapidly than necessary (thus needlessly accelerating income taxes).

The trust provides that the trustee has discretion to distribute income and/or principal of the trust to Daisy or for her benefit, or to or for the benefit of Daisy's two siblings, and contains appropriate language limiting the provisions for Daisy's benefit to supplemental needs not provided by the applicable benefit programs. The trust provides that upon Daisy's death the trust terminates and the remaining income and principal of the trust is distributed immediately and outright to Daisy's two siblings (or to the issue of a deceased sibling).

Because the trust is payable to one life beneficiary and on her death it terminates and passes immediately outright to two other named individual beneficiaries, the trust qualifies as a see-through trust; see ¶ 6.3.08 of *Life and Death Planning for Retirement Benefits* for discussion of this type of "outright-to-now-living-persons" see-through trust. The applicable distribution period (ADP) for minimum required distributions (MRDs) to the trust is the life expectancy of the oldest of the three siblings. Even though the oldest sibling is five years older than Daisy, so the ADP is a little shorter than if Daisy's own life expectancy were the ADP, it is not much different and still gives the trust a very long period of income tax deferral after the deaths of Mr. and Mrs. Dingle.

Qualifying a supplemental needs trust as a see-through is very easy if the disabled beneficiary has one or more close-in-age siblings who can be named as outright remainder beneficiaries, using the O/R-2-NLP approach. If the disabled beneficiary is an only child, or if for some other reason there is no suitable close-in-age (or younger) individual to be named as the outright remainder beneficiary, qualifying as both a supplemental needs and see-through trust may be virtually impossible.

Another approach the Dingles could consider would be to name a charitable remainder trust (CRT) as beneficiary of the IRA; see IV, above. The annual unitrust or annuity payments from the CRT could be paid to a special needs trust for Daisy so as not to disqualify her from her government benefit programs. Rev. Rul. 2002-20, 2002-1 I.R.B. 794. While this approach might be suitable for some families, it is not suitable for the Dingles because this approach would cause the bulk of their IRA to pass to charity. Their intent is to have the IRA pass exclusively to family members.

2. Conduit trust for disabled beneficiary: Very wealthy family

In contrast to the Dingles, the Ringles have substantial wealth, and intend to provide for Ronnie's needs from their wealth without attempting to qualify him for any need-based government benefit programs. They expect that their other children will always have very high incomes, while Ronnie will have no income other than what he receives from trusts they provide for him. Also, Ronnie will always have very high medical expenses. Thus, it makes sense to leave the IRA to a trust for Ronnie's benefit. IRA distributions to Ronnie through the trust will be includible in his gross income, but the income tax impact will be low due to his low income tax bracket and high medical expenses. If the IRA is paid to the other children, the income tax impact on the IRA distributions would be much higher.

Ideally, because of Ronnie's youth, it would be desirable for the trust to qualify as a see-through trust with an ADP equal to Ronnie's life expectancy.

Ronnie's parents want to provide that the trust (including the IRA it holds) would pass at Ronnie's death to a charity that does research into the medical condition Ronnie suffers from. Naming that charity directly as the remainder beneficiary of Ronnie's trust would give the trust a nonindividual beneficiary.

The trust cannot qualify as a see-through if it has a nonindividual beneficiary unless it is a Conduit Trust. Under a Conduit Trust, only the "conduit" beneficiary is considered a beneficiary for purposes of the IRS's MRD trust rules, and the remainder beneficiary is ignored. Accordingly, the Ringles' trust provides that, so long as Ronnie is living, the annual MRD, and any other amounts the trustee withdraws from the IRA, must be passed out immediately to Ronnie or to his legal guardian, or applied for Ronnie's benefit. Thus, the trust is a Conduit Trust, Ronnie is deemed the sole beneficiary, and the trust qualifies as a see-through trust for purposes of the MRD trust rules.

Ronnie's right to receive the annual MRD is "countable" for purposes of need-based government benefit qualification requirements, but this is not important to the Ringles because it is not intended that he will ever qualify for such programs.

Where to read more

Matters mentioned in this case study are discussed in full detail in the following sections of *Life and Death Planning for Retirement Benefits* (7th ed., 2011): Regarding trusts as beneficiaries of retirement benefits, see Chapter 6. See ¶ 6.3.05–¶ 6.3.06 regarding Conduit Trusts, and ¶ 6.3.08 regarding "O/R-2-NLP trusts."

CASE # XII: Providing for Minor Children

FACTS: Stan and Stacey Steinmetz are in their 30s. They have four children ages 2 to 12. They have combined net assets of $1.5 million, including Stan's $100,000 401(k) plan, Stacey's $250,000 IRA, their $1,200,000 home with a $500,000 mortgage, life insurance (through Stan's job), and various liquid investments acquired through savings and inheritance.

