Retirement Accounts and Your Estate Plan

Successful estate planning generally involves passing on your assets to your heirs at a low tax cost. To help achieve that goal, there are a few things to keep in mind about retirement accounts.

First, tax-favored retirement accounts, such as traditional IRAs, Roth IRAs, SEP accounts and 401(k) plans, are *not* good candidates to use for funding bypass trusts. These trusts, which are sometimes called credit shelter trusts, are set up by married couples as estate tax minimization tools. The main advantage of a bypass trust is that the assets used to fund the trust are not included in either spouse's taxable estate for federal estate tax purposes.

Typically, a bypass trust is funded with assets having a value equal to no more than the federal estate tax exemption amount. Funding of the bypass trust occurs when the first spouse passes away. Since the objective is to "bypass" the taxable estates of both spouses, the best assets to use for funding bypass trusts are assets that are expected to appreciate. That way, any future appreciation will not be hit with estate taxes -- even after the death of the second spouse.

However when a bypass trust is designated as the beneficiary of a tax-favored retirement account, the account generally must be liquidated under the required minimum distribution rules over the life expectancy of the oldest bypass trust beneficiary. In other words, the required minimum distribution rules turn the account into a depreciating asset.

What if the retirement account owner's estate is designated as the account beneficiary, and the account is then used to fund a bypass trust under the terms of the account owner's will? In this case, the account generally must be liquidated over an even shorter period under the required minimum distribution rules.

Required Minimum Distribution Facts

- Under tax law, you cannot keep money in a traditional IRA indefinitely. Eventually, it must be distributed. The amount that must be distributed each year is referred to as the required minimum distribution.
- If there are no distributions, or if the distributions are not large enough, you may have to pay a 50% excise tax on the amount not distributed as required.
- The requirements for distributing IRA funds differ, depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.
- Beneficiaries take distributions based on IRS tables that predict life expectancy. If there is more than one beneficiary, the one with the shortest life expectancy is the designated beneficiary for distribution purposes.
- Distributions from traditional IRAs are taxed as ordinary income.

Bottom Line: Because of the required minimum distribution rules, tax-favored retirement accounts are basically a sub-optimal choice for funding bypass trusts. Instead, when possible, bypass trusts should generally be funded with assets expected to appreciate.

On the other hand, taxable savings vehicles that contain assets expected to appreciate, such as stocks and equity mutual funds, are good candidates for funding bypass trusts. Why? There are two reasons:

- First, funding the bypass trust with appreciating assets allows the future appreciation to escape being included in the taxable estate of either spouse.
- Second, the tax basis (for income tax purposes) of capital gain assets used to fund a bypass trust will be stepped up to fair market value as of the date of the account owner's death. So the

bypass trust will have a stepped-up tax basis in the assets, which will reduce or eliminate the capital gains tax when they are later sold.

What about funding a bypass trust with taxable accounts that are loaded with cash equivalents and fixed income assets?

They are only so-so candidates because they are also not appreciating assets. However, they are better than tax-favored retirement accounts.

The Law Office of Eugene Gorrin, LLC
17 Watchung Avenue, Suite 204
Chatham, NJ 07928
973.701.9300
egorrin@gorrinlaw.com
www.gorrinlaw.com