The Legal Intelligencer

Trusts and Estates

Estate Administration With Qualified Retirement Benefits

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October 3, 2014

In our last column, we covered the topic of estate planning with qualified retirement benefits. Now we will address the end result—how to proceed upon the death of the account owner to ensure that the account balances are transferred to the beneficiaries as tax-efficiently as possible. The same overall minimum distribution rules will apply whether the account is in a qualified retirement plan, a traditional IRA or a Roth IRA.

If the deceased account owner was already in "payout" status at death because he or she had reached the "required beginning date" for the minimum distributions (generally this occurs upon reaching age 70-and-a-half), the first step is to ensure that the minimum distribution for the year of death is made by the end of the year of death (unless the decedent had already taken it for the year). There is often confusion about whether the distribution goes to the decedent's estate or to the account beneficiary. Although the distribution is taken because it was required to be taken by the decedent during the year, it does not go to the estate unless the estate was the beneficiary of the account (which usually is not the case). This is because the legal entitlement to all account assets passes to the designated beneficiary as of the date of the account owner's death. Because Roth IRAs do not have a required payout during the account owner's lifetime, there is no applicable required beginning date for such accounts before the account owner's death.

The next step is to manage the beneficiaries of the account if there are multiple beneficiaries (whether designated directly on the beneficiary designation form, or named individually through a trust that is a beneficiary). If the goal is to preserve the opportunity for the beneficiaries to have the longest "stretch-out" possible, it may be appropriate to pre-fund the share attributable to one or more older beneficiaries or a charity to eliminate them from the determination of the stretch-out period. As had been noted in our last column, a charity has a life expectancy of zero for the purposes of the minimum distribution rules, so, if a charity is named as one of multiple beneficiaries of an account, it will likely be advantageous to make the distribution to the charity before the "beneficiary determination date" occurs Sept. 30 of the year after the year of the account owner's death. The same would be true if there are any significantly older beneficiaries who would not get much benefit from a stretch-out anyway because of their short life expectancy. For example, in some cases a decedent in his or her 70s or 80s might name a sibling in the same age range as a beneficiary along with his or her children and/or grandchildren who have much longer life expectancies.

If a trust is the beneficiary, the next deadline to be mindful of is Oct. 31 of the year after the account owner's year of death. By that date, the trustees must either supply to the plan administrator or IRA custodian a copy of the governing trust instrument or a certification regarding particular aspects of the trust.

The final deadline that is relevant to the estate administration process is Dec. 31 of the year after the year of the account owner's death. By that date, the first required minimum distribution must be made to the beneficiaries. Thereafter, distributions must continue to be made by Dec. 31 of each succeeding year (unless the five-year rule discussed below comes into play), just as was the case with respect to minimum distributions required to be made to the account owner during his or her lifetime once the required beginning date was reached.

It is important to note that if the surviving spouse is the sole beneficiary, different considerations come into play, and typically the process is greatly simplified because the surviving spouse will roll over the account to his or her own IRA.

The minimum required distribution for beneficiaries is generally based on the life expectancy of the beneficiary with the shortest life expectancy as of the Sept. 30 beneficiary determination date noted above. This is usually the oldest beneficiary, but, if a charity is still a beneficiary as of that date, since it has a life expectancy of zero, it will have the shortest life expectancy if individuals are also designated as beneficiaries. The applicable life expectancy is determined by reference to tables supplied by the Internal Revenue Service for this purpose. The required distribution for the first year is determined by dividing the Dec. 31 account balance for the prior year by the life expectancy (the "applicable divisor"). In subsequent years the process is repeated and the applicable divisor is reduced by one, so that each year a greater percentage of the remaining account balance must be distributed.

There are two other potential approaches for determining the required payouts for beneficiaries. One such approach arises if the account owner died before his or her required beginning date (as is the case for all Roth IRAs for reasons noted above), the beneficiaries may elect to instead take the distributions under the "five-year rule." In such a case, the only requirement is that the entire account be distributed by Dec. 31 of the year containing the fifth anniversary of the account owner's death. This rule tends to come into play when the account is small so that it may not be worth bothering to stretch out, or, when the estate is named as beneficiary so there is no opportunity to stretch out the distributions for a longer period.

The final approach for determining the required payout for beneficiaries is the "at least as rapidly rule." This generally only comes into play if the account owner died after his or her required beginning date and the account owner's life expectancy would provide a longer stretch-out period than would the life expectancy of the beneficiary (e.g., because the estate is named as beneficiary or because a beneficiary older than the decedent is named as beneficiary). In such a case, the same methodology for determining the timing and amounts of distributions as would apply when a beneficiary's life expectancy is the applicable divisor would be pertinent, except the applicable divisor would be based on the decedent's remaining life expectancy under the applicable IRS tables.

Another important consideration during the estate administration process is oftentimes to time distributions payable to a revocable trust to match the payment of administration expenses that are deductible for federal income tax purposes for deductions that might otherwise provide no tax benefit. This would be the case if the expenses exceeded other sources of taxable income and the expenses would not otherwise be deducted for federal estate tax purposes because the estate assets are less than the exemption from the tax (currently $5.34 million).

The only other issue that typically arises when administering qualified retirement benefits for beneficiaries is the logistical issue of moving them around from one place to another and establishing separate accounts for multiple beneficiaries. With respect to qualified retirement benefits that remain in an employer-sponsored plan, the first step is typically to remove them from the plan and roll them over to an inherited IRA account for the beneficiary or beneficiaries. However, in such a case, if the beneficiary is the estate of the deceased employee, such a rollover is not possible and the estate beneficiaries are limited to whatever options the plan provides for distributions. On the other hand, IRAs can always be moved from one institution to another by means of a "trustee to trustee" transfer. It is important to be keenly aware that it is not possible to do a "60-day rollover" for inherited IRAs or qualified retirement accounts—once the benefits are distributed out of the plan or the IRA to a beneficiary they may not be returned to an IRA under any circumstances.

As a practical matter, when multiple accounts are involved, it is generally worthwhile to consolidate them all into one account for ease of administration prior to dividing them into separate inherited IRA accounts for separate beneficiaries. When taking that final step of setting up the separate inherited IRA accounts for the separate beneficiaries (whether individuals or trusts), some financial organizations are unwilling to handle that process without securing a private letter ruling that authorizes such action. However, currently it is generally possible to find another financial institution (such as Vanguard or Fidelity) that will gladly accept a trustee-to-trustee transfer of the account and facilitate the division so that the beneficiaries may go their separate ways for managing the assets of their inherited IRA accounts. Once the separate accounts are established, a particular beneficiary is free to remain with the "host" financial institution or move his or her (or its, in the case of a trust) respective inherited IRA account, by trustee-to-trustee transfer, to another selected financial institution.

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