



retirement plan distribution planning

MSK Client Alert

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If your estate is large enough (and the federal estate tax remains in effect), your retirement benefits will be subject to federal estate tax. The federal estate tax on plan assets can generally be deferred only if you name your spouse or a trust for your spouse as beneficiary. If you designate a charity as plan beneficiary, the plan assets will escape federal estate and, subject to certain limitations, most or possibly all income taxes. If your estate plan includes philanthropy, you may wish to consider using plan assets to achieve your philanthropic goals. However, philanthropy may not always be the most efficient estate planning use of your retirement plan assets. These assets may be the only assets in your portfolio that can be invested on a completely tax-deferred basis. Thus, the rate of return on plan assets can, in effect, be twenty-five to forty-five percent higher than the rate of return on other assets, depending on your combined federal and state income tax bracket and that of your beneficiaries.

Therefore, for many plan participants, the objective is to distribute as little as possible as late as possible. The longer you can postpone distributing the plan assets, the greater the amount of additional wealth that can be created. However, unless a surviving spouse is the beneficiary or the estate is exempt from federal tax, funds must be available outside the plan to pay the estate taxes in order to maximize the assets in the plan available for tax-deferred investment. And while the income tax on plan distributions cannot be escaped, with careful planning it will almost always be possible to extend distributions from qualified plans and IRAs for many years after the participant's death.

I. Minimum distribution requirements

A. To assure that taxpayers do not abuse the ability to defer distributions from qualified plans and IRAs, the IRS has prescribed complex regulations under Section 401(a)(9) of the Internal Revenue Code (the "Code") that govern the times at which minimum distributions must be made and the amounts of these distributions. These rules will allow for significant periods of deferral in many cases.

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1. A plan participant must commence taking distributions no later than April 1 of the calendar year following the calendar year in which the participant attains age 70-1/2.
2. Further distributions must be taken no later than each December 31 thereafter.
3. The amount of each distribution must be at least the amount obtained by dividing the plan assets at the end of the year preceding the distribution year by the participant's life expectancy during the distribution year.

B. Life expectancies are determined from a table prescribed by the IRS that is generally favorable to taxpayers. For example: a person at age 72 is deemed to have a remaining life expectancy of 25.6 years.

1. This table is based on the joint life expectancy of the participant and a hypothetical spouse who is ten years younger than the participant. The table applies even if the participant is unmarried or has an older spouse.
2. If the participant has a spouse who is more than ten years younger than the participant, an even more favorable divisor is available.

C. When the participant dies, the minimum distributions that must be made thereafter and the federal estate and income tax consequences with respect to the plan's remaining assets will depend to a significant extent on who the participant has designated as beneficiary.

D. Very favorable tax results can be obtained if a spouse is named as plan beneficiary.

1. In this case, the plan assets will not be subject to federal estate tax because they will be covered by the estate tax marital deduction.^[1]
2. The surviving spouse can roll over the plan assets to the spouse's IRA without income tax and spread distributions over the spouse's life expectancy starting when the spouse attains age 70-1/2. For example: if the participant had started to take distributions upon attaining age 70-1/2 and then dies, but has named a spouse as beneficiary who is age 65, the spouse can make a rollover to the spouse's own IRA and delay further distributions until the spouse attains age 70-1/2.
3. If the surviving spouse has rolled over the plan assets to the spouse's IRA, the spouse will then have the right to designate beneficiaries with respect to that IRA.
4. If the spouse designates the spouse's children as beneficiaries of the spouse's IRA and dies after attaining age 70-1/2, the children will be able to take distributions over the life expectancy of the oldest child starting in the year after the spouse's death. Although the table used to compute the life expectancy of beneficiaries is not as favorable as the table used to determine the life expectancy of participants, it would still be possible to extend distributions for possibly another 40 years or more depending on the age of the oldest child. If there is more than one child, the children may be able to divide the IRA into separate shares or separate IRAs, each with a different child as its beneficiary, so that each child can control the investment of the assets held for the child's benefit and use his or her own life expectancy to govern distributions.



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5. One potential risk in this approach is that the spouse would also have the ability to withdraw the assets from the IRA and use them for personal purposes leaving little or no assets in the IRA on the spouse's death. Also, under these circumstances, the spouse can designate any beneficiary the spouse chooses to receive plan assets on the spouse's death.

E. If the participant wants to limit the amount that the surviving spouse or other beneficiary can withdraw or assure that a certain recipient will receive the remaining amounts of IRA assets on the surviving spouse's death, a trust must be designated as beneficiary.

