RETIREMENT PLANS AND THE ESTATE:

The Thirty Year "Hot Topic" for Estate Planners

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I. Introduction

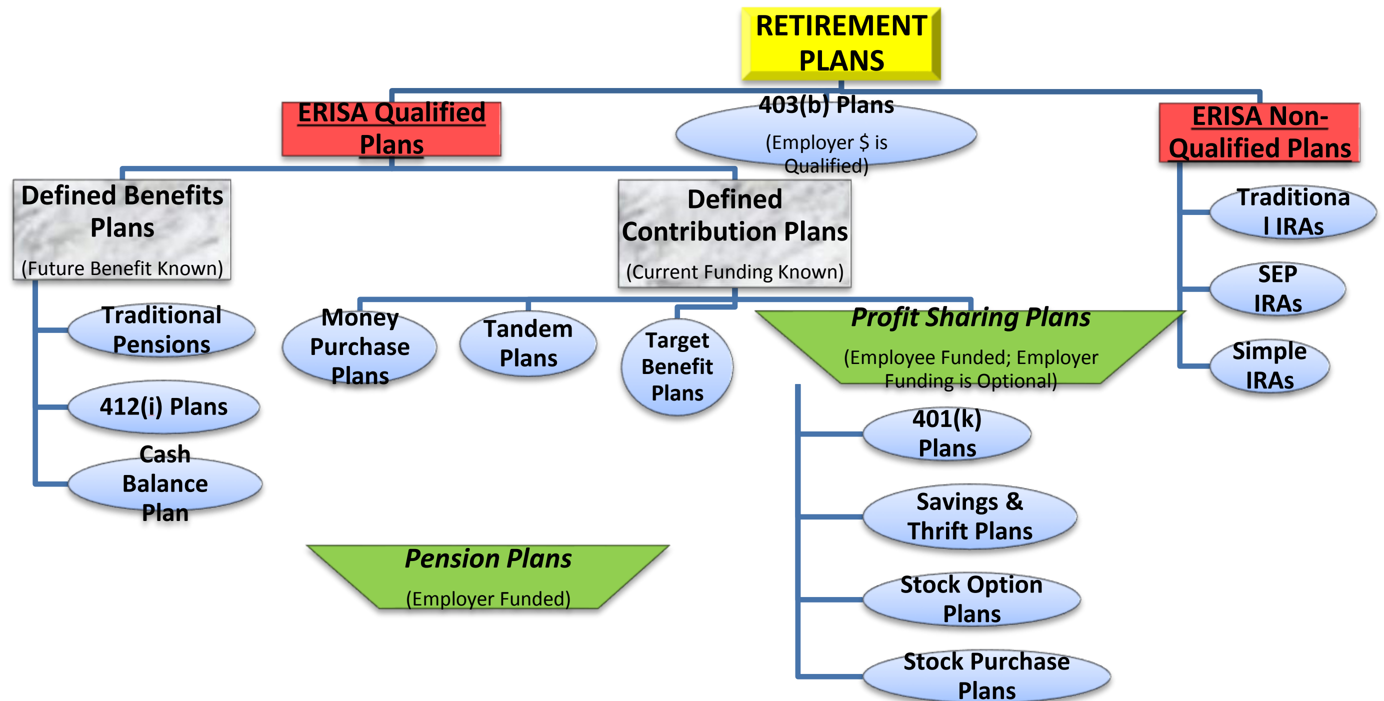
The dramatically increasing federal and New York estate tax exemptions have made estate planning professionals all too aware of the current focus on retirement planning in pre and post-mortem estate planning. This and Medicaid Planning will remain their focus for the next several decades as more Baby Boomers retire, live longer, begin taking required minimum distributions and decrease their investment risk in their IRAs. Retirement plans shall continue to be the primary liquid asset planners will need to inquire into in order to ensure proper planning

Attorneys accustomed to mere document drafting will have to make a defining decision regarding their law practice: Will they become dinosaurs content with assisting individuals with the most basic estate planning needs? Or will they commit to learning required minimum distribution rules so they can assist clients in completing beneficiary designation forms, and formulate (or more often "borrow") "see-through" provisions for post-mortem transfer documents?

