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Estate Planning For Retirement Plan Assets

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The following article was featured in the July 2015 edition of *Legacy*, the Vorys newsletter focused on wealth planning.

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Retirement plan assets – profit sharing plan accounts, 401(k)s and IRAs – account for a significant portion of many estates and frequently present unique planning issues and hurdles.

Perhaps the most significant financial aspect of these accounts is that (unless they are Roth accounts) all distributions from them constitute ordinary income upon receipt. As a result, planning for retirement plan assets revolves around the ability of the beneficiary to elect to defer distributions over his or her life expectancy, which defers the income tax associated with distributions and permits the assets to remain in a tax-free investment environment for as long as possible. This “stretch-out” treatment is available to individual beneficiaries, but such treatment is only available for retirement plan assets made payable to trusts if the trust is properly structured.

Fortunately for many married couples, planning has become simplified as a result of the changes to the federal estate tax at the beginning of 2011. Those changes include the substantial permanent increase in the federal exemption (\$5,430,000 for 2015—up from \$2,000,000 in 2008 and \$3,500,000 in 2009) and the advent of “portability,” which allows the surviving spouse to take advantage of the exemption of the first-to-die spouse without the use of a trust. Prior to 2011, many married couples were faced with a choice. They could leave retirement plan assets to a trust for the benefit of the surviving spouse and fully utilize the exemption of the first-to-die spouse, but this option came at the cost of losing the somewhat more favorable income tax treatment available to a spouse who was named as outright beneficiary. Alternatively, they could leave retirement plan assets directly to the surviving spouse and risk not fully utilizing the exemption of the first-to-die spouse. Now, as a result of the combination of the larger exemption and the ability of the surviving spouse to elect to take over

the unused exemption of the first-to-die spouse, most couples can plan to leave the retirement plan assets outright to the surviving spouse. Doing so enables the surviving spouse to defer any distributions until age 70.5 and permits the surviving spouse to name his or her own beneficiaries, which in most cases results in a much longer “stretch-out” period for any assets remaining in the retirement plan account at the death of the surviving spouse.

Planning for retirement plan assets at the death of the surviving spouse will depend on the ages of the children and any special needs or other situations that need to be taken into account. If no trust is required, the account may be made payable directly to children, who may then “stretch-out” distributions over a period equal to their life expectancies. Where situations dictate that a trust is designated as the beneficiary of a retirement plan in order to protect the assets, great care must be used to structure the terms of the trust in order to qualify for “stretch-out” treatment. This task is complicated by the fact that the rules are not well developed and compliance with the rules often requires difficult choices.

In some situations, trusts that have not been properly structured to permit “stretch-out” treatment may still be saved even after the death of the owner of the retirement assets through the use of disclaimers and other post-mortem planning techniques. Beware, however, that certain time limitations do exist in order to take advantage of such techniques.

Retirement plan assets are frequently an ideal choice for funding charitable bequests because use for that purpose permits avoidance of both income and estate tax that would be associated with the asset if left to an individual or trust. Another way of looking at it is that the government can be viewed as funding 40% to 70+% of a bequest to charity that is funded with retirement plan assets.

Proper planning can navigate and even take advantage of the complicated rules governing retirement plans. If you would like to learn more about estate planning with retirement plans or want to make sure that your estate plan is in line with your current tax and non-tax objectives, please contact your Vorys attorney.