

# **Recalibrating Retirement Spending and Saving**

EDITED BY

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## Chapter 6

# **Retirement Distributions and the Bequest Motive**

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*G. Victor Hallman*

Planning for and managing retirement assets as well as the payouts from these revolve around securing adequate retirement income and assuring the continuity of such income for as long as retirees (and their spouses) live. Most people are concerned about a possible lack of adequate retirement income and the risk that they will outlive their assets. Often advisers suggest that a logical and efficient strategy to deal with these issues for risk-averse retirees is to annuitize the retiree's assets or benefits over his or her lifetime (or if married, over the joint and last survivor lifetimes of the retiree and spouse). Another suggested strategy is to use a combination of life annuitization and an installment withdrawal plan. These approaches are indeed efficient for providing lifetime retirement income. They are based, however, on the implicit assumption of limited resources for retirement income, and hence they presume the need to disburse, and probably consume, those resources over the lifetimes of the retiree and his or her spouse.

Despite the logic of annuitization or the combination approach, we are left with the so-called 'annuity puzzle,' which notes that relatively few retirees actually purchase immediate life annuities or choose life annuitization for their retirement benefits. One reason (of several) cited for this 'annuity puzzle' is the bequest or inheritance motive.<sup>1</sup> This chapter explores the nature, limitations, and strategies used in implementing the bequest motive as part of a retiree's decision-making about how to manage his assets in retirement.

In what follows, we first discuss what we mean by the bequest motive and how current law permits tax-favored transfers to heirs. Next, we turn to the constraints limiting these transfers, and finally discuss current strategies making these more feasible. We conclude that US tax law provides tax incentives to encourage the provision of retirement income via minimum distribution rules. In practice, however, these rules and other tax law provisions now permit significant tax-favored wealth transfer and charitable giving strategies.

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### Nature and Significance of the Bequest Motive

By the bequest or inheritance motive, we mean using income-tax-favored (i.e., tax-deferred or tax-free growth) retirement plans as vehicles to pass wealth to heirs (usually children and grandchildren) of the retiree and spouse, or to charity after the last of their deaths. To accomplish this, the retiree (participant in the case of qualified retirement plans, and owner in the case of individual retirement accounts and annuities) and spouse *during their lifetimes* plan to draw down the balance of their retirement plans as little as permitted by the tax law (and by their personal needs) so that assets can continue to grow tax-deferred or tax-free (in the case of Roth IRAs) for as long as possible. They also seek to arrange plan beneficiary designations so that after their deaths their beneficiaries have the opportunity to maintain income-tax-deferral or tax-free growth for as long as possible (generally over the beneficiaries' life expectancies). This is the so-called 'stretch' IRA strategy.<sup>2</sup> As US tax law and Internal Revenue Service (IRS) regulations now stand, with proper planning, such income-tax-deferral or tax-free growth can easily continue for 50 or more years and extend over the life expectancies of the owner, his or her spouse, and their children (and possibly grandchildren)—in other words, over two or more generations.

Some researchers contend that, even if assets are needed during retirement (beyond the minimum distributions required by law), it is preferable from an income tax standpoint to first take such distributions from taxable investment accounts (investment portfolios held outside of tax-advantaged plans), and only later from tax-advantaged retirement accounts.<sup>3</sup> This is the strategy of tax-efficient *sequencing of lifetime distributions* from different categories of accounts. While such sequencing does seem somewhat to increase asset values, we conclude that it may not be a quantitatively significant strategy for wealth transfer.<sup>4</sup>

Retirement plan distributions are also a highly tax-efficient way to fulfill a person's charitable giving objectives, as they represent gross income for federal income tax purposes both to the retiree during the retirement years and to plan beneficiaries after the retiree's death. They are income in respect of a decedent (IRD). But since charities are tax-exempt, they realize no income tax liability when such distributions are payable to them. Charitable gifts at death are also deductible for federal estate purposes. As a result, some suggest that retirement plan assets, and other IRD items for that matter, should be used to fulfill a person's charitable objectives (Hoyt 2002*a*). While charitable giving may be, in itself, a socially desirable motivation, again we see the tax-driven use of retirement assets for purposes other than providing retirement income to the participant or owner and spouse. It may also be noted that in the case of tax-deferred retirement assets made

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TABLE 6-1 Number of and Growth in High Net Worth Individuals: North America 2001–5

	<i>High Net Worth Individuals (millions)</i>	<i>Change over Previous Year (%)</i>
2001	2.2	—
2002	2.2	0
2003	2.5	13.5
2004	2.7	8.0
2005	2.9	7.4

Source: Capgemini and Merrill Lynch (2004: 2; 2006: 4–5, 31).

payable to (or rolled over to) tax-exempt charities, the government never collects income taxes on the deferred amounts.