The good news is that the burden of understanding retirement plans does not fall entirely on the shoulders of Attorneys. Accountants, Financial Planners, Retirement Plan Providers, and other professionals who derive significant income from retirement plan assets have also invested in the resources to adequately service their clients in these matters. The collective infrastructure of these professionals far exceeds what's expected of individual attorneys, and these professional institutions are more than willing to share their resources with allied professionals to ensure that the assets under their management are kept under their care.

The following materials will help those who are currently "document drafters" accustomed to "sweetheart wills," take the leap to become true estate planners, capable of providing advice to those individuals who currently represent nearly $18 trillion of wealth in this country.

II. Types of Retirement Plans



A general on-going theme of estate planning is looking at it as ASSET planning, rather than income planning. While a client's income is an important matter during their lives, it is an issue more appropriately addressed by financial planners, accountants or Medicaid planning practitioners: An estate planner's control over transferring income is somewhat limited (you know what the client and his spouse will receive, and often much of that income ceases upon their passing). However, by its very nature, an asset can be transferred to beneficiaries with greater certainty of the size of the asset and control over the asset. Any income generated by that asset is, again, often better left to the determination of other professionals.

As such, while an understanding of ***defined benefit plans*** is important for the current needs of a living client (because they are paying the client income that often ceases at death), the focus should be on understanding the nature of ***defined contribution plans***, where the retirement plan contains an asset that can be transferred to future generations. Non-qualified plans shall be included in this discussion too, as they are also effectively asset-based plans.

The vast majority of employer-sponsored defined contribution plan assets are held in 401(k)s and 403(b)s. Inherited retirement accounts ["IRAs"] may either be funded during working years, or

may receive "roll overs" from other retirement plans (such as 401(k)s) when a plan participant leaves an employer.

The most basic concept of defined contribution retirement plans is that income tax is NOT accessed on plan contributions at the time of deposit.

> Ex: Sergio earned $10,000 this month for his work as an employee at ABC Corp. He invests 10% of his paycheck in his employer-sponsored 401(k) plan. He is liable for income tax on $9,000 of his income; the $1,000 contributed to his 401(k) plan is not taxed now.
>
> 40 years later Sergio retires. He is 72 years old, and rolls his 401(k) to an IRA. His total assets in all of his defined contribution plans are now $800,000 (the money invested has appreciated). As he withdraws funds he is liable for taxes on money that is withdrawn.

The effect of this arrangement between the IRS and taxpayers is as follows:

- Working individuals are incentivized to save for retirement by deferring immediate income taxes
- Funds held in the defined contribution plan do not pay taxes on dividends, capital gains, etc. while they remain in the plan
- When funds are eventually withdrawn they have appreciated, and the IRS assesses income tax liability on every dollar withdrawn at the time of withdrawal

The types of investments available for retirement plans are substantial. While employer-sponsored plans tend to have some limitations on the investment options available to employees, this is more readily due to the fact that they do not wish to pay administrative expenses associated with having several thousands of mutual funds available for their plan. As such, most 401(k) and 403(b) plans are limited to anywhere from 10 – 40 mutual fund options.

IRAs, particularly rollover IRAs, are far less limited. Because the assets are usually held at large brokerage houses with access to thousands of mutual funds and other investments, the owner of a Rollover IRA has many more options, and pays higher expenses as a result of this flexibility and the fact it is solely administered. Real estate may also be held in an IRA, but the restrictions associated with this investment option are somewhat arduous. If you aren't familiar with these restrictions, have an outside firm or professional oversee the account for liability purposes. In addition, certain investments are prohibited from IRA investing, including: Physical gold, precious metals, options and other investments that can be "shorted", etc. The entire list of prohibited transactions is beyond the scope of this material, but is available online.

