NAMING THE BENEFICIARY OF A RETIREMENT ACCOUNT

It's More Than Fill-in-the-Blanks

By Nancy H. Welber

The job of an estate planning attorney includes drafting wills, trusts, and other documents. It should also include drafting retirement account beneficiary designations, or at least assisting with the process of designating beneficiaries of retirement accounts. For many clients, their retirement account will be the largest asset in their portfolio.[1] Too often, a client leaves the estate planner's office and is expected to fill in the beneficiary designation without instructions specific enough to avoid a tax and financial disaster for the beneficiaries. The attorney should view the estate planning process as an opportunity to educate the client about the issues involved in choosing retirement account beneficiaries. The attorney should also actively assist the client with completing the forms or drafting custom beneficiary designations, as the situation warrants.

When planning with retirement benefits, the objective is typically to try to maximize the continued income tax deferral of the retirement benefits while meeting the client's non-tax goals. Under the minimum distribution regulations,[2] in most instances the account owner must begin to take required minimum distributions (RMDs) by April 1 of the year following the year the account owner attains age 70½ (the "required beginning date").[3] The account owner ordinarily determines the payout rate (the "applicable distribution period" or ADP) using the Uniform Lifetime Table[4] based on the account owner's age each year and the age of a beneficiary 10 years younger than the account owner, with an exception for a much younger spouse. There are no lifetime RMDs from a Roth IRA for the account owner. Special RMD rules apply to the surviving spouse who is the beneficiary of the retirement account, as described below. Non-spouse designated beneficiaries must take minimum distributions regardless of age, usually starting by December 31 of the year following the year of the account owner's death.

Know the Client's Plan

Choosing a beneficiary starts by knowing your client's retirement account. Qualified plans established by private employers are subject to the Employee Retirement Income Security Act of 1974 (ERISA).[5] Under ERISA and the Internal Revenue Code, the spouse must be named as the beneficiary unless the spouse waives that right.[6] The waiver procedure is specified in the Code, and benefits may also have to be paid in a specific manner such as a qualified joint and survivor annuity or a lump-sum distribution, depending on the type of plan. In contrast, IRAs and plans sponsored by public employers and religious institutions are not subject to ERISA.[7] For non-ERISA plans and accounts, the account owner is free to name whomever he or she wishes as the beneficiary. It is advisable to get a copy of the plan or the summary plan description for employer plans or the IRA adoption agreement to be sure which rules apply to the client's account and the benefits available to beneficiaries.

Designated Beneficiary

If stretching the benefits over the beneficiary's life expectancy is important to the client, then the client must name a "designated beneficiary," i.e., an identifiable individual, to allow the beneficiary to take the benefits over the beneficiary's life expectancy or over the life expectancy of the person with the shortest life expectancy in a group of multiple beneficiaries. When there are multiple beneficiaries, if the beneficiaries create separate accounts by December 31 of the year following the year of the account owner's death, then each beneficiary can use his or her own life expectancy to determine the ADP of the inherited retirement account.[8] If the beneficiaries inherit from an employer plan, non-spouse designated beneficiaries can roll over the benefits through a direct rollover to an inherited IRA, generally by that same December 31 deadline, and continue to stretch the benefits using each beneficiary's own life expectancy, as determined under the Single Life Table of the minimum distribution regulations.[9]

Fast Facts

Clients often fill out beneficiary designation forms for their retirement accounts without consulting their attorneys. What looks like a simple fill-in-the-blanks exercise can lead to unintended tax and non-tax consequences. Naming a trust as the beneficiary can be especially problematic.

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In 2012, the Senate Finance Committee considered limiting most non-spouse beneficiaries to distributions over a five-year period on the death of the account owner. If this were to become law, it would drastically change planning for non-spouse beneficiaries.[10]

Surviving Spouse as Beneficiary

Naming the surviving spouse as the sole beneficiary provides the most flexibility in planning. The following is the most common option chosen by a surviving spouse:

- Delay the commencement of minimum distributions until his or her required beginning date by rolling over the retirement benefits to the spouse's own retirement account.[11]
- Once minimum distributions begin, the spouse uses the Uniform Lifetime Table to calculate the RMD.
- The spouse can name beneficiaries who will use their own life expectancies to determine their RMDs.

Other provisions give advantages to the surviving spouse in situations encountered less frequently, such as for young widows.[12]

Children and Grandchildren

Naming children and grandchildren as beneficiaries allows the client to maximize the stretch-out of the retirement benefits. If separate accounts are established on a timely basis, the beneficiaries will be able to use their own life expectancies to determine the ADP for their inherited IRA account, including inherited Roth IRAs from which distributions are generally income-tax-free. If a client has a very large retirement account, care must be taken to avoid the generation-skipping tax if grandchildren are beneficiaries.[13]

The appeal of the stretch-out is obvious using the IRS Single Life Table to determine the ADP for an IRA. Under the IRS table:

- At age 40, a child's life expectancy is 43.6 years.
- At age 21, a grandchild's life expectancy is 62.1 years.
- At age 12, a grandchild's life expectancy is 70.8 years.