Accordingly, the bequest or inheritance motive can involve many complex goals, including the deferral of distributions from retirement plans for long periods so that income-tax-deferred (or tax-free) assets pass to at least one generation beyond that of the original participant or owner; and the use of retirement assets to make otherwise desired charitable gifts.<sup>5</sup> Of course, implied in the planning for these goals is the notion that the original participant or owner has sufficient wealth, income, and other resources so that he need not consume most of the retirement assets during retirement; in other words, he is probably a reasonably high net worth individual. Table 6-1 indicates that the number of high net worth individuals (defined as persons holding \$1 million or more in financial assets) doubled in the first five years of the twenty-first century.

The significance of retirement assets (qualified retirement plans and IRAs) in the gross estates of decedents whose estates filed federal estate tax returns is also growing over time.<sup>6</sup> Table 6-2 indicates that such percentages have doubled over the last decade of the 1990s. One explanation for this trend is the emergence of individual account-type plans that enable participants to leave retirement assets to heirs. In the future, decedents will

Au: Is "year" meant in place of "decade" here?

TABLE 6-2 Retirement Assets as a Percentage of Gross Estates for Federal Estate Tax Returns Filed: 1992, 1995, and 2001

	<i>Male Decedents (%)</i>	<i>Female Decedents (%)</i>
1992	5.8	2.3
1995	7.8	3.2
2001	11.2	5.5

Source: Johnson and Mikow (1999) and Eller (2005).

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increasingly be able to leave more account balances from these types of plans in their gross estates. Further, the substantial increases in qualified plan contribution and benefit limits, compensation limits, section 401(k) employee elective contribution limits, and IRA contribution limits, enacted in the Economic Growth Tax Relief Reconciliation Act (EGTRRA) of 2001 and made permanent by the Pension Protection Act (PPA) of 2006, are enabling higher net worth individuals to contribute significant amounts to tax-advantaged plans. Of course these changes have benefited from the long trend of generally favorable economic and investment performance, particularly for common stocks, producing good investment returns for many individual account plans.

These factors have combined to generate growing retirement assets in the hands of individuals who can afford to delay taking benefits during their retirement, and who can also consider using a portion of these assets to satisfy charitable giving objectives. This development, paired with tax law complexity regarding retirement plan distributions, has led to considerable planning activity among estate planners and wealth management professionals to aid clients in arranging for the distribution of retirement plan assets (Hoyt 2002*a*; Choate 2004, 2006).

### **Tax and Economic Constraints on Wealth Transfer**

Before discussing specific planning strategies that may be used to enable tax-advantaged retirement plans to fulfill bequest or charitable motives, it is useful to briefly describe the tax rules intended to assure that these retirement benefits will, in fact, be used for retirement. Possible economic constraints on using these benefits for wealth transfer purposes are also noted.

#### *Tax Rules Affecting Timing of Retirement Plan Distributions*

One philosophy guiding tax law holds that income tax advantages to retirement plans are intended to encourage their adoption to provide retirement income (rather than for wealth transfer or estate planning purposes). In practice, the idea would be that retirement plan distributions should be taken neither too early (presumably for current consumption or other nonretirement purposes) nor too late (presumably for wealth transfer purposes). The specific rules that embody this policy objective include the 10 percent penalty tax on 'premature distributions'; age limits on distributions from plans such as Roth IRAs and 401(k) plans; and the required beginning date (RBD), minimum distribution rules, and 50 percent penalty tax on insufficient distributions [i.e., less than the minimum required distributions (MRDs)].



