Cannon Insights
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Planning Ideas—Retirement Distributions for Spouse

As clients transition to retirement, a key consideration is who to name as beneficiary of retirement assets including qualified retirement plans (QRPs) and Individual Retirement Accounts (IRAs). In many instances, the assets are intended for spousal support following the plan participant or owner's death. The issue becomes one of whether to name the spouse out right or a trust for his or her benefit as the beneficiary. To help clients decide, it's important for Advisors to know the various options and their advantages and disadvantages.

Outright to Spouse

When the spouse is named as direct beneficiary of retirement assets, he or she has several options:

- Treat the IRA as an inherited IRA;
- Roll the IRA over to his or her own IRA; and
- Roll the IRA/QRP over to her own QRP.

In most cases, the optimal *income tax* outcome occurs when the surviving spouse rolls over the decedent's retirement assets into his or her own IRA. A Spousal IRA gives the surviving spouse a "fresh start," meaning that the surviving spouse can delay receipt of distributions until the he or she reaches age 70 ½ and then take the distributions over his or her lifetime. This enhances the potential for tax-deferred accumulation of retirement assets in excess of minimum distributions.

However, the positive income tax outcome of a spousal rollover may be offset by a negative *estate tax* outcome, depending on the size of the couple's combined estate. Although retirement assets passing to the surviving spouse qualify for the marital deduction at the participant's death, the assets are included in the surviving spouse's estate at their *then* value. This amount could be considerable due to the tax-deferred growth potential associated with a Spousal IRA paid out over many years.

On the other hand, keep in mind that currently the law gives a married couple a combined $10 million-plus exemption, double the current $5.12 million individual estate tax exemption. Second, current law permits surviving spouses to utilize the unused portion of a surviving spouse's exemption at his or her subsequent death ("portability"). Thus, if a husband dies leaving his entire estate directly to his wife, the bequest qualifies for the marital deduction. So long as the value of the estate at the wife's death does not exceed the couple's combined estate tax exemptions, no estate tax will be due at either death.

Unfortunately, for clients with estates significantly larger than $10 million, reliance solely on portability to solve the estate tax problem is not an option.

Even for clients with smaller estates, many planners are wary of making the surviving spouse the direct beneficiary of retirement assets and relying on portability to eliminate estate taxes. After all, portability is set to expire at the end of 2012, and the maximum estate tax rate and exemption are set to return to 2001 levels (55 percent and $1 million per person, respectively), unless Congress acts to extend current law or create new legislation.

Credit Shelter Trust

For the reasons noted above (likely expiration of portability and possible return to higher estate tax rates and lower exemptions), some planners favor naming a credit shelter trust as the beneficiary of retirement assets, especially when larger estates are involved.

In most cases, the credit shelter trust allows for income distributions to the surviving spouse and provides him or her with a limited power of appointment over trust corpus and/or a general power of appointment limited by an ascertainable standard. This allows the surviving spouse to benefit significantly from the credit shelter trust, while preventing inclusion of trust assets in his or her gross estate.

Another perceived benefit of the credit shelter trust is that it should serve to better protect retirement assets from claims of the surviving spouse's creditors than a Spousal IRA. Only income distributed to the surviving spouse should be reachable by his or her creditors.

In general, IRAs and Roth IRAs enjoy a bankruptcy exemption of up to $1 million, which can be increased by the bankruptcy court "in the interests of justice." However, in the case of rollover IRAs from QRPs, the $1 million limitation does not apply inasmuch as QRP assets are completely exempt from bankruptcy.

The Bankruptcy Act is less clear in connection with "inherited IRAs." For example, assume a wife becomes the owner of her deceased husband's IRA and later files bankruptcy. In the absence of clear statutory guidance, courts have reached varied conclusions. In the case of *In Re: Nessa*, 105 AFTR 2nd 2010-1825 (April 9, 2010), the court exempted an inherited IRA while the court in *In Re: Chilton*, 105 AFTR 2nd 2010-1271 (March 5, 2010) reached the opposite conclusion on similar facts.

The Bankruptcy Act doesn't apply to the claims of judgment creditors, leading to a somewhat complex maze of state and federal regulation. Here's what's at the end of that maze.

In connection with QRPs, in the case of *Patterson v. Shumate,* 503 US 753 (1992), the Supreme Court held that QRPs are exempt from claims of judgment creditors due to ERISA's prohibition against assignment and alienation of such plans.

On the other hand, because traditional IRAs, Roth IRAs, rollover IRAs, and inherited IRAs are not subject to ERISA, state law comes into play. Unfortunately, applicable law varies from state to state, and different courts have interpreted similar language differently, thus making generalizations difficult. While it is safe to say that many states allow at least a partial exemption of some types of IRAs from the claims of judgment creditors, clients should seek the advice of their legal counsel when it comes to such matters.

The major downside to leaving retirement assets to a credit shelter trust relates to the interaction of the minimum distribution rules and the income tax. A deceased spouse's retirement account payable to such a trust must generally be liquidated over the remaining *life expectancy* of the surviving spouse as opposed to the actual years he or she lives. This can result in larger than necessary minimum distributions and larger than necessary income taxation for beneficiaries living longer than the government's actuarial tables assume. By comparison, with a rollover Spousal IRA the surviving spouse is allowed to recompute the minimum distribution on an annual basis to reflect his or her actual age.

The way to assure that the assets in a retirement account payable to a trust (including a credit shelter trust) are distributed for the entire life of a long-lived surviving spouse, rather than his or her shorter life expectancy, is by qualifying the trust as a *conduit trust.* A conduit trust redistributes to the surviving spouse all of the retirement distributions that it receives and does not accumulate any such distributions in the trust. Similarly to a Spousal IRA, with a conduit trust for a surviving spouse, the required distributions can be annually recomputed to take into account his or her gradually extending life expectancy.

The disadvantage here is that the estate tax exemption of the deceased spouse will have been wasted on a "wasting" asset instead of allocated to the sheltering of assets with greater appreciation potential.

QTIP Trust

An alternative to a Spousal IRA or a Credit Shelter Trust as beneficiary of the retirement assets is a Qualified Terminable Interest Property (QTIP) trust. The advantage is that the surviving spouse receives income from the trust during his or her lifetime and trust principal is protected from his or her creditors in a manner similar to a Credit Shelter Trust.

A downside is that assets remaining in the trust at the surviving spouse's death are included in that spouse's gross estate. If the value of the estate exceeds his or her exemption, estate taxes (and income taxes on remaining retirement asset payments) will be payable. Depending on the size of the estate and the asset mix, the surviving spouse's personal representative could face a liquidity crunch.

Bottom Line

While Credit Shelter and QTIP trusts may offer greater asset protection than Spousal IRAs, there are tradeoffs to naming these trusts as beneficiaries of retirement assets.

For large estates in excess of the spouses' combined estate tax exemptions, naming a Credit Shelter trust that is a conduit trust may make sense. Estate taxes are saved on tax-deferred accumulation and income taxes on distributions are no greater than they would have been had the surviving spouse rolled over the retirement distribution to a Spousal IRA.

For smaller family estates, not in excess of the spouses' exemption, rollover to a Spousal IRA should save income taxes, assure the surviving spouse of a lifetime income, and avoid estate taxes—at least through 2012 while portability remains an option. If portability goes by the wayside after 2012 and the exemption is reduced, even smaller estates should probably look to Credit Shelter Trusts as the beneficiary of large retirement accounts.

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