Estate Planning Today
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Estate Planning For Retirement Plans

Naming an appropriate beneficiary for your 401(k) plan, profit-sharing plan, IRA or other retirement plan assets can ensure proper coordination with your Will, as well as maximum deferral of income and estate taxes.

Taxation of Retirement Assets - In General

Retirement plan assets have been described as the best place to have your assets during your lifetime, and the worst place to have your assets when you die. Money contributed to retirement plans is not taxable to the plan participant at the time of contribution, and the income earned by the retirement account is tax-free until withdrawn. These features make retirement assets an ideal investment during your lifetime. Unfortunately, however, assets owned by you at death and held in a pension plan, profit-sharing plan, 401(k), IRA, KEOGH, SEP, 403(b) or other retirement account will be subject to both income tax *and* estate tax. This combination of taxes can mean that 80% or more of the retirement plan assets remaining on hand at your death will be taken in the form of taxes.

Retirement plan withdrawals are invariably subject to income tax. Any person who receives money distributed from a retirement plan must report the distributed funds as taxable income. These rules apply not only to the person for whose benefit the plan was established (known as the "participant"), but also to persons who receive the retirement assets after the death of the participant (known as the "beneficiaries").

Although retirement plan assets must ultimately be subjected to income taxes, these taxes can, in many cases, be postponed for an extended period of time. During this deferral period, the benefit of tax-free compound growth continues to make retirement plans an extremely effective and immensely popular way to accumulate wealth. The focus of estate planning for retirement plan participants is to ensure passage of retirement plan assets to the intended beneficiaries, while at the same time reducing "transfer" taxes (i.e., estate, gift, and generation-skipping taxes) and the impact of the "minimum required distribution" rules (discussed below). This process ensures that the participant's spouse, children, and other descendants have maximum access to retirement funds, while being given an opportunity to defer or avoid taxes to the greatest possible extent.

While recent legislation eliminated some of the penalty taxes on retirement plan assets, if a distribution is taken prematurely from a retirement account, a 10% penalty tax is imposed, and if the required minimum distribution is not taken, a 50% penalty tax is imposed. Penalty taxes can be avoided by clearly following the rules.

The Minimum Required Distribution Rules

Minimum required distributions must begin no later than April 1st of the year following the year the participant attains age 70½. The April 1st date is actually an optional delay of the distribution that is required for the year that the participant turns age 70½. If the first required distribution is deferred until April 1st of the year after the participant turns age 70½, a second required distribution must still be made for that year. Retirement plan participants who continue to work past age 70½ and who do not own 5% or more of the business that sponsors the retirement plan can wait until April 1st of the year following their retirement. In either event, the date that minimum required distributions must begin is known as the participant's "required beginning date" or "RBD."

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The amount of the minimum required distribution in each calendar year is equal to the amount in all retirement plans as of December 31st of the prior year, divided by the remaining life expectancy of the participant. If the participant has named a "designated beneficiary" of the retirement plan (a phrase with a special legal meaning, discussed below), the amount of the required distribution is equal to the amount in all retirement plans as of December 31st of the prior year, divided by the *joint* life expectancy of the participant and the designated beneficiary. This fraction is adjusted every year to reflect the passage of time. The goal of most clients is to maximize income tax deferral as much as possible. Therefore, most clients try to make the minimum required distribution as small as possible. Obviously, taking distributions over the joint life expectancy of the participant and a designated beneficiary will provide greater deferral than utilizing merely the participant's life expectancy.

Joint life expectancies are available only if the participant has named a "*designated beneficiary*" on or before the required beginning date. Simply naming a *beneficiary* of a retirement account is not enough to ensure maximum deferral of retirement plan taxes. The phrase "designated beneficiary" is a term of art subject to a rather technical set of rules. In most cases, only a human being can qualify as a "designated beneficiary." If the participant names his favorite charity, a family limited partnership, his estate or most trusts as the beneficiary of his or her retirement account, the IRS treats the participant as not having a "designated beneficiary" for purposes of maximizing deferral through joint life expectancies. The participant's single life expectancy must be used instead.

