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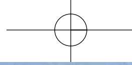
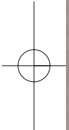
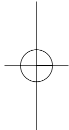
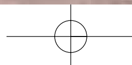


Funding Bypass Trusts *with* Retirement Assets

By Christopher R. Hoyt







Estate planners often find that to fund a married decedent's maximum credit shelter amount to a bypass trust (aka credit shelter trust or nonmarital trust), it is necessary to use some retirement assets. The situation will occur even more frequently with the increase in the credit shelter thresholds from $1 million in 2003 to $1.5 million in 2004 and to $2 million in 2006. Although it is generally preferable to fund these trusts with nonretirement assets, many individuals simply do not have this amount of wealth outside their retirement plans.

Retirement accounts bring unique and difficult challenges for funding bypass trusts. Whereas most assets have a step-up in basis that virtually eliminates income tax problems, distributions from retirement accounts are usually taxable "income in respect of a decedent" (IRD). Consequently, when it comes to funding bypass trusts with retirement assets, estate planners need to consider a strategy that integrates three or more distinct sets of laws: income tax laws, estate tax laws, and ERISA laws for required distributions after an account owner's death.

The principal challenge for funding most types of bypass trusts with retirement assets is that the ERISA mandatory distribution rules will usually cause the deceased spouse's retirement account to be distributed, and therefore taxed, more rapidly than if some other beneficiary had been named to receive the assets. This article will examine the applicable laws and planning strategies for these three legal areas and how they interact to create special problems for bypass trusts. Once the problems are understood, solutions that produce better results can be examined.

Income Tax Principles

The cornerstone income tax strategy for retirement plan accounts is to take the smallest possible withdrawals in order to keep as much as possible in the account for the longest possible time. By leaving larger amounts in the account, there is greater income tax deferral, and the employee/beneficiary will have more income from investing the deferred income taxes. This principle applies during a person's lifetime and after death as well, because distributions after death are taxable as IRD.

EXAMPLE: Jenne Heir is named as the sole beneficiary of her mother's $100,000 individual retirement account (IRA). If she withdrew the entire IRA in one year, she would pay $40,000 of federal and state income tax and would have only $60,000 to invest. By keeping the IRA balance at $100,000, she could have over 50% more investment income each year (for example, $10,000 per year rather than $6,000, assuming a 10% yield, or $5,000 rather than $3,000 assuming a 5% yield), as illustrated by the chart above.

	Distributed	Undistributed	Difference
Amount in IRA	$100,000	$100,000	
Income Tax on Distribution (40%)	40,000		
Amount to Invest	$ 60,000	$100,000	$40,000
Income at 10%:	$ 6,000	$ 10,000	$ 4,000
Income at 5%:	$ 3,000	$ 5,000	$ 2,000

Mandatory Post-death Distribution Rules

The tax laws require that a person's account in a qualified retirement plan must begin to be liquidated after the person's death. The question is "how fast"? It is usually possible to make the payments over the life expectancy of the designated beneficiary, which is what most financial planners recommend. The best results therefore occur when younger individuals, who have long remaining life expectancies, are named as beneficiaries, and the worst results usually occur when older individuals are named as beneficiaries. In oversimplified terms, the account balance can stay higher for a longer period, and so defer income taxes longer, with younger beneficiaries than with older ones.

A *stretch IRA* is the common description of an IRA that makes payments over a designated beneficiary's life expectancy. Although the post-death mandatory distribution laws for IRAs are essentially the same as the laws that apply to all other types of qualified retirement plans (profit-sharing plans, 401(k), 403(b), among others), as a practical matter the maximum stretch payments are available only through IRAs because most employers opt to quickly liquidate the accounts of deceased employees. Naming beneficiaries can also be easier with IRAs because there are few legal restrictions. By comparison, a married individual cannot name someone other than a spouse—such as a bypass trust or a child—as a beneficiary of a company retirement plan unless the spouse gives written consent. Code §§ 401(a)(11)(B)(iii) and 417(a)(2).

