WRMarketplace
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The *WRMarketplace* is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The *WRMarketplace* provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

TOPIC: Optimizing Beneficiary Designations for Retirement Plan Benefits.

MARKET TREND: As more people rely on individual retirement accounts ("IRAs"), 401(k) plans, and other qualified plans to provide for retirement, they must plan carefully to address potential taxes and protect benefits for themselves and their beneficiaries.

SYNOPSIS: For many clients, retirement plans constitute a significant portion of their retirement savings and net worth. Determining the proper beneficiary for a client's retirement plans should be an integral part of the client's overall legacy plan. As the identity of the selected beneficiary (e.g., spouse, descendants, trust, charity) can affect the available distribution options and income tax impact of the retirement plan after the client's death, the selection should be carefully made. For example, if the selected beneficiary qualifies as a "designated beneficiary" (an individual, or a trust with only individual beneficiaries), distributions can extend over a beneficiary's life expectancy, leaving assets in the plan longer to grow without imposition of income tax.

TAKE AWAYS: The distribution rules that allow a beneficiary of an inherited IRA to extend distributions over his or her life expectancy are highly technical. Advisors should work closely with each client to determine the best structure and beneficiary designation to maximize assets and to provide flexibility for the client's retirement plan beneficiaries to manage their potential tax exposure from plan distributions. Given the importance of beneficiary designations, advisors also may want to help clients to obtain and file the proper beneficiary designation forms. Providing periodic reminders to clients to review and update these forms, particularly if they have experienced a life change (marriage, divorce, birth, etc.), can add value and help maintain contact with existing clients.

PRIOR WRM REPORTS: 15-6.

For many clients, traditional IRAs, 401(k) plans and other qualified plans (collectively "**retirement plans**") constitute a significant portion of their retirement savings and net worth.[1] These plans generally are funded with pre-tax dollars and allow contributions to grow without

imposition of income tax until distributed. Taxable distributions generally are not required until after age 70½ and then extend over a participant's life expectancy, which facilitates growth within the plan.

When a client dies, however, both federal and state income and transfer taxes may apply, potentially consuming a majority of the plan's assets. Clients who undertake advanced planning and properly integrate their retirement plans with their overall legacy planning goals can address the possible income taxation to beneficiaries of their inherited plans by giving them the ability to extend taxable distributions over a longer timeframe.[2]

TIMING OF PLAN DISTRIBUTIONS

During Life. A retirement plan participant generally must take distributions beginning by April 1st of the year after the year the participant reaches age 70½ (the "required beginning date" or "**RBD**"). Thereafter, the plan participant must take annual, minimum required distributions ("**MRDs**") from the plan based upon his remaining life expectancy ("**LE**"), as determined under IRS tables. Generally, the participant will be subject to income tax on these distributions.

After Death. At a participant's death, the retirement plan passes pursuant to the participant's written beneficiary designation or, if none, then under the plan's default provisions, and the value of the plan will be included in the participant's taxable estate. Distributions to a beneficiary from an inherited retirement plan will be subject to income tax. As detailed below, however, the timeframe for these taxable distributions depends on whether (1) the participant reached his RBD before death and (2) the beneficiary is a "designated beneficiary."

WHAT IS A DESIGNATED BENEFICIARY

If a beneficiary of an inherited retirement plan qualifies as a "designated beneficiary" ("**DB**") under the MRD rules, the DB can extend distributions over his or her LE, allowing the assets to continue to grow without imposition of income tax until distributed. A DB of a plan is:

- An individual who has a quantifiable LE, such as a spouse, child, etc. (as discussed below, spouses have additional distribution options not available to other DBs); or
- A trust where all beneficiaries (present and future) are individuals.

WHO TO NAME AS A BENEFICIARY

The selection of a plan beneficiary can allow plan distributions to extend over a longer timeframe, thereby facilitating growth in the plan assets and deferring potential tax exposure.[3] Several factors may influence the beneficiary selection, including the following (see also the chart comparing beneficiary options after the take-away section below):[4]

Spouses. Naming the surviving spouse as sole beneficiary of a retirement plan provides the most flexibility for extending plan distributions following the participant's death, because a spouse can make elections not available to other DBs. Spousal elections include the following:

- Roll-Over into New IRA. A surviving spouse may roll the plan into his or her own IRA.
    - The spouse can defer MRDs until attaining his or her own RBD and base MRDs on the spouse's LE, which can further extend plan distributions.
    - The spouse can make contributions to the IRA.
    - The spouse will be subject to the tax and distribution rules applicable to IRA owners, including the 10% penalty on withdrawals prior to age 59½ (unless an exception applies).
    - If the participant died after his or her RBD, an MRD must be taken for the year of death, it the participant did not already take it.

- Lump-Sum Distribution. Although the most onerous from a tax perspective, the surviving spouse can elect an immediate (and taxable) lump-sum distribution of the entire plan.

