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EFFECTIVELY USING BENEFICIARY DESIGNATIONS ON RETIREMENT ACCOUNTS*

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INTRODUCTION/FRAMING THE ISSUE

As of March 31, 2018, total retirement assets held in the United States were valued at roughly $28 Trillion Dollars.[1] Retirement assets accounted for about 34% of all household financial assets in the U.S.[2]

Based on these statistics, and on the experience of many estate planners who see a rising proportion of estate planning clients with significant portions of their net worth invested in retirement assets, it is critical that estate planners are conversant with the options and rules applicable in deciding how to designate beneficiaries for their clients' retirement assets.

The danger is that, left to their own devices, our clients may view the seemingly simple beneficiary designation forms provided by the employer's HR personnel, or the forms provided as part of the voluminous account opening packet for an IRA account, as potentially insignificant.

In reality, the beneficiary designation forms completed for retirement accounts may be as important—or more important—than the Will and/or Trust Agreement traditionally prepared by an estate planning attorney. In a sense, each beneficiary designation form is a "mini-Will" controlling what happens to the owner's retirement accounts at death and, as such, deserves appropriate attention commensurate with the value of the assets in that account.

This article will:

1. Present the main factors in a multifactorial planning analysis relating to retirement assets
2. Discuss the hierarchy of potential beneficiaries (from a tax perspective)
3. Offer examples of some potential results
4. Discuss situations where the IRS distribution rules do not matter/exceptions to the general rules
5. Offer one possible approach to selecting beneficiaries
6. Discuss the challenges of getting beneficiary designation forms completed, transmitted, and accepted
7. Identify some valuable reference resources

SHORTHAND TERMS

The following are some helpful shorthand terms used in this article:

1. Required Beginning Date (RBD)—The IRS-defined date by which the owner or beneficiary of a retirement account must begin to take required distributions.
2. Required Minimum Distribution (RMD)—Under IRS regulations, the amount that must be distributed in a particular year from particular retirement assets to the owner or beneficiary.
3. PLR—Private Letter Ruling.
4. Client or Owner—The owner of an IRA or "plan participant" of an employer-sponsored account. Many of the applicable IRS regulations are written referencing the "plan participant," though for our purposes the term also generally applies to the owners of an IRA account.
5. Designated Beneficiary—The selected person for purposes of determining required minimum distributions from the retirement account following the death of the owner.
6. IRA or "retirement account"—Used generically in this article to refer to all manner of retirement accounts, unless otherwise specified, including 401(k) accounts, 403(b) accounts, IRAs, Roth IRAs, etc.

PRELIMINARY MATTERS

Because of the length and scope of this article, the author writes using the "90/10" Rule. The material in this article is probably correct 90% of the time, but a careful reader could probably come up with exceptions or specific cases where the general rule does not apply (the 10%). For example, 401(k) accounts and other employer-sponsored retirement plans are incrementally different than traditional IRAs. Likewise, Roth IRAs are fundamentally different from traditional IRAs from an income tax perspective, but the same insofar as IRS post-death distribution rules go. Some notable exceptions are discussed in this article, but for the most part the exceptions/differences are not addressed to respect space and time limitations, and to avoid getting lost in the details.

From an economic perspective, most retirement assets are similar, in that, so long as the assets remain inside the retirement account, they are not subject to income tax. However, when the assets are distributed from the retirement account, they are subject to income tax on a dollar-for-dollar basis. For example, the owner of an IRA who receives a normal retirement distribution from an IRA account of $1,000 will recognize $1,000 of regular income in the year the distribution is received, and will pay income tax on that income at his or her effective income tax rate. Likewise, if the owner dies and the account passes to a beneficiary, the beneficiary receiving a distribution of $1,000 will recognize $1,000 of regular income, again in the year the distribution is received, and the beneficiary will pay income tax at his or her effective income tax rate.

For income tax purposes, distribution deferral is

"King." That is, all other things being equal, it is better to defer distributions from retirement accounts for as long as possible, allowing for tax-free growth and appreciation. Deferral also avoids current income taxes. However, at the risk of stating the obvious, being able to spend some of the retirement assets eventually would be beneficial! An asset that never provides a benefit to its owner might not be properly counted as an asset at all. A Greek proverb states that "[a] society grows great when old men plant trees whose shade they know they shall never sit in." This inherent tension between tax-free growth within the account and retirement plan distributions which trigger both the ability to spend the asset and income recognition is central to administration of retirement assets.