Charities

Naming a charity as the beneficiary directly through the beneficiary designation can be advantageous for the client who has charitable intent. Naming a charity shifts "income in respect of a decedent" from individual beneficiaries to the tax-exempt charity, which will not pay income tax on the retirement account distributions.[14] If the choice is between a charity and a young beneficiary, projections should be prepared to determine whether it would be better for the child or grandchild to inherit the retirement account and take the stretch-out or inherit after-tax assets instead.

Because a charity is an entity, care must be taken when a charity will be named as a beneficiary of a retirement account along with individuals. Furthermore, it is almost never a good idea to name a charity as the beneficiary of the retirement account through a trust. Without extremely careful drafting, the benefits may become taxable to the trust when the devise is funded. The trust also may not receive an income tax deduction for the distribution to the charity.[15]

No Designated Beneficiary or "Undesirable" Beneficiaries

Naming entities such as charities and trusts that do not qualify as "see-through trusts" under the complex trust rules described later, or failing to name a beneficiary for a retirement account that defaults to the account owner's estate are scenarios that can lead to a failure to name a designated beneficiary. An entity has no life expectancy. If the entity must be taken into account when determining the ADP, the entity's presence will prevail. If there is no designated beneficiary, the ADP may be drastically reduced. If the account owner dies on or after his or her required beginning date, the ADP will be the account owner's theoretical remaining life expectancy based on the age attained by the account owner in the year of death. If the account owner dies before the required beginning date, the benefits must be distributed by December 31 of the year containing the fifth anniversary of the account owner's death if there is no designated beneficiary.[16] In employer plan situations in which plan benefits are paid in a lump sum and there is no designated beneficiary, the beneficiaries are immediately taxed on the entire distribution.

Deferral may also be less than optimal if a charity or much older beneficiary is part of a group of beneficiaries, often as a contingent remainder of a trust. Fortunately, whether an account owner has a designated beneficiary, and, consequently, the ADP, are not determined until September 30 of the year following the year of the account owner's death. Between the account owner's death and that September 30 deadline, the regulations allow for changes to the retirement account beneficiaries so the account will have a designated beneficiary. Charities or older beneficiaries can be eliminated by paying them their share of the account, using qualified disclaimers of interests in the retirement account within nine months of death, and, in some cases, making modifications to trusts or beneficiary designations.[17]

Trusts

Trusts should be used as beneficiaries of retirement accounts only when the client's non-tax objectives must be met through the use of a trust. The rules governing the use of trusts as beneficiaries are intricate. Other than the regulations, most of the law in this area is based on private letter rulings, which may help infer how the IRS feels about a particular circumstance but are only binding on the taxpayer requesting the ruling.

In most instances, to successfully use a trust as a beneficiary of a retirement account, the trust must be considered a "see-through trust," i.e., a trust whose beneficiaries are treated as the designated beneficiaries of the retirement account. A see-through trust must meet the following requirements:

- The trust must be valid under state law or would be but for the fact that there is no corpus.
- The trust must be irrevocable or will, by its terms, become irrevocable on the death of the account owner. This includes testamentary trusts.
- The trust must have designated beneficiaries who are *identifiable* from the trust instrument.
- The trustee must provide a copy of the trust and all amendments or a list of all beneficiaries and their interests in the trust to the plan administrator or IRA custodian, generally by October 31 of the year following the year of the account owner's death.[18]

The complexity results from trying to identify which trust beneficiaries make up the group that will determine whether the beneficiaries are identifiable. "Identifiable beneficiaries" must be individuals living at the time of the account owner's death. In addition, among this pool of living individuals, one or more must be entitled to all the retirement benefits either as the primary trust beneficiary following the death of the account owner or on the death of a prior trust beneficiary.

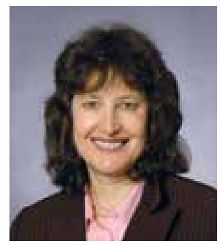
All trust beneficiaries, whether individuals or charities, will be "counted" as beneficiaries until a beneficiary takes the benefits outright. If the benefits are payable outright to the account owner's individual trust beneficiaries at the account owner's death, the trust will usually be a see-through trust. The life expectancy of the oldest beneficiary will be used to determine the ADP for all trust beneficiaries even if separate inherited IRAs are established for each beneficiary because the separate account rule usually does not apply to trusts.[19]

Likewise, if the trust (or a subtrust) is a mere conduit for the benefits, so that when the trustee receives the RMD and any additional withdrawals from the retirement account the benefits will be paid to the beneficiary or used for the beneficiary's benefit (a "conduit trust"), then the conduit trust beneficiary will usually be the designated beneficiary. If each subtrust is specifically named as a beneficiary in the beneficiary designation, then the separate account rule can apply and each conduit trust beneficiary can use his or her life expectancy to determine the ADP.[20] If the conduit trust has multiple beneficiaries, the oldest beneficiary's life expectancy will be used to determine the ADP.

