

RETIREMENT ACCOUNTS: PLANNING FOR SECOND MARRIAGES

ACTEC HEART OF AMERICA FELLOWS INSTITUTE

Class II – Master Session – St. Louis

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RETIREMENT PLANS SUBJECT TO THE LAW

- **Section 401(a)** - Employer pension, profit sharing and stock bonus plans [*incl. 401(k)*]
- **Section 408** – IRAs
- Section 403(b) - School and charity employers
- Section 457(b) plans - Government and tax-exempt employers

WHAT THE QRPs HAVE IN COMMON

- **1. Defer income taxation**
- **2. 10% penalty** - on most taxable distributions received before age 59 1/2
- **3. RMDs** - 50% penalty for failure
- **4. Taxation** – ordinary income; no 3.8%

DIFFERENCES AMONG THE RETIREMENT PLANS

Section 401(a) - Employer pension, profit sharing and stock bonus plans [*incl. 401(k)*]

- Your employer has your money
- Congress: you need protections from business failures; from creditors of your employer; from your own creditors
- ERISA

DIFFERENCES AMONG THE RETIREMENT PLANS

Section 408 – IRAs

- You select trustee / custodian of your IRA with a regulated financial institution
- There is no need to impose the many complicated ERISA laws to IRAs

DIFFERENCES AMONG THE RETIREMENT PLANS

Bottom Line:

- Your rights to your **401(k)** account are governed almost exclusively by **federal law**
- Your rights to your **IRA** are governed primarily by **your state's law**

DIFFERENCES AMONG THE RETIREMENT PLANS

Example:

Your right to get money while employed

- **401(k):** Generally, no right to money until terminate employment. *Possible exceptions:*
 1. loan
 2. hardship distribution
 3. Age 59 1/2
- **IRA :** No law restricts access to money.
(if under 59 ½, may have to pay IRS 10% penalty)

DIFFERENCES AMONG THE RETIREMENT PLANS

How accounts are split & taxed at divorce

- **401(k):** Need a QDRO
“Qualified Domestic Relations Order” §414(p)

§401(a)(13) - Assignment and alienation.

(A) In general. A trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan **may not be assigned or alienated.**

(B) Special rules for domestic relations orders.

Subparagraph (A) *shall* apply to the creation, assignment, or recognition of a right to any benefit payable with respect to a participant pursuant to a domestic relations order, ***except that subparagraph (A) shall not apply if the order is determined to be a qualified domestic relations order.***

DIFFERENCES AMONG THE RETIREMENT PLANS

How accounts are split & taxed at divorce

- **401(k): Need a QDRO**

“Qualified Domestic Relations Order” §414(p)

- **IRA : Simply divide IRA between spouses**

No QDRO for *IRA* in Divorce

§408(d)(6) Transfer of account incident to divorce

The transfer of an individual's interest in an individual retirement account or an individual retirement annuity to his spouse or former spouse under a divorce or separation instrument ...**is not to be considered a taxable transfer made by such individual** notwithstanding any other provision of this subtitle, **and such interest at the time of the transfer is to be treated as an individual retirement account of such spouse, and not of such individual.** Thereafter such account or annuity for purposes of this subtitle is to be treated as maintained for the benefit of such spouse.

§72(t) – Additional 10% tax

(t) 10-percent additional tax on early distributions from qualified retirement plans.

(1) Imposition of additional tax. If any taxpayer receives any amount from a qualified retirement plan (as defined in section 4974(c)), the taxpayer's tax under this chapter for the taxable year in which such amount is received shall be increased by an amount equal to 10 percent of the portion of such amount which is includible in gross income.

