TRA 2010 Simplifies Estate Planning for Owners of Large IRAs

By Michael Repak, JD, CPA, LL.M.
Vice President, Senior Estate Planner, Wealth Planning Department

IRA owners can take advantage of ‘portability’ by naming their spouse as beneficiary of their IRA benefits.

Under the Tax Relief Act of 2010 (“TRA 2010”), the estate tax exempt amount is $5 million in 2011 and 2012, and will revert to $1 million beginning in 2013.

For 2011 and 2012 only, a deceased spouse’s unused exempt amount can be transferred to the surviving spouse. This provision is known as “portability” and owners of large IRAs can take advantage of portability by naming their spouse as beneficiary of their IRA benefits without the tax disadvantages that existed under prior law.

Executive Summary

A spouse who is the beneficiary of an IRA can roll the IRA over into his or her own IRA, obtain a greater “stretch” by naming new beneficiaries, and/or convert to a Roth IRA. Nonspousal beneficiaries cannot do any of these things.

There are a number of planning opportunities related to IRA spousal beneficiaries. If a spouse is the beneficiary, and rolls the benefits over into his or her own IRA, he or she must then begin taking distributions upon reaching their required beginning date, which is the April 1 after he or she reaches age 70½. As an alternative, the spouse can keep the IRA as an inherited IRA, in which case he or she need not take distributions until the year the deceased spouse would have attained age 70½. Of course, if the spouse converts the IRA to a Roth IRA, there are no required distributions during the spouse’s lifetime, but conversion is a taxable event and taxes will be due for the year of conversion.

For a beneficiary other than a spouse (“nonspousal beneficiary”), the options are much more limited.

A nonspousal beneficiary must take distributions over his or her own life expectancy. If the benefits are payable to a trust, assuming the requirements are met, the benefits can be stretched out over the life expectancy of the oldest beneficiary of the trust. In the case of a bypass or credit shelter trust (CST), the spouse will generally be the oldest beneficiary of the trust. Depending upon the age of the spouse, the IRA benefits might have to be distributed over a relatively short period of time. Also, the benefits, when distributed to the surviving spouse, would then become part of his or her estate, defeating in some measure the goal of many clients in creating the CST. The RMD requirement was a major reason why, under pre-TRA 2010 law, it was generally less desirable to use an IRA to fund a CST.

As many readers know, under the Economic Growth and Tax Reform Reconciliation Act of 2001 (“EGTRRA”), the estate tax exempt amount was increased from $675,000 in 2001 to $3.5 million in 2009. There was no estate tax in 2010. The estate tax was scheduled to return in 2011, with a $1 million exempt amount.

Importantly, the exempt amount was personal to each taxpayer, meaning that it could not be inherited by another individual. So, under 2009 law, a couple could leave $7 million to heirs without incurring any federal estate tax, but this required use of the first spouse to die’s exemption amount when that death occurred. A common estate planning approach for such couples was to provide that, on the first death, an amount would be set aside into a CST and the balance would be distributed to the surviving spouse outright. The CST was typically designed to provide the surviving spouse with income for the remainder of his or her life, provide that assets would be available to the surviving spouse’s benefit if the spouse should ever need them, but would not be part of his or her estate when the surviving spouse ultimately died.

Funding a CST could pose some challenges for planners and clients. In a situation where the surviving spouse did not really need the income that a CST would provide, there might be a reluctance to fund the CST with an IRA because of the RMDs that would be required during the surviving spouse’s lifetime. However, in the case of some clients with large IRA balances, there might be no other viable ways to fund the CST. In such cases, it was frequently best to allow the IRA to pass to the CST and to simply live with the resulting loss of estate tax benefits on the second death. Also, if the IRA benefits exceeded the unused portion of the estate tax exempt amount, preparing a formula beneficiary designation leaving only that portion of the IRA to the CST was complicated.