Regardless of the type of qualified retirement plan, the laws give a surviving spouse an advantage that is not available to any other beneficiary: a *rollover.* Normally this is the best way for a surviving spouse to keep the largest possible balance from a deceased spouse's retirement accounts. The surviving spouse can establish a new IRA that can receive

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the assets from the deceased spouse's IRA or qualified retirement plan account in a tax-free transfer. See Code § 402(c)(9) for qualified retirement plans and § 408(d)(3)(C) for IRAs. The surviving spouse can then treat the rollover IRA virtually the same as any IRA that she had established during her working career. Upon her death, her rollover IRA can become a stretch IRA for the children.

There are, however, three situations when a rollover to a new IRA is not possible or is not desirable. One of them is a bypass trust. In these cases, the usual strategy is to leave the money in the decedent's IRA and to make the decedent's IRA a stretch IRA. As will be shown below, the income tax benefits from the stretch IRA will usually be less—often far less—than what can be achieved from a rollover to a surviving spouse. The estate planner and the client must then decide whether the income tax deferral benefits from a rollover are sufficiently large to offset other non-income tax objectives that would discourage a rollover.

First Situation: IRA Owner Is Not Married

The first situation when a rollover is not possible is when the decedent is not married. Only a surviving spouse can roll over an inherited distribution from a qualified retirement plan. If a rollover is not available, usually the best solution is for the IRA to become a stretch IRA for the beneficiary.

The more troublesome situation, however, is when the decedent's retirement account is at a company that has a policy of quickly liquidating a deceased employee's account. The $100,000 account is quickly reduced to $60,000. How can the nonspouse beneficiaries—typically children, siblings, or partners of the employee—obtain any income tax deferral under this circumstance? Three solutions may be available. First, some companies are willing to purchase an annuity for the beneficiary rather than make a lump-sum distribution. Another strategy is for the employee to make a lifetime rollover from the company plan account to an IRA, in which case the IRA can become a stretch IRA for the beneficiary after the employee's death. Code § 408(d)(3). If a lifetime rollover to an IRA is not possible, a third strategy is to name a charitable remainder trust (CRT) as the beneficiary of the employee's account. Because a CRT is exempt from income tax, the transfer can be made tax-free and the $100,000 balance can remain $100,000 and provide a payout of the stated percentage (5% or 6%) to the beneficiary for the rest of her or his life and then terminate to a charity. PLRs 199901023, 9820021, 9634019, 9253038, and 9237020. The CRT solution is much less attractive if the decedent's estate will be subject to estate tax because the beneficiary will likely lose the Section 691(c) deduction for estate taxes paid on the IRD. PLR 199901023.

Second Situation: Client Is in a Second Marriage

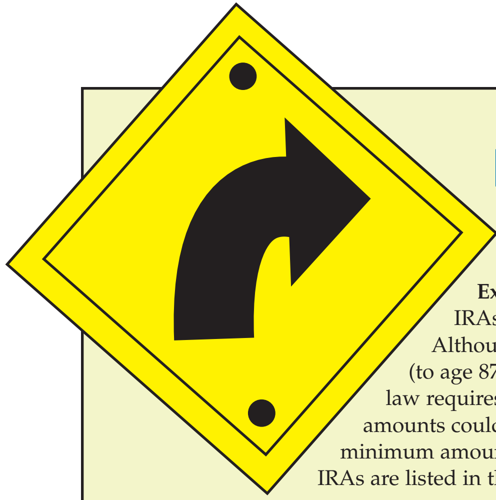
The second situation when a rollover might not be desirable is if the client is in a second marriage and would like assurance that the retirement assets will benefit children from a prior marriage after the death of the second spouse. Estate planners usually recommend QTIP trusts for these situations. These trusts can work well for assets that have a step-up in basis, but QTIP trusts usually experience the same problem that applies to bypass trusts that are named as beneficiaries of stretch IRAs (described below). Consequently, although Rev. Rul. 2000–2, 2000–1 C.B. 305, permits an IRA to qualify as a QTIP trust, there are very few income tax advantages if the decedent and the spouse are roughly the same age.

