



The Wealth Counselor

A monthly newsletter for wealth planning professionals

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Retirement Planning: Coordinating with the Client's Overall Planning Objectives

Coordinating retirement plans with wealth transfer planning can be challenging. This is primarily because retirement accounts are driven by income tax laws designed to encourage Americans to accumulate wealth for retirement, not for transferring wealth upon death.

In this edition of *The Wealth Counselor*, we will examine some of the critical rules in using IRAs and qualified retirement plans for wealth transfer planning, common misperceptions in this area, and why naming a trust as beneficiary may be the only way to accomplish some of the client's planning objectives. Completely covering these subjects requires volumes, so we will cover only the basics.

This topic is especially important now as the baby boomer generation begins retiring. At the end of 2010, IRAs and qualified retirement plans held nearly \$17.5 trillion, accounting for 37% of all household financial assets. And because of how lifetime minimum required distributions are calculated, IRAs and qualified retirement plans may be the largest assets held at death.

The Fundamentals

Distribution Calendar Year

A distribution calendar year is a year in which the participant is required to take a distribution from the plan. The first distribution calendar year is the calendar year in which the participant reaches age 70 1/2 (for some employees under some qualified retirement plans, this may be the year in which the participant retires)

Required Beginning Date (RBD)

A special rule applies to the first distribution calendar year. The required distribution for that year may be taken as late as April of the following year, which is called the required beginning date (RBD). Because all other required distributions must be made within their assigned year, the distribution for the second distribution calendar year must be made before December 31 of the year in which the RBD falls.

Minimum Required Distribution (MRD)

In each distribution calendar year, the participant is required to take at least a prescribed distribution, called the minimum required distribution (MRD). The MRD for each distribution calendar year is determined by dividing

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the prior year-end account balance by a life expectancy factor for the participant that is supplied by the IRS. If the participant's sole beneficiary is his or her spouse who is more than 10 years younger than the participant, the MRD is calculated using the *Joint and Last Survivor Table*. Otherwise, the *Uniform Lifetime Table*, which assumes a joint life expectancy with someone presumed to be ten years younger, is used. Under the *Uniform Lifetime Table*, a participant who only takes the MRD each year cannot outlive his or her retirement benefits.

Planning Tip: Taking only the MRD also means that the account will probably grow for years past the RBD. For example, if an IRA is growing at a rate of 5.5%, at age 100, the participant will still have about 60% of the original account balance is still in the account. Planning for the beneficiaries, therefore, is very important.

Minimum Required Distribution for the Year of Death

If the participant has not yet taken the entire MRD for the year in which he/she dies, the beneficiary must withdraw the remaining amount of the participant's MRD by before the end of that year. If there are multiple beneficiaries, the MRD rules are satisfied as long as the beneficiaries, in the aggregate, take the balance of the year-of-death MRD and it does not have to be pro rata.

Minimum Required Distributions after Death

After the participant's death, MRDs apply to the beneficiary and normally begin the year after the year of the participant's death. The after-death MRD rules are more complicated than the lifetime MRD rules, and are based on three factors:

- (1) Whether death occurs before or after the participant's RBD for that IRA or qualified retirement plan;
- (2) Who, or what, is the beneficiary; and
- (3) For qualified retirement plans, what the plan allows.

Note: The rules are different if the spouse is the sole beneficiary; that will be covered later.

Planning Tip: If your client is a participant in a qualified retirement plan, make sure you review and understand what the plan will allow as a part of any planning, because, in many cases, plan rules trump the general rules.

Who is the Participant's Beneficiary? Is There a "Designated Beneficiary" (DB)?

Beneficiary means those who are entitled to the plan benefits upon the participant's death. Retirement benefits generally pass as non-probate property, by contract, to the beneficiary named in the participant's beneficiary designation form or, if there are none, as specified in the plan. The provisions in the participant's will or revocable living trust are irrelevant as to who receives the benefits, unless the plan or the participant's beneficiary designation provides otherwise.

"Designated beneficiary" does not mean the beneficiary designated by the participant. It is a legal term and understanding its meaning is crucial to planning and for compliance with post-death MRDs.

