Finseca Report
Marketplace

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Optimizing Beneficiary Designations: Understanding the Various Distribution Options for Retirement Plan Beneficiaries in Light of the SECURE Act

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, especially public company executives, retirement plans can constitute a significant portion of their wealth. Determining the proper beneficiary for a client's retirement plans is an integral part of their overall legacy plan. The identity of the selected beneficiary (e.g., spouse, descendants, trust, charity) can greatly affect the income tax impact and thus a family's lasting legacy.

Take Aways: Knowing the distribution rules that allow a beneficiary of an inherited IRA to extend distributions and consequently defer income tax can add enormous value to a family's legacy. Advisors should work closely with each client to determine the best structure and beneficiary designation to maximize assets. Providing periodic reminders to clients to review and update these forms can help maintain contact with existing clients while providing a significant service.

Background

For many clients, especially public company executives, traditional IRAs, 401(k) plans and other qualified plans (collectively "retirement plans") constitute a significant portion of their weath.[1] These plans generally are funded with pre-tax dollars and allow contributions to grow income tax deferred until distributed. Taxable distributions are not typically required until after age 72 and then extend over a participant's life expectancy.

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

Timing of Plan Distributions

During Life

A retirement plan participant must commonly take distributions beginning by April 1st of the year after the year the participant reaches age 72 (the "required beginning date" or "RBD"). Thereafter, the plan participant must take annual, minimum required distributions ("MRDs") based upon his or her remaining life expectancy ("LE"), as determined under IRS tables. The participant will likely be subject to income tax on these distributions.

After Death

Distributions to a beneficiary from an inherited IRA will likely be subject to income tax. However, the timeframe for these taxable distributions can be controlled since it depends on (1) whether the participant reached his RBD before death and (2) whether the beneficiary is: (a) an "eligible designated beneficiary," (b) a "non-eligible designated beneficiary," or (c) a "non-designated beneficiary."

Prior to the SECURE Act

Prior to the Setting Every Community Up for Retirement Enhancement Act ("SECURE") Act, effective January 1, 2020, the general distribution rule was that following a participant's death, the entire retirement account must be distributed by December 31st of the fifth year following the participant's death (the "Five-Year Rule); provided, however, certain beneficiaries, known as "Designated Beneficiaries" were allowed to stretch distributions over the beneficiary's LE. In a nutshell, a Designated Beneficiary could choose between the 5-Year Rule and distributions over the beneficiary's LE affording the beneficiary a lengthy period of income tax deferral.

Enter the SECURE Act

Before the SECURE Act, retirement plan beneficiaries fell into two categories: (i) Designated Beneficiaries ("DB") and (ii) Non-Designated Beneficiaries ("NDB"). DBs pretty much consisted of individuals and qualifying trusts, while NDBs consisted of any other retirement plan beneficiary. The SECURE Act added a new subcategory to DBs called Eligible Designated Beneficiaries ("EDB"). An EDB is a DB that also falls into one of the following five categories:

- **Surviving Spouse**: The surviving spouse of the participant;

- **Minor Child**: A minor child of the participant but only until such minor reaches the age of majority;[3]

- **Disabled Beneficiary**: An individual who is disabled at the participant's death;
- **Chronically Ill Person**: A person who is chronically ill at participant's death;
- **Beneficiary Not More Than 10 Years Younger**: An individual who is not more than 10 years younger than the participant.

Most importantly, (i) an EDB can stretch distributions over the beneficiary's LE, (ii) a Non-Eligible Designated Beneficiary ("NEDB") must withdraw all funds from the inherited account by December 31st of the tenth year following the participant's death (the "Ten-Year Rule"), and (iii) an NDB is subject to the Five-Year Rule (for NDBs, the SECURE Act preserves the Five-Year Rule that existed previously).

Under the Five-Year Rule and the Ten-Year Rule, a beneficiary is not required to take distributions until the expiration of the five years or ten years, as applicable. No distributions are required prior to that time. Beneficiaries can take distributions in installments over the five-year or ten-year period or in a lump sum at the conclusion of the applicable time period.

Who to Name as a Beneficiary[4]

Again, the value proposition over naming a beneficiary is tax deferral. Below are a few critical considerations.

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 unavailable to other beneficiaries. Spousal elections include some of the following:

- Whether Participant died Before or After RBD.
    - **Roll-Over Into New IRA**. A surviving spouse may roll the plan into his or her own retirement account.
        - The spouse can defer MRDs until attaining his or her own RBD and base MRDs on the spouse's LE, which can further extend distributions.
        - The spouse can make contributions to the retirement account.
- Participant Died Before RBD. In addition to the above, if the participant died before the RBD:
    - **Inherited IRA – Delayed LE Distributions.** The surviving 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 72, whichever is later. MRDs will be based on the spouse's LE. Upon his or her later death, the 10-Year Rule will kick in and apply to the successor beneficiaries. This election can be particularly beneficial if the spouse is older than the participant.

- **Inherited IRA – 10-Year Rule**. If elected by the spouse, the retirement plan may be subject to the Ten-Year Rule.

- Participant Died After RBD

    - **Inherited IRA – LE Distribution**. If the participant died after 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, starting by December 31st of the year after the year of the participant's death.

