The rules regarding distributions and designated beneficiaries are complex, but there are strategies that will help minimize income and estate taxes.

Minimum Distributions & Beneficiary Designations: Planning Opportunities

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In our last column, we discussed some of the basic rules governing IRA distributions during life and after death, including the critical role that minimum distribution calculations and beneficiary designations play in income and estate tax planning [April 1996 issue]. In this article, we will focus on some of the many planning opportunities to consider in applying these complex rules. As we did in our last article, we will examine some of the concerns facing Sam and Louise to illustrate some of the issues you may wish to consider in reviewing your own income and estate tax strategies.

While we will discuss some guidelines, rules of thumb are dangerous when dealing with individual situations. An analysis should be made by a qualified professional to determine which election makes the most sense in the context of your overall financial and estate plan. Once you have made a decision, it can often be irrevocable, and given the size of many IRAs and qualified plan assets relative to other financial assets, a mistake in this area can be very costly.

Key Planning Considerations

To plan a successful retirement distribution strategy, Sam and Louise must evaluate how the following key considerations affect their situation:

- Their personal goals—for instance, do they wish to maximize spendable cash for themselves during life, or to maximize the aftertax proceeds to heirs or a favored charity?
- Their health and the health of their ultimate beneficiaries;
- Current and projected income tax brackets;
- Exposure to excess distribution and/or excess accumulation taxes;
- Potential investment rates of return—for instance, will a higher rate of return create exposure to excess distribution and/or excess accumulation taxes that does not exist today?
- Control over assets at death (especially when remarriage is involved); and
- Deferral of estate taxes on IRA assets using the marital deduction.

Of course, if there is one constant, Sam and Louise will probably want to maximize retirement benefits for Louise in the event of Sam's death, then pay the remainder over to the children at death at the lowest possible tax cost. Most people will wish first to maximize their aftertax cash flow during retirement, and second to arrange their affairs in such a manner as to minimize estate taxes if they are unsuccessful in spending all of their children's inheritance.

Choose a Designated Beneficiary

As you will recall from the last article, probably the most critical decision at the required beginning date for minimum distributions, generally age $70\frac{1}{2}$, is choosing an appropriate beneficiary designation. If you have a designated beneficiary and die before the required beginning date, assets from your IRA can be withdrawn over that individual's (spouse or child) life expectancy or, if the designated beneficiary is the spouse, by the later of December 31 of the year following death or December 31 of the year the IRA owner would have reached age $70\frac{1}{2}$. (As discussed later, a surviving spouse can also elect to rollover or treat the IRA as her own, which represents a significant planning opportunity for younger spouses.) If you have no designated beneficiary, tax deferral opportunities are limited since the IRA must be distributed under the five-year rule—that is, by December 31 of the fifth year after the year of death. Only in rare situations would that be an advantage, such as when heirs are currently in a low tax bracket that is expected to increase in the future.

Conversely, if you have a designated beneficiary and die after your required beginning date, minimum distributions can be made over the designated beneficiary's life expectancy under the "at least as rapidly" rule (the benefi-

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ciary can always elect to take the benefits more rapidly). A surviving spouse can also elect to treat the inherited IRA as their own.

Looking at the Decisions

For married couples, designating your spouse as primary beneficiary and your ultimate heirs (children—or a trust on their behalf if minors) as contingent beneficiaries will usually be the election of choice. This is because it permits the greatest flexibility and opportunity for continued tax deferral to your spouse in the event you should die first prior to your retirement. For example, naming Louise as the designated beneficiary has the following advantages:

- Sam can use Louise's life expectancy along with his own in determining minimum distributions, which will reduce Sam's required minimum distributions and maximize ongoing tax deferral. Remember, Sam can always take out more than the minimum required distribution, although the 15% excess distributions tax may have an impact on this decision.
- If Sam dies before the required beginning date, Louise will have the above options, or she could elect to have the five-year rule apply and withdraw the funds at any time prior to December 31 of the fifth year following the year of Sam's death.
- If Sam dies after the required beginning date, Louise can receive distributions at least as rapidly as under the method selected by Sam as of his required beginning date, or treat Sam's IRA as her own as discussed below.
- Regardless of when Sam dies, the entire IRA balance should qualify for the federal estate tax marital deduction. This will defer any potential estate tax to the second death. Furthermore, Louise can also elect to defer the 15% excess accumulations tax into her estate, as long as all but a nominal portion (1% or less) of Sam's total IRAs and qualified plans are payable to her.

