

# RETIREMENT PLANS

Retirement plans...frequently a couple's most substantial asset. Very important, very significant in an estate plan and fraught with pitfalls and complexity. New regulations in 2001 have provided us with some relief particularly from the pitfalls under the prior rules concerning the elections to be made upon reaching age 70 ½. In addition, we rarely review our beneficiary designations. Very few people *know* who they named as beneficiary. Even if they know the primary beneficiary, they rarely have any idea who they named if their primary beneficiary predeceased them. An unplanned beneficiary designation can ruin a well planned estate both in the intended disposition of our estates and in the taxes imposed on our estates. First and foremost, decide on the beneficiary of your plan and confirm that who you thought you named, was in fact named. With that caveat, let me discuss some significant planning issues including beneficiary designations, payout elections (under the new regulations) and Bypass Trust funding.

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Retirement plans are a wonderful retirement planning vehicle and a lousy wealth transfer vehicle. Although they are subject to double taxation, the retirement account is frequently the bulk of a beneficiary's inheritance. As I stated in the introductory paragraph; CHECK YOUR BENEFICIARY DESIGNATION. Write it down (or photocopy it) and send it to your attorney. This designation is a very important part of your plan. Having repeated that caveat let me proceed to the taxation of these accounts and a few of the mine fields in the law.

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Retirement plans are double taxed. When you (or your heirs) withdraw money from your retirement account, the property is included in your income. When you die, the retirement account is included in your estate. As an illustration of the impact that this double tax has,

let's assume that your estate is in the maximum estate tax bracket of 50% and that your heirs are in the 35% income tax bracket. A \$1 million retirement account paid in a lump sum will net your heirs \$325,000 if the assets are immediately withdrawn. Not that this helps, but it was worse before the 1997 Tax Act. The 1997 Tax Act repealed a 15% excise tax if you accumulated "too much" in your retirement account.

The entire retirement plan area is one of my great frustrations with the tax system. I will be brief on this soap box, but ... The government wanted us to save more money for our retirement - not rely on social security. [By the way I heard in a speech several years ago that more young people today believe in UFOs than in social security.] At any rate, the government gave us a deduction for contributions, tax free build up and exemption from estate tax. Guess what? People did what the government wanted them to do - more than the government thought they ever would, so the

government has been cutting back ever since. First the exemption from estate tax was reduced to \$100,000 then eliminated. Next a penalty was imposed if you accumulated “too much”. As I say, they have repealed the “too much” penalty.

Retirement plans...fraught with pitfalls and complexity.

And the complexity of the rules is unbelievable. They provide not only a trap for the unwary, but also for the relatively wary and even the very wary. Well, let me get back to our discussion.

In any retirement plan decision, it is important to keep in mind the main benefit derived from a retirement plan, deferral of income taxes. You can compound your money tax free. It may seem that it is the same to take out the funds now and pay tax and compound the after tax money or to leave the funds in and pay the tax when the funds are withdrawn, but this is not the case. Let me use a very simple illustration.

Let's assume that you have \$100,000 in a retirement account, are in the 35% income tax bracket and can obtain a return of 10% on your money regardless of whether the funds are in the retirement account or held outside the retirement account. Your return is all capital gain (and let's assume it will be taxed at 20%) and is all realized each year. If you take the money out of the retirement account, you have \$65,000 remaining to invest. Your return will be a net 8% return since you must pay tax on the funds (assuming the 20% capital gain rate for this purpose). At the end of ten years you will have \$140,330. If you leave the funds in

the retirement account, and you have our assumed 10% return, at the end of ten years you will have \$259,374 in the account. After withdrawing the funds and paying the 35% tax you have a net amount of \$168,593 which is greater than 20% more than you would have had if you withdrew the funds initially and invested them outside of the retirement account.

The longer the time period prior to withdrawing the funds the greater the benefit in leaving the funds in the account. For example, after 20 years the net amount in our example is \$437,287 net if you withdraw the funds at the end of the 20 year period and only \$302,962 if you invest the funds outside of the retirement account. If all of the income is ordinary income the benefit of leaving the property in the account is more dramatic.

A \$1 million retirement account may net your heirs only \$325,000.

The ability to defer receipt of the funds held in the retirement account is a significant factor in each of the three decisions to be discussed in this section: beneficiary designations, payout elections and Bypass Trust Funding. Each of these areas impact the other.

## PAYOUT ELECTIONS

In January, 2001 the IRS issued regulations which provided a significant amount of relief in this area. Although much simplified, the rules can still become confusing. As we walk through this mess, one thing to keep in mind is that we have one set of rules which apply before you reach 70-1/2 and another which apply after you reach 70-1/2.

