

# New Dimensions in Estate & Trust Planning

*An Article to Benefit Clients & Friends  
of*

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## The Importance of Naming the “RIGHT” Beneficiary to Your Qualified Retirement Account

Qualified Retirement Plans, (which include 401(k), IRA, TSP, 403(b) and other similar accounts) are the standard retirement savings vessel for Americans today. As a result, these accounts often hold large sums and constitute substantial portions of many estates. The “RIGHT” beneficiary designations for your Qualified Retirement Plan will make sure your carefully saved retirement funds pass to the right person, protected from excessive income taxes, other unnecessary expenses and possibly estate taxes. Naming an improper beneficiary can cause tax headaches, court involvement, and the total loss of control when the funds do not pass as intended. Naming the beneficiary to your Qualified Retirement Plan is one of the **most important** parts of your Estate Plan.

### How Qualified Retirement Plans Work

Unlike other investment accounts, you defer the income tax on the money you invest in a Qualified Retirement Plan. The income tax is only paid when you withdraw the funds (except for Roth IRAs). This tax-deferred growth allows the funds to accrue over the course of your lifetime at a rate which is effectively higher as compared to accounts which are subject to income tax each year. You get the most benefit from a Qualified Retirement Plan by allowing the accounts to grow as long as possible.

### Required Minimum Distributions

Congress created Qualified Retirement Plans to encourage Americans to save for their own retirement. The government wants to make sure that its citizens do not run out of funds

during their life but, for budgetary reasons, it limited the amount of time the accounts can grow on a tax-deferred basis. To balance these competing interests, the Federal Government requires that funds from Qualified Retirement Plans be withdrawn over the life expectancy of the account owner, beginning in the year after a person turns 70 ½. Tables published by the Internal Revenue Service (IRS Pub. 590) regulate the minimum amount that a person must withdraw from a Qualified Retirement Plan each year. These Required Minimum Distributions (or RMDs) are based on actuarial estimates of life expectancy and require that a certain percentage of the account balance be withdrawn each year, from approximately 3.8 % at age 70 to 45.5 % at age 113 (IRS Pub. 590, percentages rounded). Given that the RMD schedule continues well past the 100<sup>th</sup> birthday, it is quite likely that a Qualified Retirement Plan will still have a sizeable balance upon the death of the owner.

### **‘Stretching’ Qualified Retirement Plans**

The beneficiary listed on the Qualified Retirement Plan will receive any funds remaining in the owner’s Qualified Retirement Plan at the owner’s death. Because Qualified Retirement Plan accounts are tax-deferred, the beneficiary will need to pay income tax at ordinary income rates when the account is withdrawn. To avoid paying income tax all at once, and to let the remaining funds continue to grow tax-deferred, a prudent beneficiary will want to withdraw the funds remaining in the Qualified Retirement Plan over the longest period of time possible. This is sometimes called “stretching” the Qualified Retirement Plan. Tables published by the IRS indicate how beneficiaries can ‘stretch’ their inherited IRAs based on their age. These Required Minimum Distributions are generous: a beneficiary need only withdraw 2.3% at age 40, 2.9% at 50, 4% at 60, and

5.8% at 70 (IRS Pub. 590, percentages rounded). However, the beneficiary must begin calculating RMDs immediately, regardless of whether they have reached 70½ years. It is VERY IMPORTANT that the transfer of a Qualified Retirement Plan at death from an owner to a beneficiary be handled properly—be sure to check with both our Estate and Trust Administration Department and your Financial Advisor to ensure a smooth transfer from owner to beneficiary.

### **Choosing a Beneficiary**

An account owner’s choice of beneficiaries will impact the ability of the beneficiary to stretch the account over time. When designating a beneficiary, an owner must balance the desire to maximize the beneficiaries’ potential tax benefit against practical concerns: many times it is better to lose some of the account in taxes than to lose control and see the entire account needlessly dissipated. The owner must choose from the following beneficiary options: a **spouse**, a **Revocable Living Trust**, a **charity**, one or more **individuals**, or the **‘Estate’**. Good choices, which include your spouse, your Revocable Living Trust, and charities, allow the best balance of the benefits of control and tax advantage. Dangerous beneficiary choices such as individuals, your ‘Estate,’ and, worst of all, no beneficiary, cause you to lose control and may be quickly lost or squandered by the recipient.

### **Good Beneficiary Choices**

A **spouse** is the only beneficiary who can ‘roll over’ a Qualified Retirement Plan into a ‘Spousal Rollover IRA’. This means that at your death, your spouse ‘owns’ your IRA and can use his or her life expectancy as if the spouse were the original owner. This tax advantage makes the spouse a common beneficiary designation for married couples. This option is often the most income tax efficient choice, but it may not be the most estate tax efficient choice. It is important to note that the spouse becomes the new owner of the Qualified Retirement Plan in this

circumstance and so it may not be advisable for all married couples, especially those in second marriages with blended families. Again, there can be greater harm in losing control than in paying taxes.

