Multigenerational Retirement Distribution Planning

Maximizing the Family Wealth Planning Benefits of Qualified Plans and IRAs

Overview

- Qualified plans, IRAs and other tax-deferred plans often constitute a significant portion of the family wealth
- Without careful planning, the value of these assets can be eroded as a result of heavy taxation
- Required minimum distribution rules are complex, so professional advice remains essential
- Plan beneficiary selection must be coordinated with the rest of the estate plan

Defining Planning Objectives

- Retirement and estate planning objectives may conflict with one another
  - Retirement plans may be consumed by the senior generation as a major source of lifetime income
  - They may also serve as an important vehicle for intergenerational transfers of family wealth
- Beneficiary selection is influenced by the desired level of testamentary control
- Employer-sponsored plans may offer greater asset protection but less flexibility than IRAs in many cases

Preserving Planning Flexibility

- Key decisions must be made during the planning process
  - Primary beneficiaries
  - Contingent beneficiaries
  - Use of a trust as primary or contingent beneficiary
  - Single accounts vs. multiple accounts
- Distributions from employer-sponsored plans are governed by the plan document
- For IRAs, use of a custom beneficiary designation provides greater flexibility than standard forms offer

Basic Concepts

- Distributions are generally ordinary income
  - Capital gain treatment for distributions of employer stock with net unrealized appreciation or NUA
  - Qualified Roth IRA distributions are tax-free
- Required minimum distributions (RMDs) must begin by the required beginning date (RBD)
  - April 1 in the year following the year of reaching 70 1/2
  - For employer plans RBD may be delayed until retirement
- Undistributed balances at death are generally includible in the gross estate

Designated Beneficiary

- Term of art defined in the tax regulations
  - Individuals only—estates and charities don't qualify
  - Qualifying trusts allow trust beneficiaries to be treated as designated beneficiaries
- Identity of DB may affect calculation of RMDs
- September 30 in the year following participant's death is the determination date
  - Facilitates postmortem distribution planning
  - Disclaimers, creating separate accounts and/or cashing out certain beneficiaries may be beneficial

Lump-Sum Distributions[1]

- Distribution of entire balance in employer plan on account of triggering event
  - Separation from service
  - Age 59 ½
  - Death or disability of participant
- May qualify for special tax treatment for participants born before January 1, 1936
  - 10-year averaging may lower effective tax rate
  - Capital gains for pre-1974 plan participation
- Other rules for distributions of employer stock

Lump-Sum Distributions[2]

- LSD is an eligible rollover distribution
  - Participant or surviving spouse may roll over all or a portion of the distribution to an IRA
  - Rollover preserves tax-deferred status of plan
  - Rollover of any portion of distribution bars 10-year averaging and/or pre-74 capital gains treatment on the amounts retained
- 10-year averaging/pre-74 capital gains is a one-time election

Net Unrealized Appreciation

- Distribution of company stock from employer plans is eligible for favorable tax treatment
- Net unrealized appreciation or NUA = fair market value of stock minus plan trustee's basis in the stock
  - NUA is taxed as a long-term capital gain only in a taxable disposition of the distributed stock
    - No step-up in basis at death so treated as IRD
    - Transfer of stock to a CRT allows for tax-free diversification and deferral of capital gains taxes
  - Basis of NUA stock is taxed as ordinary income in the year of distribution from the plan