There is an exception to the 70-1/2 rule, if you have not yet retired and are less than a 5% owner of a company, you can delay this period until April 1 following the year of your retirement. This exception does not apply to IRAs.

In any retirement plan decision, it is important to keep in mind the main benefit derived from a retirement plan, deferral of income taxes.

What happens at age 70-1/2? At age 70-1/2 you must begin taking distributions from your retirement account if you have not done so already. Two of the many rules - you must begin withdrawals at age 70-1/2 and you cannot withdraw any before 59-1/2 without penalty and interest. Sounds like a very controlling parent.

Generally speaking, you are penalized if you take amounts out of your retirement account before age 59-1/2. At 59-1/2, you may take distributions. At 70-1/2 you must take distributions. You must take a certain amount each year or you will be penalized for not taking enough. What is enough? In determining how much you are *required* to take you look at the Uniform Table to determine the payout. The Uniform Table has replaced the process of electing single or joint lives and recalculate or do not recalculate life expectancies. The Uniform Table gives everyone - regardless of the identity of the beneficiary - a payout which is the equivalent of joint lives with the second life 10 years younger than the participant with the life expectancies recalculated annually. The Uniform Table applies even if no beneficiary is named. To give you an idea of the type of payout allowed

under the Uniform Table, the following are the payouts at five year age intervals:

| Age | Applicable Divisor |
|-----|--------------------|
| 70  | 26.2               |
| 75  | 21.8               |
| 80  | 17.6               |
| 85  | 13.8               |
| 90  | 10.5               |
| 95  | 7.8                |
| 100 | 5.7                |

In applying this table, at age 75, you would divide your account balance by 21.8 to determine the minimum amount you *must* distribute from your retirement account in that year. You can always take more than this amount. The one exception enables you to get a longer payout. That exception is if you are married, name your spouse as the beneficiary and your spouse is more than 10 years younger than you. In this situation, you can elect to use a more extended payout based on the joint lives of you and your spouse using your actual ages, recalculated annually.

Under the old rules you had to change your payout if you changed your beneficiary. No more. Upon your death if you had elected to recalculate your life expectancy the entire balance of the account balance was required to be paid out by December 31 of the year following your death. No more. As discussed below, the identity of your beneficiary will determine the payout requirements applicable at the time of your death.

## BENEFICIARY DESIGNATIONS

In naming a beneficiary on a retirement plan, two factors are important: first,

whom do you want to receive these funds and second, what options will be available to the beneficiary to defer the payout of the retirement plan proceeds over a long period of time. Frequently the retirement plan is one of the most significant assets a couple owns. The couple's entire estate may consist of a retirement plan and a home.

If you fail to name a beneficiary on your retirement account or your beneficiary is not a "designated beneficiary" as defined in the statutes, and you die prior to reaching age 70 ½, your entire account balance must be paid out in five years following your death.

Let's use an example. Let's assume a second marriage and the couple has a \$250,000 home and the husband's \$800,000 IRA and no other assets. The husband's Will leaves the home to his wife and all of the rest of his property to his children. He designates his wife as beneficiary of the IRA with his children as secondary beneficiaries. Husband dies and a year later his wife dies. What do husband's children inherit? Probably nothing. Assuming the wife rolled the IRA over into her IRA, the children inherit nothing. In this situation, did the husband want to exclude his children? Probably not. Did he want to exclude his wife from using any of the IRA assets? Probably not again. He probably did not consider the impact of the decisions he made.

Having raised the "who do you want the beneficiary to be" issue, let me move to the income tax aspects of your decisions before bringing the two issues together.

- ▶ As discussed above, deferral on the portion of the retirement account which is not presently needed for one's support is very advantageous.
- ▶ If you fail to name a beneficiary on your retirement account or your beneficiary is not a "designated beneficiary" as defined in the statutes, then if you die before reaching age 70-1/2, your entire account balance must be paid out in five years following your death.
- ▶ If you fail to name a beneficiary on your retirement account or your beneficiary is not a "designated beneficiary" as defined in the statutes then if you die after reaching age 70 ½ the account may be paid out over your single life expectancy based on your age in the year of your death, unrecalculated.

If you name an individual or a "designated beneficiary" as the beneficiary on your retirement plan, the plan account proceeds may be paid out over the life expectancy of the beneficiary. If there is more than one beneficiary, the plan account may be paid out over the life expectancy of the oldest beneficiary. Figuring out who qualifies as an individual is not a problem, but what about the "designated beneficiary"? An organization is not a "designated beneficiary". Your estate is not a "designated beneficiary".