Of course, the IRS rules are designed generally so that, if the owner achieves his or her expected life expectancy, the owner will have withdrawn most or all of the value of his or her retirement accounts before death.

Though much of this article is focused on income tax implications, it is important to remember not to let the tax tail wag the dog. If the owner's dispositive intentions do not match up with optimal tax results, and the owner understands the implications of his or her decisions, then we should proceed to follow his or her intentions rather than worrying so much about income tax results. On the other hand, the ability to quickly understand the income tax implications of any given course of action is key to helping the owner make informed decisions about estate planning options.

This article is planning oriented. That is, we assume that the owner is still living and competent to make decisions. This article is not oriented as much to situations where the "client" arrives in an already deceased condition, and the advisors are faced with post-death planning decisions/options, some of which may well constrain the remaining options. Good lifetime planning will help avoid post-death planning challenges that could arise with respect to retirement assets.

As a final preliminary matter, it is also good to "run the numbers," and then run the numbers again, to see if your understanding of what you believe should happen is borne out by the real-world projected results. There are a number of commercial products available for this purpose,[3] you can build Excel spreadsheets for this purpose, and/or you can rely on an accountant or financial planner to help with this task.

FACTORS TO CONSIDER

The following are factors to consider when an owner is deciding how best to complete the beneficiary designation forms for retirement assets:

1. Identity of potential beneficiaries, listed from most tax-advantaged to least tax-advantaged

a. Charities

b. Spouse

c. Young beneficiaries (individuals, such as grandchildren)

d. Older beneficiaries (individuals, such as children of the owner, or siblings)

e. Qualified trust beneficiaries (theoretically the same tax implications of c. and d., but with additional technical and administrative complexity)

f. Beneficiaries who are not individuals (such as a probate estate or corporation)

2. Income tax deferral and reduction opportunities

a. The longer the potential deferral, the better

b. The lower the effective income tax rate of the beneficiary, the better

3. Is there a desire to control the retirement assets from the grave to protect the beneficiary?

a. Protect the beneficiary from himself/herself (e.g., bad judgment; spendthrift issues, etc.)

b. Maturity/age issues (practical challenges when beneficiaries are under age 18)

c. Need or desire to control investment selection within the retirement account

d. Need or desire to control timing and/or amount of distributions from the retirement account (when the beneficiary cannot be trusted to take appropriate distributions)

e. Asset protection considerations (e.g., a beneficiary needs asset protection beyond the protection otherwise available to the beneficiary account)

Very generally, the owner can pick two of the following three factors to optimize:

1. Identity of beneficiaries
2. Income tax results
3. Comprehensive control from the grave

One tricky concept of retirement assets, different in kind from most other assets, is that the economic value of retirement accounts varies based on the identity of the owner or the identity of the beneficiary. A more tax-favored beneficiary equates to a more valuable asset. Likewise, a less tax-favored beneficiary equates to a less valuable retirement asset. A $100,000 IRA passing to a younger beneficiary, with a low marginal income tax rate and significant potential income tax deferral, could be worth a great deal more than $100,000 net of income taxes. In contrast, the same $100,000 IRA passing to a very elderly beneficiary, with a high marginal income tax rate and little opportunity for income tax deferral, is likely worth significantly less than $100,000 net of income taxes.

HIERARCHY OF BENEFICIARIES

One threshold question is: Does the identity of the named IRA beneficiary affect required distributions during the owner's lifetime?

The answer is a resounding "No," except in the niche case where the owner is married to a much younger spouse, and the much younger spouse is named as the sole beneficiary of the IRA. Otherwise, the selection of beneficiary does *not* affect required distributions during the owner's lifetime.

During the owner's lifetime, required distributions start when the owner reaches roughly age $70^{1/2}$, and those required distributions are recalculated each year, based on a Uniform Lifetime Table issued by IRS regulations.

IRA beneficiaries can be loosely organized into an income tax hierarchy based on their identities.

CHARITIES AS BENEFICIARIES

Charities are at the "top" of the hierarchy based on the fact that they are income tax-free organizations, so assets passing to charities are available to the charity at the gross, pre-tax value. To the extent there is potentially estate tax due, a charitable estate tax deduction applies. The overall result is the best of all worlds. The owner has never paid income tax on the IRA account value, nor will the ultimate recipient—the charity. If the owner is charitably inclined, one of the most effective techniques available is to name the desired charity(ies) as beneficiary of the IRA account. Doing so offers a tax-free in/tax-free out result, which is very attractive.