If Louise is the designated beneficiary, the above options provide a great deal of flexibility, because they allow for greater or lesser tax deferral as circumstances dictate. However, each decision should be carefully weighed against Louise's need for current income, application of penalty taxes (including the 10% excise tax on premature distributions if Louise treats Sam's IRA as her own and she is under $59^1/_2$), and the long-term value of tax deferral.

Recalculation of Life Expectancy

Remember that it generally makes sense for the IRA owner to elect to recalculate life expectancy as of the required beginning date because a fixed-life method (also known by some as term-certain), where life expectancy drops by a full year each year, reduces the opportunities for continuing tax deferral since Sam may outlive his fixed life expectancy. However, you generally should not choose to recalculate a spouse's life expectancy, since it will accelerate the income taxes payable by your beneficiaries at the death of the surviving spouse. This is because IRS regulations require that, at the death of a person who recalculated life expectancy, the remaining balance must be distributed before December 31 of the year following the year of the second death. On the other hand, if a fixed-life method is used by the surviving spouse, a contingent beneficiary, such as a child, can continue to receive the IRA based on the remaining joint life expectancy of the owner and spouse as determined at the required beginning date.

Note, however, that even if Sam elected to recalculate both his and Louise's life expectancy, Louise could eliminate the above problem by rolling Sam's IRA over into her own, as noted below, because she could then choose a new distribution method.

Spousal IRA Rollover

One useful way to minimize income taxes and maximize flexibility is for Louise to take Sam's IRA and/or qualified plan proceeds and roll them into a new IRA, or elect to treat Sam's IRA as her own. Either way, Louise acquires all of the available distribution options that Sam had, and can take advantage of continued deferred growth of the plan assets until her retirement at some later date.

Louise will be able to name the children as designated beneficiaries of her IRA, allowing her to determine her lifetime distributions using her life expectancy and that of her oldest child. Since her child's life expectancy cannot be recalculated, the child's fixed life expectancy is used to determine the number of years over which payout would occur after Louise's death. This is true even if the child is 10 or more years younger than Louise, because the 10-year rule (in which 10 years is the maximum age difference allowed between an IRA owner and non-spouse beneficiary for determining minimum distributions) applies only for calculating Louise's distributions during her life.

Furthermore, Louise could also divide Sam's IRA into separate IRAs and name each child as a beneficiary of an account. While complicated, separate accounts would allow different minimum distributions for each child based on their life expectancy. Either method can provide very significant tax deferral opportunities, because after Louise's death, the child's actual life expectancy is used to determine ongoing minimum distributions. On the negative side, by rolling Sam's pension assets into her own IRA, Louise will be exposed to the 10% early withdrawal penalty if she should later decide to take distributions from the new IRA and she is under age $59^1/_2$.

While naming Louise as primary beneficiary will usually make the most "economic" sense, there is one large caveat—Sam loses control of naming his ultimate beneficiary. If Sam has been happily married for 40 years, this may not be much of a concern. However, if Louise were Sam's spouse by a second marriage and his children were from his first, Sam may have some concerns that sound planning can minimize.

Note, though, that Sam will need Louise's permission to name anyone other than her as beneficiary if he is a participant in a qualified plan such as a company savings plan. Under the Retirement Equity Act of 1984, a married plan participant cannot name any other beneficiary than his or her spouse without that spouse's signed and notarized consent (although there is an exception for couples married less than a year.) However, this law does not apply to IRAs.