Commercial annuities can be sold inside or outside of a defined contribution plan. When purchased outside of a retirement plan, they have different treatment: The initial investment is not taxable, interest and gains are taxable as income (not capital gains), and all money withdrawn is considered "last in/first out" for taxation purposes. This means the last source of annuities funds (i.e. interest) is pulled out first, making all withdrawals taxable until only the principle remains; no taxes are owed on principle withdrawals. Annuities within retirement plans are fully taxable, as the funds have never been previously taxed. When a commercial annuity outside of a

retirement plan is annuitized only a portion of the funds are taxable, based on a ratio of interest to principle amounts plus on-going interest. Those funds within a retirement plan are fully taxable, again, because they have not yet been previously taxed.

III. Required Minimum Distribution Rules

IRC §72 mandates that owners of certain retirement accounts begin taking distributions the year the beneficiaries turn 70½.[1] These distributions are known as **required minimum distributions ["RMDs"].** Missing an RMD or underpaying what is owed enables the IRS to assess a 50% penalty on the shortfall.[2] The amount of RMD due is determined using (1) the total IRA and qualified plan balance on December 31st of the prior year, divided by (2) the percentage noted in the standard IRS "**uniform tables.**"

Age	Distribution Period	Age	Distribution Period
70	27.4*	93	9.6**
71	26.5	94	9.1
72	25.6	95	8.6
73	24.7	96	8.1
74	23.8	97	7.6
75	22.9	98	7.1
76	22.0	99	6.7
77	21.2	100	6.3
78	20.3	101	5.9
79	19.5	102	5.5
80	18.7	103	5.2
81	17.9	104	4.9
82	17.1	105	4.5
83	16.3	106	4.2
84	15.5	107	3.9
85	14.8	108	3.7
86	14.1	109	3.4
87	13.4	110	3.1
88	12.7	111	2.9
89	12.0	112	2.6
90	11.4	113	2.4
91	10.8	114	2.1
92	10.2	115+	1.9

RMDs are based on a person's life expectancy: The tables require a higher percentage of plan assets to be distributed to older recipients and lower amounts to younger recipients. A 70 year old has to withdraw 3.77% of her retirement funds (100 / 27.4*), and pay income taxes on this amount, whereas a 93 year old will have to withdraw 10.4% (100 / 9.6**) of her combined retirement account values. Some commonly used abbreviations to describe how the RMD process works include:

- **Applicable Distribution Period ["ADP"]**: the period during which benefits can be distributed
- **Required Begin Date ["RBD"]:** April 1st of the year following the year in which participant reaches age 70½
- **First Distributions Year ["FDY"]:** Typically the year owner reaches 70½, at which time the distribution can be made by December 31st of that year. However, this can be postponed to April 1st of the following year. The RBD is the following year (because a distribution is "required" by then). Waiting for the RBD will lead to two years-worth of distributions and income taxes (one for FDY and one for the RBD year).

[1] Exceptions include qualified funds when the employee is still working at the business sponsoring the plan and Roth IRAs. However, non-spousal beneficiaries of a Roth must begin taking RMDs from the inherited Roth account.
[2] Use IRS **FORM 5329**, which asks the IRS for an exception for missed RMDs (due to bad health, bad advising, etc.)

Remember that defined contribution plans have RMDs that commence at 70 ½ years of age, but may be withdrawn without penalty starting at age 59 ½. Otherwise, a 10% penalty is assessed in addition to the income that is assessed to the withdrawal. An exception to the early withdrawal rule can be found under IRC Section 72(t), known as "Separate and Equal Periodic Payments" (SEPP), which effectively allow a plan participant to commence earlier withdrawals on an accelerated schedule over a span of years. SEPPs are essential in understanding how a potential Medicaid recipient will be able to have defined contribution assets exempted for Medicaid resource limitations.