(2) Subsection not to apply to certain distributions. Except as provided in paragraphs (3) and (4), *paragraph (1) shall not apply to any of the following distributions:*

(A) In general. Distributions which are--

- (i) made on or after the date on which the employee attains *age 59 1/2* ,**
- (ii) made to a beneficiary (or to the estate of the employee) on or *after the death of the employee.***

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(A) In general. Distributions which are--

(i) made on or after the date on which the employee attains age 59 1/2 ,

(C) Payments to alternate payees pursuant to qualified domestic relations orders. Any distribution to an alternate payee pursuant to a qualified domestic relations order (within the meaning of section 414(p)(1)).

A QDRO is only for a §401(a) plan (profit sharing, 401(k) etc)

A 10% penalty does apply to a distribution received from an IRA that was split after a divorce, if the recipient is under age 59 ½.

Why? Because IRAs (§408) are not divided pursuant to a §414(p) QDRO

DIFFERENCES AMONG THE RETIREMENT PLANS

How accounts are split & taxed at divorce

- **401(k): Need a QDRO**

- * *Distributions to ex-spouse are taxable income*

- * *No 10% penalty for QDRO distribution, if under 59 ½*

- **IRA : Simply divide IRA between spouses**

- * *Distributions to ex-spouse are taxable income*

- * *Yes 10% penalty if recipient is under age 59 ½*

MARRIED COUPLES: PLANNING WITH RETIREMENT ASSETS

MARRIED COUPLES: RETIREMENT ASSETS

Tax Planning:

- Rollovers ? -- Funding Trusts ?***
- Second Marriages ?***

Legal Rights

- 401(k) plans: federal law***
- IRAs: state laws***

MARRIED COUPLES: RETIREMENT ASSETS

Surviving spouse has an option that no other beneficiary has:

a **rollover** of deceased spouse's retirement assets to her or his own new IRA

(creditor protection, too!)

Other beneficiaries only option: **an inherited IRA**, usually ***liquidated within ten years.***

MARRIED COUPLES: RETIREMENT ASSETS

Should the estate plan provide:

-- a **rollover** of deceased spouse's retirement assets to a new IRA?

-- or --

-- the deceased spouse's retirement assets are payable to a **trust for the surviving spouse?**

MANDATORY DISTRIBUTIONS

[Assume inherit IRA at age 80 and die at 94]

D. John Mustard owned three IRAs when he died this year at age 93. His surviving spouse, Honey, turned age 80 the year after his death. Each IRA had a different beneficiary:

- An accumulation trust for Honey, remainder to his children from his first marriage
- A conduit trust for Honey, remainder to his children from his first marriage
- Honey was the sole beneficiary (rollover is possible)

MANDATORY DISTRIBUTIONS

[Assume inherit IRA at age 80 and die at 94]

<u>AGE</u>	<u>ROLL - OVER</u>	<u>Accumulation Trust</u>	<u>Conduit Trust</u>
80	4.95%	-0%	8.93%
85	6.25%	-0%	12.35%
90	8.26%	100.00%	<< 10 years, since is %
91	8.77%	empty	an accumulation trust%
92	9.26%	empty	20.41%

MANDATORY DISTRIBUTIONS
[Assume inherit IRA at age 80 and die at 94]

Conduit Trust for Surviving Spouse?

- 1. A conduit trust with several beneficiaries permits an EDB to receive distributions over remaining life expectancy, rather than just ten years (There are RMDs every year, though)**

- 2. A surviving spouse can annually recompute remaining life expectancy**

MANDATORY DISTRIBUTIONS
[Assume inherit IRA at age 80 and die at 94]

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91	8.77%	empty	18.87%
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IRS PLRs: Surviving Spouse *Rollover*

20+ IRS Private Letter Rulings – 2015-2020

Surviving spouse can rollover deceased spouse's IRA, even when the account is payable to:

- Trust for the spouse
- The estate, with estate pour-over into a trust for the spouse
- The estate, where the spouse is the sole or residuary beneficiary of the estate

IRAs in SECOND MARRIAGES

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IRAs in SECOND MARRIAGES

SURVIVING SPOUSE ROLLOVER?