Naming Children as Beneficiaries

In cases where a surviving spouse may not need the IRA assets, or in second marriage situations, it may be advisable to name children as beneficiaries for all or a part of the IRA. By naming a non-spouse primary beneficiary, Sam will force distributions to begin from his IRA either under the five-year rule or over the life expectancy of the oldest primary beneficiary, with payment beginning no later than December 31 of the year following the year in which he died. The opportunity to receive IRA distributions is therefore lost to Louise. If she is in or near retirement herself, this may not be an undue hardship. However, if she is younger, the economic cost of losing the income can be huge, providing much lower support to her after Sam's death. Finally, IRA proceeds that are paid to children are subject to estate taxes, since they will not qualify for the federal estate tax marital deduction. While the $600,000 unified credit exemption may offset all or a portion of the tax, careful planning is needed to ensure that the IRA is not depleted unnecessarily.

Naming a Trust as Beneficiary

In lieu of individual beneficiaries, it may make sense to name a trust as primary or contingent beneficiary of the IRA. Of course, trusts have many uses in estate tax planning, not necessarily just tax-motivated. The trust can also provide professional asset management, protect the assets against the claims of creditors, and withhold distributions from young or spendthrift children.

Under the typical estate plan for a couple with more than $600,000 in assets, a "credit shelter" trust is created to take advantage of the $192,800 unified estate tax credit (which is the tax on the first $600,000 in property). The purpose of this trust is to ensure that the $600,000 unified credit equivalent is fully utilized, so that tax is eliminated on that amount in both spouses' estates. Typically, the remaining property of a deceased spouse passes either directly to a surviving spouse or to a trust for their benefit.

Careful planning is needed to ensure that a trust set up for estate tax purposes does not cause adverse income tax consequences. This is because only an individual can be a designated beneficiary, and in the absence of an individual named as a beneficiary, the five-year rule will apply and the entire IRA balance would need to be distributed by December 31 of the fifth year after the IRA owner's death.

However, as explained in our last article, if at the time of death the following conditions are met, distributions can be made using life expectancies of individual beneficiaries:

- The trust is irrevocable on the later of the required beginning date or the date the trust is named as a beneficiary;
- The trust is valid under state law;
- The beneficiaries are identifiable from the trust instrument, and;
- A copy of the trust instrument is provided to the plan.

Note that the first requirement, irrevocability, can cause problems, as it appears to prevent the beneficiaries of a revocable living or testamentary trust from qualifying as designated beneficiaries as of the required beginning date. (These trusts do not become irrevocable until the death of the grantor.) Since you will not have a designated beneficiary, distributions may be made only over your life expectancy, and will be subject to the five-year rule if you die after your required beginning date. Although professionals differ on the literal meaning of this rule, if you want to use a trust but treat the surviving spouse or children as designated beneficiaries for tax-deferral reasons, the trust must be irrevocable as of the required beginning date.

Using a QTIP Trust

A common trust for a surviving spouse is the QTIP, or qualified terminable interest property trust. A QTIP trust is a type of marital trust that qualifies for the marital deduction while not giving the surviving spouse full title to the property. QTIP trusts are commonly used in second marriage situations, because the grantor can maintain control over the ultimate disposition of the property through the trust, instead of granting it to the spouse under a conventional power of appointment marital trust.

In order to qualify the QTIP trust for the marital deduction in Sam's estate, the trust must provide that (1) Louise receive all the trust income for life and (2) no person can appoint any part of the trust property to anyone other than Louise during her lifetime. To satisfy Rule 1, income earned inside the IRA must be distributed at least annually to the QTIP trustee, and both this income and any other income from the trust must be distributed annually to Louise. In addition to IRA income, the trust must also withdraw amounts sufficient to cover expenses and taxes attributable to IRA income, since to be eligible for QTIP treatment Louise's income interest cannot be reduced by expenses.

Because of this very strict rule, it is critical that the IRA beneficiary form and the trust provisions state unequivocally that the income will be paid to the trust at least annually. This can cause complications, particularly if IRA income is less than the minimum required distribution. If that is the case, the trust must withdraw an additional amount from the IRA to avoid the 50% penalty tax for failing to withdraw the required minimum.