Most married retirement plan participants want to name their spouse as the beneficiary of their retirement plan assets. In fact, since 1984, federal law has required that, for most retirement plans (but not IRAs), a married participant cannot name a beneficiary other than the participant's spouse unless the spouse consents in writing. Naming one's spouse as a beneficiary often comports with the participant's estate planning objective of providing for the surviving spouse. For some plan participants, however, a different beneficiary is more appropriate. In a second marriage situation, for example, the participant may want some or all of his or her retirement assets to pass to children by a former marriage. If multiple individual beneficiaries are named for a single, undivided account, the oldest beneficiary's life expectancy must be used in calculating the required distributions. Also, if any of the multiple beneficiaries is not a human being (e.g., a charity), the participant will be treated as not having a designated beneficiary. Separate accounts or special wording in the beneficiary designation should be used to obtain the desired treatment in these cases.

As noted above, minimum required distributions are computed based on a fraction, the numerator of which is the balance in the retirement account and the denominator of which is the life expectancy of the plan participant (or the joint life expectancy of the participant and the participant's "designated beneficiary," if one has been named). The regulations generally provide that life expectancy is reduced by one year for each year that passes. In fact, however, actuarial studies show that for each year that passes, the life expectancy of the typical retired American is normally reduced by about 7/10ths of a year (not a full year). In order to take advantage of this fact, the regulations permit the participant and the participant's spouse (or either of them) to *recalculate* their life expectancies each year.

While recalculation is advantageous during the participant's lifetime (in terms of maximizing income tax deferral), the life expectancy of a party which was being recalculated is reduced to *zero* in the year after that party dies. This rule has the unpleasant effect of considerably *accelerating* the payment of income taxes after the death of the plan participant. For example, if the participant and his spouse were recalculating their joint life expectancies and the spouse were to die in the second year of an original joint life expectancy of 22 years and the participant were to die in the third year, the ultimate beneficiaries (for example, the children) would have to withdraw 100% of the remaining balance by December 31 of the year following the participant's death. If a fixed joint life expectancy had been used, the children would have had 19 more years of tax deferral. This is why recalculating both life expectancies is not recommended. Spouses may utilize the fixed life expectancy method; alternatively, a hybrid approach may be used, whereby the participant's life expectancy is recalculated, but the life expectancy of the nonparticipant spouse is not.

Trusts and the "Designated Beneficiary" Rules

Special Rules for Trusts. Because of the important role that trusts play in death tax avoidance, creditor protection, divorce protection, and asset management, many clients want to utilize trusts to receive their retirement assets at the time of their death. As a result, the regulations make a special exception for trusts that meet five specific requirements. If all of these requirements are met, then the trust's beneficiaries are treated as "designated beneficiaries," and the life expectancy of the oldest beneficiary of the trust is used to measure the minimum required distributions from the retirement account. Specifically, the five requirements are that (1) the beneficiaries of the trust must be identifiable from the trust instrument; (2) the trust beneficiaries must all be individuals; (3) the trust must be valid under state law; (4) a copy of the trust must be provided to the plan administrator or IRA custodian; and (5) the trust must be irrevocable on the later of the participant's death or RBD.

Unfortunately, the proposed treasury regulations to the Internal Revenue Code regarding naming trusts as beneficiaries of retirement plans are ambiguous with respect to many technical issues (most of which are beyond the scope of this Newsletter). Practitioners have been developing their understanding of these rules through private letter rulings issued by the Internal Revenue Service. For example, estate planners commonly add language to trusts giving one or more trust beneficiaries a "general power of appointment" (i.e., the power to direct trust assets to other persons or entities). The IRS asserts that this language disqualifies the trust from being treated as a designated beneficiary (because all of the beneficiaries of the trust are not identifiable). There is no clear statute or court case on this issue (nor on many other important issues involving retirement plans and trusts).