The new regulations do give us some relief by providing that the identity of the beneficiaries of the account is determined

as of September 30<sup>th</sup> of the year following your death. This delay is beneficial in allowing some “clean up” of an undesirable beneficiary. For example, if one of the beneficiaries is a charity, then you do not have a “designated

Regulations issued over the last several years have eliminated most of the confusion concerning whether a trust is a designated beneficiary.

beneficiary” and the account balance must be paid out over your life expectancy based on your age in the year of your death. Under the new rules, you can distribute the charity’s share prior to September 30<sup>th</sup> of the year following your death and leave only one or more individual beneficiaries (or other designated beneficiaries) and have the benefit of a payout over the beneficiary’s life expectancy.

In the past, the most commonly encountered issue was whether a trust was a designated beneficiary. This confusion was due mostly to the timing of determining when the beneficiaries on an account were “designated beneficiaries”. Under the new 2001 regulations the identity of your beneficiaries is irrelevant until your death. On December 31 of the year following your death, the beneficiaries are examined to determine if they qualify as “designated beneficiaries”. At that time, the trust must be irrevocable and the beneficiaries of the trust must be individuals who can be ascertained.

After all this discussion on beneficiaries, what is the bottom line? The beneficiary designation should be a part of your

overall estate plan. You should seek and obtain competent advice from your estate planning attorney.

Here are some of the considerations in naming a beneficiary:

- ▶ Who do you want to benefit from the plan account; who do you want to benefit if that person does not need the entire account balance?
- ▶ Do you and the primary beneficiary on the retirement account have the same secondary beneficiaries? Generally, if you name your spouse, have been married only once and have children of your marriage, you have the same secondary beneficiaries. If this marriage is a second marriage and you both have children of prior marriages, you do not have the same secondary beneficiaries.
- ▶ If you and your spouse have different beneficiaries then:
  - > Do you anticipate that your spouse will need the entire retirement account for her support?
  - > Do you have other assets you can give your children?
- ▶ How large is your account balance and how important is deferral of the payout of the retirement account balance?

The beneficiary designation should be a part of your overall estate plan.

Frequently the following decisions are made:

- ▶ Couple has only one marriage to each other and has a non-taxable estate; the couple names the spouse as the primary beneficiary.
- ▶ Couple does not fit into the above situation but has other assets to fund the Bypass Trust and/or to give their children; the couple names the spouse as the primary beneficiary.
- ▶ Second marriage with a large account balance; the participant names a trust for the spouse as the beneficiary.
- ▶ First/only marriage, the retirement account is the main asset, the estate is taxable and needs the tax savings obtained from the use of a Bypass Trust - ahh, you thought I would give you a simple answer - no, I cannot - read the section below.

Having a large retirement account may prevent the full use of a Bypass Trust.

## BYPASS TRUST

Let me begin by saying one side benefit of the increased exemptions in the 2001 Tax Act is that planning for a couple with a large portion of their net worth in a retirement plan has become a little easier. What is the issue we are confronting? Having a large retirement account may prevent the full use of a Bypass Trust.

Let's assume a couple with a \$2 million all-community estate and death in either 2003 or after 2010. If in their Wills each spouse gives his/her half of the community to his/her spouse in a Bypass Trust, then no estate taxes will be owed upon the death of the survivor. If they each left their estate outright to the survivor, then \$435,000 in estate taxes would be owed upon the death of the survivor. The use of this type of trust, a Bypass Trust (also called an exemption trust, a B trust, a Family Trust, or a Credit Shelter Trust) is one of the most basic estate planning tools.

Now let's assume that the estate consists of the husband's \$1.5 million retirement account, a \$300,000 home and \$200,000 of other property. What happens if the husband dies first and what if the wife dies first?

In Texas, the wife theoretically can give her one-half of her husband's IRA to the Bypass Trust.

If the husband dies first and he has named his wife as the beneficiary of his retirement account, then only \$250,000 of property is placed in the Bypass Trust. Upon wife's death she will have an estate of \$1.75 million and will owe a tax of about \$322,500. Note that if the wife dies when the exemption is \$2 million, there is will not be any estate tax. This increase in the exemption gives a couple more flexibility when their estate consists of a large retirement plan. However, note also if the husband names the Bypass Trust as the beneficiary of one-half of his account and his wife as the beneficiary of one-half of his account, the Bypass Trust will be funded with \$1 million in property.

