

# Coordinating Retirement Accounts with Estate Planning 101

By Keith A. Herman

In general, the receipt of inherited property usually is not subject to income tax. The major exception is retirement accounts because these accounts represent income that the government has not previously subjected to income tax. After a taxpayer's death, the beneficiaries usually will owe income tax on the amount withdrawn from the taxpayer's retirement account. When dealing with retirement accounts, the primary goal is to allow the taxpayer's beneficiaries the opportunity to defer the income tax for as long as possible by postponing withdrawals from the account.

**Basic distribution rules.** During life, the taxpayer must generally begin taking withdrawals by April 1 of the year after the taxpayer reaches age 70 and one-half; this date is referred to as the required beginning date (RBD). A taxpayer can obtain the most favorable income tax results by naming the taxpayer's spouse as the primary beneficiary. A surviving spouse is the only person who has the option of rolling over the retirement account into his or her own IRA, thereby deferring withdrawals from the account until the spouse turns 70 and one-half; any other beneficiary must begin taking withdrawals the year after the taxpayer's death.

If someone other than the spouse is the beneficiary, the beneficiary's required minimum distribution (RMD) depends on whether there is a "designated beneficiary" of the account. If there is a designated beneficiary and the taxpayer dies *before* the taxpayer's RBD, then the beneficiary's RMD is based on an IRS table that takes into account the beneficiary's life expectancy. If the taxpayer dies *after* the taxpayer's RBD, then the beneficiary's RMD is based on a table that takes into account the longer of (1) the beneficiary's life expectancy or (2) the taxpayer's life expectancy. If there is *no* designated beneficiary and the taxpayer dies *before* the taxpayer's RBD, then the beneficiary must withdraw all of the funds in the retirement account within five years of the taxpayer's death. If there is *no* designated beneficiary and the taxpayer dies *after* the taxpayer's RBD, then the beneficiary's RMD is based on a table that takes into account the deceased taxpayer's life expectancy.

**Avoiding trusts as beneficiaries.** Because of the complexity associated with using a trust as a designated beneficiary, a revocable trust should be avoided as the beneficiary of retirement accounts in most cases. Before naming a trust as a beneficiary of a retirement account, the attorney and the client should decide

that the reasons to name a trust as a beneficiary outweigh the time and costs of establishing a qualified trust. The client may decide that the use of a trust is more important than the lost ability to plan for income tax deferral that often can occur by naming a nontrust as beneficiary. A trust may be more attractive if a life expectancy payout option or spousal rollover is not important or not available.

**When trusts are crucial.** Naming a trust is crucial in certain circumstances. For example, if the beneficiary is a special-needs child who relies on government benefits, a trust must be used. Clients often use trusts when the beneficiary is a second spouse and the client wants the spouse to have unlimited access to the trust principal. A parent may wish to use a trust if the beneficiary is a minor, is a spendthrift, or has substance abuse problems. Finally, retirement account assets can fund a credit shelter trust.

A trust must satisfy five tests to qualify as a designated beneficiary. The first four tests are: (1) the trust must be valid under state law; (2) the trust must be irrevocable or become irrevocable at the taxpayer's death; (3) the trust beneficiaries must be identifiable; and (4) certain documentation must be provided to the plan administrator or IRA custodian by October 31 of the year after the taxpayer's death. If these four tests are met, then the trust generally will be treated as a designated beneficiary and the RMD will be based on the *oldest* trust beneficiary's life expectancy. But there is, in essence, a fifth test because all of the beneficiaries of the trust must be individuals the age of whom can be identified. Therefore, the fifth requirement is to draft the trust so that it is possible to determine the identity of the oldest beneficiary and to require that only individuals may be beneficiaries of the trust. This fifth test can create problems, especially with multi-beneficiary common pot trusts or multi-generational dynasty trusts. It is difficult to draft a trust that only has individual and ascertainable beneficiaries because the IRS has not explained which contingent beneficiaries can be ignored.

**Conduit and accumulation trusts.** Fortunately, the regulations do set forth a type of safe harbor trust that has beneficiaries that the IRS will treat as designated beneficiaries. The qualified trusts are often referred to as "conduit trusts." This trust requires the trustee to distribute *all* of the retirement account withdrawals by the trust to the beneficiary. As the trust may not accumulate any assets withdrawn from the retirement account, the IRS allows the beneficiary to be treated as the oldest beneficiary. Although conduit trusts have the advantage of certainty because they are specifically described in the Treasury regulations, they also have major disadvantages. A conduit trust cannot withdraw retirement account proceeds and accumulate them inside of the trust. This is often contrary to the intent of the client, who may want to use a trust specifically to prevent the retirement account assets from being distributed to the beneficiary. A trust that allows accumulations of retirement account withdrawals (an "accumulation trust") should qualify as a designated beneficiary if certain provisions are added to the trust.

**Credit shelter trust issues.** Not only are retirement accounts subject to income tax when distributed to the beneficiary, but they also are subject to estate tax at the death of the owner. This heavy tax burden makes tax-deferred retirement

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**Keith A. Herman is an associate with the St. Louis, Missouri, firm of Greensfelder, Hemker & Gale, P.C. He can be reached at [kh1@greensfelder.com](mailto:kh1@greensfelder.com).**

accounts the best source for charitable bequests at death, as charities are exempt from the income tax.

For estates that are subject to the federal estate tax, one of the most troublesome areas is the use of retirement assets to fund a credit shelter trust. If a conduit credit shelter trust is named as the primary beneficiary of the retirement account, then the entire retirement account will be paid out over the spouse's life expectancy. This will save very few estate tax dollars, as the retirement account assets will be added to the spouse's estate just as if the spouse had been named directly as the beneficiary, but without the income tax advantages of the spousal rollover. A con-

duit trust is usually a poor alternative when dealing with funding a credit shelter trust.

A better option is to name an accumulation trust as the primary beneficiary of the retirement account, preferably with a favorable private letter ruling from the IRS in hand. The accumulation trust allows the spouse to be treated as the designated beneficiary of the retirement plan. Although the spousal rollover may not be available, a life expectancy payout option will allow distributions from the retirement account (and the associated income tax liability) to be gradually withdrawn over the spouse's life expectancy. **ESOL**