PART 2: BENEFICIARY DESIGNATIONS AND REQUIRED MINIMUM DISTRIBUTIONS

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To properly plan for your retirement distributions, you need to take into consideration estate planning. A focus on the IRS rules on required minimum distributions and designated beneficiaries for payments after your death.

The complexities of taking distributions from qualified retirement plans during your lifetime were discussed in the previous Retirement Plans column in the April 1998 issue. In this article, we continue our review of beneficiary designations and minimum distributions, focusing on payments from qualified plans that will occur after the plan owner's death.

DISTRIBUTIONS AFTER DEATH

Beneficiary designations are critical in determining whether distributions and income taxes can be deferred beyond your death, and if so, for how long. Minimum distributions from qualified plans must begin no later than April 1 of the year after the year in which the plan owner reaches age 70½. This date is called the "required beginning date" (RBD). With this in mind, compare what happens to plan distributions if you die before the required beginning date, and what happens if you die after that date.

Death before the RBD:

If you die before your required beginning date, in general, all IRA and qualified plan proceeds would be distributed under the following rules:

(1) No designated beneficiary: If no "designated" beneficiary has been named (for example, you name your estate or a non-qualifying trust), the entire account must be distributed by December 31 of the fifth year following the year of your death (this is the so-called five-year rule).

(2) Spouse is designated beneficiary: If your spouse was the designated beneficiary, he or she has the following options:

- Take distributions over his or her life expectancy, beginning before December 31 of the year following your death.
- Delay distributions until no later than December 31 of the year you would have turned age 70½. Distributions are then calculated based on spouse's life expectancy.
- Take your IRA and/or qualified plan proceeds and roll them over into a new IRA with new beneficiary designations. The spouse could then wait until spouse's age 70½ to begin taking distributions.
- Elect to have the five-year rule apply, and withdraw all the funds by December 31 of the fifth year following the year of your death.

(3) Non-spouse is designated beneficiary: If you designated an heir other than your spouse as beneficiary (such as a child), the options are:

- Distribute the remaining balance over the *beneficiary's* life expectancy, but distributions must begin before December 31 of the year following your death.
- Elect to have the five-year rule apply, and withdraw the funds by Decem-

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ber 31 of the fifth year following the year of death.

Death after the RBD:

If you die after minimum distributions have begun, the tax consequences depend on who your designated beneficiary was and whether you recalculated your life expectancy. Let's look at three different beneficiary options: (1) a spouse beneficiary, (2) a non-spouse beneficiary, such as a child or grandchild, and (3) a qualified trust beneficiary.

(1) Spouse is designated beneficiary

If your spouse is the designated beneficiary, he or she can elect from the following options at your death.

- Continue to take minimum distributions "at least as rapidly as under the method chosen" by you. If you had recalculated your life expectancy, then your spouse's remaining life expectancy alone (either recalculated or fixed) would be used to determine payments. If you did not recalculate your life expectancy (you elected fixed term), then your spouse could continue to take distributions based on the combined life expectancy even though you have died. Similarly, if your surviving spouse also was not recalculating life expectancy, upon the spouse's death, beneficiaries may receive distributions based on this fixed-term factor for the number of years remaining.
- Take your IRA and/or qualified plan proceeds and roll the distribution over to a new IRA. As owner of the IRA, your spouse can name new designated beneficiaries and take applicable minimum distributions based on his or her own life expectancy, and if desired, that of a designated beneficiary (subject to "MDIB" rules, explained below). Upon your spouse's death, distributions could continue to beneficiaries based on the following "non-spouse" beneficiary rules.

(2) Non-spouse is designated beneficiary

Non-spouse designated beneficiaries, such as children or grandchildren, must begin taking distributions the calendar year following the date of your death. The life expectancy of a non-spouse beneficiary cannot be recalculated and is based on the number of years of their life expectancy as of the year you turned 70½. For example, if the beneficiary is age 16 when you turned 70½, the beneficiary's life expectancy is 65.8 more years. If you then die at age 75, distributions would begin the following year at a rate of 1/59.8 (65.8 minus six years). The following year's distribution rate would be 1/58.8, and so on. This assumes you elected to recalculate your life expectancy and, therefore, your life expectancy is zero following the year of your death.