They are leaving all of their assets outright to each other, and on the death of the surviving spouse, to a "family pot" trust for the benefit of the children. The trustee is instructed to use the principal and/or income of the trust as the trustee deems advisable for the care, support, and education of all four children until there is no child living who is under the age of 25 years, at which time the trust terminates and is distributed outright to Stan's and Stacey's issue by right of representation. If at any time there are no issue of Stan and Stacey living, the remaining trust assets pass equally to Stan's brother Fran (now age 38) and Stacey's sister Lacy (now age 36).

Where do the retirement benefits fit into this?

The first step is to determine whether the "life expectancy payout" is a desirable goal for the retirement benefits. If it is not, then Stan and Stacey can simply name each other as primary beneficiary of their respective plans, and name the family pot trust as contingent beneficiary, without worrying about whether the trust qualifies as a "see-through" trust (see ¶ 6.2.01 of *Life and Death Planning for Retirement Benefits*). On the other hand, if qualifying for the life expectancy payout is an important goal, the trust must be carefully examined to determine whether it qualifies as a see-through trust, and, if it does not, see whether the trust's dispositive terms can or should be modified to cause the trust to qualify as a see-through.

Stan's 401(k) plan: Stan and Stacey and their attorney decide qualification as a see-through trust DOES matter with respect to Stan's 401(k) plan. Although the only form of death benefit permitted under that plan is a lump sum distribution in cash, the trustee of a see-through trust named as beneficiary of the plan would be allowed to direct the plan to transfer the lump sum, by direct trustee-to-trustee transfer (also called direct rollover) to an "inherited IRA" in Stan's name, thus preserving the possibility of a life expectancy payout. See ¶ 4.2.04 of *Life and Death Planning for Retirement Benefits* (7th ed. 2011) regarding this "nonspouse beneficiary rollover" option.

Stacey's IRA: Stacey's IRA does offer the life expectancy payout form of benefit. Thus, if the trust that is named as contingent beneficiary of Stacey's IRA qualifies as a see-through trust, the trustee will have the option of stretching out distributions from the IRA to the trust over the life expectancy of the oldest trust beneficiary. This would be a desirable outcome. Even if all the IRA funds are all used to finance the raising of the children to adulthood (so that the true "stretchout" until the children themselves reach old age is not used), it would be nice for the trustee to have the option of deferring distributions from the IRA as long as possible. It is even possible there will be some funds left in the IRA for the children to take over as "successor beneficiaries" when the youngest reaches age 25. If the trust is to qualify as a see-through, then ideally for this purpose the oldest trust beneficiary should be Stan's and Stacey's oldest child (age 12), not the oldest contingent remainder beneficiaries (Fran, age 38). Since both Fran and Lacy are more than 20 years older than Stan's and Stacey's oldest child, Fran and Lacy are not desirable as "countable" remainder beneficiaries of the IRA trust.

Here are four options Stan and Stacey have regarding how to name their family pot trust as contingent remainder beneficiary of Stacey's IRA and Stan's 401(k) plan ("plans" or "benefits"):

Approach #1: Make the trust a Conduit Trust as to the benefits. Under this approach, the trustee would be required to distribute any distribution the trustee received from the IRA to (or apply it for the benefit of) such one or more of Stan's and Stacey's children as the trustee would select in its discretion. The MRDs could be distributed to any one or more of the children outright, or to a custodian or legal guardian for them, or used for the children's benefit. Many practitioners routinely adopt this approach for minors' trusts on the theory that the MRDs will be very small (because the oldest child has such a long life expectancy), and the trustee could presumably always find a use for such MRDs that would justify distributing them to or for the benefit of one or more of the children. For Stan and Stacey, the advantage of this approach is that Fran and Lacy could be left in as contingent remainder beneficiaries of the trust, without "messing up" the life expectancy payout based on their oldest child's life expectancy. With a Conduit Trust, the conduit beneficiaries (the four children in this example) are considered the sole beneficiaries of the trust for MRD purposes. The remainder beneficiaries "don't count."

Approach #2: Choose different (younger, individual) remainder beneficiaries. Stan and Stacey could provide a different remainder beneficiary for the portion of the trust consisting of the plans and distributions therefrom. Stan and Stacey could choose a new remainder individual beneficiary who is younger than their oldest child. Perhaps a niece or nephew could be named for this role; or they could give the trustee the power to choose a younger individual beneficiary at the time if the need arises. The attraction of this approach is that the trust would not have to be a Conduit Trust; it could be an accumulation trust and still qualify as a see-through trust as an "outright to now-living persons" see-through trust (see ¶ 6.3.08 of *Life and Death Planning for Retirement Benefits*). This would give the trustee more control: Since the trustee would not be required to automatically pass through all plan distributions to the children (as he would be under a Conduit Trust), the trustee could accumulate distributions. However, there are two drawbacks to this approach. The first drawback is that it requires naming as contingent remainder beneficiary someone whom Stan and Stacey do not really want to name. They might decide that outcome is acceptable, since the possibility that all four of Stan's and Stacey's children would die before the youngest reached age 25 is so remote as to be negligible, so the trust is not very likely to actually pass to this unknown younger individual. The other drawback of this approach is that it would require the plans to be paid to a separate trust from the other assets, since the plans would have different ultimate contingent remainder beneficiaries. The question is whether $350,000 of total retirement benefits are a sufficient amount to justify the creation and administration of a separate trust.