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

Non-Spouse EDBs

Non-spouse EDBs have some of the following options:

- Whether Participant Died Before or After RBD.

    - **Inherited IRA – LE Distribution**. A non-spouse EDB may take MRDs from the inherited IRA based on the beneficiary's LE (or if the participant died after the RBD, based on the longer of the beneficiary's LE or the participant's remaining LE). Upon the beneficiary's later death, the 10-Year Rule will kick in and apply to the successor beneficiaries.[5]

- Participant Died Before RBD.

    - **Inherited IRA – Ten-Year Rule**. If the participant died before the RBD and the non-spouse EDB does not elect one of the options listed above, the beneficiary will be subject to the Ten-Year Rule.

- Participant Died After RBD.

    - **Inherited IRA – Participant's LE**. If the participant died after the RBD and an election is not made for one of the options listed above, distributions must be made over the remaining LE of the participant.

NEDBs

Those impacted the most by the SECURE Act are NEDBs. Prior to the SECURE Act, these individuals could elect LE distributions. Now, under the SECURE Act, NEDBs have the following options:

- Whether Participant Died Before or After RBD. NEDBs have two options:

- **Inherited IRA - Ten-Year Rule**. The NEDB will be subject to the Ten-Year Rule (as noted hereinbelow, the Proposed Regulations have added further direction for this particular situation);[6] or

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

NDBs

The SECURE Act changed very little for NDBs. These beneficiaries have the following options:

- Participant Died Before RBD. If the participant died before the RBD, the NDB is subject to the Five-Year Rule.

- Participant Died After RBD. If the participant died after the RBD, the NDB must continue RMDs using the participant's LE.

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

Other Factors. Younger NEDBs 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 EDBs or NEDBs with special needs could be disqualified 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 retirement 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 can be established.[7] 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 likely not qualify as a DB.[8] Furthermore, the MRD rules look at the trust beneficiary to determine if the trust qualifies as an EDB. For example, a conduit trust for benefit of the surviving spouse (i.e. a trust that pays all available MRD to the spouse) will generally qualify as an EDB as the surviving spouse is considered the beneficiary for MRD purposes. Conversely, an accumulation trust for the benefit of the surviving spouse may potentially not qualify as an EDB, although it may qualify as a DB, because some amounts may be accumulated in trust for beneficiaries other than the spouse.

If a trust is considered an EDB, it will be allowed to stretch distributions over the trust beneficiary's LE. If the trust is considered an NEDB or NDB then it will, in general, be subject to the rules stated above for NEDBs and NDBs.

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.

Charities/Estates/NDB Trusts

Charities, estates and NDB 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.

Life Insurance Consideration

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 entire plan under the 5-Year Rule. Life insurance provides an alternative liquidity source to pay estate taxes attributable to retirement plans.

Take Aways

- The distribution rules that allow a beneficiary of an inherited IRA to extend taxable distributions over a period of time 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 clients to review and update these forms can help maintain contact with existing clients while providing a significant service.[9]

Bottom-Line: 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 12/31 of later of year after participant would have turned 72 or his or her death • Ten-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 Eligible Designated Beneficiary	• MRDs based on individual's LE • Ten-Year Rule • Lump-sum distribution	• MRDs based on longer of individual's LE or participant's remaining LE • Lump-sum distribution
Non-Eligible Designated Beneficiary	• Ten-Year Rule • Lump-sum distribution	• Ten-Year Rule[10] • Lump-sum distribution
Non-Designated Beneficiary	• Five-Year Rule • Lump-sum distribution	• MRDs based on participant's remaining LE • Lump-sum distribution
Trust Qualified as Designated Beneficiary	• Spouse, Non-Spouse EDB, and NEDB treatment will be available based on the "look-through" beneficiary(ies)	• Spouse, Non-Spouse EDB, and NEDB treatment will be available based on the "look-through" beneficiary(ies)
Charity / Estate / Non-Designated Beneficiary Trust	• Five-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, 8th ed., 2019).

3 The SECURE Act proposed regulations issued in late February 2022 (the "Proposed Regulations") define the age of majority as 21.

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 beneficiary is an EDB, to stretch distributions over a beneficiary's LE 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 Note that minor children may use the LE payout only until they reach the age of majority, at which point the 10-Year Rule will then apply.

6 The Proposed Regulations provide that in addition to NEDBs being subject to the Ten-Year Rule, if the participant died after the RBD, there will also be MRDs based on the longer of the plan beneficiary's LE or the participant's remaining LE. Thus, if the participant died after the RBD, the Proposed Regulations would require continuous distributions to the plan beneficiary following the participant's death and the plan beneficiary would also be subject to the Ten-Year Rule requiring full distribution by the tenth year following the participant's death.

7 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.

8 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. Note that the Proposed Regulations have added insight in understanding whether a trust qualifies as a DB and/or an EDB.

9 This article was originally published, as modified herein, on March 26, 2015 by Jonathan M. Forster, Martin Kalb, Richard A. Sirus, Steven B. Lapidus, Rebecca Manicone, Gerald H. Sherman (Counsel Emeritus 1932-2012), and Stuart Lewis (Counsel Emeritus 1945-2012) of Greenberg Traurig, LLP.

10 *See* Footnote 6 hereinabove.