IV. RMDs After Life

Estates and charities receive the worse RMD treatment, because an estate or charity does not have a life expectancy. Of course, since a charity is not required to pay federal income taxes this is not a terrible outcome. However, for the estate this will lead to the **5 Year Rule** for RMD purposes: The retirement account must be distributed in full by the fifth year after the death of the participant, leading to large income tax rates in the short term. If you have an IRA with four children and one charity named as beneficiaries then ALL 5 must withdraw all funds over the five year period; this "all or nothing" approach (mistake) should be identified by the estate practitioner immediately, and avoided at all costs.

Spouses receive the most favorable RMD treatment: A surviving spouse may either (1) keep the funds in the deceased spouse's retirement account (and distribute RMDs based on the deceased spouse's life expectancy), or (2) transfer the account to his or her own retirement plan. All other individuals must transfer the retirement account of a decedent to an "inherited IRA." A non-spousal beneficiary must begin taking RMDs no matter what his age, but because he/she will typically be younger than the participant, the RMD rates are relatively low. This allows for gradual distribution, thereby assessing lower income taxes in any given year, with longer tax deferral periods. This is known as a **stretch IRA**, since the beneficiary is stretching distributions in accordance with his or her longer life expectancy. **What follows is how RMDs are calculated for IRAs:**

<table>
<tr><th></th><th></th><th>Death BEFORE RBD</th><th>Death AFTER RBD</th></tr>
<tr><td rowspan="2">If NO Designated Beneficiary (on the Beneficiary Designation form)</td><td>First Year</td><td rowspan="2">• All Qualified Plan & IRA funds must be distributed by 12/31 of the 5th anniversary of the owner's death</td><td>• RMDs over the owner's remaining life expectancy without recalculation</td></tr>
<tr><td>Subsequent Years</td><td>▪ RMD is calculated by reducing the owner's life expectancy by "1"</td></tr>
<tr><td rowspan="2">If a Legitimate "Individual" Designated Beneficiary</td><td>First Year</td><td>• RMDs made over the bene's life expectancy from the Single Life Expectancy Table IF the bene commences distributions by 12/31 of the year after the year of owner's death
• RMD for designated bene, calculate the bene's life expectancy for his age on his birthday in the year following the year of the owner's death</td><td>• RMDs may be made over the longer of:
(1) the owner's remaining life expectancy, or
(2) the bene's remaining life expectancy</td></tr>
<tr><td>Subsequent Years</td><td>• RMD calculated by reducing bene's life expectancy by "1"</td><td>RMD calculated over bene's life expectancy from the Single Life Expectancy Table</td></tr>
</table>

Eligible Designated Beneficiaries ["DB"]: A **designated beneficiary** is different than a "beneficiary." Many entities (charities, corporations, estates, non-qualified trust) can be the latter, but only an individual or a qualifying trust can be a DB. Remember: If even ONE beneficiary is not a DB then NONE of the beneficiaries are DBs. Whether or not a beneficiary is "applicable" to be a DB is determined on Sept. 30 of the year following the participant's date of death.

Naming one or several DBs on the beneficiary designation form allows for the most favorable post-mortem stretch RMD treatment using the beneficiary's longer life expectancy. Failing to name DBs, or naming multiple beneficiaries where even one is not a DB, will invoke the 5 year rule, forcing the beneficiaries to withdraw all funds from the retirement plan within five years. This negates the opportunity to stretch distributions. The DB's actual name need not be stated as long as the DB(s) can be identified using a class or distinction, such as *"my children"* or *"my living lineal issue at the time of my death."*

If there are multiple DBs for only one qualifying trust, even if all of the beneficiaries are eligible DBs (i.e. identifiable individuals), then RMD treatment is based on the DB with the shortest life expectancy – or the oldest beneficiary. In this case, the client may want to retitle and separate their assets into separate IRAs; this can also be done post mortem by September 30th of year following the date of death, to ensure all DB's get their own life expectancy for stretch RMDs. For all beneficiaries to use their own life expectancy, IRAs must be divided into separate Inherited IRAs by December 31st of the year following the participant's date of death.