- Participant Dies before RBD. In addition to the above, if the plan participant died before the RBD:

    - *Inherited IRA – Delayed LE Distributions*. The spouse can continue or roll-over the plan to an "inherited IRA" under the participant's name but delay MRDs until December 31st of the year following the year of the participant's death or the year in which the participant would have reached age 70½, whichever is later. MRDs will be based on the spouse's LE. This can be particularly beneficial if the spouse is older than the participant.

    - *Inherited IRA – 5-Year Rule*. If elected by the spouse, the inherited IRA assets must be fully distributed by December 31st of the 5th year after the year of the participant's death (the "**5-year rule**"). As with a lump-sum distribution, this accelerated distribution would also accelerate the corresponding income tax liability.

- Participant Survived RBD: Inherited IRA – LE Distribution. If the participant survived the RBD, the spouse can opt for an inherited IRA with MRDs based on the longer of the spouse's LE or the participant's remaining LE and starting by December 31st of the year after the year of the participant's death. Also, the deceased participant's MRD for the year of death will need to be taken if the participant did not already take it.

Other Factors. Naming the spouse as a retirement plan beneficiary will give him or her full control over disposition of the plan benefits (which could be problematic for blended families). The assets also may become subject to the claims of the spouse's creditors.

Non-Spouse Individuals. Any individual named as sole plan beneficiary should be a DB. Unlike spouses, however, non-spouse beneficiaries cannot roll plan benefits into their own IRAs but still have the following options:

- Lump-Sum Distribution. The DB can elect an immediate (and taxable) lump-sum distribution of the entire plan.

- Participant Predeceased RBD. If the plan participant died before the RBD:

- *Inherited IRA – LE Distribution*. A non-spouse DB may continue or roll-over the plan to an "inherited IRA" under the participant's name, taking distributions based on the beneficiary's LE starting by December 31st of the year after the year of the participant's death.

- *Inherited IRA – 5-Year Rule*. A non-spouse DB can elect to have an inherited IRA distributed pursuant to the 5-year rule.

- Participant Survived RBD: Inherited IRA – LE Distribution. A non-spouse DB may take MRDs from the inherited IRA based on the longer of the beneficiary's LE or the participant's remaining LE. Also, the deceased participant's MRD for the year of death will need to be taken if the participant did not already take it.

Other Factors. Younger non-spouse DBs may elect to take (and spend) the plan proceeds all at once. Minor beneficiaries also may require the appointment of a guardian to manage the funds and MRDs, while the receipt of plan benefits for DBs with special needs could disqualify them from government benefits and services. For certain qualified plans, married participants may need to obtain the spouse's consent to any name any other beneficiary besides the spouse.

Trusts. For trusts named as plan beneficiaries, the MRD rules look at each trust beneficiary to determine whether the trust qualifies as a DB. To qualify, all trust beneficiaries, present and future, must be individuals whose identity and ages are identifiable.[5] For example, if a trust beneficiary can appoint any part of the retirement plan to charity, if a charity is named as a contingent remainder beneficiary of the trust, or if trust assets are to be distributed to a beneficiary's estate upon the beneficiary's death, the trust will not qualify as a DB.[6]

If a trust is a DB, the options for extending plan distributions are limited:

- Lump-Sum Distribution. The trust may take a lump-sum distribution of the plan.

- Participant Predeceased RBD.

  - *Inherited IRA – LE Distributions*. A trust can take MRDs from the inherited IRA based on the LE of the oldest trust beneficiary.

  - *Inherited IRA – 5-Year Rule*. The trust also may elect to have the proceeds distributed to the trust under the 5-year rule.

- Participant Survived RBD: Inherited IRA – LE Distribution. The trust may take MRDs based on the longer of the oldest beneficiary's LE or the participant's remaining LE.[7]

Other Factors. Naming a trust as the beneficiary of a retirement plan can provide creditor protection and professional management of the assets, especially for minor or special needs beneficiaries. But careful drafting is required to create a trust that will qualify as the DB.

Charities/Estates/Non-DB Trusts. Charities, estates and non-DB trusts do not qualify as DBs and must take distributions: (1) as a lump-sum, (2) under the 5-year rule, or (3) over the participant's remaining LE if he or she survived the RBD.

Other Factors. Although not a DB, naming a charity as a plan beneficiary will qualify the plan for the charitable estate tax deduction, and the charity will not pay income taxes on distributions. Charities and individuals, however, should not be named as beneficiaries of the same retirement plan, since it may prevent the individual from qualifying as a DB. A participant wishing to give only part of a plan to charity could divide the plan into separate accounts for the charity and the individual, or designate a charitable remainder trust ("**CRT**") as the beneficiary. A CRT can receive an immediate distribution of the plan proceeds without imposition of income tax, while allowing the individual beneficiary to benefit from the proceeds over a set time. The present value of the remainder passing to charity will qualify for the charitable estate tax deduction.

