

# 170! The ~~100~~ ^ Best and Worst Planning Ideas for Your Client's Retirement Benefits

2007 edition #1

Natalie B. Choate, Esq.  
Bingham McCutchen LLP  
150 Federal Street  
Boston, MA 02110-1745  
www.ataxplan.com

### Contents: Summary

Introduction .....	7
List of abbreviations .....	7
Resources: where to read more .....	8
Terminology used in this outline .....	9
Caution, warning, and disclaimer! .....	9
Acknowledgments .....	9

### THE IDEA GROUPS:

A. TAKING LIFETIME MRDS .....	10
B. PAYING TAXES BEFORE YOU HAVE TO .....	14
C. ROLLOVERS: WHEN, WHERE, WHY AND HOW .....	22
D. PLANNING FOR PARTICIPANT'S DISABILITY .....	31
E. ANTICIPATING INACTION BY SURVIVING SPOUSE .....	32
F. INVESTMENT IDEAS .....	34
G. DYING CLIENT .....	40
H. CHOICE OF BENEFICIARY .....	42
I. PROBLEM: FUNDING THE CREDIT SHELTER TRUST .....	50
J. PROBLEM: SECOND MARRIAGE/QTIP TRUST ISSUE .....	58
K. DRAFTING THE BENEFICIARY DESIGNATION FORM .....	59
L. LEAVING BENEFITS TO A SEE-THROUGH TRUST .....	63
M. LEAVING BENEFITS TO A TRUST: OTHER IDEAS .....	67
N. ESTATE AND INCOME TAX-REDUCING IDEAS .....	70
O. WAYS TO ACCESS BENEFITS BEFORE RETIREMENT .....	80
P. ADVISING NONSPOUSE BENEFICIARIES .....	82
Q. ADVISING THE SURVIVING SPOUSE .....	86
R. IF DECEDENT NAMED WRONG (OR NO) BENEFICIARY .....	88
S. NONCITIZEN SPOUSE .....	90

[Pages 2 through 6 contain a summary listing of the 170 ideas; 7 through 9 contain introductory matter; page 10 starts the detailed listing and description of the ideas. See sample pages below.]

## THE IDEAS

### A. TAKING LIFETIME MRDS

Once the participant reaches a certain age, he must begin withdrawing annual “minimum required distributions” (MRDs) from his retirement plans (other than Roth IRAs). See ¶ 1.3–¶ 1.4 of *Life and Death Planning for Retirement Benefits*. Here are tips and planning ideas regarding the ritual of taking annual lifetime MRDs, including steps that should be considered before the big day (the RBD). See also Idea #33 (rolling over to avoid MRDs).

1. **BEST: Use withholding from IRA distribution to reduce estimated taxes.** Most IRA providers will permit mutually voluntary withholding of income taxes from IRA distributions. See IRS Publication 575 and IRS Form W-4P. Income taxes withheld from retirement plan distributions (just like income taxes withheld from wages) are treated (for purposes of computing whether a taxpayer owes the penalty for underpayment of estimated taxes) as if paid equally on the four due dates of estimated tax payments. § 6654(g)(1). Thus, an IRA distribution in December that is sent to the IRS by the IRA provider as withheld income taxes will be treated (for estimated tax purposes) as if paid in four equal installments on the preceding April 15, June 15, and September 15, and the following January 15. A wealthy individual who does not need his MRDs to pay living expenses can kill two birds with one stone by using these required distributions to pay his estimated taxes. Late in the year, the participant requests a distribution (to satisfy the MRD requirement for the year), but (by filing Form W4-P) instructs the IRA provider to send the distribution to the IRS as withheld income taxes. Some planners prefer to take part of the distribution (1%?) in cash rather than having 100 percent of it withheld. By paying part of his estimated taxes late in the year through withholding, the participant gets a few more months’ interest on money he would otherwise have had to pay to the IRS in April, June, and September. This becomes a WORST idea if the participant dies before the withheld-taxes distribution occurs, because now (being dead) he won’t be able to take the distribution, and his estate will owe the penalty for underpayment of estimated taxes.

Where to read more: See ¶ 2.2 of *Life and Death Planning for Retirement Benefits* regarding the tax-withholding rules for retirement plan distributions.

2. **BEST: Analyze LSD options BEFORE starting MRDs from a QRP.** If the participant’s QRP account includes stock of the employer that sponsors the plan, the participant may be eligible for a special favorable tax treatment the Code affords to the “net unrealized appreciation” (NUA) in such stock. This special deal for NUA is generally available *only* if the participant takes an LSD, which is a distribution of his entire plan balance in one calendar year. Similarly, if the participant was born before 1936, he may be eligible for “special averaging” treatment, which can result in a very low rate of income tax (regardless of the amount of his other income)—but that deal is also available only for an LSD. *Now is the time to evaluate whether the participant should take an LSD to qualify for those*

*treatments*. If, instead of taking an LSD, the participant just takes the MRD following retirement, he will cease to be eligible for either of these deals the following year. An LSD means the distribution of all benefits in *no more than one calendar year* following separation from service (or other triggering event). This consideration does not apply to IRAs or 403(b) plans, as these special deals are available only for QRPs.

Where to read more: For explanation of these favorable one-time tax deals and how to qualify for them, see Ideas #14 (for NUA) and #15 (for special averaging).