There is a Designated Beneficiary for an account if, on September 30 of the year following the year of the participant's death, there is no beneficiary that has to be considered in making the analysis that is not a human being or a qualified "look-through" trust and the plan administrator or custodian can know, with certainty, the oldest person who has to be considered in making the analysis.

Planning Tip: During this period of at least nine months, clean-up strategies can be used. These include removing non-qualified beneficiaries and division into separate shares (discussed below).

Planning Tip: Most IRAs and qualified retirement plans have printed beneficiary designation forms they expect the participant to use. Most, but not all, will accept attachments. Some will accept a separate instrument. Due to the limited room on most forms, it will probably be necessary to add an attachment. *When drafting beneficiary designations, make sure the plan permits what you are trying to accomplish.*

Keys to Achieving “Designated Beneficiary” Status: Only an individual or a qualified “look through” trust can be a Designated Beneficiary. Estates, partnerships, corporations, LLCs, other trusts, and charities do not qualify. If there are multiple beneficiaries, all must be individuals and the oldest must be identifiable.

Determining the MRD for the Beneficiary after the Participant Dies

When determining the MRD for years after the participant’s death, the critical questions are: (1) Is there a Designated Beneficiary; (2) Did the participant die before or after the *Required Beginning Date*? and (3) What does the plan provide?

If there is a Designated Beneficiary, regardless of when the participant dies, each beneficiary may use the Designated Beneficiary’s age factor as shown in the *Single Life Table* to determine his or her MRD unless the plan requires rapid distribution. Using the Designated Beneficiary’s age is commonly known as a “stretch-out,” and, in most cases, a maximum stretch-out results in significantly more wealth passing to the beneficiary.

Using the *Life Expectancy Rule*, the beneficiary calculates the MRD for the first year by dividing the account balance by the Designated Beneficiary’s life expectancy. Each subsequent year, calculate the MRD by dividing the remaining account balance by the prior year’s divisor minus “1.” Thus, using this method, a beneficiary will withdraw all of the retirement benefits by the life expectancy of the Designated Beneficiary, even if taking only the MRD each year.

Death before Required Beginning Date

If the participant died before his or her RBD and there is no Designated Beneficiary, distributions must comply with the *Five-Year Rule* unless the plan requires more rapid distribution. Under the Five-Year Rule, the entire plan balance must be distributed by December 31 of the year containing the fifth anniversary of the participant’s death. Annual distributions are not required. If there is a Designated Beneficiary, use of the Five-Year Rule is optional unless the plan provides otherwise.

Planning Tip: The *Five-Year Rule* only applies if the participant dies before his or her RBD.

Death after Required Beginning Date

If the participant died after his or her RBD, unless the plan requires more rapid distributions, the beneficiary’s MRD is determined using the *Single Life Table* factor for the longer of the life expectancy of a person the same age as the participant and the life expectancy of the Designated Beneficiary, if any.

Planning Tip: Because a Roth plan has no RBD, the Five-Year Rule applies to Roth plans with no Designated Beneficiary, even if the participant has reached his or her RBD for other IRAs or qualified retirement plans. Also, distributions from a Roth plan cannot satisfy MRD requirements for non-Roth plans.

Multiple Beneficiaries

If there are multiple beneficiaries, there is no Designated Beneficiary unless all of the beneficiaries are individuals. If all of the beneficiaries are individuals, the Designated Beneficiary is the oldest beneficiary and it is his or her life expectancy that sets all MRDs. There are, however, two “escape hatches:”

- (1) *The ability to remove a beneficiary through disclaimer or distribution of that beneficiary’s share.* This must be done by September 30 of the year following the year of death.

Example: If the beneficiary designation is to a trust that distributes a specified sum to a charity and splits the balance between Child 1 and Child 2, you can make the distribution to charity prior to the critical date. That would leave you with the two individuals, Child 1 and Child 2, and the older of the two would be the Designated Beneficiary.

Example: If the beneficiary designation is to a trust that distributes one-third to the participant’s mother and one third each to Child 1 and Child 2, if the beneficiary’s mother disclaims her interest prior to the critical date, the beneficiaries would be Child 1 and Child 2 and the older of the two would be the Designated Beneficiary.

