Distribution Planning for Retirement Benefits:

The Legal and Tax Implications of Lifetime and Post-Death Qualified Plan and IRA Distributions

J. Aaron Bennett
Carruthers & Roth, P.A.
Phone: 336-478-1105
E-mail: jab@crlaw.com

2

Evolving Retirement Landscape

- **Increased longevity**
  - A 65 year old can expect to live well into their 80s
  - Senior population expected to double over 30 years
- **Retirement income sources have evolved**
  - Greater individual responsibility over retirement funds
  - Increases in delayed retirement
- **Trillions of dollars in IRAs and Qualified Plans**
  - Taxes must be considered when taking distributions
  - Consider: early withdrawal penalties, RMDs, distribution timing, etc.

3

Overview of Distribution Planning

1. **During Lifetime**
   - **Pre-59 ½ considerations**
   - **Required Minimum Distributions**
2. **After Death**
   - **Beneficiary designations**
   - **Post-death RMDs**
3. **Planning Considerations**
   - **Inherited IRAs – control and access**
   - **Minors, special needs, 2nd marriages**
   - **Correcting inadvertent benefit distributions**

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

4

During Lifetime

- **Characteristics:**
  - Contributions are generally pre-tax
  - Earnings are tax-deferred
  - Income taxation on benefits is generally avoided until distributions are made
  - Exception: Roth accounts

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

5

During Lifetime

- **Penalties:**
  - Too Early Tax – 10% penalty on distributions received prior to age 59 ½
  - Too Late Tax – 50% penalty on the amount of a minimum distribution that is required to be distributed but is not

6

During Lifetime

- **Exceptions to the "Too Early Tax "**
  - Distributions on account of death
  - Distributions on account of disability
  - Certain higher education and medical expenses
  - Substantially equal periodic payments
  - Other more discrete exceptions

7

During Lifetime

- **"Too Late Tax"**
  - 50% penalty on required amount not distributed
  - Key date: Required Beginning Date ("RBD")
    - **IRAs**: April 1 following the year the owner turns 70 ½
    - **Qualified Plans**: Later of (i) April 1 following the year the owner turns 70 ½, or (ii) year the participant retires.
      - Exception: 5% or greater owner of company must begin by April 1 following 70 ½, regardless of retirement date

8

During Lifetime

- **Required Minimum Distribution ("RMD")**
  - Timing of distributions:
    - First distribution by the RBD
      - In planning first distribution, consider timing distributions to avoid bunching distributions in one tax year
    - Second distribution by December 31 of the year in which the RBD falls
    - Subsequent distributions by December 31 of each subsequent year

9

During Lifetime

- **Required Minimum Distribution**
  - Amount of distributions: [Account balance divided by Life expectancy factor]
    - Account balance – balance as of end of preceding year (special exceptions for non-calendar year qualified plans and first distributions made after 70 ½)
    - Life expectancy factor – obtained from the Uniform Lifetime Distribution Table, unless the sole beneficiary of the account is the participant's more-than-10-years-younger spouse (see Joint Life and Last Survivor Expectancy Table)

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

10

During Lifetime

- **Required Minimum Distribution**
  - Example (1): Jerry (72) owns an IRA with a 12/31/17 balance of $500,000. Jerry's spouse is 70. Jerry's 2018 RMD is:
    - **$500,000 / 25.6 (per age 72 on Uniform Life Table) = $19,531**
  - Example (2): What if Jerry's spouse is 59? Jerry's 2018 RMD is:
    - **$500,000 / 27.7 (per age 72 / 59 on Joint Life and Last Survivor Table) = $18,051**

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

11

During Lifetime

- **Required Minimum Distribution**
  - Can be taken all at once or gradually throughout the year
  - RMD is the minimum distribution
  - Cannot treat amounts in excess of RMD as part of RMD for any later year
  - Distributions taxed as ordinary income

12

During Lifetime

- **Required Minimum Distribution**
  - Example: George's RMD Year 2 RMD is $15,000 and increases to $17,000 in Year 3. In Year 2, however, George takes $18,000.
    - George cannot apply the extra $3,000 to his third distribution year.
    - In Year 3, George must withdraw the full $17,000 to satisfy the RMD