3. **BEST: Carefully analyze whether to postpone the first year's MRD.** Normally, each year's MRD must be taken by December 31 of that year. However, the first year's MRD can be postponed until April 1 of the following year. Unless your income tax bracket is decidedly higher in the first year than it will be in the second, or Social Security considerations apply (see Idea #21), ignore the postponement option. Take the first year's MRD in the first year, so that you don't get stuck with a double distribution in the second distribution year (the second year's distribution must come out by the end of the second year), *and* to keep your second year's MRD lower (it will be higher if the prior-year-end balance on which it is calculated, i.e., the end-of-the-first-distribution-year balance, still contains the first year's MRD, which you postponed). Taking the first year's distribution in the first year also makes your life simpler: If you postpone the first year's MRD, your two MRDs in the second year will have *different deadlines* (the deadline for the postponed first year MRD is April 1 of the second distribution year, the deadline for the second year MRD is December 31 of the second distribution year). Also, the two MRDs will be computed using *different account balances* (the postponed first-year MRD is based on the account balance as of the end of the year preceding the first distribution year, the second year's MRD is based on the account balance as of the end of the first distribution year) and different divisors (the postponed first year's MRD is based on your age as of your birthday in the first distribution year, the second year's MRD is based on your age as of your birthday in the second distribution year). Whew!

Where to read more: For how to compute MRDs, see ¶ 1.2–¶ 1.3 of *Life and Death Planning for Retirement Benefits*; for when lifetime MRDs must begin, see ¶ 1.4.

4. **BEST: Take after-tax money first from your QRP.** A few QRPs contain after-tax contributions made by the employees. Usually, the employer keeps track separately, so each employee has two accounts, the “Employer Contribution Account” (containing the employer's contributions and earnings thereon; all pretax money) and the “Employee Contribution Account” (containing the employee's contributions and earnings thereon; partly pretax money and partly after-tax). The two accounts are treated as one account for MRD purposes, but treated as separate accounts for purposes of determining how much of each distribution is taxable. § 72(d)(2); Reg. § 1.401(a)(9)-8, A-2(a)(1). Thus, the employee determines the combined MRD (for both accounts), but can then take the entire MRD from the Employee Contribution Account, so that a high proportion of the distribution is tax-free. Tax-free distributions can be used to satisfy the MRD requirement just the same as taxable

distributions. Reg. § 1.401(a)(9)-5, A-9(a). You can't do this with an IRA, generally, because of the "cream-in-the-coffee rule" (see Idea #37), unless your IRAs have had all pretax money stripped out (sees Idea #38–39).

Where to read more: ¶ 1.2.02(D) of *Life and Death Planning for Retirement Benefits* discusses use of tax-free distributions to satisfy the MRD requirement. See also PLR 9840041, for an example of someone using this technique.

5. **BEST: Take the year's MRD for all your IRAs from your smallest IRAs, to close them out.** If you have multiple IRAs, take advantage of Reg. § 1.408-8, A-9 (descendant of now-superseded IRS Notice 88-38) to close out smaller accounts. Under this rule, a distribution from *any* IRA counts toward your MRD requirement for *all* your IRAs. So determine the total of your MRDs for all your IRAs for the year, then clean out smaller accounts as necessary to fill up the year's total MRD for all your IRAs. Eliminating multiple smaller accounts will make estate planning (as well as future MRD calculations) easier. The same thing works for multiple 403(b) plans. However, you can't use IRA distributions to satisfy 403(b) MRDs or vice versa; and you can't use an inherited IRA or 403(b) to satisfy the MRD requirement for non-inherited IRAs or 403(b)s (or vice versa), or for IRAs or 403(b)s inherited from another person.

Where to read more: See ¶ 1.3.04 of *Life and Death Planning for Retirement Benefits*.

6. **BEST: Ideas for hard-to-value IRA assets.** If your IRA contains a hard-to-value asset (*e.g.*, a limited partnership, "LP"), you run the risk of undervaluing that asset in computing your MRD, and then the IRS will say that you didn't take the full MRD. For example, you estimate the LP is worth \$200,000, the other assets in your account are worth \$300,000, and your MRD percentage for the year is five percent, so you withdraw five percent of the \$500,000 total, taking out \$25,000 cash. The IRS later says the LP was worth \$500,000, and therefore your MRD fell short: it should have been five percent of \$800,000 or \$40,000. The result is a 50 percent penalty on the \$15,000 shortfall. Besides paying for expensive appraisals every year, what should you do with a hard-to-value IRA asset once MRDs start?
  - A. Distribute the required percentage of the hard-to-value asset. At the beginning of each year, take out of the IRA the required proportionate amount of (1) the hard-to-value asset (in this example, that would mean withdrawing 5% of the LP units in January), and (2) the other (non-hard-to-value) assets (in this example, that would mean withdrawing 5% of the \$300,000 non-LP assets, or \$15,000). Now you are sure you have satisfied the MRD requirement. If the IRS later revalues the LP to \$500,000, that means the LP units that were distributed to you were worth \$25,000 (5% of \$500,000), not \$10,000 as you had thought. Therefore your total distribution was \$40,000 (\$25,000 worth of LP units plus \$15,000 of other assets), and you fulfilled the MRD requirement. You will owe back income taxes (and possibly a penalty) because you under-reported the amount of your distribution, but at least you won't owe the 50-percent missed-MRD penalty.