

Estate Planning & Elder Law

Beneficiaries of Retirement Assets

One of the most basic and important aspects to review

By Rosemary Durkin

Although the economic downturn of 2008 has depleted our clients' IRA and 401(k) accounts, these retirement assets are still the major assets of many of our clients, other than their residence. Therefore, it is not sufficient to only draft a Last Will and Testament for our clients to dispose of probate assets, but we should also review our clients' retirement assets, as well as other non-probate assets such as joint accounts and life insurance.

Who Are the Beneficiaries?

One of the most basic and important aspects to review and verify is the beneficiary designation. The client may have completed the forms when they were hired 20 or more years ago, and the designated beneficiaries are now deceased. Or, many people named a primary beneficiary, but often have not named contingent beneficiaries. This may have occurred for a variety of reasons, including that the form for the institution or employer did not have a space to designate a contingent

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beneficiary. As part of the estate planning process with our clients, it is vital to review the beneficiary designations and suggest appropriate changes.

The failure to review and update the beneficiary designations for a client's retirement assets may result in the client's estate becoming the recipient of the retirement assets. If the estate is the beneficiary, this will preclude the spouse's ability to roll over the retirement assets, even if the surviving spouse is the sole beneficiary of the client's estate. This will also preclude a nonspouse beneficiary from using a stretch payout period for the retirement assets. In other words, the income tax deferral advantage of IRA and 401(k)s has been completely lost.

To qualify retirement benefits for a stretch payout period, which is generally payment over the beneficiary's life expectancy, the benefits must be payable to a "Designated Beneficiary." Section 401(a) (9)(E) of the Internal Revenue Code defines a designated beneficiary as "any individual designated as a beneficiary by the employee." [Emphasis added.] Obviously, since an estate is not an *individual*, it cannot be a designated beneficiary, and therefore, the estate and its beneficiaries are not eligible for the benefits of a stretch payout. This rule still applies even when the beneficiaries of the estate

are all individuals (Treas. Reg. §1.401(a)(9)-4, A-3(a), §1.401(a)(9)-8, A-11).

If the estate is the beneficiary of the retirement assets, the payout period will depend on whether the client's death occurred before or after the client's Required Beginning Date ("RBD"). The RBD is, generally, the date on which the client attained the age of 70-1/2. If the client dies before his/her RBD, the IRA or 401(k) must be distributed no later than December 31 of the year that contains the fifth anniversary of the client's death (I.R.C. §401(a)(9)(B)(ii), Treas. Reg. §1.401(a)(9)-3, A-2). This does not necessarily require annual distributions, provided the entire retirement account is distributed by the December 31 date of the applicable anniversary year.

If the client dies after his/her RBD, the balance of the retirement assets are payable over the client's remaining life expectancy (Treas. Reg. §1.401(a)(9)-5). Determining the life expectancy of a deceased person may seem nonsensical, but no one ever claimed that the Internal Revenue Code and the Treasury Regulations were the manifestation of logic.

In any event, failing to review a client's beneficiary designations may result in the loss of the income tax deferral for the surviving spouse (who can utilize the rollover provisions) or other individuals

(who can potentially utilize their own life expectancy for a stretch payout period). From a practical standpoint, this failure may also result in an estate remaining open for the payout period, whether the five-year period or the deceased client's life expectancy, necessitating the preparation and filing of annual fiduciary income tax returns.

Trust as a Beneficiary

Whether or not to designate a trust as the beneficiary of an IRA, 401(k) or other retirement asset initially involves the same considerations as whether or not to use a trust as part of the client's estate plan. Are the potential beneficiaries, minors or spendthrifts, or have some other mental or physical disability which would prevent them from properly handling their financial affairs? Are the retirement assets the only assets available to fund the credit shelter/applicable exemption amount? Is this the client's second marriage, and does the client want to preserve most of his/her assets for children, while still providing for the second spouse?

There is no prohibition in the I.R.C. against designating a trust as the beneficiary of an IRA or other retirement account. Care must be taken, however, to properly designate the trust so that the stretch payout period is preserved, maximizing the income tax deferral.

