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ATTORNEYS AT LAW

TRUSTS & ESTATES DEPARTMENT

COORDINATING YOUR RETIREMENT ACCOUNTS WITH YOUR ESTATE PLAN

RETIREMENT ACCOUNTS PRESENT UNIQUE PROBLEMS

Almost all assets your beneficiaries receive after your death will not be subject to income tax upon receipt. The major exception to this rule is retirement accounts (traditional IRAs, 401(k)s, 403(b)s, etc.), as these accounts represent income that has not been previously taxed. After your death, income tax will be due on the amount withdrawn from your retirement accounts. When dealing with retirement accounts, the primary goal is to allow your beneficiaries the opportunity to defer this income tax for as long as possible. An estate planning attorney must deal with all of the following issues in regard to your retirement accounts: (i) who will be the primary and contingent beneficiary, (ii) how long withdrawals from the account can be deferred (in order to defer the attendant income tax liability), (iii) whether there is a compelling reason to name a trust as a beneficiary, (iv) ensuring any retirement account proceeds passing to a spouse, in trust, qualify for the marital deduction, and (v) determining the most tax efficient source of payment for estate taxes on the retirement account.

AVOID TRUSTS IF POSSIBLE

Unless a crucial reason to name a trust as a beneficiary of a retirement account exists, you should avoid doing so. It is usually best to name individuals directly as the beneficiaries, as individual beneficiaries qualify for a "life expectancy payout option" (or "stretch"). A life expectancy payout option will allow the beneficiaries to defer the income taxes associated with withdrawals from these accounts for a significantly longer period than if a typical trust was named as the beneficiary. If an "estate" or a typical trust is named as the beneficiary of a retirement account, then the entire retirement account must be withdrawn within 5 years of your death (or over your remaining IRS defined life expectancy if you died after age 70 1/2).

In a typical first marriage situation (when funding a credit shelter trust is not at issue), your spouse should be named as the primary beneficiary and your adult children as the contingent beneficiaries. If you have a minor child, then a Transfer To Minors Account is a wise alternative if the retirement account allows a life expectancy payout option. Recently enacted legislation allows beneficiaries to rollover a 401(k) to an IRA to take advantage of the stretch payment option.

WHEN AVOIDING TRUSTS IS NOT IMPORTANT

Deferring income taxes by naming an individual beneficiary is not an issue if (i) your beneficiary will need to withdraw all of the account upon your death for an immediate need (possibly to pay estate taxes, to support minor children, or to spend the money as soon as possible), or (ii) the size of the account is so small that a full withdrawal will not cause a substantial amount of additional income tax to be due.

SITUATIONS IN WHICH TRUSTS ARE CRUCIAL

Some common situations in which naming a trust is crucial are when (i) you have a special needs child that relies on government benefits, (ii) you are in a second marriage and you want your spouse to have limited access to the trust principal, (iii) you have minor children, (iv) your intended beneficiary is a spendthrift or has substance abuse problems, and (v) when retirement account assets must be used to fund a credit-shelter trust. In these situations, you may decide that the reason for the trust outweighs the lost income tax deferral, or may decide that the added cost of a private letter ruling for a custom designed accumulation trust (as described below) is justified.

WHAT TO DO WHEN YOU MUST USE A TRUST

If a trust must be used as the beneficiary of a retirement account, you have three choices. You can use a traditional trust, but this will cause all of the retirement account proceeds to be payable (and subject to income tax) within 5 years of your death (or, if you died after age 70 1/2, payable based on your IRS defined life expectancy).

The second option is to use a "conduit trust" that requires all retirement account withdrawals to be distributed directly to the trust beneficiary (i.e., the trust cannot accumulate any retirement account withdrawals). A conduit trust is not a wise alternative when trying to fund a credit-shelter trust or when you are trying to keep the assets out of the beneficiary's hands.

The last option is to create a special trust that is designed to allow trust accumulations. These trusts are very complicated and generally a private letter ruling must be obtained from the IRS before using one.

OTHER TAXES THAT APPLY TO RETIREMENT ACCOUNTS

Retirement accounts are not only subject to income tax when distributed to the beneficiary, they are also subject to estate tax at the death of the owner. For the year 2006, the combined impact of the 46% estate tax, a top federal income tax rate of 35% and a Missouri state income tax rate of 6% (or an Illinois income tax rate of 3%) can be debilitating. This heavy tax burden is another reason tax-deferred accounts are the best source for charitable bequests at your death.
These taxes may be payable from the your probate estate, a trust, or may need to be paid by a withdrawal from the IRA. Your estate planning documents should be drafted to ensure, to the extent possible, that any tax due is paid from non-retirement assets, as the withdrawal of retirement assets to pay taxes will cause additional income tax.

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