NUA Election vs. IRA Rollover

NUA Election Favored

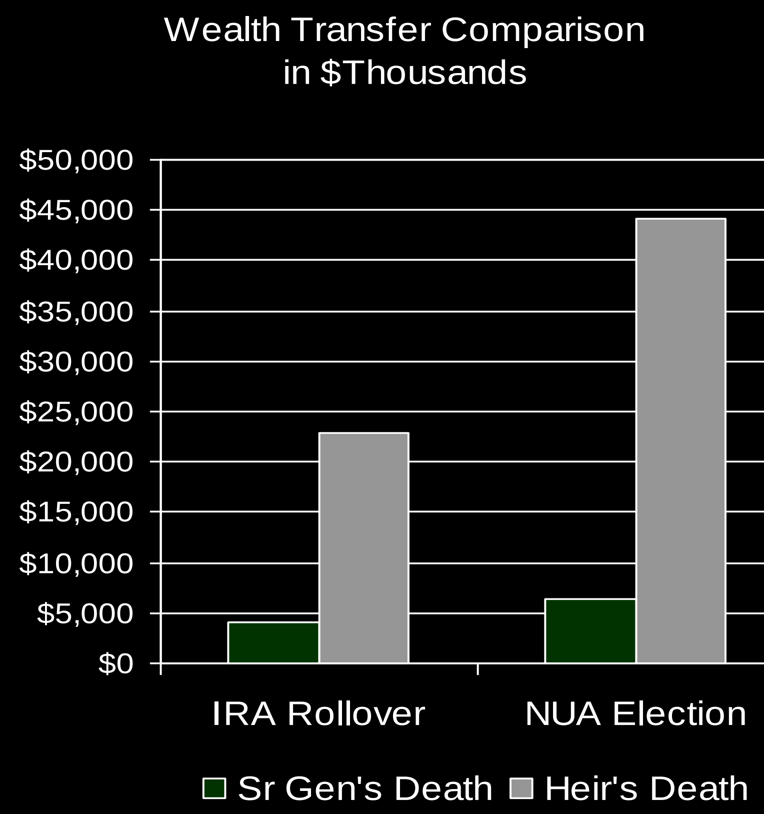
- Higher NUA: basis ratio
- Shorter post-distribution deferral period for IRA
- Higher marginal tax rate
- Special lump-sum distribution treatment
- Longer post-distribution holding period for stock
- If funding a CRT with company stock is desired

IRA Rollover Favored

- Lower NUA: basis ratio
- Longer post-distribution deferral period for IRA
- Lower marginal tax rate
- Desire to diversify
- Pre-age 55 lump-sum distribution

LSD with NUA Example

- $1,000,000 qualified plan
- $750,000 employer stock
- $600,000 NUA
- Participant age 55
- Eldest DB age 25
- Life expectancies age 85
- Highest tax brackets
- 40% federal estate tax rate
- 8% employer stock growth rate
- Employer stock held until P's death; then fully liquidated
- 2%/6% income & growth on other investments



Required Minimum Distributions

- Final regulations were published in 2002
  - Effective January 2003
  - Optional use was available for 2002
- Rules were simplified but planning remains essential
  - Use of a Uniform Lifetime Table was mandated
  - Participant's death supersedes the RBD as the date on which certain planning decisions are irrevocable for postmortem distribution purposes
- Failure to make RMDs results in 50% excise tax

Uniform Lifetime Table

- Used to determine RMDs in most cases
- Exception where spouse is sole beneficiary and is more than 10 years younger
  - Actual recalculated joint life expectancy of participant/spouse is used annually
  - Different table for determining RMD factors
- Incorporates current mortality assumptions and thus allows for longer distribution periods

Death Before the RBD

- If no DB, total distribution required by 12/31 in the 5th anniversary year of participant's death
- Spouse DB (if no spousal rollover executed)
  - RMD factor based on surviving spouse's life expectancy (recalculated until spouse's death)
  - Must begin by later of 12/31 in the year following P's death or when P would have reached 70 ½
- Nonspouse DB
  - RMD factor based on DB's fixed life expectancy
  - Must begin by 12/31 in the year following P's death

Death After the RBD

- If no DB, distributions are based on P's life expectancy at death, reduced by 1 each year
- If spouse DB, distributions are based on spouse's life expectancy (recalculated until death)
- If nonspouse DB, distributions are based on DB's life expectancy in year following P's death, reduced by 1 each year (per Single Life Table)
- If plan or account has multiple beneficiaries, DB with the shortest life expectancy is used in determining postmortem distribution schedule

