Estate Tax Savings for a Lawyer's Largest Asset: Retirement Plans and IRAs

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Assets in qualified retirement plans, such as IRA's, 401(k) accounts, and profit-sharing plans, are often the largest part of a lawyer's estate. They require the most careful and knowledgeable estate planning, because they are treated differently—and less favorably—upon death than other assets.

Perhaps because of the complexity of this subject, comparatively little has been written about it[1], as we discovered in helping organize an American Bar Association panel presentation on the issue.

The following information is greatly simplified, and various exceptions or special considerations may apply to particular estates. Individuals who are planning their estates to minimize or eliminate the double tax on retirement assets should consult and rely on their legal counsel, and should only start and not stop with this broad-brush article.

I. DOUBLE TAX ON RETIREMENT ASSETS

The federal estate tax starts at 37% and quickly rises to 55%.[2] State inheritance taxes often add to the tax burden[3]. Generation skipping transfers over the exemption double the tax rate.[4]

Retirement assets are further taxed as income in respect to a decedent (IRD)[5]. This IRD tax is in addition to estate tax. Like estate tax, it can be minimized or even avoided by careful planning. It can be quite punitive without careful planning.

In fact, the double tax of retirement assets (IRD plus estate tax) can actually reach 76.5%! The last sentence is not a misprint. The double tax of retirement assets can potentially leave only 23.5% for the retiree's family, as the following chart shows:

Combination of Estate and Income Taxes
On Income in Respect of a Decedent

EXAMPLE: Assume that a person's total taxable estate is $3,100,000 and that $100,000 in a retirement plan is immediately distributed to a child. If a child is in a 40 percent marginal income tax bracket, then the combined estate and income taxes on the $100,000 would be $76,520, leaving the child with only $23,480. The amount is calculated as follows:

Beginning Balance in Retirement Plan	$100,000
Minus: Total Estate Taxes	(55,000)
Net Balance	$45,000
Minus: Income Tax on Distribution	
Gross Taxable Income	$100,000
Reduced by 691(c) Deduction for Federal Estate Tax	
Total Estate Tax	$55,000
State Tax Credit*	(8,800)
Estate Tax Itemized Deduction	(46,200)
Net Taxable Income	$53,800
Times Income Tax Rate	x 40%
Net Income Tax On Income in Respect of Decedent	(21,520)
Net after-tax amount to child**	$23,480[6]

* The deduction for estate tax attributable to income in respect of a decedent is only for the federal estate tax; the Sec. 2011 state tax credit (8.8 percent for an estate of $3,000,000) has therefore been eliminated. Treas. Reg. Sec. 1.691 (c)-1(a).

** The effective tax rate would be even greater if the generation skipping tax (Sec. 2601) is triggered.[7]

The most common solutions divide into two noncharitable approaches, and three charitable approaches.

II. NONCHARITABLE WAYS TO AVOID OR MINIMIZE THE DOUBLE TAX

A. Outright Gifts of Retirement Assets to the Surviving Spouse

Retirement assets are often given outright to the surviving spouse.

The primary advantage of an outright gift is that the double tax is deferred until that spouse's death, if the surviving spouse rolls the retirement benefits over to her own IRA[8], and the estate tax is avoided on withdrawals from the retirement account. Withdrawals must begin by April 1 of the year following the employee's reaching the age of 70 1/2, for a 401(k) plan[9] or IRA, and are subject to income tax as they are received[10].

If the surviving spouse leaves any charitable contribution at death, it is almost always best to make that charitable contribution with retirement assets. Outright gifts of retirement assets at death avoid IRD to the extent of the income tax charitable deduction[11], and avoid estate tax because of the estate tax charitable deduction.[12]

B. In-Trust Gifts of Retirement Assets to the Surviving Spouse

Retirement assets are sometimes given in trust to the surviving spouse. If the intent is to provide income for the surviving spouse, they should not be bequeathed to the credit shelter trust, because the double tax on retirement assets can be reduced by withdrawing from those assets, and normally withdrawals should be from the marital share (such as a QTIP[13] trust) first rather than from the credit shelter trust. The reason is that what goes into the credit shelter trust of the first spouse to die is completely shielded from estate taxes[14], assuming normal planning and competent documents, whereas what goes into the marital share is subject to estate tax at the death of the surviving spouse.[15]

The primary advantage of placing retirement assets in trust for the surviving spouse, similar to an outright bequest of retirement assets to the surviving spouse, is that the double tax is deferred. However, with the retirement assets in a trust, the double tax cannot be deferred as long as through an outright gift.[16] If the assets are given outright, minimum distributions may be spread over the surviving spouse's life expectancy.[17] In contrast, since the trust is not a qualified designated beneficiary[18], it cannot spread the minimum distributions over an individual's life expectancy.[19] However, the double tax is avoided on withdrawals from the retirement account.

Another advantage of placing retirement assets in a QTIP trust, instead of a charitable trust, is that principal can be withdrawn if required to support the surviving spouse.[20] And of course, the remainder (minus the double tax) goes to family rather than charity.

