

WEALTH TRANSFER PLANNING WITH IRAs AND OTHER RETIREMENT PLANS

A Primer BY GARY ALTMAN, ESQ.

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.

This article 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. To completely cover this subject would require volumes; accordingly, as the title indicates, this article is a primer on the subject and only covers the fundamentals.

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 required minimum distributions are calculated, IRAs and qualified retirement plans (hereinafter collectively referred to as an "IRA" or "IRAs") may be the largest assets held at death. Thus, proper and efficient handling of IRAs will be important to countless numbers of families as they prepare for the older generation to retire and transfer their wealth.

THE FUNDAMENTALS

Distribution Calendar Year

A distribution calendar year is a year in which the participant is required to take a distribution from the IRA. 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 15th 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. So, depending on when the first distribution is taken, in the year after someone reaches 70 1/2 two distributions may have to be taken. For example, if someone reaches age of 70 1/2 in 2011, he or she is able to postpone the first RMD until 2012, thus be required to take two RMDs in 2012, one by April 15, 2012 and one by December 31, 2012.

Required Minimum Distribution (RMD)

In each distribution calendar year, the participant is required to take at least a prescribed distribution, called the required minimum distribution (RMD). The RMD for each distribution calendar year is determined by dividing the prior year's-end account balance by a life expectancy factor, supplied by the IRS, for the participant. If the participant's sole Beneficiary is his or her spouse who is more than 10 years younger than the participant, the RMD is calculated using the Joint and Last Survivor Table. Otherwise, the IRS requires the plan participant to use the Uniform Lifetime Table. Under the Uniform Lifetime Table, a participant who only takes the RMD each year cannot outlive his or her IRA.

Required Minimum Distribution (RMD) for the Year of Death

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

Required Minimum Distributions (RMDs) After Death

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

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

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Note: The rules are different if the spouse is the sole Beneficiary and these rules will be covered below.

Who is the Participant's Beneficiary? Is there a "Designated Beneficiary"?

"Beneficiary" means those who are entitled to the benefits of the IRA upon the participant's death. Retirement benefits and IRAs 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 IRA. The provisions in the participant's will or revocable living trust are irrelevant as to who receives the benefits, unless the IRA or the participant's Beneficiary designation provides otherwise. Therefore, it is critically important to coordinate the Beneficiary designation with the client's estate plan and to ensure that the Beneficiary designation is not out-dated, as a result of death, divorce or other factors.

"Designated Beneficiary" is a specific legal term of art. 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. Certain post-death strategies can be used to remove Beneficiaries who are not Designated Beneficiaries and to ensure that each Designated Beneficiary is able to "stretch" the IRA for the longest period possible.

Note: In practice, most IRAs 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 space on most forms, adding an attachment will likely be a necessary step. When drafting Beneficiary Designations, make sure the IRA permits what you are trying to accomplish. Since, as stated above, Beneficiary Designations in wills and trusts are generally irrelevant when determining who is going to receive the IRA, complying with IRA providers' designation procedures is imperative to accomplishing your wealth transfer goals.

Determining the RMD for the Beneficiary After the Participant Dies

As stated above, when determining the RMD 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 IRA provide?

If there is a Designated Beneficiary, regardless of when the participant dies (whether before or after the participant's RBD), each Designated Beneficiary may use the Designated Beneficiary's age factor as shown in the Single Life Table to determine his or her RMD unless the IRA requires more rapid distribution (which is becoming less common). Using the Designated Beneficiary's age is commonly known as a "stretch-out," and, in most cases, maximum stretch-out results in significantly more wealth passing to the Beneficiary.

Using the Life Expectancy Rule, the Designated Beneficiary calculates the RMD for the first year by dividing the account balance by the Designated Beneficiary's life expectancy. Each subsequent year, the RMD is calculated by dividing the remaining account balance by the prior year's divisor minus "1." Thus, using this method, a Designated Beneficiary will withdraw all of the retirement benefits by the life expectancy of the Designated Beneficiary, even if taking only the RMD each year.

Death Before Required Beginning Date

If the participant dies before his or her RBD and there is no Designated Beneficiary, distributions must comply with the Five-Year Rule, unless the IRA requires more rapid distribution. Under the Five-Year Rule, the entire balance of the IRA must be distributed by December 31 of the year containing the fifth anniversary of the participant's death. Under the Five-Year Rule, there is no requirement for annual distributions. If there is a Designated Beneficiary, use of the Five-Year Rule is optional unless the IRA provides otherwise.

Death After Required Beginning Date

If the participant dies after his or her RBD, unless the IRA requires more rapid distributions, the Beneficiary's RMD 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.