Common Mistakes: Post-mortem problems frequently occur when retirement plans have multiple DBs, or a non-DB, such as a charity being a partial beneficiary with other DBs. This can be corrected in several ways, but all require that the fiduciary change the decedent's retirement account structure post-mortem. This is permissible until the "beneficiary finalization date." Then, the fiduciary of the estate can "unlump" the beneficiaries by creating separate inherited IRAs, one for each beneficiary, thereby (1) avoiding all beneficiaries receiving RMDs at the oldest beneficiary's RMD rate, and (2) giving the charitable beneficiary its own account so the DBs can avoid the 5 year rule.

Avoid paying estate taxes with IRA assets: An estate is a non-DB, which accelerates RMDs under the 5 year rule. To avoid this, customize the beneficiary designation forms to say (1) all estate taxes and expenses and (2) all charitable bequests that may apply to a trust beneficiary of an IRA, must be made by September 30th of the year following the participant's death.

If a minor is named as a direct beneficiary there must be a guardianship proceeding[3] since a minor cannot disclaim the assets. It is better to name a trust as the IRA beneficiary: The IRA will pay RMDs based on the minor's life expectancy to the trust, which then holds the funds until the beneficiary becomes an adult and is entitled to distributions under the trust's terms.

When a DB takes over an inherited IRA that originally had a DB, the RMD is fixed at the life expectancy of the DB because he is the initial beneficiary. If an inherited IRA is in the

[3] SCPA Article 17

participant's spouse's name (which should almost never be the approach) and she dies, the successor beneficiaries get the least desirable RMD treatment. In this case, the spouse's life expectancy becomes the measuring life for RMDs, even for the successor beneficiaries. If the estate tax exemption is fully utilized at the participant's death you should always roll the IRA over to a spousal IRA. The result upon the death of the spouse is that her beneficiaries receive RMDs based on their life expectancies, since the funds are technically in the spouse's IRA, as if the participant had never lived.

Good RMD Beneficiaries	Bad RMD Beneficiaries
Spouse: Best RMD Treatment; can transfer to his/her own account and use his / her life expectancy	**Estate:** Has no life expectancy, so it is not a designated beneficiary; 5 year rule applies
Younger Individuals: Use original owner's life expectancy table as a starting point.	**Older Individuals:** Use their own life expectancy table.
"See-Through" Trusts: same as above	**Non-Conforming Trusts:** 5 year rule applies
Leaving ALL of an account to a Charity: No RMD benefit, but estate receives income and estate tax deduction	**Leaving some to a Charity, the rest to Designated Beneficiaries:** If even one beneficiary doesn't have a life expectancy then NO beneficiary has a life expectancy; 5 year rule applies

A quick mention of Income in Respect to a Decedent: IRC § 691

Under the Internal Revenue Code, any property owned by a decedent that would be income if payable to decedent during life is taxable as income at death.[4] For income and estate tax purposes these assets are considered **Income in Respect to a Decedent ["IRD"].** The most notable IRD items are retirement plans, such as 401(k), 403(b) and deferred compensation plans, and IRAs (excluding Roth IRAs and Roth 401(k)s, which have already been taxed).

Since IRD items are considered items of income that have never been taxed, there is no step-up in basis for any IRD assets upon the death of the owner of the assets. Additionally, because income taxes are due on these items the IRS permits a correlating estate tax deduction for income taxes paid. This avoids double taxation of the same funds. Therefore, IRD treatment of assets only applies where an estate is taxable for estate tax purposes: If an estate is not taxable there is no IRD deduction. Though this deduction is welcome relief for estates holding large amounts of funds in IRD assets, the estate tax "deduction" is still far less favorable than a tax "credit." Due to this quandary, in the event that a client is charitably motivated, several estate planners will consider having IRD items paid to the client's charities, thereby (1) decreasing the gross estate

[4] IRC § 691

for estate tax purposes, (2) maximizing estate tax deductions, and (3) transferring assets that would not receive a step-up in basis if left to a non-charitable recipient.

