201! The ~~194~~ ^ Best and Worst Planning Ideas for Your Client's Retirement Benefits

2013 edition

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THE IDEAS

A. HOW TO TAKE DISTRIBUTIONS FROM YOUR RETIREMENT PLAN

Once the participant reaches a certain age, he must begin withdrawing "minimum required distributions" (MRDs) from his retirement plans (other than Roth IRAs). Distributions are required annually. See ¶ 1.3–¶ 1.4 of *Life and Death Planning for Retirement Benefits.* Here are tips and planning ideas regarding how to take distributions from your retirement plan, whether required or not. Most of the Ideas in this Group A can also be used by beneficiaries when taking distributions from inherited retirement plans (see Groups R and S).

Note: MRDs were "suspended" (not required) for the year 2009. This fact is not repeated every time required distributions are referenced in this Seminar Outline/Special Report. For details on the one-year suspension, see ¶ 1.4.09 of *Life and Death Planning for Retirement Benefits*.

1. **BEST: Use withholding from IRA distribution to reduce estimated taxes.** Most IRA providers permit 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. An individual who normally is required to pay estimated taxes quarterly, and who does not need his MRDs to pay living expenses, can kill two birds with one stone by using the required distributions to pay his estimated taxes. Similarly, *anyone* who normally pays estimated taxes quarterly, and who also takes annual distributions from his IRA, can use the IRA distribution to fulfill the estimated tax requirement. Here's how: Late in the year, the participant requests his usual (or required) distribution from the IRA, but (by filing Form W-4P) 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, because they think it looks better. 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 ¶ 2.3 of *Life and Death Planning for Retirement Benefits* regarding the tax-withholding rules for retirement plan distributions. See the next two Ideas for other uses of withholding from a retirement plan distribution.

2. **BEST: Use withholding from IRA distribution, followed by tax-free rollover, to scotch penalty for underpayment of estimated taxes.** By using a late-in-the-year IRA distribution that is sent to the IRS as withheld income taxes (see Idea #1) a participant may reduce or eliminate a penalty for underestimated taxes that he would otherwise owe if he has not paid sufficient estimated taxes on April 15, June 15, or Sept. 15. An IRA distribution (even one sent to the IRS as withheld income taxes) is included in gross income, and is subject to the 10 percent penalty on premature distributions if the participant is under age 59½; the participant can avoid these downsides by rolling over the same amount to the same or another retirement plan within 60 days after the distribution, thus making the distribution tax-free (assuming it is otherwise an eligible rollover distribution). Though it seems "impossible" to have taxes withheld from a distribution that "did not occur" (because it was rolled over), the IRS recognizes that a participant may do a tax-free rollover of a distribution sent to the IRS as withheld income taxes, by using substituted funds. Reg. § 1.402(c)-2, A-11. Thus this is a good strategy for avoiding a penalty on underpayment of estimated income taxes.

Where to read more: See ¶ 2.6 of *Life and Death Planning for Retirement Benefits*, and Ideas #46 and #49, regarding requirements for tax-free rollovers, and ¶ 2.3 regarding income tax withholding.

3. **WORST: Use withholding from IRA distribution, followed by tax-free rollover, every year, to avoid ever having to pay estimated taxes.** Although using withholding from an IRA distribution, followed by a rollover-using-substituted-funds, is recommended when it's the only way to avoid incurring a penalty for underpayment of estimated taxes (Idea #2), this technique is NOT recommended as a regular practice to avoid paying estimated taxes. Tax-free rollovers are legal and good tools, but they can be hazardous (see Ideas #48 and #49).

4. **BEST: Take Lump Sum Distribution that includes appreciated employer stock.** If the client is a participant in a qualified retirement plan (QRP), and his account holds stock of the employer that sponsors the plan, the client can qualify for a special favorable tax treatment by taking a lump sum distribution (LSD) of his account. Under this special treatment, he is not taxed on the entire value of the stock when he receives the distribution; rather, the only portion of the stock value included in his gross income is the plan's "cost basis" for the stock (i.e, what the stock was worth when the plan acquired it). The rest of the value is called "net unrealized appreciation" (NUA) and is not taxed until the recipient sells the stock—at which time it is taxed as long-term gain (current maximum rate 20% or 23.8%, unless AMT applies) rather than as ordinary income (current maximum rate 39.6%/43.4%). § 402(e)(4). If the participant's account has substantial NUA, the participant may make more money by taking a "taxable" LSD (only part of which is immediately taxable, and part of which will be taxed later as long-term capital gain) rather than either (1) selling the stock while it is still inside his plan account, or (2) rolling over his plan account to a traditional IRA, either of which actions would

cause permanent loss of the potentially favorable NUA treatment. See also Ideas #11 and #87. It may even be possible to roll over (to an IRA) enough of the stock to eliminate the taxable portion of the distribution altogether, while keeping the NUA stock "outside" for later long-term capital gain-eligible sale; see PLR 2011-44040. The NUA deal is also available to the beneficiaries of a participant who dies owning employer stock in his QRP, if the distribution otherwise qualifies; see Idea #175.

