

## Estate Planning Retirement Account Basics

by Jillian Mastroianni

Retirement accounts such as IRAs<sup>1</sup> and 401(k)s are not subject to income tax during an individual's lifetime while the individual makes contributions to the account and the account increases. At the time of withdrawal, taxes are due and are computed at the ordinary income rate. These tax-deferred retirement accounts ("Retirement Accounts" for purposes of this article) are controlled by their beneficiary designations, rather than by a will. If an individual fails to name a beneficiary on his or her retirement account, the account will generally pass to his or her estate, often resulting in unfavorable tax treatment because of the estate's status as a non-designated beneficiary.

While this article addresses the use of designated beneficiaries to defer withdrawals from Retirement Accounts and allow for income tax-deferred growth, it's worth noting that for federal estate tax<sup>2</sup> (and Tennessee inheritance tax<sup>3</sup>) purposes, Retirement Accounts are treated no differently than any other asset owned by the decedent. The value of the asset is included in the decedent's taxable estate and is subject to immediate transfer tax. The only "deferral" of estate or inheritance tax available is by reason of a marital deduction on the death of the first spouse to die.

Below are a few definitions to help you navigate the world of Retirement Accounts and their distribution methods:

### Definitions:

1. **Required Beginning Date (RBD):** The RBD is the date by which a plan participant must begin receiving minimum required
2. **Applicable Distribution Period (ADP):** The ADP is the payout period that applies to the plan participant or beneficiary.
3. **Minimum Required Distribution (MRD):** Minimum required distributions are the annual distributions required based on the ADP.
4. **Designated Beneficiary (DB):** Generally, a DB must be a person.<sup>4</sup> A DB is provided with the option of a more favorable stretch payout method after the death of the plan participant.

### Basic Rules for Distribution of Retirement Accounts When a Designated Beneficiary is Named:

**Spousal Beneficiaries:** If the beneficiary<sup>5</sup> is the surviving spouse, the surviving spouse may either roll over the account balance into his or her own IRA or retitle the IRA in his or her own name, which allows the surviving spouse to delay distributions until he or she reaches age 70.5. A surviving spouse is the only beneficiary who has this delayed distribution option.

**Non-Spousal Beneficiaries:** If the non-spousal beneficiary is a designated beneficiary, then the beneficiary may roll over the account balance into an inherited IRA. This is done by direct rollover only (also known as a trustee-to-trustee transfer), to a separate inherited IRA established specifically to receive the distribution in the name of the deceased participant and payable to the beneficiary. The rollover must be completed by December 31<sup>st</sup> of the year after the participant's date of death.

The period of time for minimum required distributions from an inherited IRA to a non-spousal beneficiary is computed as follows:

- (a) If the participant **dies before** his or her required beginning date, then either (1) the entire remaining interest must be distributed within five years of the participant's death, or (2) distributions must begin within one year of the participant's death over the life expectancy of the designated beneficiary.<sup>6</sup>

The distribution of benefits over the life expectancy of a designated beneficiary who is younger than the plan participant is often referred to as the "stretch" payout method, offering the longest tax deferral, as well as tax-free accumulation.

- (b) If the participant **dies on or after** his or her required beginning date,
  - (i) a **non-spousal individual beneficiary** is the sole beneficiary, the applicable distribution period is the greater of the individual beneficiary's life expectancy, or what would have been the life expectancy of the deceased participant.<sup>7</sup>

### Basic Rules for Distribution of Retirement Accounts without a Designated Beneficiary:

It is not possible to achieve the tax-advantaged stretch payout method or spousal rollover if a designated beneficiary has not been named. Generally, where there is not a designated beneficiary, if the participant died before his required beginning date, then the entire Retirement Account must be distributed within five years of the participant's death; and, if the participant died after his required beginning date, then the entire Retirement Account must be distributed over the life expectancy of the participant. But, if the participant is dead, how can one calculate his or her life expectancy? Remember, this is tax law, and tax law doesn't necessarily comport with common sense. Under IRS rules, it is possible to calculate a deceased individual's life expectancy using the IRS's Single Life Table.

### Additional Resources:

Natalie Choate, an attorney in Boston, is a leading expert in this field and has a unique ability to explain the law in an understandable and practical way. I highly recommend her book, *Life and Death Planning for Retirement Benefits*, for anyone who wishes to provide advice in this area. Additionally, Ed Slott's book, *The Retirement Savings Time Bomb...and How to Defuse It*, is designed to be understood by both lay persons and lawyers alike.

<sup>1</sup> Roth IRAs are treated differently than traditional IRAs. This article addresses traditional IRAs.

<sup>2</sup> The federal exemption is currently \$5,340,000 and is indexed for inflation.

<sup>3</sup> Tennessee's inheritance tax exemption is \$2,000,000 for decedents dying in 2014, and \$5,000,000 for decedents dying in 2015. The Tennessee inheritance tax is repealed effective January 1, 2016.

<sup>4</sup> Certain trusts, known as "see-through trusts," are also considered designated beneficiaries.

<sup>5</sup> When I refer to the "beneficiary," I am referring to the named beneficiary on the Retirement Account. For example, if the Retirement Account passes to the account-owner's estate, and the spouse is the sole beneficiary of the estate, the same rules do not apply because an estate is not a designated beneficiary.

<sup>6</sup> According to 26 CFR § 1.401(a)(9)-3, A-1, a plan can permit the designated beneficiary of a participant who died before his or her required beginning date to choose between the 5-year rule and the life expectancy payout method. Natalie Choate, *Life and Death Planning for Retirement Benefits* 75 (Ataxplan Publications, 7th ed. 2011).

<sup>7</sup> See 26 CFR § 1.401(a)(9)-5, Question and Answer 5(a)(1). The "at least as rapidly rule" of Internal Revenue Code § 401(a)(8)(B)(i) has been administratively repealed. Natalie Choate, *Life and Death Planning for Retirement Benefits* 67 (Ataxplan Publications, 7th ed. 2011).