Taking Maximum Advantage Of Retirement Plan Assets

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Retirement plan assets can be the worst assets in your client's estate, or they can be the best. Without proper planning, these assets might be subject both to estate tax and to income tax, so that heirs could receive as little as 25 percent of the assets. With proper planning, these same assets can multiply many times over and the income tax due will be paid with dollars generated by tax free compounding. The estate planner's challenge is to maximize tax free growth while minimizing the tax bite.

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Contributions to a retirement account (and the subsequent earnings on these contributions) are not subject to income tax until withdrawn. This allows retirement plan assets ("plan" will include all qualified retirement plans under IRC §401(a), such as 401(k) plans and defined benefit plans, 403(b) plans and IRAs, but not Roth IRAs) to grow more quickly than assets subject to current income tax. Because the power of tax deferred growth is so significant, the primary objective is to keep the plan assets in the tax free environment for as long as legally possible. Of course, if additional funds are required by the client or the heirs, then the assets can be removed sooner.

Ideally, one would remove funds from the plan only when money is needed to provide retirement income. Congress, however, has determined that plan funds must be withdrawn over a designated time period once your client reaches his or her required beginning date, which is generally the April 1 of the calendar year following the calendar year in which the client reaches age 70½. It is anticipated that Congress will push the required beginning date back to age 75 in the near future.

Before jumping into the required minimum distribution rules, we take a step back to understand the big picture. First, look at a worst case scenario. Your client has designated his or her child to receive his plan assets in one lump sum upon his death. Plan assets are taxable in the participant's gross estate for federal estate tax purposes unless sheltered by the marital or estate tax deduction. Because the assets have never been subject to income tax during the participant's lifetime, the assets will also be subject to immediate income taxation when distributed from the plan. A lump sum distribution to a descendant results in the largest possible income taxation. Depending on the decedent's income and estate tax brackets, the tax bite at death could be quite significant.

Now contrast that worst scenario with the best – the IRA legacy (sometimes called the multi-generational IRA or Stretch IRA) which is designed to keep plan assets in a tax free environment for as long as possible. Your client has a carefully prepared beneficiary designation naming his spouse as beneficiary. The

spouse can roll over the funds to her or his own IRA, disclaim some or all of the assets into your client's by-pass trust, or retain the assets in the client's IRA. (We provide a written memo with our designations so that the client's spouse, perhaps many years later, will have some guidance when deciding what to do.) If there is no surviving spouse, then this best case designation provides for separate shares for the children and/or grandchildren.

Let us assume that the client leaves a surviving spouse who is not young and there are sufficient other assets to fund the by-pass trust. The surviving spouse should then decide to establish a rollover IRA, designating the children as beneficiaries. During the spouse's lifetime, she or he will be required to take out distributions based on her or his life expectancy and that of a hypothetical beneficiary ten years younger than the spouse.

Both life expectancies are recalculated annually, thereby extending the measuring period. After the death of the spouse, withdrawals are based on the oldest child's life expectancy (unless the spouse creates separate shares for each child). Income taxes are significantly deferred, thus providing the opportunity for tax free compounding on these assets.

Alternatively, assume that the surviving spouse was not yet 59½ and needed money. This spouse could choose to keep the decedent's IRA as an inherited IRA and begin receiving distributions immediately without the 10 percent penalty. Because the surviving spouse was named the designated beneficiary, the estate tax liability was postponed until her death, due to the marital deduction. This approach, however, sacrifices some income tax deferral. During the spouse's lifetime, withdrawals are based on her or his recalculated life expectancy. After the death of the spouse, withdrawals are based on her or his unrecalculated life expectancy applicable at the time of death.

In another IRA legacy variation, grandchildren are the designated beneficiaries. Because estate taxes on the IRA are due when the client dies, this technique works best when non-IRA assets pay the estate taxes generated by the IRA, so that the maximum amount of plan assets are retained in a tax deferred environment. Upon the client's death, the measuring period for required minimum distributions is the actual life expectancy of the grandchildren. When using this variation, consider allocating the generation skipping transfer tax exemption to these assets.