Where to read more: ¶ 2.4 of *Life and Death Planning for Retirement Benefits* explains the legal requirements of a "lump sum distribution"; ¶ 2.5 explains NUA treatment. Customers of the major financial institutions should check to see if the firm provides assistance in evaluating the choice between rollover (to continue tax deferral) versus cashout (to take advantage of the NUA deal).

5. **BEST: Take an LSD if born before 1936, to use special averaging.** Another special deal for lump sum distributions (LSDs): if the distribution meets numerous requirements, the distribution is taxed using a different rate schedule. For smaller distributions (up to approximately $400,000) the special averaging tax rate can be lower than the current maximum regular income tax rate (39.6%/43.4%). Also, there is a 20 percent maximum tax on the portion of the LSD (if any) attributable to pre-1974 participation; the pre-1974 participation portion is determined by a formula, *not* by tracing the actual pre-1974 balance. The primary requirements are that the participant was born before 1936, and that this is a distribution of his entire plan balance within one taxable year following separation from service, attaining age 59½, or death. § 1122(h) of the Tax Reform Act of 1986 [effective date provisions and transition rules for amendments to Code § 402(a), (e)], as amended by § 1011A(b)(13)–(15) of the Technical and Miscellaneous Revenue Act of 1988.

The ideal candidate for special averaging is overweighted in retirement plans (see Idea #23), is approaching age 70½, and has among his many plans one smallish separate qualified plan that could be cashed out in an LSD. Special averaging gives him a way to get some money out of his retirement plans at a bargain tax rate. The special averaging rate is applicable to the LSD *regardless* of how much other taxable income the person has. For example, even if he is in the 39.6 percent bracket for all his other income, a qualifying LSD of $300,000 would be taxed at only approximately 22 percent. If the individual rolls over any part of the distribution, or if his distributions stretch over more than one taxable year since the most recent triggering event, he will lose eligibility for LSD treatment. That is why this option MUST be evaluated for born-before-1936 clients BEFORE they retire and start taking distributions; see the next Idea. Special averaging is also available to the beneficiaries of a born-before-1936 participant, if the distribution otherwise qualifies (death is a new triggering event); see Idea #175.

Where to read more: Best free sources regarding special averaging are IRS Form 4972 (and its instructions) and Form1099-R (see payer's instructions for Box 3). There are no regulations. For

Appendix: Client Profiles

This Appendix describes various client profiles and suggests the Ideas that may be particularly useful to a person with those characteristics.

Everybody!

See Ideas # 75 and #76.

Everybody: estate planning essentials

To construct an estate plan for someone who owns retirement benefits, start with the "Group H," "Group J," and "Group L" Ideas. If the retirement plan offers only the lump sum distribution form of benefit, also read Ideas #28 and #179. If the client is married and concerned about estate taxes, read the "Group M" Ideas and Idea #37. If the client is reluctant to leave retirement benefits outright to his or her spouse, read the "Group N" Ideas. Then when you are finally ready to draft the documents, read the "Group O" Ideas (when drafting the beneficiary designation forms) and "Group Q" Ideas (when drafting a trust that is to be named as beneficiary of the retirement plan).

Client about to retire

This person is about to retire from his employment and is considering his options regarding the benefits he holds in his company's retirement plan. Ideas #4–#8, #11, and the "Group C" Ideas.

Client taking MRDs (or approaching the required beginning date)

Anyone who is approaching age 70½ or already into the system of taking MRDs should review the "Group A," Group B," and "Group C" Ideas.

Surviving spouse who has inherited a retirement plan

A surviving spouse should review the "Group S" Ideas (and, if not a U.S. citizen, also the "Group U" Ideas).

Nonspouse beneficiary who has inherited a retirement plan

The "Group R" Ideas are for the nonspouse beneficiary who has inherited a retirement plan. Also, many of the Ideas regarding how to take MRDs that apply to living participants over age 70½ also apply to beneficiaries who are taking MRDs: see Ideas #1, #4–#14, and #16–#20. If there are problems, see also the "Group T" Ideas.

Roth retirement plans (client has one or is considering one)

See the "Group G" Ideas.

Client looking for novel ideas and daring strategies

Ideas #3, #13, #40–#41, #48, #53, #56, #58–#64, #66–#67, the "Group E" Ideas, #85–#87, #92, #97–#101, #133, and #143.

Very wealthy individual

The very wealthy individual does not need all of his retirement benefits to live on. He either has lots of other assets to live on, or has way more in his retirement plans than he is likely ever to need. He should consider Ideas #1, #11, #13, #21, #23, #24, #82, #118–#119, #131, and #138.

Not so wealthy individual

See Ideas #26 and #69.

Parents and grandparents

See Ideas #44, #101, and #113.

Client with very short life expectancy

See "Group K" Ideas and Ideas #138, #139.

Client considering marriage or divorce

Idea #32 and "Group N" Ideas.

Client interested in giving to charity

Ideas #11, #13, #64, #74, and #118–#122.

Client has died, you are administering estate

Look at Ideas #4–#6, #46, #70, and #201, and the "Group T" Ideas.

Client younger than age 59½

Ideas #30–#31, #42–#43, #77–#81, and #188.

Client's spouse is not a U.S. citizen

See "Group U" Ideas.