1. A trust would also be appropriate where the participant wants the plan assets to be used for the benefit of minor children.
2. If the trust becomes irrevocable on the death of the participant and satisfies certain other requirements set forth in IRS regulations, then the oldest beneficiary of the trust is used to determine the minimum distributions that the plan must make to the trust.
3. This means that if you want to designate a trust as beneficiary, but allow for a long period of distributions, you should review the ages of all the beneficiaries of the trust to make sure that the desired result is maintained. If the participant's spouse and children are all beneficiaries of the same trust that is named as plan beneficiary, then the spouse's life expectancy would generally be used to determine minimum distributions. If this is not consistent with the participant's goals, the participant may wish to designate as plan beneficiary a special trust of which only the children are beneficiaries in order to obtain a longer period of plan distributions.
4. If one of the beneficiaries of the trust is an entity that is not an individual, such as a charity, then the life expectancy of the beneficiaries will not be taken into account for minimum distribution purposes. Instead, minimum distributions will be determined based on the participant's life expectancy under the IRS tables at the time of his death. This would result in a significantly less favorable result than if the life expectancy of the participant's children could be used.
5. If a charity is named as a direct beneficiary of a portion of the plan or IRA, a trust for individuals may still be used for the balance without jeopardizing the stretch-out on the amount payable to the trust if the separate share rule is satisfied. For example: a charity could be designated as beneficiary of an IRA as to 20 percent of plan assets and a trust for the benefit of the participant's children for the other 80 percent. If the charity is not paid out entirely by September 30 of the year following the participant's death, income must be allocated to the share payable to the charity between the date of death and the date of distribution to assure that the children can use the stretch-out.

II. Using the special PPA provisions to make gifts of plan assets to a charity

A. Until the enactment of the Pension Protection Act of 2006 (PPA), charitable gifts from retirement plans were treated as distributions to the participant followed by contributions of the same amount to charity. This will generally result in taxable income (and possibly excise taxes) attributable to the receipt of the plan distribution followed by a deduction for a charitable contribution which in certain cases will not fully offset the income from the plan distribution.



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B. Among the reasons that a deduction for charitable contributions may not fully offset the income from a plan distribution are the following:

1. If the recipient is under age 59-1/2 or otherwise ineligible for any of the exceptions to the early distribution penalty tax, the distribution will be subject to a ten-percent penalty tax for early distributions that will not be offset by the charitable contribution.
2. If the individual's charitable contributions would exceed the limitation that the amount deductible for charitable contributions cannot exceed 50 percent of the donor's contribution base, then the charitable contribution deduction will not be fully available in the year of contribution, although a carryover of the amount that was not deductible may be deducted in future years.
3. If the donor is subject to the phase-out of itemized deductions for certain higher income taxpayers, the charitable deduction will not fully offset the income from the plan distribution.

C. Under a limited exception enacted as part of the Pension Protection Act of 2006, however, an IRA participant may transfer \$100,000 per year to a charity directly from the IRA during 2006 and 2007 without having the distribution included in income and without having the amount transferred to the charity count toward the individual's limit on charitable contributions, provided the individual has attained age 70-1/2.

1. Even though the participant does not actually receive the distribution, it is counted toward satisfying the participant's requirements under the minimum distribution rules. Thus, a participant can satisfy the minimum distribution rule (assuming the minimum distribution is less than \$100,000) without incurring any taxable income by directing payment of the minimum distribution to a qualified charity.
2. If the individual has several IRAs, the \$100,000 limit applies to all of the individual's IRAs in the aggregate.
3. If a husband and wife each satisfy the requirements of the statute, each may transfer \$100,000 per year to qualified charities.
4. The transfer could be accomplished from either a traditional IRA or a Roth IRA. However, to the extent that distributions from the Roth IRA would be otherwise excludable from income, there may not be any benefit to using a Roth IRA for this purpose.
5. If the IRA is maintained for the benefit of a beneficiary after the death of the IRA holder, then the beneficiary must have attained age 70-1/2 to be able to use this provision.
6. The amounts distributed under this provision are not subject to income tax withholding even if the IRA participant has elected withholding with respect to other distributions.
7. If the IRA participant has an outstanding pledge to a qualified charity, the transfer may be used to satisfy the pledge without violating the prohibited transaction rules of Code Section 4975.



D. In order to claim this exclusion, the following additional conditions must be satisfied:

1. The contribution must be to a public charity, other than a donor advised fund or supporting organization, and not a private foundation.
2. The IRA cannot be part of a simplified employee pension, under Code Section 408(k) or a "Simple IRA" under Code Section 408(p).
3. The transfer of funds must go directly from the IRA to the charity without an intervening distribution to the participant. However, a check from the IRA made payable to the charity may be delivered to the IRA holder for transmittal to the charity.
4. The transfer must satisfy rules for charitable contributions generally including substantiation requirements and that the donor not receive any economic benefit in return.
5. If the IRA includes amounts attributable to both deductible and nondeductible contributions, the amount paid to the charity is treated as first coming from the portion attributable to deductible contributions.

E. If the requirements set forth above are not entirely satisfied, then the distribution is treated as a payment to the IRA participant followed by a contribution to the charity.

III. Rollovers by non-spouse beneficiaries

A. Can a beneficiary still stretch out plan distributions following the death of the participant if the participant participates in a plan that requires a lump sum distribution on death and the participant has designated a beneficiary other than the participant's spouse? Effective in January 2007, participants other than surviving spouses can now make rollovers to IRAs.

