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RETIREMENT ACCOUNT BASICS

Retirement accounts, like IRAs, Roth IRAs and 401(k)s are often some of the most substantial assets that people own, so it's essential to consider them when doing your estate planning. Failure to plan for these assets or poor planning can lead to a number of unintended and potentially devastating consequences.

THE BASICS

Retirement accounts do not pass through an individual's will or trust unless certain special measures are taken. Instead, retirement accounts pass to chosen and named beneficiaries according to the account agreement and the beneficiary designations the account owner puts in place. Typically, if an account owner fails to name a plan beneficiary, or the beneficiary designation fails for some reason, a contingent beneficiary may be named. Without naming a contingent beneficiary, the plan will determine the beneficiary or beneficiaries, which sometimes may not match the wishes of the account owner.

DISTRIBUTIONS

Distributions, whether discretionary or mandatory made from the account, are subject to income tax. This means that, in the event the account owner dies and the named beneficiary is now the owner of the policy, he or she will pay tax on everything that is withdrawn from the account.

Distributions from retirement accounts can be discretionary or mandatory. Discretionary distributions can occur upon the request of the plan owner, most times with an additional penalty for early distribution. They can also be mandatory. Mandatory Required Distributions (MRD) are made to account owners or beneficiaries after a certain point whether they are desired or not. That means that planning is necessary in order to avoid untimely tax liability on distributions. MRDs are determined by looking at the owner's life expectancy, and they must begin no later than April 1st of the year after the account owner reaches age 70 ½.

Rules for MRDs vary depending on the owner's age, whether the plan has an identifiable designated beneficiary, whether the account owner is living at the time required distributions must begin and whether the account owner is married. The chart below illustrates the period used to make distributions.

| Did the account owner die before reaching 70 ½? | Is there a designated beneficiary? | Period for Distribution |
|---|---|---|
| Yes | Yes | Beneficiary’s life expectancy |
| Yes | No | Five years from owner’s death |
| No | Yes | Longer of (1) beneficiary’s life expectancy or (2) deceased owner’s life expectancy |
| No | No | Deceased owner’s life expectancy |

NAMING BENEFICIARIES

More often than not, an account owner will name a spouse as the beneficiary under a policy. That’s usually a good idea, as it will enable the spouse to roll over the retirement account into his or her own account upon the death of the account owner thereby enabling him or her to continue growing the account funds tax deferred. If a spouse is not named, account owners should be sure that someone is named as the beneficiary to the account, as accounts without a named beneficiary will be deemed owned by individuals according to the account agreement. It is also important to name a contingent beneficiary in the event the primary beneficiary passes away or otherwise cannot inherit the account funds upon death.

EARLY WITHDRAWALS

Account assets that are withdrawn before the account owner reaches age 70 ½ are subject to income tax as well as a 10% penalty. Assets withdrawn after age 70 ½ are also (usually) subject to income tax upon withdrawal, however by leaving the assets in the plan until a later date, an account owner permits the assets to grow meaning that, when distributions become mandatory, the increased value of the account will offset the tax incurred.

NAMING A REVOCABLE TRUST AS BENEFICIARY

It is common for account owners that have done some estate planning to want to name a revocable trust as the beneficiary of their retirement accounts. The benefit of such an arrangement is that a trust may provide much needed management and control for minors or beneficiaries that are too young or monetarily unsophisticated to properly manage such a large sum.

Naming a revocable trust as the beneficiary of a retirement account does come with some potential pitfalls and consequences, however. Tax rates on trust income can be substantial and account owners must be very careful to ensure that the revocable trust named as beneficiary of an account has clearly identifiable individual beneficiaries. Moreover, trusts will only be viewed as acceptable beneficiaries if some very specific requirements are met. A four part text is used to determine if the trust is an acceptable beneficiary of a retirement account: a) the trust must be valid under state law; b) the trust must be irrevocable; c) the trust beneficiaries and their ages must be readily identifiable; and d) trust documentation must be provided to the plan administrator by a specified date.

If the four part test is met, then mandatory required distributions will be required based on the age of the oldest trust beneficiary's life expectancy. That means that younger beneficiaries will be forced to take larger mandatory distributions over a shorter period of time and pay higher taxes on the distributions.

POTENTIAL SOLUTIONS TO CONSIDER

While it may seem convenient to name an already existing revocable trust as the beneficiary of a retirement account, many times a better solution is to create separate individual only trusts for each individual beneficiary. An individuals-only trust requires that all account assets paid to the trust be allocated to a sub-trust, which, if properly drafted permit minimum required distributions to be calculated based on the primary beneficiary's life expectancy. Using this type of solution requires careful drafting of the beneficiary designations, and care must be taken to each separate trust as the appropriate beneficiary.

As with all estate planning mechanisms, it's important to evaluate your individual goals, objectives and concerns in order to make the best possible decision on how assets should be planned for.

*Michael F. Brennan is an attorney at the Virtual Attorney™ a virtual law office helping clients in Illinois, Wisconsin, and Minnesota with estate planning and small business legal needs. He can be reached at michael.brennan@mfblegal.com with questions or comments, or check out his website at www.thevirtualattorney.com.*

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By Michael Brennan