- The surviving spouse sets up a new IRA in her/his own name
- Then the surviving spouse selects the beneficiaries upon death
- What assurance that a child from the deceased spouse's prior marriage will be named as a beneficiary?

IRAs in SECOND MARRIAGES

- All IRAs to spouse? Buy some life insurance for children?
- Divide IRAs? Some to spouse;
some to children from prior marriage
*-- caution: 401(k) & ERISA plans:
100% to spouse, unless executes waiver*

MARRIED COUPLES: 401(a) RETIREMENT ASSETS

Legal Rights: Regardless of who a plan participant named as a beneficiary of a 401(a) account, the surviving spouse is entitled to 100% of the assets in the account ***unless*** that spouse executed a waiver. By comparison, IRAs are generally subject to state laws, including general divorce and community property laws.

MARRIED COUPLES: 401(a) RETIREMENT ASSETS

A Waiver:

A spouse may waive the privilege to receive the entire account balance by executing a qualified waiver. Such a waiver is also required for other transactions that might reduce a surviving spouse's benefit at death, such as a rollover from a QRP to an IRA.

MARRIED COUPLES: 401(a) RETIREMENT ASSETS

A Waiver:

- Prenuptial agreements usually ineffective
- The waiver must be signed while married; must acknowledge the effect of the waiver; and must be witnessed by a plan representative or by a notary public

IRAs in SECOND MARRIAGES

-- 401(k) versus IRA --

Divorce? Then die? And the will or a life insurance policy never changed (still names former spouse as beneficiary)?

- State law in most states: Then the former spouse will not receive under the will, unless the decedent reaffirmed intent that the former spouse should inherit.

IRAs in SECOND MARRIAGES

-- 401(k) versus IRA --

Facts: Man dies with ex-spouse still named as beneficiary of retirement account and company group-term life insurance. There are children from a prior marriage.

- U.S. Supreme Court: ERISA pre-empts state law. Ex-spouse gets 100% since she is named as beneficiary. *Egglehoff v. Egglehoff*

IRAs in SECOND MARRIAGES

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- U.S. Supreme Court: ERISA pre-empts state law. Ex-spouse gets 100% since she is named as beneficiary. *Egglehoff v. Egglehoff*
- **IRAs?** Probably follow state laws

IRAs in SECOND MARRIAGES

- All IRAs to spouse? Buy some life insurance for children?
- Divide IRAs? Some to spouse; some to children from prior marriage
- IRAs to a 2-generation charitable remainder trust ?

CHARITABLE REMAINDER TRUST

- Payment to non-charitable beneficiary (ies) for life *or* for a term of years
(maximum 20 years)
- Remainder interest distributed to charity
- ***Exempt from income tax***

2-GENERATION CHARITABLE REMAINDER TRUST

- Typically pays 5% to elderly surviving spouse for life, then 5% to children for life, then liquidates to charity
- Like an IRA, a CRT is exempt from income tax
- Can be like ***a credit-shelter trust for IRD assets*** [no estate tax marital deduction]

2-GENERATION CHARITABLE REMAINDER TRUST

- Can be a solution for ***second marriages*** when estate is top-heavy with retirement assets.
Example:
 - Half of IRA to surviving spouse
 - Other half of IRA to a CRT for 2nd spouse and children from 1st marriage

2-GENERATION CHARITABLE REMAINDER TRUST

TECHNICAL REQUIREMENTS

- Minimum 10% charitable deduction
-- all children should be over age 30
- CRUT – minimum 5% annual distrib
- No estate tax *marital* deduction
- Charitable intent !

MANDATORY DISTRIBUTIONS

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IRAs in SECOND MARRIAGES

- All IRAs to spouse? Buy some life insurance for children?
- Divide IRAs? Some to spouse; some to children
- IRAs to a 2-generation charitable remainder trust ?
- What about the grandchildren?
(Trust assets go to charity upon death of last child)
- Solution: Life insurance on lives of the children, to benefit grandchildren

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