These numbers illustrate the impact of tax-free compounding Assume the client is 70½ with $3,000,000 in the IRA, the IRA appreciates at a steady 7 percent rate, the client takes only required minimum distributions and the client has designated a 40 year old child as beneficiary. Assume further that the client dies at age 90½. At that time, the value of the IRA would be approximately $3,900,000. If the estate does not use IRA assets to pay estate taxes and the child receives required minimum distributions for the balance of the child's life, the child could receive approximately $8,000,000 from the IRA on an after-tax basis, provided the child enjoys a similarly long life.

The IRA legacy is extremely flexible. Your clients are not bound regarding distributions. If they want to increase IRA distributions beyond that required by the minimum distribution rules in any year, they are free to do so without penalty. They simply lose the opportunity for tax deferred growth on the incremental withdrawal and subject those assets to income tax earlier than otherwise required.

Required minimum distributions Rules. Distributions from qualified retirement plans are governed by IRC §401(a)(9). IRC §408(a)(6) applies the same rules to IRAs. On April 17, 2002, the IRS issued final regulations ("regs") governing required minimum distributions. The final regs apply to distributions made in 2003 or thereafter. For 2002, IRA owners and plan participants may determine required minimum distributions under the final regs, the 2001 Proposed Regulations, or the 1987 Proposed Regulations. In most situations, the final regs produce smaller required minimum distributions than the 1987 Proposed Regulations. The terms of a particular plan, however, may not permit all of the options permitted by the regs. In that event, the more restrictive terms of the plan control.

Required Beginning Date: The required beginning date is the date on which distributions from a plan must begin in order to avoid penalties. Distributions from an IRA or from a plan in which the participant is a 5 percent (or more) owner of the plan sponsor must begin no later than April 1 of the calendar year following the calendar year in which the participant or IRA owner reaches age 70½. Distributions from a plan in which the participant is not a 5 percent (or more) owner, however, may be delayed until April 1 of the year Following the year in which the participant retires, if that date is later than the year in which the participant reached age 70½.

Distributions During Participant's Lifetime: During a participant's ("participant" will include an IRA owner unless otherwise specified) lifetime, required minimum distributions are, in most situations, determined by using the IRS Uniform Lifetime Table ("Uniform Table") which is included in the regs. The required minimum distributions is determined by locating on the Uniform Table the appropriate life expectancy factor (called the "applicable distribution period") which serves as a divisor for a person of a given age.

The account balance as of the end of one calendar year is divided by the divisor to determine the required minimum distributions for the subsequent calendar year. The divisor represents the joint and survivor life expectancies (based on IRS life expectancy tables) of the participant and a hypothetical individual who is ten years younger than the participant, with both life expectancies being recalculated each year.

If a participant's spouse is more than ten years younger than the participant, then the participant's required minimum distributions is determine by recalculating the actual joint and survivor life expectancies for the participant and the spouse. In other words, the actual life expectancy of the younger spouse is taken into account (this is sometimes referred to as the "younger spouse" rule). Because the required minimum distributions during the participant's lifetime are determined by the Uniform Table (or by the younger spouse rule), the designation of a beneficiary does not affect lifetime distributions to the participant.

Under the regs, the Designated Beneficiary, the person who serves as a measuring life for determining required minimum distributions after the participant's death, is no longer required to be irrevocably determined when the participant reaches age 70½. Indeed, the beneficiaries may be changed during the participant's lifetime without affecting lifetime distributions. Designation of a beneficiary is critical, however, in determining distributions after the participant's death.

Distributions After A Participant's Death. The key concept in determining required minimum distributions after the participant's death is that of the Designated Beneficiary. Only an individual (as in a person, a human being) may be a Designated Beneficiary. Although an estate, charitable organization or trust may be designated as a beneficiary, because none of these has a life expectancy, none can serve as a Designated Beneficiary. (The beneficiaries of a trust may be used as measuring lives if the trust satisfies the requirements of a "look-through" trust, discussed below.)

Indeed, if an entity other than a person or persons is designated as a beneficiary, the participant will be treated as having no Designated Beneficiary, even if there are also individual persons named as beneficiaries. This problem can be remedied by removing the non-individual beneficiary is before the time at which Designated Beneficiaries are determined, which is the September 30th of the calendar year following the calendar year in which the participant dies. Reg. §1.401(a)(9)-4, Q&A 3.

