



## COMMITTEE REPORT: RETIREMENT BENEFITS

By **Bruce D. Steiner**

# Using Portability for Retirement Benefits

Under ATRA, IRA owners can have their cake and eat it too

**T**he American Taxpayer Relief Act of 2012 (ATRA)<sup>1</sup> made the applicable exclusion amount (estate tax-exempt amount) permanent at \$5.25 million, indexed for inflation. It also made portability permanent.<sup>2</sup>

For this purpose, “permanent” doesn’t mean that the estate tax-exempt amount will never change. Indeed, the Obama administration has proposed reducing the estate tax-exempt amount to \$3.5 million, effective in 2018, and repealing the indexing of the exempt amount for inflation.<sup>3</sup> However, the administration proposes to retain portability. The higher exemption amount and portability provisions in ATRA open up some new possibilities when it comes to retirement benefits planning.

### Statutory History

The estate tax-exempt amount was substantially lower for many years. The Economic Recovery Tax Act of 1981<sup>4</sup> increased the exempt amount from \$175,625 to \$600,000, phased in from 1982 through 1987. The Taxpayer Relief Act of 1997<sup>5</sup> increased the exempt amount from \$600,000 to \$1 million, phased in from 1998 through 2006. The exempt amount had reached \$675,000 in 2001 when the Economic Growth and Tax Recovery Reconciliation Act of 2001 (EGTRRA)<sup>6</sup> increased it to \$1 million in 2002-03, \$1.5 million in 2004-05, \$2 million in 2006-08 and \$3.5 million in 2009. Under EGTRRA, there wouldn’t have been any estate tax in 2010. However, the prior law would have returned in 2011, with a \$1 million exempt amount.

The Tax Relief, Unemployment Insurance



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Reauthorization and Job Creation Act of 2010<sup>7</sup> reinstated the estate tax for 2010, with a \$5 million exempt amount, but allowed estates to elect carryover basis (with certain adjustments) in lieu of estate tax. The exempt amount was \$5 million in 2011, indexed for inflation, and portability was introduced. However, the pre-EGTRRA law was scheduled to return in 2013, with a \$1 million exempt amount. ATRA made permanent the \$5 million exempt amount, indexed from 2011, and made portability permanent.

### Credit Shelter Trusts

Before portability, most married individuals left the estate tax-exempt amount to a credit shelter trust, so that the assets would be available for the benefit of the surviving spouse, but wouldn’t be included in the surviving spouse’s estate. Under portability, it’s no longer necessary to create a credit shelter trust to keep the exempt amount out of the surviving spouse’s estate. However, there are still some benefits to creating a credit shelter trust. **Since portability isn’t indexed for inflation, the credit shelter trust can shelter not only the exempt amount, but also the income and growth thereon during the surviving spouse’s lifetime.** In addition, portability isn’t available for the generation-skipping transfer (GST) tax exemption. Therefore, the credit shelter trust still makes sense for larger estates.

In smaller estates, a credit shelter trust may not be necessary to eliminate the estate tax and to shelter all of the assets from GST tax. However, there’s still a tradeoff. On one hand, the credit shelter trust protects against the surviving spouse’s potential creditors and future spouses and may provide protection if the surviving spouse ever wants Medicaid. On the other hand, trusts are generally subject to income tax at higher rates, and the assets in the credit shelter trust won’t receive a basis step-up at the surviving spouse’s death.



In this regard, ATRA increased the income tax cost of retaining income in a trust. A trust reaches the top income tax rate at \$11,950 of taxable income. ATRA increased the top income tax rate from 35 percent to 39.6 percent. At the same time, ATRA made permanent the income tax rate reductions enacted in 2001 and 2003 for individuals with income under \$400,000 (single) or \$450,000 (joint). Similarly, under the Affordable Care and Patient Protection Act, the 3.8 percent Medicare tax on net investment income applies to trusts with taxable income over \$11,950, but doesn't apply to individuals with taxable income under \$200,000 (single) or \$250,000 (joint). As a result, more beneficiaries will be in lower tax brackets than their trusts.

Trustees can mitigate the income tax cost by making distributions to carry out income. However, if the trustees distribute income, this will throw the income into the beneficiaries' estates and subject it to the beneficiaries' potential creditors, including ex-spouses. While it may sometimes be possible to distribute capital gains, it may not always be an option.<sup>8</sup>

Some states have state estate taxes, with exempt amounts lower than the federal exempt amount. For example, the exempt amount is \$1 million in New York and \$675,000 in New Jersey. Some states allow separate, state-only qualified terminable interest property (QTIP) elections, and others allow separate, state-only QTIP elections only when no federal estate tax return is filed. However, a detailed discussion of the issues involving state estate taxes is beyond the scope of this article.

## Retirement Benefits

When the estate tax-exempt amount was lower, many participants and individual retirement account owners didn't have sufficient nonretirement assets to fully fund the credit shelter trust. To that extent, they were faced with a tradeoff between the income tax advantages of leaving the retirement benefits to their spouse and the potential estate tax benefits of leaving the retirement benefits to the credit shelter trust or to or in trust for their children or grandchildren.