The vast majority of this article focuses on leaving retirement assets to a beneficiary <u>at death</u>. However, there is also an opportunity for the owner to give retirement assets to charities <u>during the lifetime</u> of the owner. This powerful but niche technique was created by Congress in 2006, but was available on a temporary and often retroactive basis before it was made permanent by Congress in December 2015. This technique, usually referred to as a "qualified charitable distribution" (QCD), allows a traditional IRA owner or beneficiary who is over age 701/2 to instruct the custodian of the IRA to transfer up to $100,000 in any given calendar year directly to one or more charities (other than donor-advised funds and supporting organizations). The amount transferred is not included in the gross income of the IRA owner, even though the transfer is a distribution from his or her IRA, and even though the transfer may be used to satisfy the owner's lifetime RMDs. Any owner looking to use the QCD technique should examine the technical requirements in much more detail.

SPOUSE AS BENEFICIARY

The spouse as beneficiary is the next-most advantageous class of beneficiary, from an income tax perspective. A spouse is the <u>only</u> beneficiary who can complete a "rollover" of the account and take that account as his or her own, using the

Uniform Lifetime Table for distributions throughout the spouse's lifetime. For many married owners, this is the starting point for discussion, and it is only if there are overriding factors present, such as a desire to ensure the remaining assets pass to children of a prior marriage, that the owner should consider a beneficiary other than the surviving spouse.

INDIVIDUALS OTHER THAN A SPOUSE AS BENEFICIARY

If any individual other than a spouse is named as the beneficiary, then the beneficiary must create a beneficiary account or "inherited IRA" account, under which the beneficiary is able to control both the investments of the account and the timing and amount of distributions. The beneficiary is obligated to take distributions based on the beneficiary's remaining life expectancy. The Single Life Expectancy table, which is not recalculated in any future years, stands in contrast to the approach of the Uniform Lifetime Table (life expectancy recalculated each year of the owner's life). Overall, then, naming an individual (other than a spouse) as beneficiary is a comparatively tax-advantaged way to proceed—the younger the named beneficiary the better.

SEE THROUGH TRUST AS BENEFICIARY

If a Trust is named as beneficiary of an IRA, the IRS may be willing to "see through" the Trust and treat the Trust beneficiary(ies), or the sub-trust to which the retirement assets are directed by the beneficiary designation, as the beneficiary for purposes of computing required distributions from the IRA. If certain technical requirements are met, a See-Through Trust can offer the best of all worlds—with additional asset protection characteristics and control offered by the Trust, but with the same required minimum distribution schedule that would have been in place had the named beneficiary been the Trust beneficiary himself or herself. On the other hand, the IRS rules for See-Through Trusts, and practical compliance with those rules, are complicated.

There are typically three types of Trusts named as beneficiaries of an IRA:

1. A Conduit Trust
2. An Accumulation Trust
3. A Non-Qualified Trust Beneficiary (equivalent to a Non-Individual as beneficiary—see below)

As a threshold matter, any Trust seeking See-Through Trust treatment must meet the following threshold requirements:

1. Trust must be valid under state law
2. Trust must be irrevocable, at least immediately after the death of the owner
3. Trust beneficiaries must be identifiable by being named, or by being members of a class of beneficiaries that makes each person identifiable
4. Certain documentation must be provided to the plan administrator (IRA custodian) by October 31st of the year after the year of the owner's death
5. All Trust beneficiaries must be individuals (this threshold requirement is not explicit in the regulations but is implied for the Trust to avoid treatment as a Non-Qualified Trust Beneficiary)

By far the most complicated of the requirements is #3—making sure the Trust beneficiaries are identifiable (and are all individuals). This issue is complicated and has many nuances beyond the scope of this article.

If a Trust meets the threshold requirements for all See-Through Trusts, then the question is whether it is a Conduit Trust or an Accumulation Trust.

To be a Conduit Trust, the See-Through Trust must provide that all distributions from the IRA account are paid to the (individual) Trust beneficiary upon receipt by the Trustee (when distributions are made, the Trustee is a mere "conduit" between the IRA and the Trust beneficiary). If that requirement is met, then remainder beneficiaries (e.g., permissible appointees under a power of appointment; charities; older beneficiaries, etc.) do not count for purposes of determining RMDs or

See-Through Trust status. Note that distribution from the IRA account can be used to pay appropriate Trust expenses.