Keep in mind, however, that while post-death distributions can be paid to beneficiaries based on their life expectancies, you are limited in the amount you can reduce minimum distributions during your lifetime by naming a child or grandchild. A special rule requires that a non-spouse beneficiary cannot be treated as being more than 10 years younger than the owner for purposes of the owner's minimum required distribution (this is referred to as the MDIB rules—minimum distribution incidental benefit). This applies even if you name multiple beneficiaries to the IRA.

In addition to this rule, if a plan or IRA has multiple non-spouse beneficiaries, they must use the life expectancy of the oldest beneficiary in calculating distributions following your death.

For example, if you die at age 79 and were recalculating life expectancy, the remaining IRA proceeds can be distributed over the next 59.8 years to the three grandchildren we'll assume you named. This is calculated by taking the oldest child's life expectancy at your age 70½, less the 10 years which have elapsed: At age 12, single life expectancy is 69.8 more years. Because 10 years have elapsed since distributions began, this figure is reduced to 59.8.

Alternatively, if you were not recalculating your life expectancy, distributions could be further extended since the life expectancy factor would be based on the joint lives of you and the oldest beneficiary.

But there is a danger to naming grandchildren as beneficiaries. In this case, you skipped a generation of estate taxpayers (the children). The IRS will tax amounts in excess of $1 million that skip a generation, at a rate of 55%. This generation-skipping tax must be considered when making grandchildren the beneficiaries of IRAs.

(3) Qualified trust is beneficiary

Trusts created to provide estate tax benefits, such as unified credit trusts and QTIP (qualified teminable interest propety) trusts, can be named as beneficiaries of IRA plans. Generally, as mentioned above, trusts are not considered "designated beneficiaries" and, therefore, plan proceeds would need to be distributed:

- Within five years of the date of death if death occurs before your required beginning date,
- Within one additional calendar year if death occurs after your required beginning date and you recalculated your life expectancy, or
- Over your remaining life expectancy if death occurs after your required beginning date and you did not recalculate your life expectancy.

However, if certain rules are met, the beneficiaries of the trusts can be treated as the designated beneficiaries of the IRA or qualified plan. In general under Proposed Regulations issued July 27, 1987, as of the required beginning date, or the date the trust is named as beneficiary, whichever is later:

TABLE 1. RULES FOR MINIMINUM DISTRIBUTIONS

IRA Owner Dies Before Before the Required Beginning Date for Minimum Distributions

Spouse is designated beneficiary	*Non-spouse (such as a child) is designated beneficiary*	*No "designated" beneficiary*
Beneficiary has the following options: • Take distributions over his or her life expectancy, beginning before December 31 of the year following your death. • Delay distributions until no later than December 31 of the year you would have turned age 70½. Distributions are then calculated based on spouse's life expectancy. • Take the IRA and/or qualified plan proceeds and roll them over into a new IRA with new beneficiary designations. The spouse could then wait until spouse's age 70½ to begin taking distributions. • Elect to have the five-year rule apply, and withdraw all the funds by December 31 of the fifth year following the year of the IRA owner's death.	Beneficiary has the following options: • Distribute the remaining balance over the beneficiary's life expectancy, but distributions must begin before December 31 of the year following the IRA owner's death. • Elect to have the five-year rule apply, and withdraw the funds by December 31 of the fifth year following the year of the IRA owner's death.	Entire account must be distributed by December 31 of the fifth year following the year of your death (the so-called five-year rule).