- (2) *The separate accounts rule:* If the participant’s benefits under a plan are divided into separate accounts with different beneficiaries, the post-death MRD rules apply separately to each account. This allows multiple beneficiaries to each use their own life expectancy in determining post-death MRDs. (The separate account rule is not applicable to multiple beneficiaries who take their interests through a trust that is named as a beneficiary of the plan.)

Planning Tip: In order to satisfy compliance for the separate accounts rule, there must be pro rata sharing in gains and losses, which is normally done by fractional or percentage division. A pecuniary gift would not meet the definition unless (under local law or beneficiary designation) the gift shares in post-death gains and losses pro rata with the other beneficiaries’ shares. However, you can eliminate the recipient of a pecuniary gift from being included in the Designated Beneficiary determination by distributing that gift before September 30 of the year following the year in which the participant died.

Planning Tip: Separate accounts must be established by December 31 of the year following the year of the participant’s death to use separate life expectancies. If established later, the separate accounts are still effective for all other purposes.

Critical Dates

September 30 of the year following the year of death

* Beneficiaries must be identified

* Non-designated beneficiaries eliminated by disclaimer or satisfaction of bequest

October 31 of the year following the year of death

* Trust documentation must be filed with the plan administrator if a trust is named a designated beneficiary

December 31 of the year following the year of death

* First distribution to beneficiary must be made

* Separate accounts must be created to be able to use individual life expectancies

Surviving Spouse as Sole Beneficiary

Special rules apply if the surviving spouse is the sole beneficiary. For example, if the surviving spouse is more than ten years younger than the participant and the sole beneficiary, the participant's MRDs are determined by using the *Joint and Survivor Table*.

If the surviving spouse is the only beneficiary, he or she can roll over the inherited benefits into his or her own retirement plan or elect to treat an inherited IRA as his or her own IRA. There is no deadline by which the spouse must make the rollover decision, but until the rollover is made, MRDs would have to be under the inherited IRA rules based on the spouse's age unless the plan requires more rapid distributions.

Planning Tip: A spouse who is under 70 1/2 can postpone distributions until reaching his or her own required beginning date, and can take MRDs using the recalculation method from the *Uniform Lifetime Table*. In addition, after rollover the spouse can name his or her own beneficiaries who can then use their own life expectancies after the surviving spouse dies, resulting in the maximum stretch-out.

Planning Tip: If the surviving spouse is under 59 1/2, special care must be taken in deciding whether and when to do a rollover. This is because distributions taken from the account after rollover and before the survivor reaches age 59 1/2 are subject to the 10% early withdrawal penalty.

If the participant dies before his or her RBD and the spouse does not do a rollover (i.e., treats the plan as an inherited plan), annual distributions to the surviving spouse can be postponed until the end of the latter of the year following the year in which the participant died or the year in which the participant would have reached age 70 1/2. If, after rollover, the surviving spouse dies before his or her RBD, the MRDs for her beneficiaries will not be based on the participant's remaining life expectancy. For them, MRDs will be based on either the five-year rule or, if the spouse has a Designated Beneficiary, the life expectancy of that Designated Beneficiary.

While the surviving spouse remains the beneficiary and has reached his or her RBD, following the surviving spouse's death, distributions may be stretched over the surviving spouse's hypothetical remaining life expectancy under the fixed-term method (life expectancy rule).

Trust as Beneficiary

There are two common myths about estate planning for qualified retirement plans and IRAs:

- (1) You cannot name a trust as beneficiary and get a stretch-out; and
- (2) Naming an individual as beneficiary will result in a stretch-out.

The problem with naming an individual as beneficiary is that he or she is likely to cash out the IRA or plan account, thus negating the participant's careful planning for long-term tax-deferred growth. Example: A 25-year-old inherits a \$100,000 IRA. Will he choose a \$60,000 automobile (the amount after cashing in the IRA and paying the income tax) or \$400,000 in after-tax income over his life expectancy (based on 5% growth and

combined state and federal income tax of 35%)? If the client's goal is to preserve tax-deferred growth, it is advisable to have a trustee involved who will ensure that happens.