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The 10 percent penalty tax (also called the section 72(t) penalty) is levied on retirement plan distributions to participants or owners who are younger than age  $59\frac{1}{2}$ . There are a number of exceptions to this penalty tax, but they do not change the fundamental purpose just noted. The minimum distribution rules apply to qualified retirement plans, section 403(b) plans, IRAs, and section 457 plans. For lifetime benefits of participants or owners, minimum distributions must begin by an RBD which is specified as the first of April of the calendar year following the year in which the person attains age  $70\frac{1}{2}$ . The person must take MRDs for the year in which he or she attains age  $70\frac{1}{2}$  and for each subsequent year (by December 31 of that year).<sup>7</sup>

During the participant's or owner's lifetime, the MRDs are based on his or her life expectancy from a Uniform Lifetime Table as stipulated by the Federal Government (see Appendix Table 6-A1). To calculate the MRD for a particular year, the account balance at the end of the previous year (or plan year) is divided by the distribution period shown in the Table for his or her attained age in that distribution year. The distribution periods decline with age but never reach zero. Thus, they are recalculated each year since that year's life expectancy becomes the applicable divisor.<sup>8</sup> The effect of this is that MRDs will continue over the person's lifetime, although the amounts will normally increase with time. The distribution periods under the Uniform Lifetime Table are based on the joint life expectancies of the participant or owner and a theoretical person (beneficiary) 10 years younger. This generally is true regardless of whom the beneficiary may be.<sup>9</sup>

The Uniform Lifetime Table is beneficial for the bequest motive. It will call for relatively low MRDs for many years after a person attains the RBD. Depending on the investment return inside the plan, this means retirement plan account balances may continue to grow, and hence be available for beneficiaries, for many years after minimum distributions must begin. For example, assuming plan assets have a 6 percent investment return, the MRD will not exceed that year's investment return inside the plan until the participant or owner reaches age 83. If plan assets can earn 8 percent, the corresponding age is 89.

Roth IRAs are not subject to the minimum distribution rules for distributions during the *owner's* lifetime; they do apply, however, to *plan beneficiaries* after the owner's death. This lifetime treatment is also very beneficial for the bequest motive. It means Roth IRA account balances can grow tax-free without any diminution for an owner's entire lifetime, which may be 20, 30, or more years after retirement, before passing to a beneficiary at the original owner's death. Roth IRAs have grown significantly since they were first introduced in 1997. For example, in 2002 taxpayers contributed ~\$42.3 billion to individual retirement arrangements of which

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about \$13.2 billion or 31.2 percent were contributions to Roth IRAs. Such Roth contributions have increased about 14.1 percent from the year 2000 when such data for IRAs were first produced. In addition, in 2000, 3,989,390 taxpayers *rolled over* ~\$204.4 billion into traditional IRAs. Of course, when the total fair market value of IRA assets in 2002 of about \$2.6 trillion are considered, Roth IRA assets represented only about 3.0 percent because Roth plans are of such recent origin (Bryant and Sailer 2006).

Recent legislative developments are likely to increase the proportion of assets in Roth plans. For one, the Tax Increase Prevention and Reconciliation Act of 2005 eliminated (for years after December 31, 2009) the \$100,000 or less modified adjusted gross income eligibility requirement for conversion of a traditional to a Roth IRA. Thus, for 2010 and thereafter, persons with modified adjusted gross incomes in excess of \$100,000 will be able to convert some or all of their traditional IRAs to Roth IRAs by paying income tax on the converted amount. This should increase such conversions substantially because higher income persons are more likely to be able to afford the income tax on conversion and to benefit from the tax-free investment growth and no minimum distribution requirements during their lifetimes than lower income traditional IRA owners. In addition, the PPA of 2006 made Roth 401(k) and 403(b) plans permanent. These Roth plans were created by EGTRRA in 2001 for 2006 and thereafter, though the provision for these (along with the rest of EGTRRA) was to 'sunset' in 2011. In 2006, the PPA nullified the 'sunset' as to the pension and IRA provisions of EGTRRA, in effect making them permanent. It is possible that many employers may have hesitated to add a Roth 401(k) option to their benefit plans, possibly because of the greater administrative cost, but more likely because they were unsure that this option would survive by 2011. Now they are.