III. CHARITABLE WAYS TO AVOID OR MINIMIZE THE DOUBLE TAX

In a large estate, not much charitable motive is necessary to make it worthwhile to give retirement assets to charity from the second estate, because the double tax can reach 76.5% and the amount left for the family can dip to 23.5%. The next two approaches assume that the surviving spouse or the children enjoy the retirement assets, and then make the charitable gift at their death(s).

EXAMPLE: Assume again that the second to die of the business founder or his wife has a taxable estate of $3,100,000, and that he or she has to choose between leaving the $100,000 in his 401(k) plan to their child outright or to their child in a charitable remainder trust with remainder to their church. The business founder is 65 years old, and the child is 35. Both are in a 40% marginal income tax bracket.

	Outright Gift to Child	*CRT Gift to Child & Church*
Beginning Balance in Retirement Plan	$100,000	$100,000
Minus: Total Estate Taxes	(55,000)	0
Net Balance	$45,000	$100,000
Minus: Income Tax on Distribution		
Gross Taxable Income	$100,000	$100,000
Reduced by 691(c) Deduction for Federal Estate Tax		
Total Estate Tax	$55,000	
State Tax Credit[21]	(8,800)	
Estate Tax Itemized Deduction	(46,200)	
Charitable Deduction		$100,000
Net Taxable Income	$53,800	0
Times Income Tax Rate	x 40%	x40%
Net Income Tax on Income in Respect of Decedent	(21,520)	0
Net after-tax amount to child[22]	**$23,480**	
Net after-tax amount to charity		**$100,000**

A. Gifts of Retirement Assets to the Surviving Spouse in a Charitable Remainder Trust

Retirement assets can be given upon the first spouse's death into a charitable remainder trust[23] for the surviving spouse that pays a specified amount of income per year to the surviving spouse[24], and then at her death pays the remainder to charity.[25] Such a transfer of retirement assets should be made at the first death, rather than before, because if it were made during life the first spouse would be treated as receiving all the retirement income but could only deduct a portion based on the present value of the charitable interest.

Retirement assets placed in either a charitable remainder trust or a QTIP trust in which a charity is the remainder beneficiary are not taxed in either the first estate (because of the marital deduction[26]) or the second estate (because of the estate tax charitable deduction[27]). A key difference, and an advantage to a charitable remainder trust, is that assets in a charitable remainder trust accumulate tax free. There is no need to be able to defer income tax on the retirement benefits over the surviving spouse's lifetime, because they are deferred until paid out by the charitable remainder trust at the payout level selected by the first spouse.[28]

The primary disadvantage of a charitable remainder trust is that there cannot be distributions of principal, if the surviving spouse needs them, though the income payout can be set as high as the regulations permit that govern a charitable remainder trust.[29] In addition, the income payout is likely to be taxable to the surviving spouse.

B. Gifts of Retirement Assets to the Children in a Charitable Remainder Trust

Instead of a gift to the surviving spouse, retirement assets can be given upon the first or second spouse's death into a charitable remainder trust for the children or other beneficiaries, that pays a specified amount of income per year to the children or others, and then at their death pays the remainder to charity. Less of the unified credit will be used (or more dollars can be given tax-free) if a separate trust is set up per child with that child's fraction of the inheritance,[30] though that will mean additional accounting expenses each year for multiple tax returns (and additional appraisal expenses if there are any illiquid assets). It is important for such a gift to be made directly from the spouse's estate to the charitable remainder trust, to avoid taxation of the IRD to the estate[31], and to avoid estate tax on that noncharitable part.[32] Otherwise, the noncharitable portion of the retirement assets is taxed in the donor's estate, though the unified credit can be used to avoid estate tax, because there is no marital gift and no marital deduction.

The advantage is that no part of the retirement assets is taxed in either the first spouse's estate or the second spouse's estate, so long as the retirement assets are transferred directly under the designation of beneficiary form from the retirement plan to the charitable remainder trust. Also, the income tax can be minimized as follows.

Deferral of the income tax apparently can occur over each child's life expectancy[33]. If the IRS changes position and follows its usual rule that the charity is a nonqualified designated beneficiary that destroys the ability to defer income tax over the life expectancy of the child, then deferral of the income tax otherwise can occur over a five year period, using five year forward averaging.[34]

C. Gifts of Retirement Assets to Charity Alone

Instead of split gifts to family and charity, it is possible to give all or part of the retirement assets to charity at the first or second spouse's death.[35] If structured properly, that avoids all estate tax and all IRD tax on those retirement assets. Even an individual with limited charitable goals, but a large estate, may find that it is better to give 100% of retirement assets to charity than to give as little as 23.5% of retirement assets to family.

In fact, any individual planning to make any charitable gifts out of his or her estate should normally start with the retirement assets, because those are the least desirable to the heirs (because of the double tax) but are no less desirable than other assets to the charity (because it does not face the double tax).

