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Advising Clients Regarding Lifetime Distributions from Qualified Retirement Plans

Qualified retirement plans, with their myriad rules and requirements, complicate the estate planning process, and uninformed decision-making can greatly affect the success of a client's overall program. This review of the various requirements of qualified plans can aid the advisor in helping clients to make appropriate choices.

By Barbara Freedman Wand

Estate planning for the elderly involves much more than ensuring that clients' assets pass at death in accordance with their wishes. As clients near retirement, they must make important decisions regarding lifetime distributions from retirement plans. They often look to their advisors for guidance in making these decisions. The choices that clients make during their lifetimes regarding distributions from retirement plans can have a significant impact not only upon the stream of retirement income available to them during their lifetimes, but also upon what remains to be passed on to the next generation and how long those benefits can remain tax deferred after the death of the plan participant. Advisors to the elderly must become familiar with the rules regarding lifetime distributions from retirement assets in order to effectively counsel their clients and must understand the relationship between choices made during lifetime and the disposition of retirement assets at death.

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Understanding the Plans in Question

The advisor cannot give generic advice to a client about the appropriate course without understanding the nature of the retirement plans in which the client has an interest. Just as an advisor would not give advice to a client about real estate without determining whether the particular property in question is unimproved land, a single-family residence, or commercial real estate, no advisor should dispense advice to a client with respect to a retirement plan without understanding the nature of the plan and the client's interest in it.

Retirement plans may be qualified plans, governed by both the Internal Revenue Code and the Employee Retirement Income

Security Act of 1974 (ERISA), or nonqualified plans. Nonqualified plans are contractual arrangements between employers and employees, often used in the compensation of executives. Qualified plans are creations of statute that provide employers and employees with significant tax benefits. In return for these benefits, employers are subject to extensive regulation in connection with the administration of these plans, and employees must comply with regulations regarding distributions. Among the types of qualified plans are *defined contribution plans* (such as profit sharing plans, 401(k) plans, money purchase pension plans, and employee stock ownership plans (ESOPs) and *defined benefit plans*. Keogh plans are qualified retirement plans for self-employed individuals. Plans sponsored by tax-exempt organizations, such as governments and charitable organizations, and traditional individual retirement accounts[1] (IRAs) are subject to many of the same rules as qualified plans.

When clients provide the advisor with information regarding their assets, that information should include specific information regarding the type of retirement plans in which they have an interest. Preferably they should also provide the advisor with, or authorize the advisor to obtain, a copy of the plan, or at least the summary plan description, which employers must maintain and make available to plan participants. The advisor should obtain information regarding the current balances in the plans, the history of contributions to the plan(s), and copies of any current beneficiary designations then of record.

Penalty for Premature Withdrawals from Qualified Plans

Clients may seek counsel when they need funds for a particular purpose and want to access the funds in a retirement plan. For clients who are less than age 59½ and who are not disabled, there is a 10 percent penalty for premature withdrawals from the plan under Section 72(t) of the Internal Revenue Code (Code), unless the withdrawals fit within one of the permissible exceptions to that rule. The exceptions include (a) withdrawals from qualified plans up to the amount of the participant's deductible medical expenses; (b) withdrawals from qualified plans other than IRAs for participants who have attained age 55 and who have "separated from service" as that term is defined in the Internal Revenue Code; (c) withdrawals that are calculated with reference to the participant's life expectancy and that are taken annually or more frequently for a period of at least five years or until the participant attains age 59½, whichever occurs later;[2] (d) withdrawals from IRAs up to $10,000 (over the lifetime of the participant) if the withdrawal is used within 120 days for the costs of acquiring, constructing, or reconstructing a principal residence for "first time home buyers;" (e) withdrawals from IRAs for certain "qualified higher education expenses" with respect to the taxpayer, spouse of the taxpayer, or any child or grandchild of the taxpayer or the taxpayer's spouse; (f) stock dividends paid on stock held by an ESOP; (g) distributions made to alternate payees under Qualified Domestic Relations Orders; and (h) distributions from IRAs to unemployed persons to pay health insurance premiums. One should keep in mind that distributions that are exempt from the premature withdrawal penalty are nevertheless subject to ordinary income tax, since one important characteristic of qualified plans is that contributions to these plans are generally made on a pre-tax basis, with income tax on the contributions and on the growth of the contributions inside the plan being deferred until distributions from the plans are made.