One consequence of IRD and the associated deduction is that they are assessed in the year when received. This may be problematic in the case of “stretch IRA” payments on inherited IRAs, since only partial distributions and income taxes are taking place on these funds every year; in this case the IRD deduction must be calculated every year, which can lead to additional repetitive accounting fees.

IRD has become less of an issue since the increase of estate tax exemptions: Since IRD is typically assessed on estate taxable assets, yet the exemptions have increased enough to exclude most tax payers from owing an estate tax, the number of clients facing IRD on their retirement plans is and shall continue to decrease further.

V. Inherited IRAs

Aside from instances of fraud or the use of a QUADRO in divorce disputes, retirement plans generally cannot be transferred to another person or creditor during the account owner's life. However, when a plan participant (the owner of the retirement plan) passes away, the funds may either be transferred to his or her spouse's IRA, or be transferred to another person through the use of an "Inherited IRA."

These must be titled as ***"IRA f/b/o Tom Smith, John Smith, Dec'd"*** or ***"John Smith, IRA (deceased on May 21, 2007) f/b/o Tom Smith, Beneficiary."*** Be very cautious in working with the financial institution that is holding the account: Failure to fulfill Inherited IRA requirements—for example, rolling over the funds directly into a non-spousal beneficiary's IRA—may cause immediate taxation of ALL the funds, which will result in an income tax nightmare.

As stated herein, inherited IRA beneficiaries have to take RMDs, even before the age of 59 ½. However, unlike the plan participant's IRA withdrawals prior to age 50 ½, Inherited IRA beneficiaries are NOT assessed a 10% penalty on these withdrawals. In addition, no additional funds can be contributed to the IRA by the beneficiary: The plan is essentially its own entity waiting to be depleted without any ability to be replenished.

Suggestions for Naming Children as Primary or Contingent Beneficiaries to a Retirement Plan
1. Split up IRA accounts so that each child is a contingent beneficiary of his or her own account for RMD purposes (this can be done as an alternative to "see-through" trusts, and can be completed after death).
2. Younger beneficiaries are able to "stretch" RMDs for longer periods of time due to their increased life expectancy, which allows for a longer period of tax deferral.
3. If children need funds now and the retirement plan does not have a Trust as the beneficiary, the RMD rules won't matter. They need the money immediately, so they will have to take it along with incurring a hefty income tax.
4. If the account owner's estate will be subject to **IRD** consider (1) converting the plan to a Roth IRA, and/or (2) having desired charitable legacies paid for out of the retirement plan to minimize short term and future income taxes.
5. Name a see-through trust as the beneficiary of the plan.

VI. Creditor Rights and ***Clark v. Rameker***

Money within qualified retirement plans is protected from almost all creditors, save a divorcing spouse, or in cases of fraud. In other words, an employer-sponsored retirement plan is free from liens placed by the IRS, standards creditors, Medicaid (provided RMDs are being withdrawn), etc. In the world of estate planning, the typically moniker for funds within the control of the client is "You can't protect yourself from your creditors, but you can protect your children from their creditors." Defined contribution plans are the exact opposite: In general, the client can protect his funds from his creditors, but cannot protect the funds from his children's (or beneficiaries') creditors.

This was made dramatically apparent in ***Clark v. Rameker***, 134 S. Ct. 2242 - 2014. In a nutshell, the fact pattern had a daughter beneficiary of a parent's IRA claim that the funds, now in the daughter's inherited IRA, were exempt from the daughter's bankruptcy creditors.

The US Supreme Court determined that funds held in an inherited IRA were not protected from bankruptcy creditors: The funds in the inherited IRA (1) were never earned or saved by the daughter beneficiary, and thus were never truly saved by her for retirement purposes, (2) the beneficiary did not have to pay the 10% penalty associated with withdrawals prior to age 59 ½, even in the event that all plan assets were immediately depleted, (3) the beneficiary could not make additional contributions to the inherited IRA. As such, the assets in the inherited IRA were available for bankruptcy creditor invasion.