Spouse Beneficiary

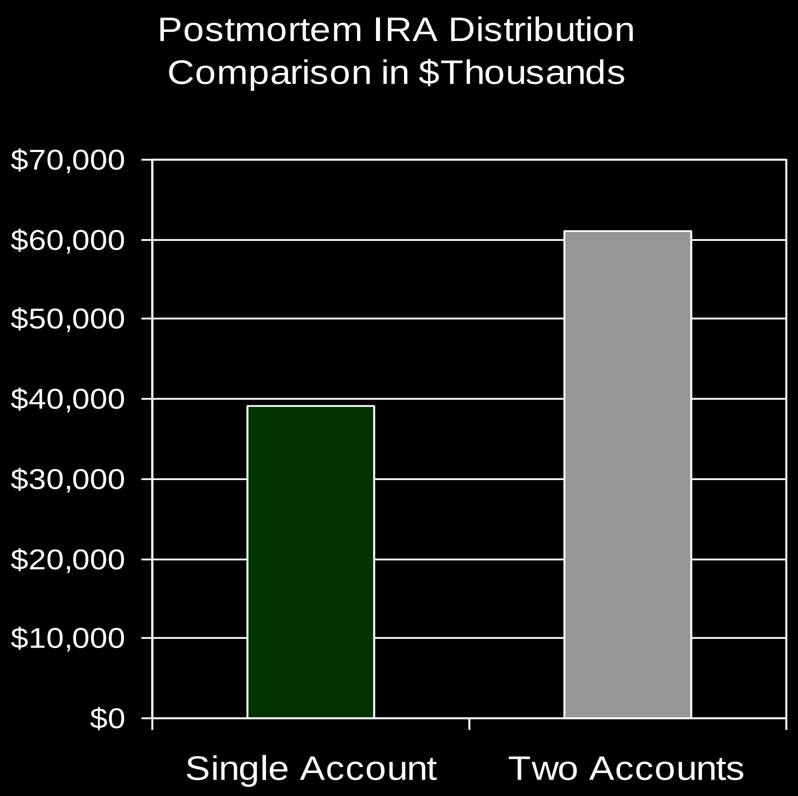
- Naming P's spouse as DB provides flexibility as spouse can accept or disclaim plan/IRA
- Spouse can execute a postmortem IRA rollover and elect to treat the account as own
  - Spouse names one or more DBs
  - Spouse can delay RMDs until his/her own RBD
  - Spouse can also receive postmortem RMDs as a beneficiary rather than electing to own the account
- Creating multiple rollover accounts increases pre-59 ½ distribution planning flexibility

Heirs as Beneficiary

- If spousal ownership via rollover would imperil heirs' chances of receiving plan/IRA benefits
- Postmortem IRA distributions can be stretched out over DB's life expectancy using Single Life Table
- If separate accounts are established by 12/31 in year following P's death, each account beneficiary uses his/her own life expectancy
- Employer plan may require lump-sum or other payout
- Postmortem IRA rollovers (i.e., trustee-to-trustee transfers) are permitted

Separate Accounts Example

- $2,000,000 IRA
- Account owner age 55
- Eldest DB age 25
- Youngest DB age 10
- DB life expectancies age 85
- In multiple account scenario, IRA is split 50:50
- 8% total pretax return



Trust as Beneficiary[1]