Approach #3: Last man standing. Stan and Stacey could revise their trust to provide that, at such time as only one child of theirs is still living, if the trust is still in existence, the trust terminates as to the plans (and their proceeds), and the plans and such proceeds are distributed outright to the surviving child. This so-called “last man standing” approach seems like it should work under the IRS’s rules, though it has never been specifically commented on by the IRS. Drawback: This approach also would require the plans to be paid to a separate trust from the other assets, since the trust for the benefits trust would have a different termination time.

Approach #4: Ignore see-through trust status. Stan and Stacey might decide that the complexities, uncertainties, and compromises involved in trying to qualify for see-through trust status are not worth the prize. After all, where the total value of the assets they are leaving to their four young children is only $1.5 million, how likely is it that any portion of the plans will actually still be there, once the children are raised, to be paid out over the children’s life expectancy? Rather than pay lawyers and trustees to draft and administer multiple trusts, or revise their trust to say things they don’t want it to say, Stan and Stacey could assume the plans will *not* qualify for stretchout treatment, and purchase term life insurance to assure adequate funds for payment of any extra income taxes. This saves fees (there will be no need to draft or administer a separate trust just for the benefits) while allowing Stan and Stacey to have the trust say exactly what they want it to say for the benefit of their children (and Fran and Lacy).

<u>Where to read more</u>: Regarding trusts as beneficiaries of retirement benefits, see Chapter 6 of *Life and Death Planning for Retirement Benefits* (7^{th} ed., 2011). See ¶ 6.4.05 regarding options for minors’ trusts. See ¶ 6.1.05 regarding transferring the IRA from the trust to the individual children as successor beneficiaries when the trust terminates.

Chart 1: The Uniform Lifetime Table

Use this chart to determine a retirement plan participant's lifetime required distributions from his own retirement plan (unless the sole beneficiary of the plan is the participant's more-than-10-years-younger spouse). Do not use this chart for any inherited retirement plan. A beneficiary may not use this chart for an inherited plan for any year after the year of the participant's death.

Table for Determining Applicable Distribution Period (Divisor)			
Age	**Distribution period**	**Age**	**Distribution period**
70	27.4	93	9.6
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115 and older	1.9

Under the final Minimum Distribution Regulations, the above "Uniform Lifetime Table" is used by all taxpayers to compute their lifetime annual required minimum distributions for 2003 and later years (for exceptions see below). For each "Distribution Year" (i.e., a year for which a distribution is required), determine: (A) the account balance as of the preceding calendar year end; (B) the participant's age on his or her birthday in the Distribution Year; and (C) the "applicable divisor" for that age from the above table. "A" divided by "C" equals the minimum required distribution for the Distribution Year.

Exceptions: This table does not apply to beneficiaries of a deceased IRA owner; or if the sole beneficiary of the IRA is the participant's spouse who is more than 10 years younger than the participant; or for the year 2009. (No minimum distributions were required for the year 2009.)

Chart 2: Single Life Expectancy Table

For computing MRDs after the participant's death; see ¶ 1.5.05 of *Life and Death Planning for Retirement Benefits*.

Ages 0 to 57

Age	Life Expectancy	Age	Life Expectancy
0	82.4	29	54.3
1	81.6	30	53.3
2	80.6	31	52.4
3	79.7	32	51.4
4	78.7	33	50.4
5	77.7	34	49.4
6	76.7	35	48.5
7	75.8	36	47.5
8	74.8	37	46.5
9	73.8	38	45.6
10	72.8	39	44.6
11	71.8	40	43.6
12	70.8	41	42.7
13	69.9	42	41.7
14	68.9	43	40.7
15	67.9	44	39.8
16	66.9	45	38.8
17	66.0	46	37.9
18	65.0	47	37.0
19	64.0	48	36.0
20	63.0	49	35.1
21	62.1	50	34.2
22	61.1	51	33.3
23	60.1	52	32.3
24	59.1	53	31.4
25	58.2	54	30.5
26	57.2	55	29.6
27	56.2	56	28.7
28	55.3	57	27.9

Single Life Table, cont.