In spite of the complexity, it is possible for Sam to name a QTIP trust as

primary or contingent beneficiary and maintain some of the tax advantages that inure where Louise alone is named as beneficiary. However, the primary reason to use the QTIP trust is that Sam can maintain the ability to designate the ultimate beneficiaries of the property, a valuable right if he has children from a prior marriage. It is important to keep in mind, however, that there are disadvantages to naming a QTIP trust, including:

- You cannot extend the payment of benefits beyond your spouse's life expectancy,
- Generally there is almost never an opportunity for a spousal IRA rollover and redetermining distributions with children as beneficiaries,
- There is no opportunity for deferral of tax on any new income in the IRA, since all income must be distributed to the spouse,
- The spouse cannot defer the 15% excess accumulations into her estate, since the benefits are not paid to her.

Using a Credit Shelter Trust

Sam might also consider naming his credit shelter trust as the primary beneficiary using his qualified plan assets to fund his $600,000 exemption. Once again, however, this choice can have some serious income tax implications for Louise. IRA benefits are not the best assets to use in funding a credit shelter bequest, since as the trust receives the IRA distributions, income taxes must be paid out of trust assets. Because the trust principal is reduced by the income tax burden, the full value of the trust (plus appreciation, if any) cannot be passed to trust beneficiaries and a portion of the unified credit is wasted.

Also, keep in mind that if the credit shelter trust is named as beneficiary, the formula by which it is funded must be carefully drafted. There are a variety of formulas used in estate planning documents to describe how assets will be divided between the marital and credit shelter trust; suffice it to say that a pecuniary formula (one that refers specifically to a fixed dollar amount, say $600,000) should not be used. Under IRS regulations, if the right to future taxable income (commonly called "income in respect of a decedent") is used to satisfy a bequest, the result is immediate taxation of the amount used, even if nothing has actually been distributed from the IRA.

Nonetheless, for some an IRA may represent the only liquid asset available to fund the credit shelter trust. In that case, a careful analysis may show that the income tax cost of funding the credit shelter trust is offset by the estate tax savings. Furthermore, IRS regulations provide that amounts received from the plan by the trust do not have to be immediately distributed to the beneficiaries, although the trust itself will owe income taxes on amounts not paid. Thus, if a spouse does not require the assets to live on, they can be maintained in trust for future distribution to heirs.

Disclaimers Provide Flexibility

One other option that can provide more flexibility is not to name the credit shelter trust as primary beneficiary, but as contingent beneficiary with a spousal disclaimer. In this case, Sam designates Louise as the primary beneficiary, but the designation provides that if Louise "disclaims" all or a portion of the IRA proceeds, the disclaimed portion passes to a credit shelter trust. A disclaimer is a technique by which assets are redirected to an alternative beneficiary through a refusal to accept some interest in property passing from a decedent.

Certain technical rules must be followed for the disclaimer to be effective. A qualified disclaimer is an unqualified and irrevocable refusal to accept benefits that is made in writing and describes the interest being disclaimed. The disclaimer must be delivered to the executor within nine months after the decedent's death, and the person disclaiming cannot accept any of the benefits of or interest in the property. It is important to place disclaimer provisions into beneficiary designation forms to avoid having the estate as beneficiary, since otherwise the five-year rule will apply because the estate cannot be a designated beneficiary.

The disclaimer technique would give Louise nine months to review Sam's estate and determine the best course of action with respect to funding the unified credit. If it turns out that other assets are available to fund the credit shelter, Louise can simply do nothing: a disclaimer is completely voluntary. Also, after Sam has reached his required beginning date, the mere fact that Louise has the power to disclaim will not affect Louise's status as a designated beneficiary for purposes of the minimum distribution rules.

Naming a Charity as Beneficiary

For those who are charitably inclined, an excellent answer for both income and estate tax perspectives may be to name a charity as beneficiary of the IRA assets. This is because IRA assets are subject to as many as five different levels of taxation, including:

- Up to 39.6% regular income tax on lifetime distributions,
- 15% excise tax on excess distributions during life or accumulations at death,
- 55% generation-skipping tax if distributions are made to persons two or more generations below the IRA owner,
- Income tax to the estate or ultimate recipients under the "income in respect of a decedent" rules.