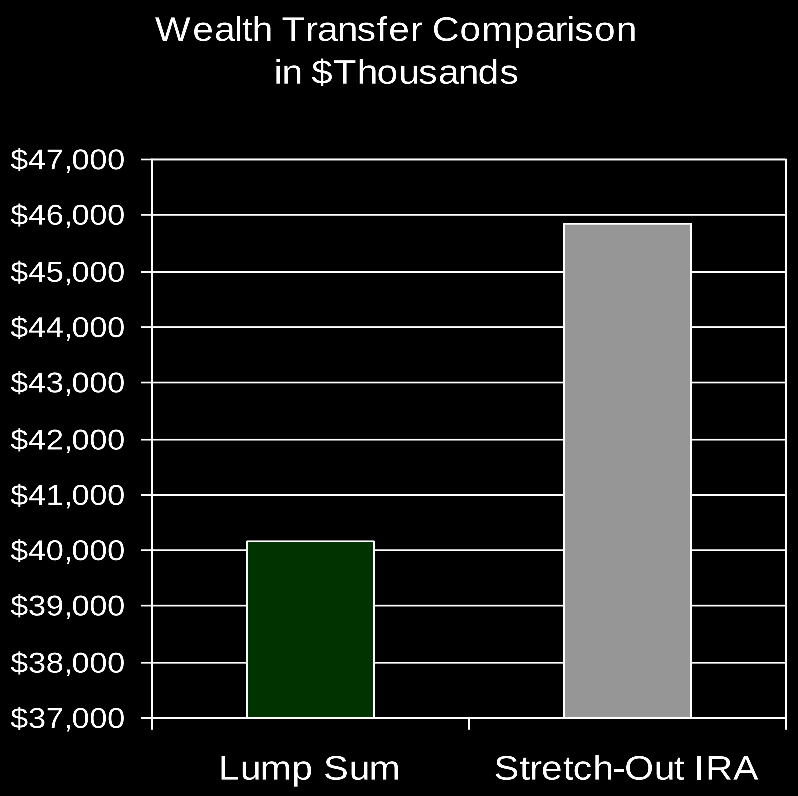
- Provides greater testamentary control and asset protection than outright bequests
- If the following requirements are met, trust beneficiaries can be treated as DBs
  - Valid under state law but for lack of corpus
  - Beneficiaries of trust are identifiable
  - Is irrevocable or becomes irrevocable at P's death
  - Certain trust information must be furnished to plan administrator, trustee, custodian, etc. by 10/31 in the year following participant/account owner's death

Trust as Beneficiary[2]

- Separate share rule states that plan benefits payable to a multi-beneficiary trust must use the shortest life expectancy period, even if the trust is split into separate shares
  - Solution 1: Plan or account is split into separate shares via the beneficiary designation
  - Solution 2: Subtrusts are named beneficiaries
  - Solution 3: Separate trusts are named beneficiaries
- Potential trap for the unwary, requiring coordination of plan/IRA beneficiary designations with trust provisions

Trust IRA Stretch-Out Example

- $2,000,000 IRA
- Eldest DB age 25
- DB life expectancy age 85
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth



QTIP Trust as Beneficiary

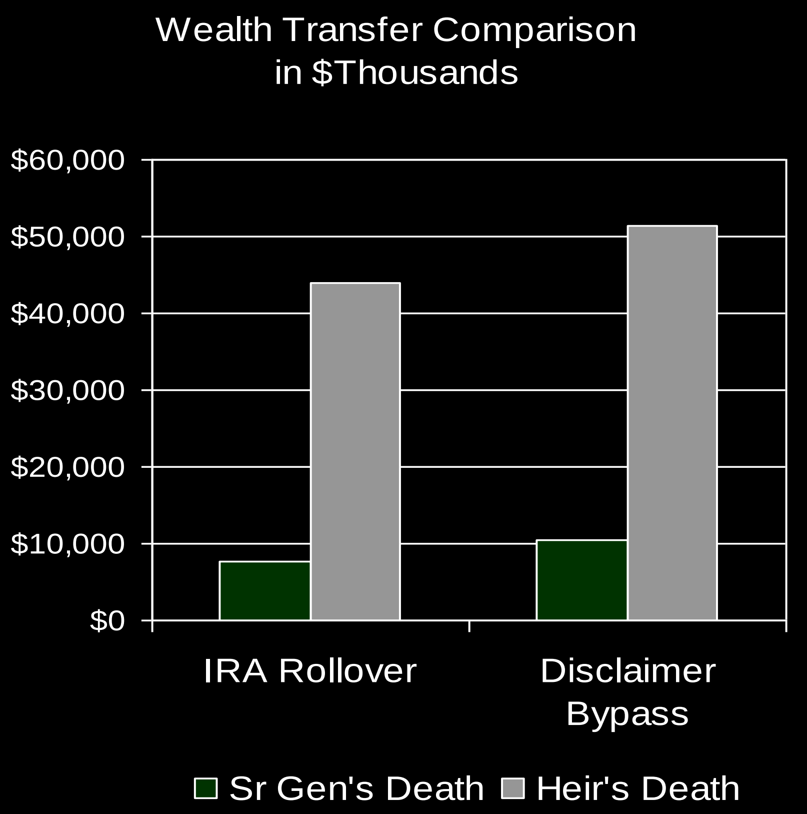
- Rules governing both RMDs and qualified spousal interests for estate tax purposes apply
- Advantages
  - Participant maintains testamentary control
  - Estate-tax deferral via unlimited marital deduction
- Disadvantages
  - Potential sacrifice of income-tax deferral relative to spousal IRA rollover
  - Complexity involving the interaction of federal tax laws with local property laws and fiduciary accounting rules