Naming your **Revocable Living Trust** allows you to balance both your tax and control goals. Your trust allows you to protect your Qualified Retirement Plan assets with the same provisions you created to shelter your other assets. The protections a Revocable Living Trust affords against a beneficiary's youth, failed marriage, disability, or spending concerns can be extended to a Qualified Retirement Plan if the Trust is the beneficiary. It also may be necessary to use your Qualified Retirement Plan against your Federal Estate Tax exemption in a Revocable Living Trust that includes an Estate Tax Plan. Under current regulations, the IRA will be stretched according to the age of the oldest of your after-death beneficiaries. For example, if your spouse is the beneficiary of the trust, his/her life expectancy will determine RMD. If you have a Revocable Living Trust, it should be named as either the primary or secondary beneficiary of your Qualified Retirement Plan. **Be sure to check with your Estate Planning Attorney before naming your Trust as the primary or secondary beneficiary of your Qualified Retirement Plan.** An experienced Estate Planning Attorney must include special language drafted under the IRS Rules to qualify the Trust's underlying beneficiary as a "Designated Beneficiary". These IRS rules were made permanent in March, 2002.

Naming a **Charity** as beneficiary may be the best choice if you are so inclined. Gifts to a university, church, or other charitable organization can be a vital part of your legacy. Remember that the Qualified Retirement Plan is taxed as ordinary income by any person who withdraws the funds. Although children named as beneficiaries would lose up to

35% in income taxes upon their withdrawal, a tax-exempt charity would receive the entire balance of your account **income tax-free**. If you wish to name a portion of your Qualified Retirement Plan to a charity, you must separate that into a different account than the accounts passing to a Trust or person because the charity's lack of a 'life expectancy' will damage another beneficiary's ability to "stretch" the Qualified Retirement Plan. Again, check with your Estate Planning Attorney on this issue.

### **Dangerous Beneficiary Choices**

One's "**Estate**" is a common default beneficiary designation. **THIS IS A SERIOUS MISTAKE!** First, "Estate" means your Probate Estate which would subject Qualified Retirement Plan assets to the delay of court probate proceedings, the scrutiny of the public record, and probate expenses. Second, an Estate has no life expectancy and so has no option to stretch distributions beyond a mandatory five-year schedule. This means that by naming your "Estate" as your beneficiary, you will achieve neither your tax nor your control objectives.

The only thing worse than naming your "Estate" as beneficiary of your Qualified Retirement Plan is to not designate any beneficiary at all. Instead of you choosing your beneficiary, all the assets you accumulated in your Qualified Retirement Plan will be passed according to the "fine print" default terms of the IRA (or 401(k), etc.) agreement. **Doing nothing is not a viable option.** Make sure you have named a primary and secondary beneficiary that coordinates with your Estate Plan.

Naming **an individual** as beneficiary is more perilous than it might seem. Some financial commentators have given the (poor) suggestion that one should name the youngest living relative as beneficiary of a Qualified Retirement Plan to maximize the stretch-out tax benefit. This can be terrible advice because it gains the tax benefit at the absolute expense of control. A minor child or grandchild cannot legally own the account and so it must be

administered through a costly and burdensome court guardianship. Upon attaining legal adulthood, an 18 year old might find himself with a sizeable account and neither restrictions nor guidance on how to spend or save said funds. Such a beneficiary is extremely unlikely to prudently conserve this resource which the original owner worked so hard to build. **Minors should be beneficiaries of Qualified Retirement Plan Accounts through Revocable Trust Agreements.** Similarly, people who are not competent to manage their affairs will have an inherited IRA managed by the court if the original owner did not have the foresight to put a Trust in place.

Many people name an adult child as beneficiary of their Qualified Retirement Plans. Healthy adult beneficiaries may well have the mental capacity and financial discipline to make the most of their inherited IRA. Many children, however, do not know how to manage an inheritance; most inheritances are squandered in a few years. Further, even the healthiest adult could at any time suffer an accident or illness that limits his or her mental capacity and could require management of their assets by the Court. Any beneficiary could suffer from a failed marriage through no fault of their own. The safeguards provided by a

Revocable Living Trust can insulate the beneficiary from these financial and legal perils. Remember, if the underlying beneficiary of a Trust is a qualified “designated beneficiary” under IRS rules, then the beneficiary can use his/her life expectancy to determine Minimum Distributions Requirements.

### **Conclusion**

The beneficiary designation of the Qualified Retirement Plan governs one of the largest assets in many estates. Selection of your beneficiary must be made after careful examination of your goals and objectives to make sure the assets you have accrued over a lifetime continue to support your legacy after your passing. Whatever your goals may be, make sure that your beneficiary designation ensures that the remaining balance of your Qualified Retirement Plan passes to whom you intend with a maximum tax advantage and a minimum of outside interference. **Finally, be sure to review your goals and objectives with an experienced Estate Planning Attorney and your Financial Planner before filling out any ‘Change of Beneficiary’ forms. The beneficiary designation MUST be coordinated with your Estate Plan.**

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