To be a Designated Beneficiary, the person must be named as a beneficiary as of the participant's date of death. Beneficiaries may be removed between the date of death and the September 30 deadline, but new beneficiaries may not be added during that period. A named beneficiary can b e removed, if the beneficiary properly disclaims his or her entitlement before September 30 or if the beneficiary receives, the entire benefit to which the beneficiary is entitled before that deadline. Removal of a beneficiary can be important if a non-individual is named as a beneficiary in addition to one or more individual beneficiaries. If the non-individual is not eliminated, the individual beneficiaries will not be able to stretch out distributions over the life expectancy of the oldest beneficiary. (Special rules for creating separate shares are discussed below.)

If a surviving spouse and children are named as beneficiaries, it is generally beneficial to distribute the spouse's share outright so that the children can receive distributions over their lifetimes. The surviving spouse can roll over her interest to an IRA. She will be deemed the owner and can withdraw distributions under the Uniform Table rather than over her life expectancy. The surviving spouse can name the children as beneficiaries of separate shares of the rollover IRA, allowing them to withdraw assets remaining upon her death over their life expectancies. (This is the IRA legacy concept discussed above.)

Distributions to the surviving spouse must begin by her required beginning date: April 1 of the year following the year in which she reaches age 70½. The rollover creates a "fresh start" under which she substitutes for the participant and can name new beneficiaries. Note that if the surviving spouse rolls over the account, subsequently remarries, and predeceases the new spouse, the new surviving spouse may not further roll over the account and obtain yet a new fresh start.

A participant would be considered as having no Designated Beneficiary if, for example, the participant designated a charity as the beneficiary. This result also occurs if the charity is one of several beneficiaries, if the beneficiaries do not have separate accounts as of the deadline for determining Designated Beneficiaries, and if the disqualifying interest has not been commuted. Reg. §1.401(a)(9)4, Q&A 3. If a participant fails to name a beneficiary, the plan may have designated a beneficiary in a default provision. The fact that a participant's interest in a plan passes to a certain individual under state law does not make that individual the Designated Beneficiary unless the individual is designated as a beneficiary under the plan. Reg. § 1.401(a)(9)-4, Q&A 1.

Basic Rules Governing Required Minimum Distributions: The rules governing required minimum distributions after the participant's death are controlled by who or what is the Designated Beneficiary. Several rules apply:

1. If an individual other than the participant's spouse is named the beneficiary, withdrawals are based upon the Designated Beneficiary's single life expectancy with no recalculation of life expectancy. (Note that the regs include a Single Life Expectancy Table showing the life expectancy of an individual at a given age.) Distributions must start no later than December 31 of the year following the year of the participant's death.

2. If the surviving spouse is the Designated Beneficiary and does not roll over the account, she uses her single life expectancy with recalculation. If she is the sole beneficiary, distributions must begin by the later of December 3 of the year following the year of the participant's death or December 31 of the year in which the participant would have reached 70½.

3. After the Designated Beneficiary's death, any remaining assets must at least be withdrawn based upon the Designated Beneficiary's life expectancy with no recalculation or (if longer) the participant's life expectancy with no recalculation. Reg. §1.401(a)(9)-5, Q&A5. In other words, once the participant dies and the Designated Beneficiary is determined, then except for a rollover situation with a surviving spouse, the measuring life is irrevocably determined. Although a surviving spouse can recalculate his or her life expectancy, any other Designated Beneficiary may not recalculate his or her life expectancy, and after the death of the Designated Beneficiary (whether or not the surviving spouse), the Designated Beneficiary's life expectancy continues to be used without recalculation.

4. If there is no Designated Beneficiary, then the rule governing required minimum distributions is determined by whether or not the participant reached his Required beginning date. If the participant reached the required beginning date, then post-death distributions will be based upon the participant's life expectancy without recalculation, using the participant's age as of his birthday in the year of death. If the participant died before reaching his required beginning date, then distributions must be completed by December 31 of the year which includes the fifth anniversary of the participant's death. Reg. §1.401(a)(9)3, Q&A 2 and Q&A 4.

5. Upon the participant's death, if distributions are based upon the Designated Beneficiary's age, that age is determined as of the Designated Beneficiary's birthday in the year following the year of the participant's death. Upon the Designated Beneficiary's death, distributions to the remainder beneficiary are determined based upon the Designated Beneficiary's age as of his birthday in the year of his death.