Bypass Trust as Beneficiary

- Qualified plans and traditional IRAs are not ideal assets for funding bypass trusts
  - Income tax burden reduces value of the bequest
  - Still worth considering if other assets are insufficient
  - Trust can be named as contingent beneficiary which inherits plan in the event of spousal disclaimer
- Roth IRA is ideal funding vehicle since qualified distributions are tax-free
- Pecuniary funding of trust accelerates income tax

Bypass vs. Rollover Example

- $2,000,000 IRA
- Surviving spouse age 52
- Eldest DB age 25
- Life expectancies age 85
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth



Generation-Skipping Transfers

Benefits

- Bypasses estate taxes at second generation level
- Longer postmortem distribution period
  - Greater tax deferral
  - Tax-free with Roth IRAs
- Creates or adds to a significant legacy for children's heirs

Drawbacks

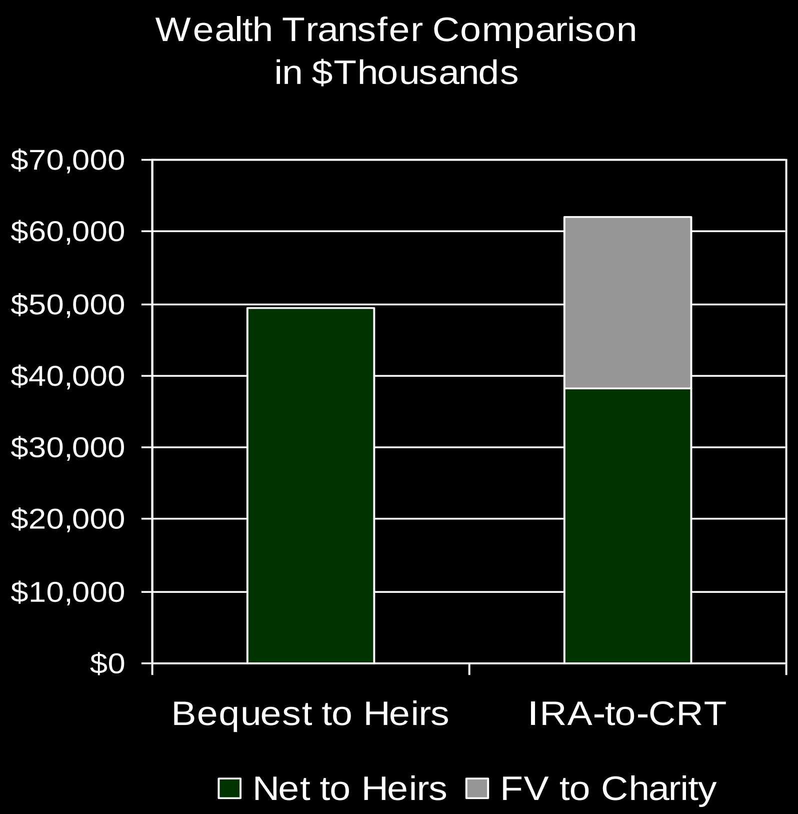
- Income taxes reduce value of transfer
- Must completely bypass children in order to use grandchildren's life expectancies
- Estate taxes if transfer exceeds applicable exclusion amount

Funding Charitable Bequests

- Qualified plans and traditional IRAs are ideal assets for funding charitable bequests
  - Charities are tax-exempt so IRD not a problem
  - Assets entitled to step-up in basis can pass to family
- Charities do not qualify as DBs, so should be cashed out by 9/30 in year following P’s death to avoid acceleration of postmortem RMDs
- Bequests to CRTs can serve as a substitute for RMDs for P’s heirs while benefiting charity