Estate Tax Strategies for Married Couples—Bypass Trusts

The third situation when a rollover might not be desirable is if a married couple might be subject to estate tax. If all of the retirement plan assets of the first spouse to die are rolled over to the surviving spouse, then the estate of the surviving spouse will be increased and subject to greater estate tax. Normally this is the situation that calls for a bypass trust.

By way of background, the most common estate planning arrangement for a married couple with combined wealth over $1.5 million is to provide that no estate tax will be due upon the death of the first spouse and that estate taxes will be deferred, and hopefully minimized, upon the death of the surviving spouse. This is often accomplished by dividing the estate of the first spouse into two parts: (1) a bypass trust equal to the amount that can pass free from estate tax ($1.5 million in 2004) and (2) either a marital trust or a QTIP trust that qualifies for the marital estate tax deduction. A bypass trust typically pays income to the surviving spouse for life and then distributes the remainder to the children. Upon the death of the surviving spouse, the assets in the marital or QTIP trust will have to be included on her or his federal estate tax return, but the assets in the bypass trust will escape taxation.

The problem with funding bypass trusts with retirement plan assets is that the mandatory distribution rules usually will cause the retirement assets to be distributed, and therefore



Distribution Options Available to a Surviving Spouse

Example: At age 70, Ms. Widow began receiving distributions from several IRAs, including the IRAs of her older husband and her older sister (both of whom had died in the preceding year). Although the life expectancy of a 70-year-old is 17 years (to age 87), Ms. Widow in fact lived to age 92. Whereas the law requires two IRAs (IRAs C and D) to be empty by age 87, amounts could still be in the other IRAs for her entire life. The minimum amounts required to be distributed from each of five IRAs are listed in the table.

AGE	IRAs A & B	IRAs C & D	IRA E
70	3.65%	5.88%	5.88%
71	3.78%	6.25%	6.13%
72	3.91%	6.67%	6.45%
73	4.05%	7.14%	6.76%
74	4.21%	7.69%	7.09%
75	4.37%	8.33%	7.46%
76	4.55%	9.09%	7.87%
77	4.72%	10.00%	8.26%
78	4.93%	11.11%	8.77%
79	5.13%	12.50%	9.26%
80	5.35%	14.29%	9.80%
81	5.59%	16.67%	10.31%
82	5.85%	20.00%	10.99%
83	6.14%	25.00%	11.63%
84	6.46%	33.33%	12.35%
85	6.76%	50.00%	13.16%
86	7.10%	100.00%	14.08%
87	7.47%	empty	14.93%
88	7.88%		15.87%
89	8.33%		16.95%
90	8.78%		18.18%
91	9.26%		19.23%
92	9.81%		20.41%

A – ***Her own IRA,*** established with contributions she made during her working career.

B*– ***A rollover IRA***, funded after her husband's death with a distribution from his 401(k) plan.

C – ***A stretch IRA—Her sister's IRA***, in which Ms. Widow was named as the beneficiary. Payments from this IRA must be made over a term of years that cannot exceed Ms. Widow's remaining life expectancy in the year that follows her sister's death (that is, 17 years). A rollover is not possible. Only a surviving spouse can roll over distributions from a deceased person's retirement account.

D – ***Bypass Trust #1—Her deceased husband's IRA is payable to a standard bypass trust***, in which the trust distributes net income to her for life and then to a child. This is treated as a stretch IRA payable to a *look-through trust* in which the required distributions are based on looking at the ages of the beneficiaries of the trust. The same distribution rules apply to a QTIP trust.