Withdrawals Between Age 59½ and Required Beginning Date

Clients may have the most flexibility in making withdrawals from their retirement plans between age 59½ and the time when, under law, they must begin taking withdrawals from their plans. Plans may prohibit withdrawals while an employee is still employed, and therefore the first step in advising a client must be to check the plan document to determine whether in-service withdrawals are permitted. For accounts such as IRAs, however, there are no such restrictions on withdrawals, and thus these accounts may be accessed with no penalty during these years, even if the account owner remains employed. Clients should be counseled, however, about the income taxes payable on withdrawals and about the effect of withdrawals on projected retirement income.

Required Minimum Distributions from Qualified Retirement Plans During the Lifetime of the Participant—When Must They Begin?

When a participant reaches his or her "required beginning date," that participant must begin taking required minimum distributions from his or her retirement plan. The general definition of "required beginning date" is April 1 of the calendar year following the later of

1. The calendar year in which the employee attains age 70½, or

2. The calendar year in which the employee retires.[3]

Prior to the amendment of this definition in 1996, a participant's required beginning date occurred when the participant attained age 70½ even if the participant had not then retired.

The revised definition that delays the required beginning date until the retirement of the participant does not apply to IRAs nor to an employee who is a "5-percent owner" of the employer sponsoring the plan.[4] Since it is possible that a client may have an IRA and at the same time be a participant in a plan for which he is not considered as a "5-percent owner," the client may have different required beginning dates for different plans and, hence, be required to begin distributions with respect to those plans at different times.

It is important to note that while a participant's first required minimum distribution can be taken up to April 1 of the calendar year after the calendar year in which the participant attains age 70½, that distribution is taken *with respect to* the calendar year in which the participant turned age 70½. If, therefore, the participant waits until the next calendar year to take the first required minimum distribution, he or she will be required to take another required minimum distribution in that same calendar year for that calendar year, thus potentially "bunching up" income in a single calendar year. It is important to work with clients in each individual case and with their tax advisors to determine whether postponing the first required minimum distribution to the calendar year after the participant attains age 70½ is advisable.

Consequences of Failure to Take Timely Required Minimum Distributions

The consequences to the participant of failing to take the required minimum distribution from a plan can be disastrous. The participant is subject to a 50 percent excise tax on the payments that should have been distributed.[5] This excise tax is in addition to the income tax due with respect to the distributions. Given the impact of the excise tax, it is extremely important that clients be made aware of their obligations to take required minimum distributions.

Calculating the Required Minimum Distribution

The amount of a client's required minimum distribution will be based in part upon the size of his plan balance at the end of the year prior to that for which the required minimum distribution must be taken. For example, if a client is retired and turns age 70½ in 1999, then while he may wait until April 1, 2000 to take his first required minimum distribution payment, that payment will be for the year 1999, and the balance of the plan at the end of 1998 will be used in determining the required minimum distribution for 1999. The required minimum distribution for the year 2000 will be based upon the plan balance at the end of 1999.

If a participant does not have a designated beneficiary as of her required beginning date, then the plan benefits must be withdrawn over a period determined by the participant's life expectancy. If, on the other hand, the participant has a designated beneficiary, the participant can withdraw her plan assets over the *joint* life expectancy of herself and that designated beneficiary. However, if the designated beneficiary is someone other than the participant's spouse, that designated beneficiary will be deemed to be no more than ten years younger than the participant for purposes of calculating the joint life expectancy. This limitation on the deemed age of a nonspouse designated beneficiary is called the "minimum distribution incidental benefit" rule (MDIB).

Since the joint life expectancy of a participant and another person will almost always be longer than the participant's alone, having a designated beneficiary results in the required minimum distribution being lower than if the distribution were calculated solely by reference to the participant's life expectancy. The longer qualified plan benefits can remain in the plan, the longer the income taxes on those assets can be deferred. This income tax deferral has a significant impact on the growth of the plan assets.