If a See-Through Trust does not qualify as a Conduit Trust, then it is considered an Accumulation Trust.

An Accumulation Trust, though, requires careful, tailored drafting to ensure that no person older than the intended (designated) beneficiary can ever be a beneficiary of the Trust/sub-trust receiving IRA distributions. On that basis, drafting considerations include:

1. Any permissible appointees under powers of appointment should generally be limited to individuals younger than the current beneficiary

2. Contingent beneficiaries generally count for RMD purposes

3. The Trust terms should generally prevent the adoption of an older beneficiary, or otherwise adding any older beneficiary

4. A non-individual (e.g., estate, charity, creditor, etc.) cannot be a beneficiary of the Trust/sub-trust receiving IRA distributions

An Accumulation Trust is not required to distribute the value of distributions from the IRA to the Trust, but keep in mind that those distributions still likely qualify as taxable income from an income tax perspective, on a dollar-for-dollar basis. Therefore, any "accumulated" IRA distributions to the Trust are likely taxed at the Trust level for income tax purposes, using the current (compressed) income tax brackets applicable to trusts.

Note that, though various PLRs issued in recent years provide more clarity, there is still significant uncertainty about who is considered a "designated beneficiary" (a permissible counted individual) of a Trust for purposes of setting the RMDs. More precisely, there is ambiguity about which Trust beneficiaries are considered "mere potential successor" beneficiaries under the applicable IRS regulations, and which beneficiaries are more than mere potential successors and as such their existence endangers optimal RMD treatment.[4]

If the purported See-Through Trust does not meet the tests as a Qualified Trust, then the IRA is treated as if there is no "designated beneficiary" (no individual who is a beneficiary), and the Trust must take distributions under the same rules as if the IRA passed to any other "non-individual"—on a shortened basis. See more discussion below.

NON-INDIVIDUALS AS BENEFICIARY

If the owner names a beneficiary who is not an individual, the result is the least tax advantaged. If the owner dies after the owner's RBD, required distributions must be made over the remaining (non-recalculated) life expectancy of the deceased owner, beginning by the end of the year following the year of the owner's death. If the owner dies before the owner's RBD, the entire account must be distributed within five years of the owner's death. This class of beneficiary includes any Non-Qualified Trust—any trust that fails to qualify as a See-Through Trust, as discussed above.

POST-DEATH PLANNING/ADMINISTRATIVE DEADLINES

Though this article does not concentrate on post-death planning issues, following are some dates which a beneficiary should pay attention to in a post-death planning/administration context:

1. Disclaimer deadline—nine months after the owner's death or, if later, nine months after the beneficiary reaches age 21

2. Deadline to determine beneficiaries (so-called Beneficiary Finalization Date, e.g., deadline to take action to narrow the class of beneficiaries, for RMD purposes)—September 30th of the year following the year of the owner's death

3. Deadline to provide IRS custodian with trust documentation—October 31st of the year following the year of owner's death—Treas. Reg. 1.401 9(a)(9)-4, Q&A 6

4. Deadline for creating separate accounts allowing each beneficiary to use his or her life expectancy—December 31st of the year following the year of the owner's death

5. Deadline to begin distributions using RMDs based on the life expectancy of a person—December 31st of the year following the year of the owner's death

WHEN THE DISTRIBUTION RULES DO NOT MATTER

Sometimes the post-death distribution rules do not matter or are not important, for example:

1. When the owner has named a beneficiary who wants to or needs to take IRA distributions very rapidly following the owner's death
2. When charities are the beneficiaries (lump sum distribution is likely)
3. When the owner dies after her RBD and the beneficiary is older than was the owner
4. Other situations where deferral and/or income tax issues are not important

When these niche situations arise, it is important for a planner to recognize that the typical rules/concerns can be ignored, at least to a point.

PLANNING POINT ABOUT MIXING AND MATCHING CLASSES OF BENEFICIARIES

When planning, one valuable rule of thumb is to avoid "mixing and matching" different classes of beneficiaries within the same IRA account. For example:

1. Use separate accounts to benefit charities
2. Use separate accounts to benefit the spouse
3. Use separate accounts to benefit the children (or persons of similar age)
4. Use separate accounts to benefit grandchildren (or other young persons of similar age)

Many of the problems that arise if this rule of thumb is ignored can be mitigated or eliminated with effective post-death planning. However, usually those issues can be eliminated with effective pre-death estate planning by adhering to this rule of thumb.