The minimum distribution rules are different for distributions to plan or IRA beneficiaries after a participant's or owner's death: in particular, they depend on who the beneficiary is and whether the participant or owner died before or after his or her RBD. In general, if the only beneficiary is a 'designated beneficiary,' who would be an individual, two or more individuals, or a see-through trust (defined later as one having only individual beneficiaries), the benefits can be made payable over the beneficiary's life expectancy using the Single Life Table (as in Appendix Table 6-A1). The *individuals* (persons) for this purpose may be either a surviving spouse or individuals other than a surviving spouse. Minimum distributions to a see-through trust are based on the life expectancies of the individual beneficiaries of the trust.

In general, if a *surviving spouse* is the only designated beneficiary of a plan, let us assume an IRA, he or she can: (a) leave the IRA in the name of the deceased spouse and treat it as an 'inherited IRA'; taking minimum

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distributions usually over the surviving spouse's life expectancy using the Single Life Table but recalculating the remaining life expectancy at the surviving spouse's age each year;<sup>10</sup> or (b) treat the IRA as his or her own, naming his or her own beneficiaries, not having to begin distributions until the surviving spouse's RBD (aged 70½), and using the Uniform Lifetime Table with its much slower MRDs. The second choice is usually preferable for deferral purposes.

If the designated beneficiary is an *individual or individuals other than a surviving spouse*, the account balance generally can be payable over the beneficiary's life expectancy or the life expectancy of the oldest beneficiary in the case of multiple beneficiaries (without separate accounts) using the Single Life Table but with a fixed-term or 'reduce-by-one' approach (no recalculation). This may be less advantageous for deferral purposes.

Finally, if there is *no designated beneficiary* (which might occur, e.g., if the beneficiary is a trust that is not a see-through trust, a charity, the decedent's estate, or multiple beneficiaries when at least one is not an individual), the no-designated-beneficiary rule applies. In this case, if death occurs before the participant's or owner's RBD, a five year rule applies and the account balance must be paid out by the end of the fifth anniversary of the decedent's death. If death occurs on or after the RBD, the account balance must be paid out at least over the deceased participant's or owner's remaining life expectancy using the Single Life Table with no recalculation (i.e., applying the fixed-period method). These 'no-DB' rules are the least favorable for deferral purposes.

As noted previously, after a Roth IRA owner's death, the post-death minimum distribution rules just described also apply to Roth IRA beneficiaries. Of course, the distributions to them are tax-free just as they were during the original owner's lifetime.

#### Economic Constraints on the Bequest Motive

The bequest advantage from 'stretching' retirement plan payouts depends almost entirely on income-tax-deferral or income-tax-free investment growth of the payouts. Therefore, a fair question is how valuable income-tax-deferral is from an economic or investment viewpoint.

Qualified dividends on stocks and long-term capital gains are currently taxed at a top rate of 15 percent (at least through 2010); by contrast, distributions from qualified retirement plans, traditional IRAs, and other retirement plans are taxed as ordinary income. Further, most capital assets get a stepped-up income tax basis at death, while most retirement plan distributions are IRD. Accordingly, some commentators have questioned

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the economic value of deferral in retirement plans versus direct after-tax ownership of assets.<sup>11</sup> But deferral in a retirement plan will always be advantageous, assuming that the applicable income tax rate at the time of contribution is the same as at the time of distribution, and that the asset allocations inside the plan and outside the plan are such that the *before-tax* total returns are the same for both, while *after-tax* investment returns outside the plan are less than the returns inside the plan (because the outside return is subject to income taxation). This is true, in essence, because the retirement plan participant or owner is getting tax-deferred investment income on money that otherwise would be paid in taxes; he is in a sense investing the government's money. But the *degree* of this advantage depends on a host of factors including the length of the period of deferral, whether there is a rising or declining stock market, the level of interest rates and other investment returns, turnover of common stocks outside the plan, and the availability of investment products (such as index mutual funds) that affect such turnover, whether there will be step-up in basis at death, investment expenses, and others.

Another economic question is what income tax rates will be at the time of the retirement plan distributions. At present, individual income tax rates are at a historically low level. Yet conventional wisdom argues that income tax rates during a person's retirement years tend to be lower than during the working years. As a rule, higher tax rates at distribution rather than during the contribution phase would favor tax-free investment growth (Roth plans) and be relatively disadvantageous for tax-deferral plans. The reverse would be true for lower rates at distribution than at contribution.