The Designated Beneficiary

If a client's objectives include keeping retirement plan assets tax deferred as long as possible, it is extremely important to ensure that the client has a designated beneficiary as of his required beginning date whose life expectancy can be used, together with the participant's, in calculating the required minimum distribution. The term "designated beneficiary" is described by the Internal Revenue Service in its proposed regulations[6] and means more than whatever the participant fills in on his beneficiary form as the recipient of the remaining retirement plan assets at his death or whatever default beneficiary the plan has established if a participant has not completed a beneficiary designation form. A "designated beneficiary" must be an individual, which means that an estate, corporation, partnership, charity, or a trust cannot be a designated beneficiary (although if certain requirements are met, one can "look through" a trust and consider one of the beneficiaries of the trust as the designated beneficiary for purposes of the minimum distribution calculation).[7] In a circumstance where a participant has named multiple beneficiaries to receive shares of his retirement plan, *all* of the beneficiaries must be individuals in order for the life expectancy of one of the beneficiaries to be used in a joint life expectancy calculation. If one of the beneficiaries is not an individual, then the participant will be deemed to have no designated beneficiary, and the participant will be restricted to using only his life expectancy in calculating the required minimum distribution. Where there are multiple individuals named to receive a participant's retirement plan benefits upon the participant's death, the life expectancy of the oldest of those individuals is to be used in the required minimum distribution calculation.

When advising a client regarding appropriate beneficiary designations, it should be kept in mind that the Retirement Equity Act of 1984 (REA) may require spousal consent for beneficiary designations other than the spouse. This requirement does not apply to IRAs or to certain profit sharing plans.

One must examine the client's existing beneficiary designations to determine whether they will preclude the extension of tax-deferral opportunities with respect to the plan benefits. While naming one's estate as the beneficiary of one's retirement plan may be viewed as a shortcut mechanism for ensuring that the plan benefits are directed to the individuals named in the client's will, this short-cut can have serious consequences as to the rate at which the client will be required to withdraw his retirement plan benefits. A client with charitable inclinations whose IRA beneficiary designation leaves one half of her IRA to her children and the other half to a charity will be deemed to have no designated beneficiary. Other ways of structuring the charitable and noncharitable dispositive wishes of the client (such as dividing an IRA into separate IRAs with different beneficiaries) can preserve some tax-deferral opportunities while accomplishing the client's goals.

Changing Designated Beneficiaries After the Required Beginning Date

As clients review their estate plans, they may wish to change their beneficiary designations for their retirement plan benefits. The outer limits of continued tax deferral are set, however, by the beneficiary designation in place as of the participant's required beginning date. No change in the beneficiary designation made by the participant after his required beginning date can result in a longer joint life expectancy being used to compute the participant's required minimum distribution. For example, if the designated beneficiary of a 70-year-old client as of his required beginning date was his 65-year-old companion, then, while the client has the freedom to change that beneficiary designation, no change can result in a longer joint life expectancy for purposes of the required minimum distribution calculation, which will continue to be based upon the joint life expectancy of the participant and the 65-year-old companion.

Alternatively, if a participant changes a beneficiary designation after the required beginning date to someone who is older than the designated beneficiary as of the participant's required beginning date, the participant must recalculate his required minimum distributions from that time forward to be based upon the shorter life expectancy of the new designated beneficiary.

Even more dramatic is the effect of a change in beneficiary designation from an individual to a charity or an estate. In that case, the participant would be deemed not to have a designated beneficiary, and future required minimum distributions would be based upon the participant's sole life expectancy.

Choosing a Calculation Method for Determining Life Expectancy

IRS regulations direct that the unisex life expectancy tables designated as Table V (for single life expectancy) and as Table VI (for joint life expectancy) of Treasury Regulations Section 1.72-9 be used in calculating life expectancy for purposes of required minimum distributions from retirement plans. Although the use of these tables is mandated, the participant may have a choice as to how her life expectancy and that of her spouse (if he is her designated beneficiary) is to be determined in years following the initial required minimum distribution.