NAMING MULTIPLE BENEFICIARIES

If a participant names multiple beneficiaries for a retirement plan, all beneficiaries must qualify as DBs in order to extend distributions over a DB's LE. The MRDs will be based upon the oldest individual beneficiary's LE unless the plan is divided into separate accounts for the beneficiaries before December 31st of the year following the year of the participant's death.

OTHER PLANNING CONSIDERATIONS

Clients with taxable estates should consider ways to pay for transfer taxes attributable to their retirement plans. Funds withdrawn from a retirement plan to pay transfer taxes will be subject to income tax, and, if withdrawn after September 30th of the year following the client's death, could require distribution of the plan under the 5-year rule. Life insurance could provide an alternative source of liquidity to pay estate taxes attributable to retirement plans, as the death benefits should not be subject to income tax (or estate tax if held in an irrevocable life insurance trust).

TAKE AWAYS

- The distribution rules that allow a beneficiary of an inherited IRA to extend taxable distributions over his or her life are highly technical. Advisors should work closely with each client to determine the best structure and beneficiary designation to address the potential tax exposure to the client's retirement plan beneficiaries at death.

- Given the importance of proper beneficiary designations, advisors should assist clients with the accurate completion and filing of beneficiary designation forms with plan administrators.

- Providing periodic reminders to client to consider reviewing and updating these forms, particularly if they have experienced a life change (marriage, divorce, a birth, etc.) can add value and help maintain contact with existing clients.

Comparison: Retirement Plan Distribution Options by Beneficiary

Sole Plan Beneficiary	Retirement Plan Distribution Options After Death of Plan Participant	
	Death Before RBD	**Death After RBD**
Spouse	• Roll-over to own IRA • MRDs based on spouse's LE but deferred until Dec. 31st of later of year after participant would have turned 70½ or his death • 5-year rule • Lump-sum distribution	• Roll-over to own IRA • MRDs based on longer of spouse's LE or participant's remaining LE • Lump-sum distribution
Non-Spouse Individual	• Lump-sum distribution • MRDs based on individual's LE • 5-year rule	• MRDs based on longer of individual's LE or participant's remaining LE • Lump-sum distribution
Trust Qualified as DB	• MRDs based on LE of oldest trust beneficiary • 5-year rule • Lump-sum distribution	• MRDs based on longer of oldest trust beneficiary's LE or participant's remaining LE • Lump-sum distribution
Charity/Estate/Non-DB Trust	• 5-year rule • Lump-sum distribution	• MRDs based on participant's remaining LE • Lump-sum distribution

NOTES

[1] Note that the discussion of the income taxation of contributions to, and distribution from, IRAs generally refers to "traditional" IRAs, as the income tax rules and distribution considerations applicable to "Roth" IRAs differ.
[2] For an in-depth discussion on estate planning with retirement plans, see Choate, *Life and Death Planning for Retirement Benefits, The Essential Handbook for Estate Planners* (Ataxplan Publications, 7th ed., 2011).
[3] Note that the Administration's 2016 budget proposes capping contributions to retirement plans once balances reach approximately $3.4 million and requiring non-spousal beneficiaries of inherited IRAs to take distributions within five years. Although unlikely to become legislation under the current Congress, AALU will continue to monitor any developments around these proposals.
[4] Note that options are subject to availability under the plan terms. Certain qualified plans may not allow inherited plan assets to remain in the qualified plan and thus require a roll-over to a spousal IRA or an inherited IRA. Also, regardless of whether the DB is a spouse, another individual or a trust, to stretch distributions from an inherited IRA, careful attention must be paid to how the account is titled after the participant's death. Title to the inherited IRA must continue in the participant's name (for example, John Doe, deceased, traditional IRA for the benefit of Sally Doe). If the beneficiary retitles the account in just the beneficiary's name, the beneficiary will be deemed to have received a distribution of all IRA assets, and the distribution will be subject to income tax.
[5] The trust also must be valid under state law, be irrevocable (or become irrevocable upon the participant's death), and have certain documentation filed with the plan administrator by October 31st of the year following the participant's death.
[6] The determination of whether the trust qualifies as a DB is made on September 30th of the year following the participant's death. Post-mortem planning can help qualify an existing trust by ensuring any charitable gifts are satisfied prior to the September 30th deadline. In addition, if preparing a new trust or modifying an existing trust to serve as the retirement plan beneficiary, the trust could prohibit the use of retirement plan proceeds to satisfy charitable gifts after the September 30th date, and/or prohibit a beneficiary from appointing retirement plan proceeds to charity.
[7] If the trust instrument directs division of the retirement plan among multiple beneficiaries, the MRD will still be based on the LE of the oldest beneficiary (or possibly the participant's LE). The separate account rules referenced herein are not available to trusts. One solution may be to divide the retirement plan into separate accounts during the participant's lifetime and then name each trust beneficiary as a beneficiary of one of the accounts.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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