TAX ORDER OF PREFERENCE IF THE SPOUSE IS CURRENT INTENDED BENEFICIARY

If the owner's goal is to benefit the spouse during the spouse's lifetime, following is a "tax order of preference," offering a rule of thumb as to the income tax and transfer tax efficiency of benefitting the spouse with IRA assets:

1. Surviving spouse as direct beneficiary (most efficient from a tax perspective)
2. QTIP Trust as beneficiary
3. GST-Exempt QTIP Trust (so-called "Reverse QTIP") as beneficiary
4. Non-GST-Exempt Credit Shelter Trust as beneficiary
5. GST Exempt Credit Shelter Trust as beneficiary

Of course, in addition to the tax implications, there are a variety of other factors at play (e.g., owner's desire to control disposition at a spouse's death; factors driven by the owner's mix of assets; etc.).

SIMPLICITY AND TAX ORDER OF PREFERENCE WHERE CHILDREN ARE THE INTENDED BENEFICIARIES

If the owner's goal is to benefit a child or children during the child's lifetime, the following is a combined "tax order of preference" and simplicity order of preference, offering a rule of thumb as to the income tax and simplicity of benefitting a child or children with the owner's IRA assets:

1. Name the child as direct beneficiary;
2. Name a separate trust for the benefit of the child (generally allows for RMDs over the single life expectancy of the child);
3. Name a "main" trust as beneficiary that divides in separate trusts for multiple children (if drafted properly under current law, generally allows for RMDs over the life expectancy of the <u>oldest</u> child); or
4. Name a "pot trust" as beneficiary that eventu-

ally terminates or divides into separate trusts for multiple children (if drafted properly under current law as an Accumulation Trust, generally allows for RMDs over the life expectancy of the oldest child).

PUTTING IT ALL TOGETHER—ONE APPROACH

For one possible approach to making beneficiary designations for retirement assets, see Appendix Chart (One Approach to Beneficiary Selection) for a decision-tree discussing commonly encountered issues and how to think about those issues.

COMPLETING BENEFICIARY DESIGNATION FORMS

Actually getting appropriate beneficiary designation forms completed, submitted to the custodians, and accepted in due course is one of the big challenges facing estate planners today.

Who is responsible for preparing and submitting the beneficiary designation forms? The client/owner? The attorney? A financial advisor?

In the ideal world, the attorney can work closely with the client's financial advisor(s), to make sure the forms are appropriately submitted and accepted. However, there are often practical considerations that make this ideal approach difficult, such as fee sensitivity, resistance by the client for various reasons, too many financial advisors involved, or a lack of professional financial advisors involved, etc.

There can also be challenges in getting the beneficiary designation forms accepted by the custodian:

1. Form-centric approaches, offering little or no flexibility, particularly in "contingent" situations
2. Electronic submission of beneficiary designation forms, with similar challenges to the above
3. References to information or decisions outside the beneficiary designation forms themselves are generally resisted by the custodian, presumably out of concern about legal liability