Finally, contributions to tax-advantaged retirement plans involve inflexibilities (due to plan requirements and tax law contribution limits), lack of liquidity (due to tax law limits on distributions), possible penalty taxes, and the risk of possible future disadvantageous changes in the tax law. Participants and owners also may forgo other tax advantageous uses of plan contributions and assets, such as making gift-tax-free transfers to children and grandchildren.

### **Strategies for Wealth Transfer and Charitable Giving with Retirement Benefits**

Various strategies may be used to make tax-effective transfers of retirement assets within the family and as charitable gifts. In our overview, we assume that the participant or owner has a substantial qualified retirement plan or IRA individual account balance at retirement.

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### The 'Stretch IRA' Concept with Spouse as a Designated Beneficiary

This is the simplest and most effective tax-deferral strategy. The participant or owner names a spouse as a beneficiary of the qualified plan or IRA account balance, with perhaps the children or trusts for the children as contingent beneficiaries. Upon the participant's or owner's death, the surviving spouse normally rolls over the participant's qualified plan account balance to an IRA, or elects to treat the decedent's IRA as an own rollover IRA.<sup>12</sup> The surviving spouse then may name a beneficiary or beneficiaries for the IRA, often the children (or trusts for the children). The original beneficiaries (the children) also may name successor beneficiaries in case they do not outlive their life expectancies. This spousal rollover IRA strategy can result in the deferral of taxable distributions (in the case of traditional IRAs) or continuation of tax-free investment growth (in the case of Roth IRAs) under the minimum distribution rules for the spouse's lifetime and then over the life expectancies of the children. This is the classic 'stretch IRA' approach-distributing benefits over one or more life expectancies.

### An Example of a Spousal 'Stretch IRA'

As an example, assume that Homer Smith is about to retire from the XYZ Corporation and he is 65 years old (his birthday is February 1). He and his wife, Mary, aged 61, have two children: Homer Jr., aged 35, and Hortense, aged 28. They all are in good health. Homer and Mary appear to be happily married, have no prior spouses, and both are competent in investing and property management (Mary having been a successful accountant for many years). Their nonretirement asset picture is summarized in Table 6-3.

TABLE 6-3 Nonretirement Assets of Homer and Mary Smith: A Hypothetical Example

<i>Assets and Ownership</i>	<i>Value (\$)</i>
Principal residence (owned by Homer and Mary as joint tenants with right of survivorship)	600,000
Summer home (owned by Homer and Mary as joint tenants with right of survivorship)	400,000
Individually owned securities (common stocks, bonds, and CDs) owned by Homer	1,000,000
Individually owned securities (common stocks, bonds, and CDs) owned by Mary	500,000
Cash and other assets (owned by Homer and Mary as joint tenants with right of survivorship)	100,000

*Source:* Author's computations.

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As Homer's retirement approached, Homer and Mary have determined that their asset allocation (other than their real estate) should be 50 percent in a diversified portfolio of common stocks (selected conservative individual stocks and mutual fund shares), 45 percent in bonds and CDs (diversified as to maturity, issuer, and credit quality), and 5 percent in cash equivalents. In light of good *asset location planning*, they decide to hold their taxable bonds and CDs in tax-deferred or tax-free retirement accounts, and their common stocks, tax-exempt bonds, taxable bonds, and their cash equivalents individually. They expect an average annual total return on their common stock portfolio of 8 percent (3 percent qualified dividends and 5 percent long-term capital gains) and an annual current yield on their bonds and CDs of 6 percent. They also plan to rebalance their portfolio periodically to maintain their desired asset allocation. Homer's employer, the XYZ Corporation, has a defined benefit (DB) pension plan covering both retirees (under a qualified joint-and-survivor annuity form) and a 401(k) plan. Homer and Mary will also receive government social security benefits. Mary also has a vested pension promise from a previous employer that will commence when she reaches age 65. Homer and Mary will be eligible for Medicare and XYZ Corporation at present has a retiree medical plan that will cover them.

Homer's and Mary's objectives are to maintain their living standards during retirement, to protect themselves against medical expenses and possibly custodial care expenses during retirement, to have an emergency fund, possibly to make lifetime (annual exclusion) gifts to their children, and possibly to make gifts to charity. Assuming that these objectives can be met from their pension, social security, and individually held investment income (as it would appear they can), at the last of their deaths they would like to leave as much as possible to their children (and hopefully grandchildren) with as little tax shrinkage as possible.