To simplify the planning, many IRA owners simply named their spouse as the primary beneficiary of the IRA with a disclaimer trust as the contingent beneficiary. In that way, in addition to simplifying the beneficiary designation, the decision could be postponed until the IRA owner's death. However, at that time, the spouse had to decide between taking the IRA and giving up the potential estate tax benefits of fully funding the CST and disclaiming some or all of the IRA, potentially giving up the income tax benefits of the rollover. Making that decision even more complicated was that the spouse could not have a power of appointment over a disclaimer trust, nor could the spouse participate in discretionary distributions from the trust to other beneficiaries (except as limited by an ascertainable standard).

Alternatively, the IRA owner could leave some or all of their IRA to their children or grandchildren (and thereby avoid the CST), or trusts for their benefit. That allowed for a longer "stretch" than if the benefits were payable to the CST, but did not keep the benefits available for the spouse if he or she ever needed them.

Finally, leaving the IRA to the spouse would allow the spouse to roll them over into his or her own IRA, name new beneficiaries, possibly convert to a Roth IRA, and obtain an even longer "stretch." But, as noted above, this wasted a portion of the decedent's estate tax exempt amount, potentially resulting in additional estate tax in the surviving spouse's estate.

Under TRA 2010, for 2010, the estate tax was made optional, with a $5 million exempt amount. For 2011 and 2012, the estate tax exempt amount is $5 million but is currently scheduled to revert back to $1 million in 2013. As noted above, for 2011 and 2012 only, a deceased spouse's unused exempt amount can be transferred to the surviving spouse, a provision known as "portability."

Portability largely solves the problems in the previous tax laws. An IRA owner can name their spouse as the beneficiary of the IRA. The spouse can take the IRA, roll it over, name new beneficiaries to get a longer stretch-out, and convert to a Roth IRA, either all at once or over a number of years. Except with respect to the income and growth on the exempt amount during the spouse's lifetime, *the estate tax benefit of the credit shelter is preserved*. Portability allows the IRA owner's unused estate tax exempt amount to be transferred to the spouse.

In order to transfer the unused estate tax exempt amount to the spouse, the IRA owner's estate must file an estate tax return and elect to transfer the unused estate tax exempt amount to the spouse. The opportunity to shelter the income and growth on the unused estate tax exempt amount during the spouse's lifetime is lost.

This will not be the right approach for everybody. But, the good news is that a married person can continue to provide for a CST in his or her Will. By creating a CST, the income and growth on the estate tax exempt amount during the surviving spouse's lifetime can be excluded from the surviving spouse's estate.

For example, suppose the first spouse to die has an estate of $5 million, which he leaves to a CST. At the spouse's death, the trust has grown to $7 million. The entire $7 million is excluded from the spouse's estate. If the first spouse instead left the $5 million to their spouse, that second spouse could take advantage of the unused $5 million exempt amount, but this would not cover the additional $2 million of income and growth gained during the second spouse's remaining lifetime.

A CST also protects the assets from the spouse's potential creditors, including future spouses if the surviving spouse remarries. It may also serve to protect against Medicaid, if the spouse goes into a nursing home.

Nevertheless, the ability to leave the IRA to the spouse while preserving the unused estate tax exempt amount provides a major benefit, and simplifies the planning for IRA owners with large IRAs who do not have sufficient other assets to fully fund a CST. This situation will likely become more common with the new $5 million estate tax exempt amount.

Of course, under current law, 'portability' is only in effect for 2011 and 2012, and the estate tax exempt amount is scheduled to revert to $1 million in 2013. It is possible that this portability provision may be extended or made permanent, or that the estate tax exempt amount will be increased to more than $1 million beginning in 2013. In the meantime, IRA owners who do not have enough non-retirement assets to fully utilize their estate tax exempt amounts can leave their IRA benefits to their spouses. They can then further review their estate plans if portability is not extended or made permanent.

Conclusion

Owners of IRAs who are named beneficiaries (but who are not spouses) can consider taking advantage of their estate tax exempt amounts and also can review/revise their financial and estate plans to determine whether it would be desirable to name the spouse as beneficiary beginning in 2011 in light of the availability of portability. Janney can assist clients in this review.

For additional information, please contact your Janney Financial Advisor.

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