Naming a Bypass Trust. While general powers of appointment are never used in a bypass trust (so this particular problem doesn't arise in that context), there is a difference in the income tax deferral that can be achieved when retirement accounts pass directly to a spouse, for example, versus to a bypass trust for the benefit of the spouse and children. A spouse as a designated beneficiary can roll over retirement accounts passing to him or her and name new beneficiaries. This amounts to a "fresh start" under the minimum distribution rules. Suppose the spouse designates the children as the beneficiaries of the IRA rollover. While a special tax rule treats the children as no more than ten years younger than the spouse during her lifetime (even this adds ten years to the spouse's single life expectancy and reduces the otherwise required distribution), once the surviving spouse dies, the children can continue the deferral by taking distributions of the remaining account balance over the oldest child's life expectancy. This "stretch-out" IRA opportunity is lost if the retirement accounts pass to the bypass trust. In this example, if the participant had already begun taking required distributions, distributions will be made to the trust under the "at least as rapidly" rule. This means that the retirement account continues to be distributed based on the method elected at the participant's RBD. If the participant dies before reaching RBD having named the bypass trust as his or her beneficiary, distributions are based on the surviving spouse's single life expectancy (as the oldest beneficiary of the trust). Of course, on the surviving spouse's death, undistributed retirement accounts owned by the bypass trust are not subject to estate taxation in that spouse's estate. Thus, there is a trade off. Because of these differences, and also partly due to the uncertain interpretation of some of the trust rules, the safest and most flexible approach in many cases involves naming an individual, such as the participant's spouse, as the primary beneficiary of retirement plan benefits, while naming a trust, or the trustee in a person's Will, as the contingent beneficiary. In this way, the participant will clearly have a designated beneficiary upon reaching his RBD and, upon the participant's death, the surviving spouse can disclaim amounts necessary to fund a bypass trust created in the participant's Will (for example) and roll over the rest. Through the creative use of disclaimers and other post-mortem planning techniques (such as non pro rata partitions and exchanges), the bypass trust can be funded with the "best" assets and the pretax assets can be owned by the surviving spouse.

Community Property Issues

In 1997, the United States Supreme Court decided the case of *Boggs vs. Boggs*. This important decision has a direct impact on estate planning for qualified retirement plans in community property states. The essence of the *Boggs* case is that the "nonparticipant spouse" does not have a right to dispose of her community property interest in the participant spouse's qualified retirement plans. The *Boggs* case does <u>not</u> stand for the proposition that qualified retirement plans accumulated by married persons living in community property states are not community property; only that if the nonparticipant spouse dies first, she cannot dispose of her interest in the plan to anyone. The *Boggs* case does not apply to individual retirement accounts (IRAs), and presumably does not apply to IRA rollovers from qualified plans. Because IRAs are not qualified plans under ERISA (the federal law governing employer-sponsored retirement plans), they do not come within the *Boggs* ruling. Thus, under Texas law, the nonparticipant spouse continues to have the ability to dispose of her 50% community property interest in the participant spouse's IRA or IRA rollover. For this reason, where the primary asset belonging to a couple is one spouse's qualified plan, estate planners frequently recommend that the participant roll over his or her qualified plans to IRAs after retirement to avoid the *Boggs* problem.

By the way, another reason to consider a rollover of a qualified plan to an IRA is to avoid immediate distribution from a qualified plan after the participant's death if a trust is named as (or becomes) the beneficiary of the plan. Many qualified plans require this result, even though tax laws would otherwise permit deferral.

NUA Stock Considerations

Rolling over a qualified plan to an IRA is not the best strategy for all clients. One important exception to the general planning recommendation of implementing an IRA rollover arises if the qualified plan holds stock in the employer sponsoring the plan. The primary benefit of taking a distribution of employer stock, versus rolling it over with the rest of the plan assets into an IRA, is the ability to defer the gain ("net unrealized appreciation" or "NUA") until the stock is sold; it is then taxed at long term capital gains rates rather than as ordinary income. When employer stock is distributed as a lump sum distribution to the participant, it is taxed according to the usual lump sum distribution rules, except that the NUA is not currently included in the recipient's gross income. Only the basis (i.e., the cost of the stock at the time of its contribution to the plan) is subject to income tax at the time of the distribution. If the participant later sells the stock, the difference between his basis and the proceeds (i.e., the NUA) is taxed at long term capital gains rates. (Appreciation after the date of the lump sum distribution would be either short term or long term capital gain, depending upon whether the stock is held for more than one year from the distribution date). One often overlooked rule involving NUA stock, however, is that there is no step up in basis for such stock on the death of the participant. Also, caution is warranted in the mechanics of taking NUA benefits as a lump sum distribution while rolling over the balance of the qualified plan to an IRA. A person planning to take advantage of this opportunity should obtain assistance from a qualified professional.

Contact Us:

If you have any questions about the material in this issue, or if we can be of assistance to you in your estate planning, feel free to contact us at the address and phone number shown below. You can also reach us by e-mail addressed to:

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