Given this scenario, assume that Homer has a \$1.5 million 401(k) account balance in his XYZ Corporation plan and decides to *directly transfer (roll over)* this account balance to his own traditional IRA at age 65. He names Mary as a designated beneficiary of the IRA. Homer and Mary plan to take only the MRDs from this IRA so that it can continue to grow tax-deferred for as long as possible for the benefit of their children. Homer need not take any distributions from the IRA until the *required beginning date* at age  $70\frac{1}{2}$  (in about five years).<sup>13</sup> Using the Uniform Lifetime Table, Homer's distribution period (life expectancy) at age 70 is 27.4 years, which in effect requires a minimum distribution of 3.6496 percent of the IRA account balance as of the end of the previous year.<sup>14</sup> If we assume that account balance is \$2,007,338 (\$1.5 million at 6 percent for five years), the minimum distribution for Homer's  $70\frac{1}{2}$  years is \$73,260, which is

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substantially less than the 6 percent interest income (of \$120,440) from the IRA for that year.<sup>15</sup>

Homer continues to take increasing minimum distributions until his *death* which we shall assume to be at age 86. To the extent that the minimum distribution for the year of his death was not taken by Homer, it must be taken by Mary as a beneficiary. Assuming Homer's estate plan calls for an 'optimal marital deduction' strategy (use of the marital deduction only until it reduces the federal estate tax on Homer's estate to zero and then the balance of his estate to a credit-shelter or by-pass trust or gift—a 'reduce to zero formula'), there will be no federal estate tax payable at Homer's death. The IRA account balance payable to Mary will qualify for the federal estate tax marital deduction and hence will be deductible for federal estate tax purposes.<sup>16</sup>

As a general principle, making income-tax-deferred retirement plan account balances payable to a surviving spouse also is an efficient estate tax strategy because they represent IRD and so the distributions will be taxable as ordinary income to the beneficiary (the surviving spouse). Therefore, the income tax payable on those distributions (which must be paid in any event) comes from the surviving spouse's assets and hence will not be in his or her gross estate when the surviving spouse subsequently dies, thereby reducing his or her federal estate tax liability.

After Homer's death, as the designated beneficiary of his IRA, Mary elects to treat the IRA as her own and names her two children as equal beneficiaries. She must begin taking minimum distributions in the year following Homer's death since she then would be age 83 (beyond her RBD). Her distribution period at age 83, using the Uniform Lifetime Table (since she is treating the IRA as her own), is 16.3 years, so she effectively must withdraw (and pay tax on) 6.1350 percent of the account balance (calculated as of the end of the year of Homer's death) by December 31 of the year following his death. She then must continue taking increasing minimum distributions until the year after her death. Assuming further that Mary also dies at age 86 (four years after Homer's death), the remaining IRA account balance is payable equally to her and Homer's two children as designated beneficiaries of Mary's IRA.<sup>17</sup> Since they are designated beneficiaries, the account balance may be paid out to them over their life expectancies using the Single Life Table and fixed-period (one year less) method.

At Mary's death, the remaining IRA account balance will be included in her gross estate for federal estate tax purposes. It normally will also result in a federal estate tax in her estate unless she has remarried and names a surviving spouse as a beneficiary or leaves it to charity (which seem unlikely in this case). Her will normally should specify (in a tax clause) that any death taxes attributable to the tax-advantaged retirement account

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should be payable from other assets in her estate so the full amount of the retirement account can continue to grow tax-deferred (in this case) or tax-free (in the case of a Roth IRA).

The IRA now will be payable to the two children as an inherited IRA. As of Mary's death, Homer Jr. will be age 60 and Hortense will be 53. When IRAs are payable to multiple beneficiaries, the general rule is that the account balance must be paid out over the fixed-period life expectancy of the oldest beneficiary, which here is Homer Jr. But if separate accounts are established for each beneficiary by December 31 of the year following the year of Mary's death, each beneficiary can use his or her own life expectancy in calculating MRDs. Assuming such separate accounts are created, under the Single Life Table Homer Jr.'s life expectancy would be 24.4 years (at age 61) and Hortense's life expectancy would be 30.5 years (at age 54), as of the year following the year of their mother's death when they must begin taking minimum distributions. In that year, the percentage withdrawals would be 4.0984 percent and 3.2787 percent, respectively. The applicable divisor (life expectancy) for each would then be reduced by one each year thereafter. Therefore, the IRAs must be exhausted (entirely distributed) by the 25th and 31st years, respectively.