IRA-to-CRT Example

- $2,000,000 IRA
- Eldest DB age 25
- DB life expectancy age 85
- Highest tax brackets
- 40% federal estate tax rate
- 5% CRT payout
- 2% income
- 6% growth
- 2.6% 7520 rate



Charitable IRA Rollover

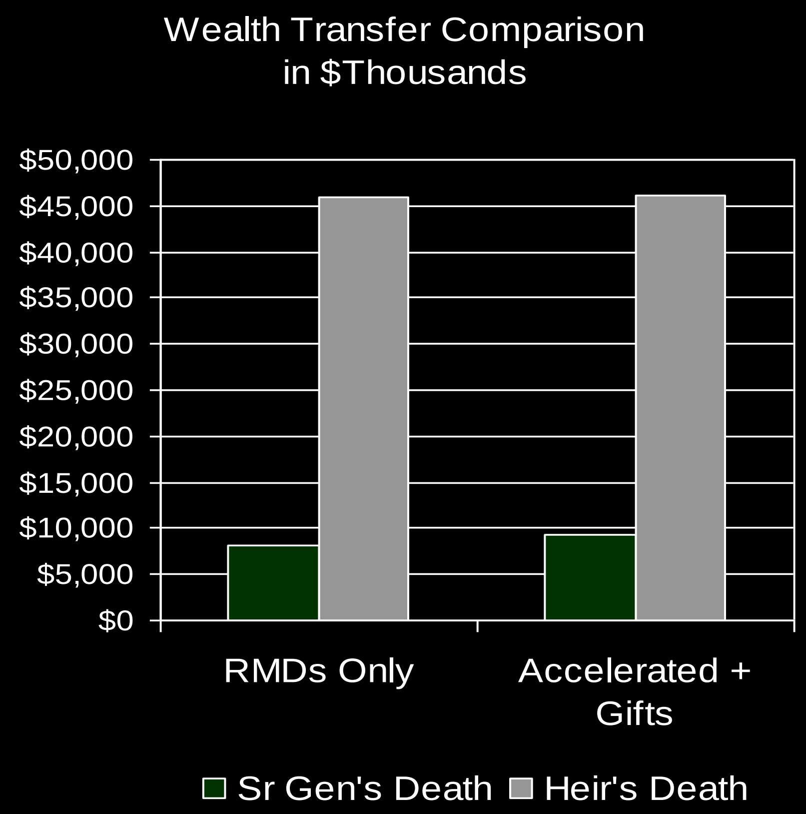
- Individuals 70 ½ or older can make lifetime transfers directly from IRAs to qualified charities
  - Up to $100K can be transferred per year
  - Charitable remainder trusts, gift annuities, donor advised funds, supporting organizations do not qualify
- Transfer is income tax-neutral
  - Excludable from gross income
  - Nondeductible
- Transfer applied towards minimum distribution requirements

Acceleration vs. Deferral

- Maximizing tax-deferred compounding by minimizing distributions is generally advisable
- Accelerating distributions may be more beneficial in limited circumstances
  - Funding a lifetime gifting program with distributions where other sources are unavailable
  - Funding a “non-propertied” spouse’s unified credit
- If retirement plan assets are needed to fund living expenses, create multiple accounts, especially for pre-59 ½ distributions

Accelerated Distributions Example

- $2,000,000 IRA
- Account owner age 55
- Eldest DB age 25
- Life expectancies age 85
- Discretionary distributions between now and the required beginning date
- Annual exclusion gifts
- 4 donees
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth



Role of Life Insurance

- Provides estate liquidity
  - Large retirement plan balances create significant tax exposure
  - Insurance may be necessary to preserve the tax-deferred status of these plans
- Lifetime gifts with after-tax plan distributions
  - Reduce P's taxable estate
  - Assets in irrevocable trust can fund premiums
- Can combine a retirement plan-to-CRT bequest with a wealth replacement trust