This leads to some troubling questions: Can the IRS pursue inherited IRA assets? What about the Department of Social Services in an instance in which a child is receiving Medicaid? The history of government agencies would suggest that their exercise of creditor rights is not far behind…

VII. Retirement Plans with Trusts as Beneficiaries

Qualified / “See-Through” Trusts: With these trusts, the beneficiary is treated as the beneficiary of the retirement account for purposes of determining whether there is a DB. *This is the most desirable outcome for a parent-to-child transfer*, especially if the child is still a minor, since RMDs will take place at the rate of the child beneficiary. In order for a see-through trust to accomplish this end, the following requirements must be met:

(1) The trust must be valid under state law,
(2) The trust must have identifiable beneficiaries; “classes,” such as “my children” are okay, but the beneficiaries with the longest and shortest life expectancies must be identified at the time of the transfer,
(3) The trust must be irrevocable before or as of the participant’s death,
(4) A copy of the trust must be sent to the plan administrator or trustee by 10/31 of the year following participant’s death, or the plan administrator or trustee must receive a list of all trust beneficiaries (including contingent and remainder beneficiaries) by September 30th of the year following the participant’s death, and
(5) All primary trust beneficiaries must be individuals

Conduit trusts: With a conduit trust, all distributions paid to the trust are immediately distributed to the beneficiary and not accumulated for future distributions to the successor beneficiaries. This language must be written into the trust in order for it to be effective. In addition, make sure there are separate trusts for each beneficiary in order to take advantage of favorable stretch RMD distributions for the younger beneficiaries.

Accumulation trusts: These trusts are good if the settlor / plan participant wants to withhold principal and income from the initial trust beneficiaries, and thus it is the opposite of a conduit trust. However, these trusts receive the least desirable RMD treatment, as they must use the life expectancy of the oldest beneficiary, even if he or she is only a contingent beneficiary, and even if there is an extremely low probability that beneficiary will collect the funds.

Simple Retirement Plan Language for a Testamentary Trust:

F. Retirement Accounts:

If the trust established under this Will for my living children receives funds from retirement plans, then I direct the Trustee adhere to the following:

1. Should this Trust be designated as beneficiary of any IRA, 401(k), or any other tax-deferred or "Roth" retirement accounts (Retirement Accounts), then the Trustees shall remove from the funds the "required minimum distribution" of the total of all Retirement Accounts. The amount of the "required minimum distribution" and the mechanism by which it is determined and removed shall be determined by the Trustees

based on current federal and state tax law and IRS rules and regulations in effect at the time of the determination.

2. This Paragraph F shall in no way prevent the Trustees from removing any or all of the principal of any Retirement Account in which the Trust is named beneficiary if the Trustees determine such sum is needed to accomplish the purposes of the Trust.

3. When the beneficiary reaches the age of thirty-five (35) years, the Trustees shall, if permitted by federal and state law and IRS rules and regulations governing distribution of Retirement Accounts, transfer the Retirement Accounts from the Trust as beneficiary to the child as beneficiary. If federal or state law, or IRS rules and regulations governing distribution of Retirement Accounts do not allow this beneficiary transfer without creating a taxable event, then the Trust shall remain open for the purpose of receiving distributions from these Retirement Accounts, and the child shall become the sole Trustee of the Trust. If the child's designation as Trustee shall result in a taxable event, then the persons who serve as Trustees immediately prior to the child's thirty-fifth (35th) birthday shall continue as Trustees and may name a new Trustee or new Trustees at any time to serve in his/her/their stead. The purpose of this paragraph is to maintain the tax deferred or tax free status of the Retirement Accounts, and at the same time to allow the child to direct these Retirement Accounts himself.

4. The Trustees of this Trust, in consultation with any professional financial advisor if the Trustees so choose, shall make all investment decisions for all Retirement Accounts in which this Trust is designated beneficiary.

5. The Trustees shall have the power to change and amend the Trust without court permission to reflect any changes in federal or state tax law and IRS rules and regulations governing distributions of Retirement Accounts. Such change shall be accomplished by a duly signed and acknowledged instrument in writing.