13

During Lifetime

- **Required Minimum Distribution**
  - **<u>Penalty calculation</u>**: Jerry's 2018 RMD was $19,531, but he only took $10,000.
    - Jerry's 50% penalty is: ((19,531 – 10,000) * 0.5) = **<u>$4,765</u>** and Jerry must take a catch-up distribution to cover the 9,531 shortfall
  - IRS Form 5329
  - Don't deduct shortfall from the prior year-end account balance in subsequent years
  - Waiver of Penalty? Within IRS discretion for reasonable errors where steps are being take to correct the shortfall

C|R
CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

14

During Lifetime

- **Taxation of Designated Roth Account Distributions**
  - **No RMD requirement for Roth IRAs (**Roth Plans do have RMD requirement**)**
  - **Qualified distributions not subject to income tax**
    - Five-year participation, and
    - 59 ½ of older, death, or disabled
  - **Non-qualified Roth Distributions:**
    - Withdrawn earnings subject to tax and penalty
    - First-in/first-out

C|R
CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

15

Post-Death

- **What happens to IRA/Qualified Plan balances at death?**
- **Key questions:**
  - Had the deceased owner started taking RMDs?
  - Who/what is the account beneficiary?
- **IRA/qualified plan assets do not receive a step-up in basis at the owner's death**

16

Post-Death

- **Beneficiary Designations**
  - **Importance of proper beneficiary designations on IRAs and Qualified Plans**
  - **Avoid unintended consequences associated with:**
    - **Taxes**
    - **Creditor issues**
    - **Divorce/remarriage**
    - **Financial management concerns**
    - **Substance abuse concerns**
  - **Tailoring designations to accomplish objectives**

17

Post-Death

- Death <u>AFTER</u> owner's RBD
  - <u>RMD in the year of death:</u>
    - RMD must still be taken by December 31 of that year (use life expectancy distribution table used by decedent)
  - <u>RMDs for year(s) following year of death</u>:
    - Based on longer of:
      (i) the beneficiary's life expectancy, <u>or</u>
      (ii) deceased owner's remaining statistical life expectancy

    [Single Life table, reduce by one annually]

18

Post-Death

- Death <u>BEFORE</u> owner's RBD, with non-spouse beneficiary
  - (A) Five-Year option:
    - Entire account distributed by Dec. 31 of the fifth anniversary year of the owner's death

      <u>or</u>
  - (B) Life expectancy option:
    - Inherited IRA (trustee-to-trustee transfer!)
    - Begin distributions in year following owner's death
    - RMD based on beneficiary's life expectancy [Single Life table, reduce by one annually]

19

Post-Death

- **Spousal beneficiaries**
  - **Lump sum**
  - **Treat as an inherited IRA**
    - **Before RBD: Five-years; survivor's life expectancy [Single Life Table, no annual reduction]**
    - **After RBD: longer of (i) the survivor's life expectancy, or (ii) deceased owner's remaining statistical life expectancy**
  - ****Spousal rollover ** into an IRA in surviving spouse's name**

C|R
Carruthers & Roth, PA
ATTORNEYS AT LAW

20

Post-Death

- **Example: Harold (68) dies in March 2018. Maude (62) is sole IRA beneficiary.**
  - **Options:**
    - **(i) Five year rule – all distributed by 12/31/2023**
    - **(ii) Keep in decedent's name - Defer until 12/31/2020, then begin RMDs using Single Life table each year**
    - **(iii) Rollover into Maude's name - Defer until 70 ½ with first RMD due on, using Uniform Life table4/1/2027**

C|R
Carruthers & Roth, PA
ATTORNEYS AT LAW

21

Post-Death

- Example: Harold (38) dies in March 2018. Maude (38) is sole IRA beneficiary.
  - Options:
    - (i) Five year rule – all distributed by 12/31/2023
    - (ii) Keep in decedent's name - Defer until 12/31/2050, then begin RMDs using Single Life table each year
    - (iii) Rollover into Maude's name - Defer until 70 ½ with first RMD due on 4/1/2051, using Uniform Life table
    - If Maude thinks she'll need to access the account before 59 ½, she may want to consider not rolling the account over (and thereby avoid 10% penalty)

C|R
Carruthers & Roth, PA
Attorneys at Law

22

Post-Death

- Choice of beneficiary impacts distribution rules and income tax treatment
- No designated beneficiary?
  - Accelerated distribution rule
  - Adverse income tax consequences
- Designated beneficiaries:
  - Only an individual can be a designated beneficiary, except in certain cases involving specialized trusts