Because a Roth IRA has no RBD, the Five-Year Rule applies to Roth IRAs with no Designated Beneficiary, even if the participant has reached his or her RBD for other IRAs. Also, distributions from a Roth IRA cannot satisfy RMD requirements for non-Roth IRAs.

Multiple Beneficiaries

If there are multiple Beneficiaries, there is no Designated Beneficiary unless all of the Beneficiaries are individuals (or a qualified "look through" trust). 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 RMDs. There are, however, two "escape hatches":

1. The ability to remove a Beneficiary through disclaimer or distribution of that Beneficiary's entire share. This must be done by September 30 of the year following the year of death.

Example 1:

If the Beneficiary designation is to distribute 1/3rd to a charity and the balance equally to Child 1 and Child 2, the IRA must pay the charity its 1/3rd share by September 30th of the year following the year of death in order for the oldest of Child 1 and Child 2 to be considered the Designated Beneficiary.

Note: If the Beneficiary was a revocable trust that provided for part of the IRA to be paid to charity, paying out the charity by September 30 of the year following death does not change the result that the IRA had no Designated Beneficiary.

Example 2:

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 an IRA are divided into separate accounts with different Beneficiaries, the post-death RMD rules apply separately to each account. This allows multiple Qualified Beneficiaries to each use their own life expectancy in determining post-death RMDs. So, in the first example above, if Child 1 and Child 2 created separate accounts, each of them would be able to use their own life expectancy in determining post-death RMDs.

Note: The separate account rule is not applicable to multiple Designated Beneficiaries who take their interests through a trust that is named as a Beneficiary of the IRA.

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 participant's 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 administrator of the IRA 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, the participant's RMDs 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 IRA 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, RMDs would have to be under the inherited IRA rules based on the spouse's age unless the qualified retirement plan requires more rapid distributions.

Note: 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 IRA as an inherited IRA), 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 RMDs for her Beneficiaries will not be based on the participant's remaining life expectancy. For them, RMDs will be based on either the five-year rule or, if the spouse has a Designated Beneficiary, the life expectancy of that Designated Beneficiary.

If the surviving spouse remains the Beneficiary (of the participant's IRA) and has reached his or her RBD, then 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), if there is no Designated Beneficiary (or if the Designated Beneficiary has a shorter life expectancy).

Trust as Beneficiary

There are two common myths about estate planning for 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, 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 or her life expectancy (based on 5% growth and combined state and federal income tax of 35%) when the payment each year will be only a few thousand dollars? 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 RMDs. 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.

Caution:

If a trust is made the Beneficiary, neither the spousal rollover nor the separate 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 roll over 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.
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 IRA. 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, the class, "my descendants" can be identifiable even if the trust does not name the individuals in the class.

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 RMDs 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 (those who are going to receive the RMDs being paid to the Conduit Trust) because all others are mere potential successors. Thus, with a Conduit Trust's remainder Beneficiaries could be charities and older Beneficiaries, and not be considered at all when determining whether the trust qualifies as a Designated Beneficiary and which life expectancy to use when determining the RMDs.

Caution:

Because RMDs paid to Conduit Trust must be paid to the current Beneficiaries, there is no asset protection for those RMDs. Also, if there is a special needs beneficiary, required minimum distributions could result in the loss of government benefits.

Accumulation Trusts:

The advantage of these trusts is that required minimum distributions can accumulate and do not have to be immediately distributed to the Beneficiaries, so they provide asset protection for required minimum distributions (and do not result in the loss of government benefits for disabled Beneficiaries). However, these trusts are more difficult to draft so that there will be a Designated Beneficiary (and to insure the proper life expectancy is used when determining the required minimum distributions). All potential remainder Beneficiaries must be identifiable and they must all be individuals. This is not possible, for example, when the remote contingent Beneficiaries is someone's heirs at law or a charity.

Stand-Alone Retirement Trust (SRT)

Using an SRT to receive IRA benefits is often the best solution. As you have seen, 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 (asset protection, long term estate tax minimization, bad marriage protection, etc.). When the facts are such that an accumulation trust is best, it is more difficult to draft it in a revocable living trust than in a SRT.

An SRT is an inter vivos trust created by the participant as grantor; it can be revocable or irrevocable. It becomes the Beneficiary or contingent Beneficiary of an IRA, and upon the death of the participant, the SRT will receive the RMDs based upon the life expectancies of the measuring lives of the Beneficiaries of the SRT. Thus, using an SRT can ensure stretch-out (if that is the client's objective) while also allowing for professional financial management of the IRA. The key is making sure the Beneficiary Designation is coordinated with the SRT.

Conclusion

Understanding retirement planning helps the entire 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 so that each Beneficiary's life expectancy can be used when determining his or her RMDs (after the participant's death).

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 estate and wealth transfer planning.

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