Plans are permitted, but not required, to give participants a choice as to whether or not to recalculate their life expectancy (and that of their spouse/designated beneficiary) each year. Therefore, it is important to review the plan to determine whether that choice is available. Plans also include a default decision to become effective if a timely choice regarding recalculation is not made.

If one chooses not to recalculate life expectancy, then once the tables are consulted to determine the initial life expectancy to be used to calculate the first required minimum distribution, those tables are not consulted again. Rather, in each subsequent year, one year is subtracted from the previous year's life expectancy to determine the remaining life expectancy and, hence, the size of the required minimum distribution. Under this approach, if the initial life expectancy were 15.3 years, 1/15.3 of the plan balance would be required to be withdrawn in the first year. The next year, the life expectancy would be 14.3 years (15.3 minus 1.0), and 1/14.3 of the plan balance would be required to be withdrawn for that year. Each year, 1.0 is subtracted from the previous year's life expectancy. At the expiration of the initial life expectancy, the entire remaining balance would be required to be withdrawn.

The alternative is to recalculate the participant's life expectancy each year under the IRS tables. As the tables make clear, an individual's life expectancy is not reduced by a whole year for each year of life. Each year that a person survives increases his total life expectancy. For example, the life expectancy of a 71-year-old under Table V is 15.3 years, thus predicting that the individual will reach age 86.3 years. Recalculating that person's life expectancy at age 72, the life expectancy has decreased by less than one year to 14.6 years, thus predicting that the person will live to age 86.6 years. Under the recalculation method, in the first year 1/15.3 of the plan must be withdrawn, but in the next year, 1/14.6 of the plan must be withdrawn, as opposed to the larger 1/14.3 fraction of the plan, if the life expectancy were not being recalculated.

The effect of recalculating life expectancy is to slow down the rate at which required minimum distribution must be made. The "catch" is that under the recalculation method, a participant's life expectancy is reduced to zero in the year he dies, thus potentially accelerating the required minimum distributions following his death.

If a participant's designated beneficiary is his spouse, then the participant may choose whether to recalculate both his and his spouse's life expectancies, neither of their life expectancies, or one or the other of their life expectancies. If the designated beneficiary is not the spouse, recalculation of the designated beneficiary's life expectancy is not permitted.

A careful examination of a client's retirement and estate planning goals must be undertaken to assist a client in making the appropriate choices regarding the calculation method for life expectancies. Once made, this decision is irrevocable, thus heightening the importance of a thoughtful and comprehensive review of all relevant issues in connection with this decision.

Required Minimum Distributions from Retirement Benefits Following Death of Participant

As we have seen, the designation of who is to receive the participant's remaining retirement benefits at his death has a significant impact on the rate at which the retirement benefits must be withdrawn during the participant's lifetime. While the beneficiary designation also directs *who* will receive the retirement benefits at the participant's death, it does not entirely control the rate at which these benefits must be withdrawn from the retirement plan after the participant's death. That is because the Internal Revenue Code also requires minimum distributions from retirement plans following the death of the participant.

As with lifetime distributions, the rate at which distributions must be taken from the plan after the participant's death depends significantly upon whether the participant had a designated beneficiary at the time of his death. Another factor that will determine the rate of required minimum distributions is whether death occurred before or after the participant's required beginning date.

Death of Participant Before Required Beginning Date

If a participant dies before his required beginning date, then unless the participant had a designated beneficiary, all retirement plan assets must be distributed within five years of the participant's death. The withdrawals do not have to be made ratably during the five-year period, so long as the distribution is complete by December 31 of the calendar year that contains the fifth anniversary of the participant's death.