E*– ***Bypass Trust #2—Her deceased husband's IRA is payable to a similar trust, but the trust requires all retirement plan distributions to be made to Ms. Widow***. This provision permits a look-though trust to be treated as a *conduit trust*. When a surviving spouse is the beneficiary of a conduit trust, she is treated as the "sole" beneficiary of the IRA, which permits her life expectancy to be "recalculated" each year rather than frozen for a fixed term of years. The same rules would apply to a QTIP trust.

Required Payments after Ms. Widow's Death: **IRAs A & B:** IRAs A & B can become "stretch IRAs," in which payments are made over the life expectancy of one of the beneficiaries selected by Ms. Widow. Treas. Reg. § 1.409(a)(9)-5, Q&A 5(a)(1)(i). **IRA E:** After Ms. Widow's death, payments from IRA E must be completed over a term of years based on the life expectancy of someone who was her age in the year of her death. Because she died at age 92, payments must be made over no less than 4.9 years. Treas. Reg. § 1.409(a)(9)-5, Q&A 5(c)(2).

****Payouts "B" and "E" are available only to a surviving spouse.*** Other payouts are available to anyone.

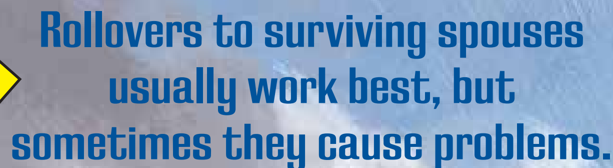
Legal Authority for Various Payout Rules: **IRA A**: Treas. Reg. § 1.409(a)(9)-5, Q&A 4, and Treas. Reg. § 1.409(a)(9)-9, Table A-2. **IRA B:** Same, and also Code §§ 402(c)(9) and 408(d)(3)(C)(ii)(II). **IRA C:** Code § 408(d)(3)(C) and Treas. Reg. § 1.409(a)(9)-5, Q&A 5(a)(1)(i). **IRA D:** Treas. Reg. § 1.409(a)(9)-5, Q&A 7(c)(3), Example 1. **IRA E:** Treas. Reg. § 1.409(a)(9)-5, Q&A 7(c)(3), Example 2. The life expectancies are from Treas. Reg. § 1.409(a)(9)-9, Table A.

taxed, at a faster rate than would be possible by naming alternative beneficiaries, such as the spouse or the children. This is because when an IRA is payable to two or more beneficiaries, the IRA must be liquidated over the life expectancy of the oldest beneficiary. Treas. Reg. § 1.409(a)(9)-5, Q&A 7(c)(3), Example 1. Usually that is the spouse. In other words, by making the retirement assets payable to a bypass trust, the $100,000 account will be required by law to shrink to $60,000 sooner than if either the assets were rolled over to the surviving spouse or if they were left solely to the children.

This frustrates estate planners. For estate tax purposes, the estate planner would like the assets in the bypass trust, which will escape the estate tax upon the death of the surviving spouse, to grow in value. Conversely, the assets in the marital trust, which will be subject to estate tax upon the death of the surviving spouse, should ideally be frozen or shrink in value. Funding a bypass trust with retirement assets often produces results that are diametrically opposed to these normal estate tax planning objectives. The bypass trust will likely be small because the retirement assets will have been fully distributed and taxed over the surviving spouse's remaining life

expectancy. At the same time, the retirement accounts that were rolled over to the surviving spouse's IRAs, and that will be included in the surviving spouse's estate, could be very large because rollover IRAs tend to have relatively small required distributions.

This result is illustrated in the box on page 13, which computes the minimum required IRA distributions that must be made to a 70-year-old widow(er). The small required distributions from a rollover IRA (IRA B) match those of a surviving spouse's own IRA (IRA A). By comparison, a stretch IRA (IRA C) must be completely empty at the end of the widow(er)'s life expectancy, as determined at the time of the original IRA owner's death. For example, an IRA must be empty by the time a beneficiary is age 87 if the beneficiary was about age 70 when the original IRA owner died. As a general rule, this result also applies to an IRA that is payable to either a bypass trust or a QTIP trust with a 70-year-old beneficiary (IRA D payable to a "look-through trust"). In over-simplified terms, the $100,000 IRA that existed at age 70 will have been reduced to $60,000 by age 87.