IRA Owner Dies After the Required Beginning Date for Minimum Distributions

Spouse is designated beneficiary	*Non-spouse (such as a child) is designated beneficiary*	*No "designated" beneficiary*
Beneficiary has the following options: • Continue to take minimum distributions "at least as rapidly as under the method chosen" by the IRA owner. If owner had recalculated his or her life expectancy, then the spouse's remaining life expectancy alone (either recalculated or fixed) would be used to determine payments. If the IRA owner did not recalculate his or her life expectancy (you elected fixed term), then the spouse could continue to take distributions based on the combined life expectancy even though the owner died. Similarly, if the surviving spouse was not recalculating life expectancy, upon the spouse's death, beneficiaries may receive distributions based on this life expectancy factor for the number of years remaining. • Take the IRA and/or qualified plan proceeds and roll the distribution over to a new IRA. As owner of the IRA, the spouse can name new designated beneficiaries and take applicable minimum distributions based on the new owner's life expectancy, and if desired, that of a designated beneficiary. Upon the spouse's death, distributions could continue to beneficiaries based on their life expectancies.	Beneficiaries must begin taking distributions the calendar year following the date of death. The life expectancy of a non-spouse beneficiary cannot be recalculated, and it is based on the number of years of life expectancy as of the year you turned 70½. Remember that, while post-death distributions can be paid to beneficiaries based on their actual life expectancies, you are limited in the amount you can reduce minimum distributions during your lifetime by naming a child or grandchild due to the MDIB rules. In addition, if a plan or IRA has multiple non-spouse beneficiaries, the life expectancy of the oldest beneficiary must be used in calculating distributions both during and after the owner's lifetime. Also, beware of the generation-skipping tax when making grandchildren the beneficiaries of IRAs.	Entire account must be distributed: • Within one additional calendar year if the owner recalculated his life expectancy, or • Over the owner's remaining life expectancy if the owner did not recalculate his life expectancy. Generally, trusts are not considered "designated beneficiaries" and, therefore, plan proceeds would need to be distributed as stated above. However, if certain rules are met (see text), the beneficiaries of the trusts can be treated as the designated beneficiaries of the IRA or qualified plan, and the rules for designated beneficiaries apply.

- The trust must be valid under state law;
- The beneficiaries must be identifiable from the trust instrument;
- A copy of the trust instrument must be provided to the qualified plan or IRA custodian; and,
- The trust must be irrevocable.

Under regulations proposed November 1997, the third and fourth conditions for a trust to qualify as a designated beneficiary have been eased. The 1997 proposed regulations allow you, the plan owner, to provide a list of all trust beneficiaries (including contingent beneficiaries) and their entitled share of the trust in lieu of a copy of the trust document, unless the trust document is demanded by the plan administrator. The trust may be revocable while the grantor is alive as long as the trust, by its terms, becomes irrevocable upon the death of the grantor. This is true even if this is later than the date the trust is named as beneficiary or the date on which you reach your RBD.

If you name a qualified trust as beneficiary, the above rules for designated beneficiaries apply. However, it appears the IRS will not allow your spouse to roll the IRA proceeds over to his or her own account. Remember that the age of your oldest trust beneficiary will determine the minimum amount of lifetime distributions.

USING QUALIFIED TRUSTS

There are many issues to be considered when using qualified trusts as beneficiaries for your retirement plan. The most important considerations are:

Estate exemptions: Using the unified credit trust as IRA beneficiary means that your heirs may not receive the full benefit of the $625,000 estate exemption (1998 limit). The reason is that all IRA dollars distributed are fully taxable as ordinary income to the recipient. Therefore, beneficiaries only get the remainder of the proceeds after income taxes are paid. You should only use the credit trust for IRAs if no other assets are available for funding this trust.

Less favorable tax consequences: By designating the QTIP trust as IRA beneficiary, you may create income tax consequences that are not as favorable as if your spouse were named as the beneficiary directly. Generally, no rollover is allowed, so the spouse has a limited choice of distribution options. In addition, all income from the QTIP trust must be distributed each year, including income from the IRA. Therefore, distributions in excess of the required minimum distribution amount may be necessary, thereby accelerating the income tax consequences. It is also recommended that the plan documents, as well as the trust itself, require all income be distributed annually. Finally, the QTIP election must be made on the Form 706 as to the trust and the IRA.