1. The PPA permits non-spouse beneficiaries to make rollovers to Individual Retirement Accounts provided the transfer of funds is made by direct trustee-to-trustee action. Therefore, if the distribution is paid to the beneficiary (rather than directly transferred to the IRA trustee), the beneficiary loses the right to make the rollover once he receives the funds.
2. The rollover rules for non-spouse beneficiaries are not as favorable, however, as the rollover rules applicable to surviving spouses.

a) The rollover by the non-spouse beneficiary does not extend the period for minimum distributions beyond the period already available to a beneficiary under the terms of existing law.

b) Unlike a surviving spouse, the non-spouse beneficiary cannot wait until he or she attains age 70-1/2 to start taking minimum distributions.

c) The IRA receiving the rollover from the non-spouse beneficiary must be established for the exclusive purpose of accepting the rollover. Therefore, the beneficiary cannot use a pre-existing IRA, for example, from the beneficiary's own deductible or rollover contributions, as could a surviving spouse.



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1. The resulting IRA is then treated as an inherited IRA so that the effect is the same as if the participant had made the rollover to an IRA prior to death and designated the beneficiary as beneficiary of that IRA.

B. The IRS has issued Notice 2007-7 which clarifies a number of issues with respect to these new rollover rules:

1. The IRA must be established in a manner so that the IRA is identified with respect to both the decedent and the beneficiary, for example: "Tom Smith as beneficiary of John Smith."
2. A qualified plan is not required to offer this distribution option. This suggests that plans will have to be amended to provide this option, although the amendment can be retroactive. Under the general rules in the Pension Protection Act for plan amendments, amendments required by the Act can be made as late as 2009 retroactive to the applicable effective date. In the case of a terminated defined contribution plan, the plan will be deemed to offer this option even without amendment.
3. If the beneficiary does not elect a rollover, the beneficiary is not subject to the mandatory 20 percent withholding rules applicable to other eligible rollover distributions.
4. Minimum distributions may be taken based on the beneficiary's life expectancy starting in the year following the death of the decedent. Although, distributions may also be taken by the end of the fifth calendar year following the death of the decedent if the decedent dies before his required beginning date (April 1 of the year following attainment of age 70-1/2), in most cases the greater tax savings can be obtained by making payments over the life expectancy of the beneficiary. The IRA documents should be reviewed carefully to make sure this option will be available.
5. If the decedent dies after his required beginning date, but has not taken the minimum distribution due for the year of death, this amount is not eligible for rollover and must be distributed to the beneficiary prior to the end of the year in which the death occurs. For this reason, it is usually recommended to take the minimum distribution first and then make the rollover. Also, if there are minimum distributions that were not made for prior years, these amounts are not eligible for rollover.
6. If a trust is named as beneficiary and the trust satisfies the requirements under the minimum distribution rules so that the trust beneficiaries are treated as the plan beneficiaries for minimum distribution purposes, then the IRA can be opened in the name of the trust as beneficiary of the decedent. Under these circumstances, the IRA documents should be reviewed to assure that only the trustee of the trust has the right to withdraw funds from the IRA.

C. The IRS has also stated that a non-spouse beneficiary can use the life expectancy payout in the recipient IRA provided that the rollover from the distributing plan is made no later than the last day of the year following the year in which the participant died.

1. This means that non-spouse beneficiaries (and their advisors) who want to be able to stretch out distributions in a rollover IRA may lose the opportunity if they wait too long to make the rollover.



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2. Here is how the minimum distribution rules work in different scenarios that can occur if a participant dies before the date on which the participant is required to begin minimum distributions and the distributing plan permits non-spouse beneficiaries to make a rollover:
 - a) If the rollover is completed before the end of the year in which the death occurs, the entire account balance in the distributing plan may be rolled over and the beneficiary may use the life expectancy rule in the recipient IRA regardless of the distributing plan minimum distribution provisions.
 - b) If the rollover is completed during the calendar year following the year in which the death occurs, the minimum distribution for that calendar year may not be rolled over, but the balance may be rolled over to an IRA and the beneficiary may apply the life expectancy rule in the recipient IRA with respect to the amount rolled over.
 - c) If the rollover is completed after the end of the calendar year following the year in which the death occurred, but prior to end of the fourth calendar year following the year in which the death occurred, a rollover could still occur but the beneficiary would be required to make minimum distributions from the recipient IRA under the five-year rule and all amounts would have to be distributed from the IRA by the end of that fifth calendar year.
 - d) If a rollover is not completed by the end of the fourth calendar year following the year in which the death occurred, no rollover will be possible.

D. Alternatively, the participant can roll over his plan benefit from his employer's plan to an IRA as soon as the plan permits. If plan assets are in an IRA, the IRA documents will generally permit distributions over extended periods. Even if the participant names no beneficiary (which is not recommended), the assets can generally be paid over the participant's life expectancy in the year of death as determined under the IRS tables as though the participant had not died or over a five year period following the participant's death. (However, participants who have significant concerns about creditors trying to reach their plan assets may be one group that is better off staying in the employer plan, which generally enjoys greater protection from the claims of creditors than an IRA.)

[1] Special rules apply to non-U.S. citizen spouses. If you are married to a non-U.S. citizen spouse, the plan or IRA assets must be distributed to a "qualified domestic trust" in order to obtain a marital deduction from estate tax.

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