C|R
Carruthers & Roth, PA
Attorneys at Law

23

Post-Death

- Multiple beneficiaries
  - Use life expectancy of oldest beneficiary
  - Example: Harold names his brother (75) and child (40) as equal beneficiaries of his IRA. Harold dies in 2018. 12/31/18 account balance of $500,000. What is the amount of beneficiaries' first required distribution?
    - Use brother's life factor (age 76 in 2019) = 12.7
    - Brother's share = $19,685.04 ; Son's share = $19,685.04

24

Post-Death

- Multiple beneficiaries
  - Separate account exception
    - Deadline: Divide IRA/Plan into separate accounts by 12/31 of year following owner's death
    - Each beneficiary can use own life expectancy
  - Prior example: If separate accounts were timely completed in prior example, son's first RMD (age 40) based on 43.6 life factor, is $5,733.94 (versus $19,685.04)

25

Post-Death

- No designated beneficiary?
  - Charity, estate, or nonqualified trust
  - Before owner's RBD:
    - Entire account distributed by Dec. 31 of the fifth anniversary year of the owner's death
    - Life expectancy rule is <u>not</u> available
  - After owner's RBD:
    - Distributions based on deceased owner's statistical life expectancy

    [Single Life table, reduce by one annually]

Carruthers & Roth, PA
Attorneys at Law

26

Post-Death

- Jerry (75) died in 2018, leaving his IRA to his estate. The 12/31/18 balance is $100k.
  - The 2019 RMD is $8,065 [$100k / 12.4 (Jerry's single life expectancy factor in year of death minus 1)]
- Jerry (69) died in 2018, leaving his IRA to his estate.
  - The entire balance must be distributed by 12/31/23

Carruthers & Roth, PA
Attorneys at Law

27

Post-Death

- **Trusts as Beneficiaries**
  - **Trusts generally are not "designated beneficiaries"**
  - **<u>But</u> can qualify as a "designated beneficiary" if requirements are met**
  - **"See-through trust" – benefits distributed in annual installments over life expectancy of oldest beneficiary**
    - **Trust must be valid under state law,**
    - **be irrevocable,**
    - **have "identifiable" beneficiaries,**
    - **have documentation submitted to IRA custodian/Plan Administrator no later than October 31 of the year following owner's death**
    - **All trust beneficiaries must be individuals**

C|R
CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

28

Post-Death

- **Trusts as Beneficiaries**
  - **<u>Example</u>: Ned (40) dies in 2018 naming his Revocable Trust as beneficiary of his $1 million 401(k) account. Trust directs division of assets among separate shares for each of Ned's children, and that the RMD be withdrawn and distributed to each child on an annual basis.**
    - **Can each child use his or her own life expectancy?**
      - **No, each beneficiary must receive their RMD over the life expectancy of the oldest trust beneficiary**
        - **(PLR 200317041)**

C|R
CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

Post-Death

- **Trusts as Beneficiaries**
  - **Example: Ned (40) dies in 2018 specifically naming each to-be-established separate trust share under his Revocable Trust as beneficiary of his $1 million 401(k) account. Each child's separate trust share mandates that the RMD be withdrawn and distributed to such child on an annual basis.**
  - **Can each child use his or her own life expectancy?**
    - **Yes, by having the single 401(k) account payable in specified shares to the respective trusts, each beneficiary should be able to use his/her life expectancy to determine payout**
      - **(PLR 200537044)**

Carruthers & Roth, PA
Attorneys at Law

Post-Death

- **Conduit trust:**
  - **Trust instrument requires the trustee to immediately distribute to the trust beneficiary any retirement benefit plan distributions**
  - **No accumulation of retirement benefits**
  - **Conduit trust beneficiary is considered the sole beneficiary for RMD calculation purposes**
  - **All remainder beneficiaries are disregarded under RMD rules**
- **Accumulation trust:**
  - **The trustee has the discretion to accumulate some or all benefit distributions**
  - **Remainder beneficiaries count for RMD purposes**
  - **Remainder beneficiaries should be identifiable individuals younger than the beneficiary whose life expectancy the owner wants used for RMD calculation purposes**

Carruthers & Roth, PA
Attorneys at Law

31

Beneficiary Access and Control

- Deferred income tax burden falls on beneficiary
- Beneficiary can designate his or her own beneficiaries
  - Note: successive beneficiaries are locked-in at original beneficiary's RMD payout (unless original beneficiary engaged in a spousal rollover)
- Inherited IRAs are generally not protected from the beneficiary's creditors
  - BUT NC's Bankruptcy exemptions specifically exempt inherited IRAs from a NC resident's bankruptcy estate N.C.G.S 1C-1601(a)(9)