Separate Shares: If a designation names several beneficiaries and does not establish separate accounts (for defined contribution plan or IRA) or segregated shares (for defined benefit plans), then distributions after the participant's death are measured using the life expectancy of the oldest beneficiary, without recalculation. If the designation establishes separate accounts, each Designated Beneficiary's life expectancy is used for his or her separate account, without recalculation (except for spouses). For this reason,

establishing separate accounts in the designation is generally preferable.

The regulations specify conditions which must be fulfilled for separate accounts to be recognized for required minimum distributions purposes. The beneficiary of one account must differ from the beneficiary of each other account. The separate accounts must be "established" by December 31 of the year following the year of the participant's death. Finally, the beneficiaries must have separate interests as of the participant's death. PLR 199903050 (Oct. 28, 1998).

After the participant's death, until separate accounts are established, separate accounting for each potential separate account must be maintained. All post-death investment gains and losses, contributions and forfeitures must be allocated during this interim period pro rata among the separate accounts. The separate accounting must also allocate any post-death distributions to the separate account of the beneficiary receiving the distribution.

Because pecuniary bequests do not generally share in profits and losses during the period of administration, a share of a plan account defined as a pecuniary amount generally cannot qualify as a separate account. Therefore, any pecuniary share should be removed (by disclaimer or full distribution) before September 30 of the year following the year of the participant's death.

For many reasons, clients may want plan assets distributed to trusts after the participant's death. To calculate required minimum distributions based upon the life expectancies of the trust beneficiaries (that is, to treat the trust as a "see-through" trust), several requirements must be satisfied. The trust must be valid under state law. Trust beneficiaries must be identifiable from the trust instrument (e.g., by clear description of a class).

The trust must be irrevocable or must, by its terms, become irrevocable upon the participant's death. Certain documentation must be provided to the plan administrator or IRA Trustee and, to preserve the option of using the life expectancy method of calculating required minimum distributions, all trust beneficiaries must be individuals (or all non-individuals must be removed as beneficiaries before September 30 of the year following the year of the participant's death). Reg. §1.401(a)(9)-4, Q&A 5 and 6.

This requirement is intended to ensure that the oldest beneficiary (the measuring life) can be determined as of the participant's death. If an older beneficiary could possibly be added to the class of trust beneficiaries, this requirement is not satisfied. Trustee sprinkle powers and broad powers of appointment may violate this requirement. The possibility that unidentifiable contingent beneficiaries could be added in case of premature death of a predecessor beneficiary, can be ignored. Reg. §1.401(a)(9)-4, Q&A

Generally, a copy of the trust agreement (or a list of all trust beneficiaries) must be provided to the plan administrator by October 31 of the year following the year of the participant's death. Reg. §1.401(a)(9)-4, Q&A 6(b). If a trust of which the spouse is the sole beneficiary is named the plan beneficiary, however, then for the spouse to be treated as the sole Designated Beneficiary, the participant must provide the plan administrator with a copy of the trust (or list of all trust beneficiaries), presumably before the participant's required beginning date. Reg. §§1.401(a)(9)-4, Q&A 6(a).

When a trust is a beneficiary, determining the measuring life requires consideration of contingent beneficiaries. Unless a contingent beneficiary is strictly a successor to the interest of a predecessor beneficiary based solely on the predecessor beneficiary's death, the contingent beneficiary must be taken into account for purposes of identifying the measuring life. Reg. §1.401(a)(9)-5, Q&A 7(b). This death contingency exception is narrowly construed; if the "successor" beneficiary has any rights other than being a potential successor due to the death of another beneficiary, then the "successor" must be taken into account.

One safe harbor is a conduit trust in which all distributions to the trust From the plan must be distributed annually to the beneficiary. Conduit trusts may be particularly useful in QTIP situations. Requiring that the QTIP trust distribute all trust income to the spouse is not sufficient to render the spouse the sole beneficiary, because distributions from the plan to the QTIP trust in excess of plan income could be treated as principal, so possibly accumulated for future distribution to contingent beneficiaries. Reg. §1.401(a)(9)-5, Q&A 7(c)(3), Examples 1 and 2. See also, PLRs 9809059, 199903050.