Ages 58 to 111+

Age	Life Expectancy	Age	Life Expectancy
58	27.0	87	6.7
59	26.1	88	6.3
60	25.2	89	5.9
61	24.4	90	5.5
62	23.5	91	5.2
63	22.7	92	4.9
64	21.8	93	4.6
65	21.0	94	4.3
66	20.2	95	4.1
67	19.4	96	3.8
68	18.6	97	3.6
69	17.8	98	3.4
70	17.0	99	3.1
71	16.3	100	2.9
72	15.5	101	2.7
73	14.8	102	2.5
74	14.1	103	2.3
75	13.4	104	2.1
76	12.7	105	1.9
77	12.1	106	1.7
78	11.4	107	1.5
79	10.8	108	1.4
80	10.2	109	1.2
81	9.7	110	1.1
82	9.1	111+	1.0
83	8.6		
84	8.1		
85	7.6		
86	7.1		

Chart 3: Choosing a Beneficiary for the Retirement Plan

There are basically six possible choices of beneficiary for a traditional retirement plan, three of which are "tax-favored" and three of which are not tax favored. See details next page ☞

A **TAX-FAVORED BENEFICIARIES**	**B** **UN-TAX-FAVORED BENEFICIARIES**
1 YOUNG INDIVIDUAL(S) (or a "see-through trust" for young individuals)	1 OLDER INDIVIDUAL(S) (or a "see-through trust" for older individuals)
2 YOUR SPOUSE	2 A TRUST FOR THE BENEFIT OF YOUR SPOUSE
3 A CHARITY (or CHARITABLE REMAINDER TRUST)	3 YOUR ESTATE

NOTE: This chart is about income taxes only. It does not cover estate taxes or generation-skipping taxes. The fact that a beneficiary is (or is not) income-tax-favored does not mean you should (or should not) leave retirement benefits to him/her. Leave the benefits to the person you want to leave the benefits to. Just be aware in choosing your beneficiary that some beneficiaries will receive greater after-tax value from those benefits than others.

The same chart applies to Roth IRAs and plans EXCEPT that charity is not a "tax-favored" choice for a Roth IRA or plan.

KEY TO THE SIX-WAYS CHART

Box A-1: YOUNG INDIVIDUAL(S) (or a "see-through trust" for young individuals). Young individuals get the benefit of long-term tax deferral using the "life expectancy of the beneficiary" payout method. This is no advantage, however, if the beneficiary does not take advantage of the method (because he/she needs or wants the money immediately). Also, a lump sum distribution may be more advantageous than the life expectancy payout method in some cases. A see-through trust for young individual beneficiary(ies) gets the same long-term deferral individuals do; however, not every trust qualifies for this treatment.

Box B-1: OLDER INDIVIDUAL(S). Older individuals (or a "see-through trust" for the benefit of one or more older individuals) can also use the "life expectancy of the beneficiary" payout method, but receive less advantage from it because of their shorter life expectancy.

Box A-2: THE SURVIVING SPOUSE. A surviving spouse who inherits a retirement plan from his or her deceased spouse can elect to treat an inherited IRA as his/her own IRA, or roll over any inherited plan to his/her own IRA or other eligible plan. This means the spouse can defer distributions until he/she is age 70½, then withdraw benefits using the Uniform Lifetime Table (which is much more favorable than the Single Life Table); and name his/her own designated beneficiary for benefits remaining at his/her death, allowing further deferral.

Box B-2: TRUST FOR THE BENEFIT OF THE SURVIVING SPOUSE. A trust for the spouse, even if it qualifies as a "see-through trust," must withdraw benefits from the deceased spouse's plan over the single life expectancy of the surviving spouse (at best). Unlike the surviving spouse him/herself, a trust for the spouse's benefit can NOT roll over the inherited benefits, can NOT defer distributions until the surviving spouse reaches age 70½, can NOT use the Uniform Lifetime Table, and can NOT extend deferral (after the surviving spouse's death) over the life expectancy of the next generation. Thus, leaving benefits to a trust for the spouse may result in income taxes' being paid much sooner, and at a higher rate, than leaving benefits to the spouse outright.

Box A-3: CHARITY (or CHARITABLE REMAINDER TRUST). A charity or charitable remainder trust is income tax-exempt, thus pays no income tax on any retirement benefits.

Box B-3: YOUR ESTATE. Usually, the reason benefits end up being payable to the participant's estate is that the participant failed to complete a beneficiary designation form for the plan. The participant's estate does not qualify for "life expectancy of the beneficiary" payout method, is not income tax-exempt, and often is in a higher income tax bracket than family members. Thus, generally "my estate" is not a good choice of beneficiary. However, there are cases in which the estate IS a good choice of beneficiary; consult with your estate planning attorney.