If the trust will accumulate any of the retirement benefits (an "accumulation trust"), the designated beneficiary is determined by looking at all life beneficiaries and remainder beneficiaries until an individual beneficiary who is living at the time of the account owner's death is found who will, upon the death of a prior beneficiary, take the retirement benefits outright. An accumulation trust would include a trust for children that distributes income and principal for the children's support and education and terminates when the youngest is age 35. In that case, if the remainder beneficiary takes the trust assets outright, only the children and the remainder beneficiary are "counted" to determine whether the trust has a designated beneficiary and to establish the ADP. The oldest beneficiary's life expectancy would be used. If the remainder beneficiary is the child's issue, the child must have issue living at the time of the account owner's death or more remote remainder beneficiaries must be identified who will take the benefits outright. If the remainder beneficiary is a charity, there is no designated beneficiary. Likewise, a marital trust for the spouse's lifetime is also an accumulation trust in most cases. Special drafting rules apply to marital trusts so they will meet the RMD rules and qualify for the estate tax marital deduction.[21]

There are myriad ways in which a trust can fail the see-through test, e.g., by allowing the trustee to use retirement benefits to pay expenses of administration, debts, and taxes of the account owner after the September 30 beneficiary determination date or through hold-back provisions for disabled beneficiaries. Fortunately, some issues can be fixed by the September 30 deadline.

Choosing a beneficiary is complicated. Complex planning often requires the use of custom beneficiary designations attached to the form provided by the plan or IRA custodian. The client should be advised: don't try this at home. ■



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FOOTNOTES

1. For purposes of this article, the term "retirement account" refers to defined contribution employer plans governed by 26 USC 401(a), 26 USC 403(b), 26 USC 414(h), and 26 USC 457, and traditional and Roth IRAs governed by 26 USC 408 and 26 USC 408A. It does not include defined benefit pension plans under 26 USC 401(a) or nonqualified deferred compensation plans. The term "account owner" refers to the employer plan participant or IRA owner.
2. Treas Reg § 1.401(a)(9)-0 *et seq.*
3. Treas Reg § 1.401(a)(9)-2, A-2.
4. Treas Reg § 1.401(a)(9)-9, A-2.
5. 29 USC 1003(a) and (b).
6. 26 USC 401(a)(11); 26 USC 417.
7. 29 USC 1003(b).
8. Treas Reg § 1.401(a)(9)-8, A-2. If the account owner dies after the required beginning date, the designated beneficiary uses the longer of the designated beneficiary's life expectancy or the account owner's theoretical remaining life expectancy. Treas Reg § 1.401(a)(9)-5, A-5(a)(1).
9. Treas Reg § 1.401(a)(9)-9, A-1.
10. Joint Committee on Taxation, *Description of the Chairman's Modification to the Proposals of the "Highway Investment, Job Creation and Economic Growth Act of 2012"* (JCX-11-12), February 7, 2012, pp 12–17. This provision was not included in the American Taxpayer Relief Act of 2012 (HR 8, signed by President Obama on January 2, 2013, as this article was edited).
11. 26 USC 402(c)(9); Treas Reg § 1.401(a)(9)-2, A-1.
12. Treas Reg § 1.401(a)(9)-3, A-3(b).
13. See 26 USC 2601.
14. See 26 USC 691(a); 26 USC 501(a). Most retirement account distributions are taxed as ordinary income because they have never been taxed during the account owner's lifetime.
15. Office of Chief Counsel, Internal Revenue Service, CCM 2006-44020 (2006), available at <http://www.irs.gov/pub/irs-wd/0644020.pdf> (accessed December 24, 2012) (finding that any transfer of retirement benefits through a pecuniary bequest is considered a sale of benefits, triggering the realization of taxable income under 26 USC 691(a)(2)).
16. Treas Reg § 1.401(a)(9)-5, A-5(b).
17. Treas Reg § 1.401(a)(9)-4, A-4(a).
18. Treas Reg § 1.401(a)(9)-4, A-5.
19. A retirement account does not have to be cashed out when it is distributed to the trust beneficiary. An inherited retirement account can be established for the beneficiary instead of accelerating all of the income.
20. Department of the Treasury, Internal Revenue Service, CCM 2005-37044 (2005), available at <http://www.irs.gov/pub/irs-wd/0537044.pdf> (accessed December 24, 2012). Since this private letter ruling was issued, the IRS has allowed this limited exception to the prohibition on the use of separate accounts for trusts. Treas Reg § 1.401(a)(9)-4, A-5(c).
21. Internal Revenue Service, Revenue Ruling 2002-2.