Two issues should be considered. The first, just discussed, is whether the spouse is the sole beneficiary, thus obtaining special advantages. The second is whether the plan will qualify for the marital deduction. Rev. Rul. 2000-2, 2000-3 I.R.B. 305, provides guidance. Assuming the trust satisfies the usual QTIP requirements, then marital deduction treatment is available if (i) the spouse has the power, exercisable annually, to compel the trustee to withdraw from the plan an amount equal to income earned on plan assets during the year and distribute that amount through the trust to the spouse and if (ii) the trust and plan do not prohibit the trustee from withdrawing from the plan amounts exceeding the required minimum distributions.

This ruling is significant: it permits marital deduction treatment even if income in excess of the required minimum distributions is retained in the plan as long as (i) the spouse has the power to compel distribution to the QTIP trust and through the trust to the spouse and (ii) the trust agreement and beneficiary designation do not prevent distributions of all plan income where that income exceeds the required minimum distributions.

Generally, naming a QTIP as the beneficiary will destroy the tax-free compounding nature of the IRA legacy technique. If the spouse demands withdrawal of all income generated by the plan, there is no growth upon which to compound. The IRA legacy technique works because the required minimum distributions for many years is generally less than the income earned by the plan.

Caution is needed when using plan assets to fund a Bypass Trust because some or all of the estate tax exemption is "wasted" if trust assets are used to pay income taxes on plan distributions. When plan assets represent large portions of a client's estate and as the estate tax exemption increases, the pressure to use these assets to fund the Bypass Trust increases. In using plan assets to fund a Bypass Trust, two issues should be kept in mind.

First, the designation should indicate expressly that plan assets should be distributed to the Bypass Trust over the

longest period allowed by law, and the trust agreement should expressly authorize the trustee to withdraw assets from the plan over that extended period. Second, the trust terms and the selection of beneficiaries should be monitored to ensure that the life expectancy of the income beneficiary (rather than older contingent beneficiaries) can be used to determine required minimum distributions.

Some practitioners believe that the life expectancy of the primary beneficiary may be used as the measuring life, as long as the trust requires distribution of all income to the primary beneficiary, the contingent beneficiaries are all younger than the primary beneficiary and the contingent beneficiaries receive their interest outright (or if they predecease the primary beneficiary, then their share passes to their estate).

Other commentators believe that the primary beneficiary's life expectancy can be used even if the assets passing to remainder beneficiaries are held in trust, as long as these later trusts also do not permit accumulation of income and the potential beneficiaries of these later trusts are all younger than the primary beneficiary. Most clients will want a contingent designation that benefits the child's siblings if the child has no then living descendants, or possibly a contingent designation that benefits charitable organizations.

Where the client prefers flexibility in naming contingent beneficiaries, the client may need(i) to create a special trust for plan benefits in the trust document, providing different terms for the plan trust than for the regular Bypass Trust or (ii) to create a stand-alone trust just for plan assets. The plan trust would not provide for contingent beneficiaries who might be older than the primary beneficiary, but the remaining trust assets (e.g., the non-IRA assets funding a Bypass Trust) would be permitted to pass to the full range of potential contingent beneficiaries. The drafting goal is to qualify for

The rule that members of a class are treated as identifiable if one can identify the class member with the shortest life expectancy. Limited powers of appointment need to be carefully restricted to ensure that (i) no interest may be appointed to a person older than the primary beneficiary and (ii) if interests are appointed in further trust, the same dispositive restrictions apply to the further trust.

Alternatively, the separate trust could be designed as a conduit trust. While the conduit trust does not provide the advantage of accumulating distributions within the trust, it still offers spendthrift protection and protects against the beneficiary's removing more than the required minimum distributions.

Qualified retirement assets often comprise a substantial share of an estate. The beneficiary designation for this asset should be given the same attention that is given to the will and trust agreements. A standard brokerage house form will almost never suffice. In fact, a separate trust only for plan assets may be the beneficiary of choice. A beneficiary designation, as is the case with a will, must deal with all contingencies, because distributions could extend over several generations.

The designation must be drafted so that the brokerage houses can administer it over the years without resorting to the courts for interpretation or determination of a beneficiary. With a properly designed beneficiary designation, plan assets can become the most important assets your clients will leave their heirs.