Roth IRAs

- Contributions are nondeductible
  - Post 70 ½ contributions are allowed
  - Subject to phase-out at specified AGI levels
- Qualified distributions are not subject to federal income taxes or penalties
  - Age 59 ½, death, disability or first home purchase
  - Must meet 5-year holding period requirements
- No lifetime RMDs
- Postmortem stretch-out distributions available
- Powerful wealth transfer planning vehicle

Roth IRA Conversions

- Taxpayers at all income levels are eligible
  - Income related to conversion is excluded
  - AGI < $100K requirement does not apply after 2009
- For best long-term results the taxes associated with the conversion should be paid with non-IRA funds
- CAUTION: RMDs cannot be converted
- Recharacterizations (i.e., unwinding) of Roth IRA conversions are no longer permitted due to the Tax Cuts & Jobs Act of 2017 (effective for taxable years beginning after 2017)

Pros & Cons of Conversion

Benefits

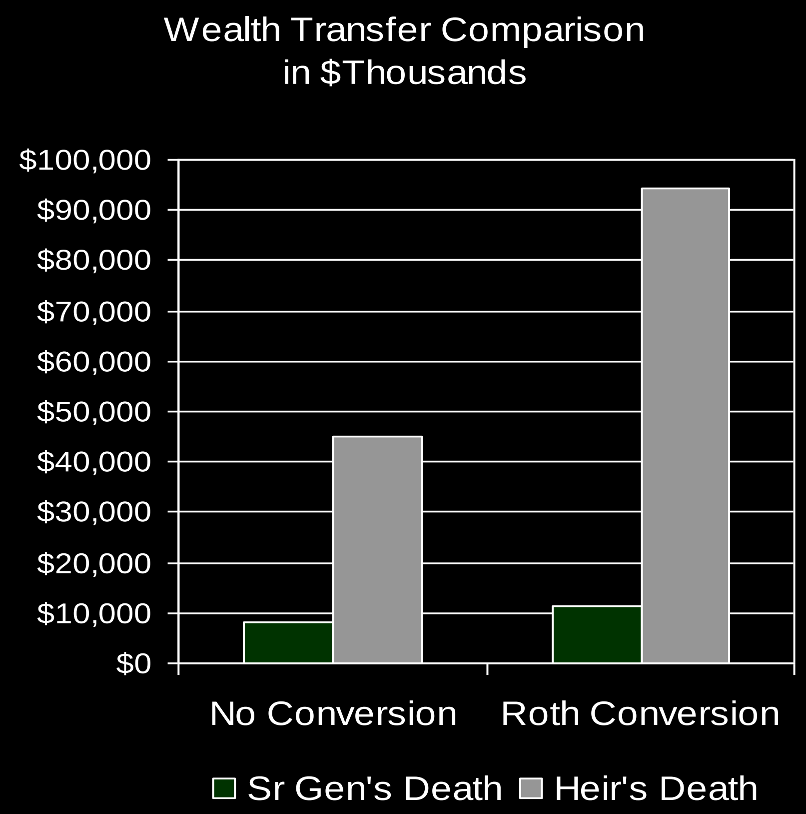
- Income-tax burden on IRA is frozen
- Conversion income may be offset with unused tax carryovers (e.g., NOLs)
- No lifetime RMDs
- Tax-free growth
- Tax-free distributions
- Ideal funding vehicle for credit shelter bypass trusts

Drawbacks

- Income taxes are accelerated
- Using IRA funds to pay taxes reduces benefits
- State creditor protection statutes may leave Roth IRA vulnerable
- Uncertainty surrounding future tax laws

Roth IRA Conversion Example

- $2,000,000 traditional IRA
- Account owner age 55
- Eldest DB age 25
- Life expectancies age 85
- 100% conversion in 2018
- Taxes paid with non-IRA funds
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth



Summary

- Rules governing distributions from qualified plans and IRAs are complex
- RMD rules present numerous potential traps, so careful planning and sound advice is paramount
- Customized IRAs and contingent beneficiary designations can provide maximum flexibility
- Don’t overlook the estate planning advantages of using trust beneficiaries, disclaimers and Roth IRAs
- Ensure adequate estate liquidity to preserve the tax-favored status of retirement plans