There are several income tax benefits to leaving

retirement benefits to a spouse. The spouse can roll them over into an IRA, name new beneficiaries, obtain a longer deferral period and convert to a Roth IRA. However, the retirement benefits will be included in the spouse's estate.

By leaving retirement benefits to a credit shelter trust, the benefits will be available for the spouse's use and won't be included in the spouse's estate. However, at best,

By electing portability, the surviving spouse can receive the benefit of the deceased's unused estate tax-exempt amount.

the benefits will have to be distributed over the spouse's life expectancy based on single life tables, instead of the two-life tables that apply to the spouse's own retirement accounts.<sup>9</sup> This gives up a substantial amount of income tax deferral,<sup>10</sup> in addition to subjecting the retirement benefits to income taxation at the trust's tax rates. The trustees can mitigate the income tax cost by making distributions. However, that will throw the distributions into the recipient's estate and expose them to the recipient's creditors, including ex-spouses, thus destroying the benefits of the credit shelter trust as to the amounts distributed.

Another possibility is to leave the retirement benefits to or in trust for the children or grandchildren. This allows the retirement benefits to be paid over the life expectancy of the children or grandchildren (limited to the life expectancy of the oldest beneficiary in the case of a trust) and keeps the retirement benefits out of the spouse's estate. However, the retirement benefits payable to or in trust for the children or grandchildren will no longer be available for the spouse.

Under ATRA, more participants and IRA owners can



leave their retirement benefits to their spouses, allowing them to have their cake and eat it too. By leaving the retirement benefits to their spouses, they can take advantage of the income tax benefits of the rollover. The spouse can name new beneficiaries, get a longer income tax deferral and, possibly, convert to a Roth IRA. By electing portability, the surviving spouse can receive the benefit of the deceased's unused estate tax-exempt amount. While portability isn't indexed for inflation and isn't available for purposes of the GST tax, the income tax benefits of the rollover and the possible Roth conversion will often outweigh portability's lack of indexing

### Bifurcating the retirement benefits destroys the ability to leave assets in a marital or credit shelter trust.

and its unavailability for GST tax purposes.

In this regard, the ability of the surviving spouse to convert to a Roth IRA is more valuable under ATRA. Providing in trust for children and grandchildren, rather than outright, keeps the assets out of the their estates and provides protection against creditors and spouses. However, trusts reach the 39.6 percent income tax bracket at \$11,950 of taxable income. **Because the surviving spouse won't reach the 39.6 percent income tax bracket until \$400,000 of taxable income (and the 35 percent bracket only applies to single taxpayers with taxable income between \$398,350 and \$400,000), many surviving spouses can convert to a Roth IRA at a tax bracket below 35 percent.** This will allow them to obtain the benefits of both the Roth conversion and leaving the retirement benefits to the children or grandchildren in trust, rather than outright, while incurring income tax at rates lower than 35 percent.<sup>11</sup>

#### Other Factors

Notwithstanding the increased exempt amount and portability, there will still be cases in which leaving all of the retirement benefits to the spouse may not be appropriate.

One such situation is a second marriage in which the retirement benefits are greater than the amount the participant or IRA owner wants to leave to her spouse. In this case, the participant or IRA owner could leave a portion of the retirement benefits to her spouse and a portion to or in trust for her children or grandchildren.<sup>12</sup> However, bifurcating the retirement benefits destroys the ability to leave assets in a marital or credit shelter trust that can provide the spouse whatever amounts she needs from time to time, while preserving for the children whatever amounts she doesn't need. This can be solved by leaving a portion of the retirement benefits to the spouse, a portion in trust for the spouse and a portion to or in trust for the children or grandchildren.

Another such situation occurs when the spouse is a spendthrift. If the participant or IRA owner were to leave the retirement benefits to the spouse, there's a concern that she would squander them. One solution is to leave some or all of the retirement benefits to or in trust for the children or grandchildren and other assets in trust for the spouse. 🌐

#### Endnotes

1. P.L. 112-240, H.R. 8, 112th Cong., 2d Sess.
2. For a comprehensive discussion of portability, see Stephanie G. Rapkin, "Portability: The New Estate Plan Modality," *Trusts & Estates* (May 2013), at p. 34.
3. General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 2013), [www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf](http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf).
4. P.L. 97-34.
5. P.L. 105-34.
6. P.L. 107-17.
7. P.L. 111-312.
8. Treasury Regulations Section 1.643(a)-3.
9. For a detailed discussion of trusts as beneficiaries of retirement benefits, see Bruce D. Steiner, "Trusts as Beneficiaries of Retirement Benefits," 29 *Estates, Gifts & Trusts J.* 108 (March 2004).
10. For a detailed discussion of this point, see Christopher R. Hoyt, "Retirement Assets to a Surviving Spouse: Rollovers and Portability Are Your First Choice," 26 *Probate & Property* No. 1, <http://ssrn.com/abstract=2014996> (Jan./Feb. 2012).
11. See Bruce D. Steiner, "Roth Conversions Are More Attractive Under ATRA," *Trusts & Estates* (April 2013), at p. 13.
12. In the case of a qualified plan, the spouse may be entitled to some or all of the retirement benefits under Internal Revenue Code Section 417. In addition, the spouse may be entitled to an elective share under state law.