With this extreme tax burden, IRA assets may represent one of the best assets for a charitable gift. Even if you are married, you can designate your spouse as primary beneficiary and a charity or charitable trust as contingent beneficiary. Of course, the advantage to naming a charity or charitable trust as beneficiary is that withdrawal of the assets can be partly or completely tax-free, since bequests to charities are eligible for an income tax deduction, as well as a gift or estate tax deduction due to the tax-exempt status of the charity.

Outright Bequest to Charity

Sam could elect to give his IRA assets directly to charity during his life, but this does not avoid income tax or the 15% excess accumulations tax entirely. He would, however, be entitled to an income tax charitable deduction, subject to the percentage limitations (generally 50% of adjusted gross income). However, the best tax result will be realized if the IRA is given to charity at death, because the charity will not pay income tax. Also, the full value of the bequest will be deductible against the value of the estate for estate tax purposes.

It is important to note that, while a charitable deduction would apply for estate tax purposes, it cannot be claimed against the 15% excess accumulations tax. However, this problem is lessened because the excess distributions tax is a deduction in calculating the estate tax. However, an alternative source of funds other than retirement proceeds should be provided to pay this tax.

Charitable Trusts

Using a charitable trust can also provide some significant benefits where a surviving family member needs the use of the assets during lifetime, and may be the best way to minimize adverse tax effects and maximize the assets passing to heirs. A charitable remainder trust is a trust that is created at death (testamentary) or during life (inter vivos) that names one or more individuals as single or joint income beneficiaries. (The amount of income will depend on the specific terms of the trust and the age of the beneficiaries.) At the death of the income beneficiary, or for a period of not more than 20 years, the trust property is distributed to the charity.

If Sam were to contribute IRA assets to a charitable remainder trust created during life, he would be taxed immediately on the full amount withdrawn to fund the trust. The 15% excess distributions tax could also apply. He would receive a current income tax deduction based on the present value of the remainder interest passing to charity, which would then partially offset the income tax on the current income distribution.

Because of the income tax consequences of lifetime charitable remainder trusts, their best use is typically at death. Sam might consider establishing a charitable remainder trust at death with Louise as beneficiary, in which case the initial transfer of assets to the trust could be free of estate taxes if Louise were the sole beneficiary. This is because the value of Louise's interest could qualify for the marital deduction, and the remainder interest could qualify for an estate tax charitable deduction. If Sam named his children as beneficiaries in addition to Louise, a taxable gift to them will occur.

The economic value of using a charitable remainder trust can be significant. Because the trust is tax-exempt, the trust principal can appreciate without reduction by taxes. Louise, as the income beneficiary, is taxed on distributed income, but the required annual payment from the trust is often less than the actual increase in value each year. The required annual payout rate depends on whether the trust is an annuity trust, which pays a fixed sum equal to at least 5% of the initial trust value (the annuity), or a unitrust, which pays a fixed percentage (at least 5%) of the trust assets, which are valued each year. Depending on how long the income beneficiaries live, it is possible for the cumulative value of the amounts paid to the family over time to exceed the value of that transferred to charity.

Of course, the disadvantage of a charitable remainder trust is that, at Louise's death, the trust assets do not pass to their children. However, it is also possible to combine a charitable remainder trust with an irrevocable life insurance trust, whereby Louise would gift a portion of her income to the insurance trust to fund an insurance policy. At her death, the policy proceeds would replace the amount passing to the charity, and would not be taxed in Louise's estate due to the irrevocable trust.

A word of caution: If Sam names a charity as beneficiary, it is best to recalculate his life expectancy. If he doesn't, he may outlive his life expectancy, and nothing would be left for the charity since all IRA proceeds would have been distributed to him. If Sam recalculates his life expectancy, on the other hand, he will never run out of life expectancy at least until age 115, the point at which the IRS tables end. At death the remaining IRA balance would be paid to the charity prior to December 31 of the year following death.

Conclusion

Retirement and estate tax planning contain some of the most complex provisions of the tax code, and this review of planning strategies has been somewhat simplified.

One thing is certain: A well-coordinated plan developed by competent tax and legal counsel is critical to maximize income and estate tax benefits. By far the most important thing you can do is to thoroughly understand your family's goals and objectives, then communicate them to your family and your professional advisers for sound implementation.