The facts in the exhibit are actually more favorable than the typical scenario. The average age of decedents reported on 1998 federal estate tax returns was 76.6 years for men and 81.4 years for women (2.8 years and 1.9 years, respectively, older than the national average). Barry W. Johnson & Jacob M. Mikow, *Federal Estate Tax Returns, 1998–2000,* IRS SOI Bull. 133, 136 (Spring 2002). If a bypass trust is established for a 76-year-old female spouse when the male spouse dies, the maximum stretch period would be only 12 years instead of 17 years.

IRA E illustrates a way to extend the payments beyond a fixed 12- or 17-year term: the IRA can be payable to a "conduit" bypass trust or a "conduit" QTIP trust. This is accomplished by providing in the trust instrument that all retirement plan distributions must be conveyed to the surviving spouse and that no part of any distribution can be accumulated in the trust. There are two advantages to using such a clause. First, the spouse will likely be in a lower income tax bracket than the trust, so less income tax will be paid on the IRA distributions. Second, a surviving spouse who is a beneficiary of a conduit trust can re-compute her or his life expectancy so that the IRA does not have to be empty at age 87. This last strategy can increase the likelihood that some assets will be in an IRA for the entire lifetime of the surviving spouse.

Despite these advantages, there are two significant problems with IRA E, especially if the surviving spouse lives a long life. First, the annual mandatory payments from an IRA to a conduit bypass or QTIP trust are always greater than the minimum mandatory payments from a rollover IRA. After age 87, the mandatory bypass/QTIP trust payments are more than double the mandatory rollover IRA payments. Following repeated annual payouts as large as 14%, 16%, and 20%, the assets in such an IRA will likely be virtually depleted upon the death of a long-lived spouse. Second, because all payments were made to the surviving spouse, there is the undesirable result that all of the accumulated after-tax distributions could be included on the surviving spouse's estate tax return, which is an outcome that the bypass trust was supposed to prevent. Thus, there is little point in funding a conduit bypass trust with retirement assets if the spouse will live a long life. A rollover usually will be much better. That is, it would be better for the surviving spouse to have a large rollover IRA ($100,000) produce investment income than to have a smaller IRA if, in either case, the assets will be included on her estate tax return at death.

Charitable Remainder Trust as a Bypass Trust for IRD

One solution that addresses the combination of estate tax and income tax concerns is the use of a two-generation charitable remainder unitrust (CRUT). Such a trust can accomplish the estate tax advantages of a traditional bypass trust and can also achieve income tax advantages similar to a two-generation IRA rollover. The feature that makes the income tax benefits possible is the fact that a CRT is exempt from income tax. Code § 664(c). Like an IRA, no income tax is collected from the income generated by a CRT until a distribution is made to a noncharitable beneficiary. Thus, a CRT could produce the estate planning objectives for a decedent's IRD assets that a traditional bypass trust or QTIP trust produces for conventional assets that have a step-up in basis.

EXAMPLE: Professor Ben E. Fitt and Professor Ima Welloff are married with two children. Virtually all of their wealth is in their 403(b) retirement accounts: he has $500,000 and she has $2 million. Regardless of who dies first, each has expressed a desire that the surviving spouse should receive income from both 403(b) accounts for life and that payments should begin to their children only upon the death of the surviving spouse. Ben is in poor health.

Instead of a traditional bypass trust, Ben should consider naming a two-generation CRUT (first to spouse and then to children) as the beneficiary of his entire 403(b) account.