Normally a trust is a non-individual and cannot qualify for Designated Beneficiary status, but it is possible to name a trust as beneficiary and still have a Designated Beneficiary for purposes of determining MRDs. Special rules allow a "see-through trust" that lets you look through the trust and treat the trust beneficiaries as the participant's beneficiaries, just as if they had been named directly as beneficiaries by the participant.

Planning Tip: If a trust is made the beneficiary, neither the spousal rollover nor the special accounts treatment is available. However, if the trust states that property can be distributed out to the spouse, then the IRA could be distributed to the spouse and the spouse could rollover the IRA.

Requirements for a See-Through Trust

To qualify as a see-through trust, the trust must meet certain criteria:

- (1) The trust must be valid under state law.
- (2) The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the participant. (While it is not necessary to include this wording in a revocable living trust or testamentary trust under a will, WealthDocx™ does so out of caution and for the benefit of the plan provider. Also, a trustee's power to amend the administrative provisions of the trust should not be considered a power to revoke. See PLRs 200537004 and 200522012.)
- (3) Certain documentation must be provided to the plan administrator by October 31 of the year after the year of the participant's death.
- (4) Trust beneficiaries who are to be included in the Designated Beneficiary determination must be identifiable from the trust instrument and all must be individuals.

A Designated Beneficiary need not be specified by name as long as the individual who is to be the Designated Beneficiary is identifiable under the plan. Thus, the members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy. For example, "my descendants" is a class that can be identifiable even if they are not individually named.

Which trust beneficiaries are to be included in the Designated Beneficiary determination? The general rule is that contingent and successor beneficiaries count, unless the beneficiary is a "mere potential successor to the interest of one of the beneficiaries upon that beneficiary's death." What is a "mere potential successor" beneficiary is demonstrated by an examination of "conduit" and "accumulation" trusts.

Conduit Trusts: These specifically require that any distributions that come from the IRA and go into the trust must be immediately distributed to the identifiable current beneficiaries. The IRS regulations say that, with a conduit trust, the Designated Beneficiary analysis has only to look at the current beneficiaries because all others are mere potential successors. Thus, with a conduit trust remainder beneficiaries could be charities and older beneficiaries.

Planning Tip: With conduit trusts distributions cannot accumulate in the trust, so there is no asset protection for those distributions. Also, if there is a special needs beneficiary, required distributions could result in the loss of government benefits.

Accumulation Trusts: The advantage of these trusts is that distributions can accumulate and do not have to be immediately distributed to the beneficiaries, so they provide asset protection for plan distributions. However, these trusts are more difficult to draft so that there will be a Designated Beneficiary. All potential remainder beneficiaries must be identifiable and they must all be individuals. This is not possible, for example, when the remote contingent beneficiaries are someone's heirs at law.

Stand-Alone Retirement Trust (SRT)

Using an SRT to receive retirement plan benefits is often the best solution. As you have seen, qualified retirement plans and IRAs are special assets with unique tax rules that provide well for accumulating wealth for retirement but do not work so well when trying to pass this wealth on to the next generation. It is always best to transfer property to the next generation in trust rather than outright. When the facts are such that an accumulation trust is best, it is difficult to draft it in a revocable living trust.

An SRT is an inter vivos trust created by the participant as grantor; it can be revocable or irrevocable. It is nominally funded during the grantor's life and will receive retirement plan benefits upon the death of the participant by means of properly drafted beneficiary designations.

Planning Tip: Using an SRT can ensure stretch-out (if that is the client's objective) while also allowing the financial professional to maintain the assets under management.

Conclusion

Understanding retirement planning helps the planning team help clients pass more wealth to their loved ones, integrate a client's IRA with their overall wealth plan, maximize continued tax-deferred growth, protect and grow IRA savings for their families, and take advantage of the rules applying to separate accounts governing IRAs and qualified plans so that each beneficiary can control his or her own inheritance.

Like other aspects of planning, it is helpful to review client retirement planning objectives and beneficiary designations frequently to ensure they coordinate with the client's planning.

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