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ESTATE PLANNING FOR RETIREMENT and I.R.D. ASSETS

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- I. Taxation Of Retirement Plan Distributions - The Double Whammy of Income Tax and Estate Tax
- II. For Estates Near the \$5 Million Threshold, Consider a Pre-Mortem Roth IRA Conversion to Eliminate the Estate Tax
- III. Consider Charitable Bequests of IRD, Especially if the Income Tax Rates and the Estate Tax Rates Are Higher in Future Years

I. Taxation Of Retirement Plan Distributions - The Double Whammy of Income Tax and Estate Tax

A. Income Tax

1. Generally, every distribution that a person receives from his or her IRA or QRP account is fully taxable as **ordinary income**. Secs. 402(a) and 72 for Sec. 401(a) QRPs; Secs. 408(d) and 72 for IRAs. See Rev. Rul. 92-47, 1992-1 C.B. 198 for inherited IRAs.
2. Exceptions apply if :
 - (a) the distribution includes a return of non-deductible contributions, The return of a non-deductible contribution will be tax-free to the recipient. Secs. 402(a) and 72(b).
 - (b) a portion of the distribution is "rolled over" into another IRA or QRP, Sec. 402(c)). , or
 - (c) the distribution is a lump-sum distribution of the entire balance in an account of a Section 401(a) QRP that qualifies for the old ten-year forward-averaging tax. IRS Form 4972.
3. *Inherited Accounts*: Payments received after the death of the account owner by a beneficiary or by the probate estate are generally taxed in the same manner. An IRA or QRP will usually issue a Form 1099-R directly to the person who received the distribution and that person will be liable for the income tax rather than the probate estate. Sec. 691(a)(2); Reg. Secs. 1.691(a)-2(a)(2) and 1.691(a)-2(b); Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 1). The beneficiary will not be subject to the 10% early distribution penalty even if she or he is under the age of 59 1/2 or even if the account owner died before attaining the age of 59 1/2. Sec. 72(t)(2)(A)(ii) exempts distributions from the 10 percent early distribution penalty tax if they are made to the estate of the account owner or to a beneficiary after the death of the account owner.

In addition, most distributions after death are exempt from the 20% withholding provisions. There is mandatory income tax withholding for most distributions from QRPs to employees. Secs. 3405(c) and 402(c), enacted as part of The Unemployment Compensation Amendments of 1992 (Pub.L. 102-318). The 20% withholding requirement generally does not apply to a distribution from a QRP after a participant's death. Reg. Sec. 1.402(c)-2, Q & A-10(b). This is because the withholding requirement technically only applies to distributions that are eligible to be rolled over. Secs. 3405(c)(3), 402(c)(4), 402(f)(2)(A) and 403(a)(4). Most distributions after death are not eligible for rollover treatment. The only person who can rollover a distribution received after a participant's death is the surviving spouse. Sec. 402(c)(9), Reg. Sec. 1.402(c)-2, Q & A-10(a) and Reg. Sec. 1.402(a)(5)-1, Q-1. Consequently, the

only post-death distributions that are subject to the 20% withholding requirement are those made to a surviving spouse.

The beneficiary could, however, be subject to the 50% penalty tax if distributions are not received in accordance with the minimum distribution rules described above. Secs. 4974 and 401(a)(9)(B); Reg. Sec. 54.4974-1.

B. Estate Tax

1. The federal estate tax is imposed on transfers of wealth at death, including assets held in IRAs and QRP accounts. IRAs, QRP assets, conventional annuities, Sec. 403(b) annuities and other deferred compensation assets are reported on the federal estate tax return (Form 706). Sec. 2039.
2. These assets are fully included in the gross estate, even though one can argue that the amounts are inflated since the heir or the estate will pay income tax upon the receipt of any distribution. At one time Congress had provided relief for this situation by excluding a portion of QRP assets from the estate tax, but Congress repealed this relief for most individuals who die after 1984. Former Sec. 2039(c) was repealed by the Tax Reform Act of 1984, Pub. L. 98-396. Today the principal relief is that the heir who receives distributions can claim an itemized income tax deduction for the portion of the federal estate tax attributable to the IRD, described below.
3. Income Tax Deduction for Federal Estate Tax on IRD
 - a. A beneficiary is entitled to deduct the federal estate tax attributable to IRD in the same taxable year that the IRD is included in the beneficiary's income. Sec. 691(c)(1)(A); Reg. Sec. 1.691(c)-1(a); Rev. Rul. 92-47, 1992-1 C.B. 198 (Holding 2).
 - b. The amount is computed based on the highest marginal estate tax rate imposed on the estate. The estate tax attributable to the IRD is computed by comparing the amount of estate tax that would have been paid if the estate had no IRD with the actual amount of estate tax that the estate paid with the IRD. Sec. 691(c)(2)(C).
 - c. The deduction is reduced by any estate tax credits -- most notably the state tax credit. Sec. 691(c)(2)(A). The state tax credit is contained in Sec. 2011. It was eliminated in the year 2007 but is scheduled to return in the year 2013 after the "Bush Tax Cuts" expire. The

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