Charitable gifts of retirement assets should be made via the designation of beneficiary form for the qualified retirement plan, rather than by will. If the donor's spouse is alive, she will have to consent in writing to the designation of a charity (or anyone other than the spouse) to be effective.[36] If some but not all retirement assets are being contributed, they should be rolled over to a separate IRA[37] that is exclusively designated for charity to avoid complications with pecuniary bequests and gifts not of entire interests.

Gifts to private foundations of retirement assets may not follow all the above rules. References to "charities" are meant to describe public charities exempt under Section 501(c)(3).

Gifts to pooled income funds[38] are fatal, because pooled income funds are not exempt entities, and are subject to complex allocations of principal and income.[39]

Different or unmentioned facts could change the application of these complex rules, and advice from one's own lawyer should be sought.

ABOUT THE AUTHORS

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~ FOOTNOTES ~

[1] *See, e.g.*, Christopher R. Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities*, **Virginia Tax Review**, Vol. 13, No. 4, Spring 1994; Stephen P. Magowan, *Doing Right by Doing Good: Giving IRAs to Charity*, **Probate & Property**, Sept.-Oct. 1997, at 17.

[2] I.R.C. § 2001(c)

[3] For example, New York rates reach 21%, exceeding the federal credit for state death taxes (I.R.C. § 2011).

[4] I.R.C. §§ 2602, 2641.

[5] I.R.C. § 691.

[6] Christopher R. Hoyt, *Charitable Gifts from Donors' Retirement Plan Accounts*, **Trusts & Estates**, 20, 25, August 1994.

[7] The 15% excise tax on retirement plan accumulations was repealed by the Taxpayer Relief Act of 1997 § 1073(a). I.R.C. § 4980A.

[8] I.R.C. § 402(c)(9).

[9] I.R.C. § 401(a)(9)(A)(ii),(C).

[10] I.R.C. § 61.

[11] **Estate of Clymer v. Commissioner**, 221 F.2d 680 (3d Cir. 1955); Treas. Reg. § 1.642(c)-3(a)

[12] I.R.C. § 2055(a)(2).

[13] A QTIP trust is a qualified terminal interest property trust for a spouse, I.R.C. § 2056(b)(7)(B).

[14] I.R.C. § 2010(a): Priv. Let. Rul. 8649002 (Aug. 14, 1986).

[15] § 2056(b)

[16] I.R.C. § 401(a)(9)(B)(ii).

[17] I.R.C. § 401(a)(9)(B)(iii).

[18] I.R.C. § 401(a)(9)(E); Prop. Treas. Reg. § 1.401(a)(9)-1.

[19] I.R.C. § 401(a)(9)(B)(ii).

[20] Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities, supra* note 1, at 704.

[21] See note * *supra*.

[22] See note ** *supra*.

[23] I.R.C. § 664.

[24] A charitable remainder annuity trust must pay a minimum of 5% of the initial net fair market value of the trust each year. I.R.C. §664(d)(1); Treas. Reg. § 1.664-2(a)(2). A charitable remainder unitrust must pay out a minimum of 5% of the net fair market value of the trust assets as determined annually. I.R.C. §664(d)(2); Treas. Reg. § 1.664-3(a)(2).

[25] I.R.C. § 2055(e)(2)(A); Rev. Rul. 77-374, 1977-2 C.B. 329; Priv. Let. Rul. 8419005 (Jan. 26, 1984).

[26] I.R.C. §§ 2056(b)(7), (8); Priv. Let. Rul. 9704029 (Jan. 24, 1997).

[27] I.R.C. § 2055(a), (e)(2), Treas. Reg. §20.2055-2.

[28] This payout percentage cannot be changed once the trust is funded, although it may vary from year-to-year if a net-income trust is selected. I.R.C. § 664(d)(1)(A), (2)(A); Treas. Reg. §§ 1.664-2(a)(1), 3(a)(1).

[29] Rev. Rul. 77-374, 1977-2 C.B. 329, Priv. Ltr. Rul. 8419005 (Jan. 26, 1984).

[30] A single life has a shorter life expectancy, and smaller life income value, and larger remainder, than that life plus a second life.

[31] Priv. Let. Rul. 9341008 (July 14, 1993); Treas. Reg. § 1.642(c)-3(b).

[32] Priv. Let. Rul. 9237020 (June 12, 1992).

[33] Priv. Let. Rul. 9253038 (Oct. 5, 1992), Priv. Let. Rul. 9237020 (June 12, 1992).

[34] I.R.C. §§ 170 (b)(1)(B), (C)(ii), (D)(ii); 402(d)(1)(A), (4)(A)(i).

[35] Retirement plan assets may not be transferred to charities prior to the employee's death. Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities, supra* note 1, at 647; I.R.C. §§ 401(a)(13)(A); 408(a)(4).

[36] I.R.C. § 401(a)(11)(B)(iii)(I).

[37] I.R.C. § 402(c).

[38] I.R.C. § 642(c)(5).

[39] *See* Hoyt, *Transfers from Retirement Plans to Charities and Charitable Remainder Trusts: Laws, Issues, and Opportunities, supra* note 1, at 705-08.