C|R
Carruthers & Roth, PA
ATTORNEYS AT LAW

32

Minor Beneficiaries

- Avoid naming minor as direct beneficiary
- Conduit trust?
  - Minors generally have relatively small RMDs
  - Multiple children – separate shares versus "pot trust"; large age gaps?
- Accumulation trust?
  - Trust until minor(s) reaches certain age
  - Problem: need a young "wipeout" beneficiary to receive account if minor(s) die before stated age
- Are the income tax savings worth the complications of a see-through trust?

C|R
Carruthers & Roth, PA
ATTORNEYS AT LAW

33

Minor Beneficiaries

Mike is a serial entrepreneur and husband, currently single with 7 children from age 5 to 32. In addition to closely held stock, Mike has a $500K IRA. He wants to leave his estate equally among his 7 children.

- **Avoid naming minor as direct beneficiary**
- **Conduit trust?**
  - **Minors generally have relatively small RMDs**
  - **Multiple children – separate shares versus "pot trust"; large age gaps**
- **Accumulation trust?**
  - **Trust until minor(s) reaches certain age**
  - **Problem: need a young "wipeout" beneficiary to receive account if minor(s) die before stated age**
- **Are the income tax savings worth the complications of a see-through trust?**

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

34

Special Needs Beneficiaries

What if a beneficiary is disabled or has special needs and relies on need-based government benefit programs?

- **Avoid naming the disabled beneficiary as direct beneficiary**
- **Conduit trust?**
  - **No, because mandatory RMDs jeopardize governmental benefits**
- **Accumulation trust?**
  - **Benefits can accumulate within the trust**
  - **Need a "wipeout" beneficiary close in age as remaindermen**
  - **Compressed trust income tax rate schedule generally result in a greater tax burden**

CARRUTHERS & ROTH, PA
ATTORNEYS AT LAW

35

Second Marriage

- Dennis the dentist has a $2 million IRA.
- Dennis is on his third marriage, this time to a woman much younger than him. His kids, almost the same age as his wife, don't like her and don't trust her.
- Dennis is crazy about his wife. He's provided her a high lifestyle, and want her to continue in that lifestyle if something happens to him.
- What should Dennis do with his beneficiary designation?

Carruthers & Roth, PA
Attorneys at Law

36

Second Marriage (cont.)

- Name his wife as beneficiary?
  - She can roll it over, and defer withdrawals for a long time. She can also name a younger beneficiary who can withdraw it over their life expectancy.
  - Problem? What if she names her children from a prior marriage? Or her new husband?
- Solution – name a lifetime trust for her benefit as beneficiary.
  - Provides a substantial RMD for her over her life expectancy (assuming she is the oldest beneficiary).
  - His kids will inherit whatever is left at her death. But will they survive her?

Carruthers & Roth, PA
Attorneys at Law

37

Charitable Giving

- During lifetime – RMD planning
  - **Have charitable giving count towards RMD, up to $100,000 per year**
    - **Direct IRA custodian to transfer funds *directly* to qualified charity, 501(c)(3)**
    - **Amounts in excess of RMD don't count towards subsequent years**
- At death – designation planning
  - **Charity is not a "designated beneficiary"**
  - **Separate accounts / charity payout by beneficiary finalization date**

C|R
Carruthers & Roth, PA
Attorneys at Law

38

Post-Death Correction Procedures

- **Mix of beneficiaries: young individuals, older individuals, non-qualifying trusts, and charities?**
  - Remove the older non-individual beneficiaries by Beneficiary Finalization Date (9/30 of year after owner's death)
- **Beneficiary designations cannot be altered after death (PLR 201628004)**
- **Inadvertent issues where paid to estate?**
  - Benefits payable to special needs beneficiary? Petition Clerk of Court to establish special needs trust

C|R
Carruthers & Roth, PA
Attorneys at Law

Distribution Planning for retirement benefits:

The Legal and Tax Implications of Lifetime and Post-Death Qualified Plan and IRA Distributions

J. Aaron Bennett
Carruthers & Roth, P.A.
Phone: 336-478-1105
E-mail: jab@crlaw.com