There would be no income tax liability triggered by the transfer from the 403(b) account to the tax-exempt CRUT. PLRs 199901023 and 9820021. The CRUT could pay an income stream (for example, 5% of assets) to Ima for life, then to his two children for their lives, and upon the death of the last child the assets would be transferred to a charity. If the trust could consistently earn over 5%, the balance in the trust would never shrink below $500,000. There are income tax benefits: the $500,000 balance will last for the lives of both Ima and the children. There are also estate tax benefits: none of the $500,000 held by the CRUT will be included in Ima's estate when she dies. Furthermore, they have the satisfaction of knowing that they will benefit a charitable cause.

There are a host of technical issues with using a CRT as a bypass trust/QTIP trust for IRD assets. For a detailed analysis, see Christopher Hoyt, *When a Charitable Trust Beats a Stretch IRA,* Tr. & Est. (May 2002).

Conclusion

Retirement plans in estates represent the pinnacle of integrated estate tax and income tax planning. With the increase in the estate tax thresholds to $1.5 million and $2 million, an increasing number of people will confront the confusing legal issues posed by funding credit shelter amounts with retirement assets. Some basic planning principles:

Basic Tax Planning Strategies for Married Individuals

No Estate Tax Problems? If the estate is so small that neither spouse's estate will be subject to estate tax, then planners can focus primarily on income tax strategies. Normally the best income tax results will occur if the assets in a decedent's qualified retirement plan accounts are rolled over to an IRA for the surviving spouse. The spouse can withdraw amounts for life, and after the spouse's death the IRAs can become stretch IRAs for beneficiaries selected by the spouse, usually children.

Estate Tax Concerns That Would Normally Call for a Bypass Trust? First, try to fund the bypass trust to the maximum extent possible with non-IRD assets. If there are insufficient non-IRD assets, some retirement assets will be necessary to fund the full credit shelter amount. Of course, the best solution will be tailored to the wealth and spending patterns of each client. Assuming there is sufficient wealth so that all retirement assets will probably not have to be consumed over the surviving spouse's lifetime, consider some of the following strategies:

- Instead of transferring the entire available credit shelter amount to a single bypass trust that benefits both the spouse and children, consider using a portion of IRA assets to establish stretch IRAs solely for the benefit of the youngest beneficiaries. This is particularly advantageous if the other beneficiaries are considerably younger than the surviving spouse. For example, if $800,000 of IRA assets are needed to fund the credit shelter amount for an individual who has a 78-year-old spouse and two children, consider establishing a $200,000 stretch IRA for each child and only using $400,000 for the conventional bypass trust.
- Consider establishing a two-generation CRUT to accomplish both the estate planning objectives of a bypass trust and the income tax advantages of something akin to a two-generation IRA rollover.
- Consider establishing a conduit bypass trust to reduce both the size of the required distributions and the income tax rate imposed on their receipt, but realize that a rollover will probably be more beneficial if the surviving spouse lives a long life.
- If the surviving spouse is young, consider rolling over the entire retirement account and forgoing a bypass trust for any retirement assets. The significant income tax benefits from a rollover, which could last for the life of the spouse, could outweigh a speculative amount of estate tax benefits that might not be determinable for decades. Decisions concerning the amount that should fund a bypass trust or whether it should be funded at all can be made after the IRA owner's death by using disclaimers. See Natalie Choate, *Life and Death Planning for Retirement Benefits* 342–54 (4th ed. 2002).

QTIP Trusts

Use similar integrated estate tax and income tax planning strategies when considering the use of retirement assets to fund QTIP trusts. Consider the implications of accelerated payouts that can occur when there is a big spread in the ages of the beneficiaries of the trust (see IRAs D and E in the box on page 13). Consider using a two-generation CRUT when appropriate.

Unmarried Clients

There are no opportunities for marital bypass trusts or for rollovers of inherited retirement accounts of unmarried individuals. Usually stretch IRAs are the best alternative, but consider naming a CRT as a beneficiary if a stretch IRA is not available. If the client is so wealthy that estate tax is likely, consider making a charitable bequest of retirement accounts and other IRD assets so that the resources can be used for charitable purposes rather than a double-whammy of estate and income taxes. ■