



Take my retirement benefits, please Tax considerations when naming retirement plan beneficiaries

You've worked hard for your wealth, and an impressive retirement plan is one of the fruits of your labor. You're fortunate enough that you don't need to depend on this nest egg to support your retirement, so you want to determine how you can best use it to benefit your family.

Whom should you select as your beneficiary? Among the most important considerations is the income and estate tax impact of your choice.

A double-edged estate planning tool

IRAs and employer sponsored "qualified" plans, such as 401(k)s, can effectively build wealth for your family because no taxes are due until funds are withdrawn, which allows you to take advantage of tax-deferred compounding. (In the case of Roth accounts, no taxes are ever due on growth — as long as all distributions are qualified. Your estate planning advisor can tell you more.)

When it comes to estate planning, though, tax-deferred retirement plans are a double-edged sword. Most inherited assets, such as stocks and real estate, receive a step-up in basis on the death of the owner of the assets, which means that heirs will owe income tax only on income or capital gains generated *after* they inherit the asset. (Note that, during the estate tax repeal scheduled for 2010, the step-up in basis will be limited.)

But for family members who inherit funds from your traditional 401(k) plan, traditional IRA or most other qualified plans, that isn't the case: The beneficiaries will have to pay income tax on 100% of the distributions they receive, except to the extent that you used nondeductible contributions to fund the account.

For example, if one of your children inherits your \$1 million traditional IRA and another child inherits your \$1 million brokerage account, their actual inheritances after taxes could be drastically different. If each liquidates his or her account immediately upon inheriting it, the child receiving the IRA could owe as much as \$350,000 in federal income tax alone, whereas the child receiving the brokerage account could owe no tax.

Minimizing the income tax bite

To minimize the income tax bite — and maximize the wealth-building power of a tax-deferred retirement plan — consider how long the beneficiary will be able to defer distributions, how large any required minimum distributions (RMDs) will be and the beneficiary's likely tax bracket. Generally, for inherited retirement plans, annual RMDs must begin immediately. (An employer-sponsored plan may require the beneficiary to take a lump sum distribution of the plan's balance, but the Pension Protection Act of 2006 now allows most beneficiaries to roll the funds into an IRA, which will be treated as an inherited IRA.)

The size of the RMDs will depend on the size of the account and the age of the beneficiary — the younger he or she is, the smaller the RMDs will be. Because the account will be depleted more slowly with smaller RMDs, there's a greater opportunity for tax-deferred growth. Plus, a younger beneficiary may well be in a lower tax bracket, at least for the early years of RMDs.

However, there also may be deferral benefits to naming your spouse as beneficiary. Your spouse has more flexibility in deferring distributions because he or she can treat your IRA as his or her own and delay any distributions until age 70½. Although this rule doesn't generally apply to other retirement plans, your spouse can roll the plan into an IRA for him- or herself and then take advantage of this deferral.

Estate tax considerations

From an estate tax perspective, however, naming your spouse as the beneficiary may or may not make sense. The advantage is that you'll avoid any estate tax liability on the retirement plan assets at your death because transfers to your spouse (provided he or she is a U.S. citizen) are free of estate tax. However, the IRA will increase the size of your spouse's estate, which may result in increased estate tax at his or her death.

If you name a beneficiary other than your spouse, the retirement plan generally will be included in your estate. Whether it will cause any estate tax liability will depend on a variety of factors, such as the size of the plan, the size of your estate, and the estate tax exemption available for the year of your death.

It's also important to consider the potential estate tax consequences for the beneficiary. For example, Tom, recently widowed with no children, wants to name his sister, Julie, as beneficiary of his IRA. He and Julie discuss the idea with his estate planning professional, and they determine that it makes more sense to name Julie's son, Eric, as beneficiary.

Why? Julie's net worth is already close to the \$2 million estate tax exemption, so inheriting the retirement plan could cause estate tax liability at her death. She doesn't need the funds, and she'd name Eric as beneficiary after she inherited the account anyway. Plus, because Eric is 30 years younger than Julie, his RMDs will be smaller, so there will be greater opportunity to enjoy tax-deferred growth in the account.

Not a one-time decision

Once you've determined your beneficiaries, review them regularly. Major life events such as marriages, divorces, births and deaths may require you to revise your beneficiary choices.

Other beneficiaries to consider – or avoid

You aren't limited to naming a family member – or even a person – as beneficiary; you can name just about anyone or anything as the beneficiary of your retirement benefits, such as:

A trust. If you're married or your major asset is your retirement plan and you have a taxable estate over \$2 million, including your retirement plan, naming a trust could be a viable option because it can help you maximize what ultimately goes to your heirs without negatively affecting your spouse's inheritance. If you're single and wish to manage and protect your retirement plan assets for the benefit of your children or other young beneficiaries, a trust may also be a viable option. Bear in mind that you must adhere to special tax rules when naming a trust as a beneficiary to ensure that the RMD is based on the beneficiary's age. Otherwise, the distribution requirements will be treated as though your estate were the named beneficiary.

Your estate. When you name your estate, you're essentially not naming a beneficiary. If you die before you're required to start to take RMDs, all of the money in the plan will have to be paid out to the beneficiaries of your estate by Dec. 31 of the fifth year after you die. If you die after you've started taking RMDs, all of the funds in the plan will have to be paid out to the beneficiaries of your estate over what would have been your remaining life expectancy. Either scenario accelerates the payment of income tax on the plan balance so generally should be avoided.

A charity. If you're charitably inclined, this can be a great way to cut your family's income and estate taxes. Neither your estate nor the charity will owe income tax on the retirement plan assets, and your estate should be eligible for a charitable deduction for estate tax purposes. However, if the charity is a beneficiary along with any individuals, it could affect the tax-deferral opportunities of the noncharitable beneficiaries. This will depend on how soon after your death the charity receives its share of the benefits.

For more information, please contact us via phone or e-mail, or visit us on the World-Wide Web:

Lennington Law Firm, PLLC
821 Raymond Avenue, Suite 315
St Paul, MN 55114

Peter Lennington, Esq.
peter@lennington.com

651-641-0741
<http://www.lennington.com/>