SOME VALUABLE RESOURCES

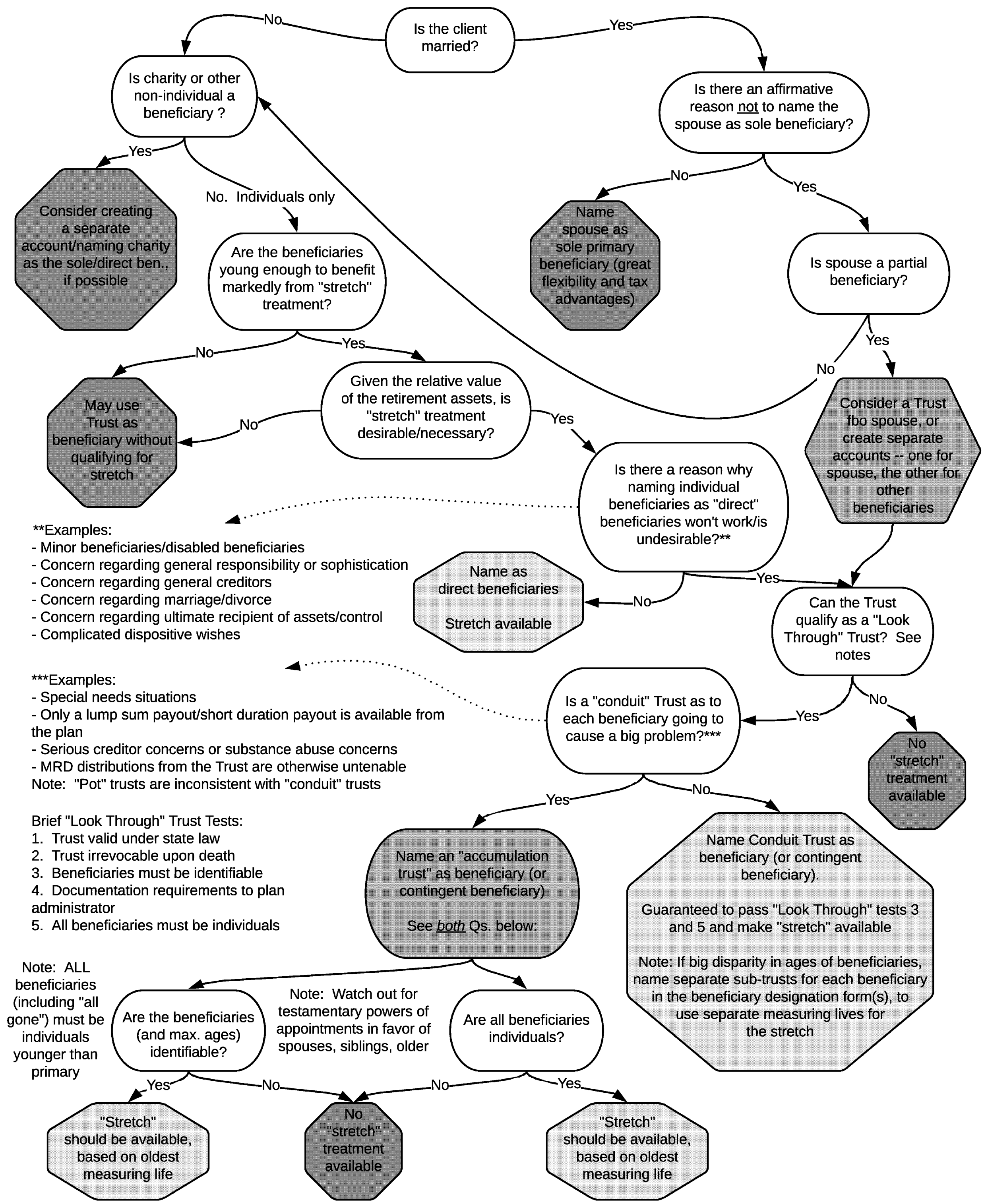
The following are valuable resources, each of which is more detailed/nuanced than this article:

1. Life and Death Planning for Retirement Benefits, by Natalie B. Choate, 8th Edition 2019, and monthly subscription (e-book) available for $9/mo. See www.ataxplan.com. The paper version of this book is 648 pages, and is probably the definitive secondary source for this subject matter.
2. Planning for Ownership and Inheritance of Pension and IRA Account and Benefit in Trust or Otherwise, by Alan S. Gassman, Christopher J. Denicolo, Edwin P. Morrow, and Brandon L. Ketron—E-book.
3. Quick reference charts and related materials from Denise Appleby. See http://www.applebyconsultinginc.com/
4. Estate Planning for Retirement, by Marcia Chadwick Holt.
5. Leimberg resources.

Appendix Chart

One Approach to Beneficiary Selection

This chart is not valid for Roth IRAs or Roth 401(k)s



ENDNOTES:

[1]Pensions & Investments: U.S. Retirement Assets at $28 trillion in Q1, Little Changed from End of 2017, by Charles McGrath, June 21, 2018, http://bit.ly/2Y1Ukb6

[2]Think Advisor: Retirement Assets Slipped Slightly in Q1: ICI, by Emily Zulz, June 26, 2018, http://bit.ly/2GS6IUa

[3]For example, the Retirement Plan Analyzer program, by Leimberg resources.

[4]See Trusts as IRA Beneficiaries; Breaking the silence of the Treasury regulations, by David S. Sennett, Trusts & Estates, July 2018, starting on p. 28; PLR 2016633025.