As mentioned above, the beneficiary of a retirement asset must be a designated beneficiary to qualify for the stretch payout period. Usually, the designated beneficiary must be an individual (the rule that disqualifies an estate), but Treas. Reg. §1.401(a)(9)-4, A-5(b) will allow a trust to be a designated beneficiary, in order to utilize the life expectancy of the trust beneficiary to compute the stretch payout period. The Treasury regulation requires that the:

- Trust must be valid under state law;
- Trust must be irrevocable, or will become irrevocable at the death of the client/ participant/

employee;

- Trust beneficiaries must be identifiable from the trust instrument;

- A copy of the trust instrument or a list of all the trust beneficiaries must be supplied to the retirement plan administrator or IRA custodian;

- All trust beneficiaries must be individuals.

Other issues impact on the designation of a trust as beneficiary of retirement assets which should be of concern to the estate planner:

- **What is "income"?** Income for trust accounting purposes is a different concept from the Minimum Required Distribution amount from a retirement account (generally what the annual withdrawal should be for the beneficiary). Perhaps the trustee should be given discretion to distribute income and principal (This option should not be used for a marital deduction trust since it will disqualify the marital deduction.). Or, the trust agreement should specifically define the term "income" as it relates to retirement benefits

- **Separate accounts:** It is not sufficient to designate a trust with multiple beneficiaries, even if each beneficiary has a separate share of the trust (Treas. Reg. §1.401(a)(9)-4, A-5(c)). If separate account treatment is desired, so as to utilize each beneficiary's life expectancy, it would be better to designate each separate sub-

trust (e.g., Trust FBO John Doe under Article Six of the James Doe Revocable Trust), instead of naming the general trust.

Charity as a Beneficiary

For those philanthropic clients, designating a charity may be the simplest and most tax-efficient way to achieve their charitable goals. If a charity is designated as the beneficiary of the client's retirement assets, the charity-recipient is not losing any portion of the retirement assets to income tax because of its tax-exempt status. Therefore, the charity will usually receive more from the retirement assets than an individual beneficiary would have received. The remaining nonretirement assets are then available for the client to divide among the individuals of his/her choosing.

This tax-efficiency is only achieved when a charity (or multiple charities) is designated as beneficiaries. If a charity and an individual are named as beneficiaries of a single IRA or 401(k), the individual loses the stretch payout benefit, since a charity cannot be a Designated Beneficiary. Instead, if a client wishes to designate a charity and an individual, it would be better to divide the retirement account into two shares, and designate the charity(ies) as beneficiary of the first new retirement account, and the individual(s) as beneficiaries of the second new retirement account.

Tax Apportionment

The client's will does not control the distribution of the IRA or 401(k), unless the retirement assets are payable to the client's estate. The tax apportionment clause of the will, however, can have a drastic effect on the administration of the estate at death. This issue usually arises for single clients, when the beneficiaries of the estate are not identical to the beneficiaries of the retirement accounts.

Most boilerplate tax apportionment clauses provide that estate and inheritance taxes are paid from the residuary estate,

without apportionment or reimbursement from anyone. This can create a situation, however, where the retirement beneficiaries will receive a substantial IRA or 401(k), and the residuary beneficiaries of the estate effectively pay the estate or inheritance taxes on what they are receiving under the provisions of the decedent's will, as well as the retirement assets that they are not receiving.

In the event that the client wants to designate beneficiaries of the retirement plan different from the beneficiaries of

the residuary estate, the tax apportionment issue should be discussed with the client. The client may wish to provide for apportionment, and authorize the executor to seek reimbursement or contribution. This does, however, beg the question as to how the executor will obtain contribution from an uncooperative retirement beneficiary, and this issue should be brought to the client's attention during the planning process.

Conclusion

As we know, there are far too many issues relative to retirement assets than can be discussed in one article. At a minimum, whom the beneficiaries are, or should be, is an item to be discussed with the client. Are the named beneficiaries current? Is there a contingent beneficiary? Other topics of discussion may center on whether a trust or charity should be considered as a beneficiary. In any event, the disposition of one of our clients' most substantial asset is a major consideration of the estate planner. ■