This structure will result in the Bypass Trust being fully funded. This result is not the one which causes concern in an estate of this size with a large retirement account. However, much of the post mortem planning with a Bypass Trust will be lost since all distributions from the retirement account will be ordinary income and will be subject to income tax at the trust's income tax rates (reaching the top income tax bracket at \$9,250 in 2003 with the amount indexed upward each year for inflation) unless the funds are distributed to the wife. The post mortem planning in the retirement account which allows the wife to roll the retirement account over into her own IRA and name a new beneficiary will not be available to her.

Most attorneys in this area think that it is not possible to have the Bypass Trust be the beneficiary of the non-participant spouse's share on the retirement accounts without causing the portion transferred to the Bypass Trust to be treated as a distribution from the account.

The situation which causes the most concern is, what does the couple do if the wife dies first? The wife is not the participant in the plan. She does not have the power to name a beneficiary on the plan. If the wife cannot name a beneficiary what can you do? The options are fairly limited. Some possible options are:

- ▶ The couple partitions and exchanges their property so that the wife owns the property outside of the plan as her separate

property and the husband owns all or a larger portion of the plan as his separate property. For example, if in our situation the couple had \$1 million in the husband's retirement account and \$1 million in other property consisting of a home and investments, the couple could partition their property so that the wife owned the home and investments as her separate property and the husband owned the retirement account as his separate property. In the situation described above, a partition and exchange does not help much since the couple only has \$500,000 in property outside the retirement account.

- ▶ In Texas, the wife theoretically can give her one-half of her husband's IRA to the Bypass Trust. OK, take a deep breath let me discuss this quirk under Texas law.

In a Texas case, *Allard v Frech*, the wife died and left all of her estate to her children. The children sued their father stating that they should receive their mother's community one-half of his retirement account. Needless to say, dad was not too pleased with this idea. This case went to the Supreme Court of Texas and the court held that the wife did have the power to give away her half of her husband's retirement account. Recently, a U.S. Supreme Court case (Boggs) held that the non-participant spouse of a qualified retirement account cannot transfer her interest in the retirement account by his/her Will. However, the U. S. Supreme Court case did not consider what happens to IRAs which are in

existence before the death of the non-participant spouse which presumably leaves such IRAs subject to the *Allard v Frech* decision.

All well and good, at least all well and good assuming this is a result you want and have planned for ... but how do you do that?

Is it possible to put half of the retirement account into the Bypass Trust without having that half treated as a distribution from the account and thus recognizing income on it? Most attorneys in this area think that it is not possible to have the Bypass Trust be the beneficiary of the non-participant spouse's share on the retirement accounts without causing the portion transferred to the Bypass Trust to be treated as a distribution from the account.

The whole retirement account area is so confusing that almost no one really understands it.

I have structured agreements between the Bypass Trust and the surviving husband as to the management and distribution of the deceased wife's half of the retirement account. I think this ought to work. By that I do not mean to imply that I think the law as it currently stands allows you to do this. There is no authority on it that I know of, but it seems like it is the way the law ought to be. Unfortunately taking this type of action without authority, may not be upheld and you may be the test case, so it is not a good planning technique.

- ▶ Take a "wait and see approach". Have the wife include a bequest of

the husband's retirement account to the husband in her Will. Provide that if the husband "disclaims" the bequest (refuses to take it) then the property passes into the Bypass Trust. Then we can see not only what property the couple has at the time of her death (if she dies first) but we can also see if the law is any clearer in the retirement plan area at that time and if the exemption increase has eliminated the problem for this couple.

The whole retirement account area is so confusing that almost no one really understands it. Clients don't, attorneys don't, accountants don't and administrators don't. So who do you turn to? I personally am exasperated with the law and the complexity of the area. The law needs to change. One aspect of the law which needs revision is that the law should allow a division of the retirement account upon the death of the non-participant spouse (the wife in the above example) so that the Bypass Trust can be named as the beneficiary without risking a deemed taxable distribution of the portion distributed to the Bypass Trust.

Be patient with your attorney and with yourself; this area is extremely complex and confusing.

The law has a provision like this in the event of divorce. The law allows the plan to be divided pursuant to a Qualified Domestic Relations Order (a QDRO - pronounced "kwa-dro"). In the interim you live with the limited options that we have.

To refer back to my initial comment, you need to review all of the areas discussed in this newsletter as a part of your overall estate plan. Be patient with your attorney and with yourself; this area is extremely complex and confusing. However, it is important so take the time.

The new 2001 regulations simplified the distribution rules and the beneficiary designation rules in ways which were badly needed. The area continues to be complex but more dangerous than the complexity, are the failure to review and update the beneficiary designations on retirement accounts and the failure to coordinate those designations with the structure of the overall plan.