If, however, the participant had a designated beneficiary, then the retirement benefits can be withdrawn in annual installments over the life expectancy of the designated beneficiary, beginning no later than December 31 of the year after the calendar year in which the participant died. If the designated beneficiary is the spouse of the participant, then additional tax-deferral opportunities are available, since there is a special rule that permits the spouse to defer any distributions from the plan until December 31 of the year in which the participant would have reached age $70\frac{1}{2}$.[8]

Death of Participant After Required Beginning Date

When a participant dies after his required beginning date, then the remaining benefits must be distributed at least as rapidly as the rate in effect as of the participant's date of death. Since that rate will have been affected by whether or not a designated beneficiary was in effect at the required beginning date, the existence of a designated beneficiary will have continued significance after the participant's death in determining the rate of required plan withdrawals. Whether the participant's life expectancy was being recalculated will also have an effect upon the rate at which the remaining benefits must be withdrawn, since if the participant's life expectancy was being recalculated, it will be reduced to zero at his death, thus eliminating the use of the participant's life expectancy together with the designated beneficiary's in calculating required minimum distributions.

Although the rule is that benefits must continue to be withdrawn as rapidly as they were being withdrawn during the participant's lifetime, that standard may in practice permit a *slower* rate of withdrawal in a particular circumstance. The MDIB rule discussed above, that deems a designated beneficiary to be no more than ten years younger than the participant, ceases to operate following the death of the participant. Following the participant's death, the actual life expectancy of the designated beneficiary can be used in computing required minimum distributions. Where a grandchild has been named as the designated beneficiary, the tax-deferral benefits from allowing the benefits to remain in the plan as long as possible are substantial.

Other Important Issues

Special rules may be available to alter the ordinary income-tax treatment of distributions from qualified retirement plans. Familiarity with these rules is essential to providing solid and complete advice to clients. For example, lump-sum distributions from retirement plans may be eligible for five- or ten-year income averaging[9] and for capital gains treatment of a portion of the distribution.[10] Net unrealized appreciation on distributions of employer securities from ESOPs may be eligible for special income tax treatment.[11] Future columns will discuss these subjects in more detail, as well as special issues surrounding qualifying retirement benefits for the marital deduction and the use of retirement plan benefits to fully utilize the applicable exclusion amount.

Conclusion

Retirement benefits often represent a significant portion of a client's wealth. To properly counsel clients, advisors must become familiar with the rules governing distributions from retirement plans and the impact of decisions about distributions on retirement income and on disposition of the plan balances upon death. Significantly in advance of the "required beginning date," clients should be educated about their rights and obligations with respect to distributions, so that appropriate choices can be made to effectuate their retirement and estate planning goals.

Endnotes

1. For purposes of this column, the terms "individual retirement account" and "IRA" will mean traditional IRAs, as opposed to the newly created Roth and Education IRAs, which will be the subject of a future column.

2. There are restrictions on the use of this option for certain 401(a) plans.

3. *See* I.R.C. § 401(a)(9)(C)(i) (1998).

4. I.R.C. § 401(a)(9)(C)(ii) (1998).

5. *See* I.R.C. § 4974(a) (1998).

6. *See generally* Proposed Regulations for I.R.C. § 401(a)(9)(D) (1998).

7. A detailed discussion of the requirements for "looking through" a trust to use one of its beneficiaries as the designated beneficiary will be the subject of a future column. These requirements include (1) that the trust be valid under state law; (2) that all beneficiaries of the trust be individuals; (3) that all beneficiaries of the trust be identifiable; and (4) that the trust by its terms be irrevocable upon the death of the employee; and (5) that by the earlier to occur of the required beginning date or the end of the ninth month beginning after the death of the employee the plan administrator be provided with either a copy of the trust or with a list of all the beneficiaries of the trust together with certification that all the requirements for the "look-through" are satisfied as of the date of death and together with an agreement to provide a copy of the trust upon demand.

8. Additional tax-deferral opportunities may be available to the spouse if he chooses to rollover the plan benefits to his own IRA, which will permit him to delay distributions until he reaches age 70½ and to base required minimum distributions over the joint life expectancy of himself and his own designated beneficiary.

9. *See* I.R.C. § 402(e) (1998). Five-year forward averaging was repealed by the Small Business Job Protection Act of 1996 for lump-sum distributions for taxable years beginning after December 31, 1999. Ten-year forward averaging is available only to participants who attained age 50 before January 1, 1986.

10. Capital gains treatment on pre-1974 portions of lump-sum distributions is available only to participants who have attained age 50 before January 1, 1986.

11. *See* I.R.C. § 402(e) (1998).