Disclaimers can 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, you designate your spouse as the primary beneficiary, but the designation provides that if the spouse "disclaims" all or a portion of the account, that amount 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. This refusal is made in writing and describes the interest being disclaimed. The disclaimer must be delivered to the executor within nine months after your 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—otherwise the five-year distribution rule may apply because the estate is not a "designated" beneficiary.

The disclaimer technique would give your spouse nine months to review your 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 trust, your spouse can simply do nothing since a disclaimer is voluntary. Also, if you reached the required beginning date before your death, the mere fact that your spouse has the power to disclaim will not affect his or her status as a designated beneficiary for purposes of the minimum distribution rules.

CHARITY BENEFICIARIES

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

- Up to 39.6% regular federal income tax on pre-death distributions;
- Up to 55% estate tax at death;
- 55% generation-skipping tax if certain distributions are made to persons two or more generations below the IRA owner; and,
- Up to 39.6% income tax to the estate or named beneficiaries 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.

If you are married, you can designate your spouse as primary beneficiary and a charity or charitable trust as a contingent beneficiary. The advantage to naming a charity or a charitable trust as beneficiary is that distribution of the

assets can be partly or completely tax-free. This is true since bequests to charities are eligible for an income tax deduction, and can be excluded from the estate tax calculation.

Outright gift to charity: You could elect to give IRA assets directly to a qualified charity during your lifetime, but this does not avoid income tax entirely. The IRS assumes that you took a distribution first (subject to income tax) and then made a charitable contribution. You would be entitled to an income tax charitable deduction, but would be subject to the percentage limitations (generally 50% of adjusted gross income and the 3% of adjusted gross income limitation for itemized deductions).

The best tax result may be realized if the IRA is given to charity at death, because the charity will not pay income tax; also, there will not be a presumption that a taxable distribution was made first, then a deductible transfer made (as noted in the discussion regarding lifetime transfers). Also, the full value of the bequest will be deductible against the value of the estate for estate tax purposes.

SPLITTING YOUR IRA

Be aware that you may split up your IRA into multiple IRA accounts, each with *different* beneficiary designations.

RENAMING A BENEFICIARY

After the required beginning date, you generally cannot change minimum distribution calculation options. But, if the beneficiary dies, you may have to increase distributions depending on if the beneficiary was a spouse whose life expectancy was being recalculated.

If your spouse was your beneficiary and you elected to recalculate your spouse's life expectancy, then the remaining distributions will be based on your single life expectancy, since your spouse's life expectancy is reduced to zero the year following death. Otherwise, if your spouse's life expectancy was not being recalculated, your distributions will continue in the manner established before your spouse's death.

If a child or other non-spouse beneficiary dies, in general, you continue to use the same distribution pattern established at your required beginning date. This is true even if no new beneficiary is named, or a "non-designated" beneficiary is chosen, such as your estate, a charity, or non-qualified trust.

What if you decide to replace a living beneficiary after your required beginning date with a new "designated" beneficiary? You can do this, but your payout will continue to be based on the life expectancy of the original beneficiary. The only exception to this rule is if you replace the original beneficiary with an older beneficiary. The shorter life expectancy must then be used, which will accelerate the minimum distribution required. In this case, you must "look back" to your required beginning date and use the life expectancy of the replacement beneficiary at that time, reduced by one for each year a distribution was taken. If a new designated beneficiary is not named, the payout must be based on your single life expectancy (i.e., you name a non-qualified trust, charity or your estate to replace the beneficiary).

KNOW THE PLAN TERMS

It is important to understand that the terms of the IRA or qualified plan may limit distribution options. For example, some IRA agreements don't permit recalculation of life expectancies, and some provide only lump-sum distributions after death. The tax law is much more flexible than many IRA agreements.

Read the IRA agreement carefully and make sure that you understand the options and make an informed decision about naming beneficiaries and taking future minimum distributions. ◆