The IRA distributions will be taxed as ordinary income to the children. However, since there was federal estate tax attributable to the IRA account balance paid by Mary's estate, and the distributions to the children are IRD, the children are entitled to an itemized income tax deduction each year for the pro rata share of the federal estate tax paid on their retirement plan distributions. This is to avoid double taxation of distributions of IRD items.

Given this example then, Table 6-4 shows the periods of income-tax-deferral made possible by this 'stretch IRA' strategy in this situation starting

TABLE 6-4 Periods of Income-Tax-Deferral for the Smith Example:  
The Spousal 'Stretch IRA' Strategy

<i>Distributee and Age</i>	<i>Period of Deferral</i>
Homer: the ages of 65 through 69: no distributions	5 years
Homer: age 70 through 86: minimum distributions using Uniform Lifetime Table	17 years
Mary: age 83 through 86: minimum distributions using Uniform Lifetime Table	4 years
Homer, Jr.: age 61 through 85+: minimum distributions using Uniform Lifetime Table (fixed period)	24+ years
Hortense: age 54 through 84+: minimum distributions using Uniform Lifetime Table (fixed period)	30+ years

*Source:* Author's computations; see text.



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with Homer's retirement at age 65. It is interesting to observe that in this rather straightforward example, income-tax-deferrals continue for more than 30 years after the deaths of the original plan participant, Homer, and his spouse, Mary. This was actually a longer deferral period than applied during the lives of the participant and his spouse.

If any part of this retirement plan had been a Roth IRA, no distributions from the Roth would be required over Homer's or Mary's lifetimes since there are no MRDs from a Roth IRA for the owner's lifetime. In this case, it would result in 26 years of tax-free investment growth. At Mary's death, the Roth IRA account balance would be in her gross estate for federal estate tax purposes and would be an inherited Roth IRA for the children for income tax purposes. Thus, the children must begin taking minimum distributions at this point over their life expectancies (normally using separate accounts) under the fixed-period method. These distributions would be income-tax-free (not IRD), so no itemized deductions for federal estate tax paid on the retirement account would be available. Clearly the 'stretch' Roth IRA approach offers substantially more income-tax-advantaged bequest potential than even the 'stretch' traditional IRA.

### Possible Problems with Spousal Rollover 'Stretch IRAs'

While this approach normally can provide the best purely tax-driven deferral (bequest) potential, it is not without possible nontax problems. First, the retirement account is made payable to the spouse as a designated beneficiary and so this spouse *controls the account* after the original owner's death. Hopefully, the surviving spouse will follow the just described rollover 'stretch IRA' strategy and also name the deceased spouse's children as beneficiaries of the survivor's rollover IRA. However, there may be a number of practical impediments to this actually happening. It may be a second (or more) marriage and the survivor may not be willing to designate the deceased spouse's children of a prior marriage as beneficiaries of his or her rollover IRA. Similarly, the surviving spouse may remarry and have a new family to consider in planning for the retirement account.

A second concern is that management of the rollover IRA will be in the hands of the surviving spouse and he or she may not be experienced or competent concerning investments and wealth management. Further, the surviving spouse may decide that deferral is not for him or her and for various reasons (good or bad) take the retirement money now, despite paying higher taxes (the consumption motive). But there also may be valid estate planning reasons for taking more than the required minimum distributions, such as the need for funds to make annual exclusion (or other gift-tax-free) gifts to children or grandchildren or for charitable contributions.

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These same issues may apply to children named as beneficiaries of the original IRA or the spousal rollover IRA.

Additionally, when retirement benefits constitute the bulk or a large part of an estate, and the estate is large enough to attract potential federal estate taxation, there may not be enough non-retirement-plan assets (directly owned assets) to fund fully a credit-shelter or by-pass trust (or gift) when executing an optimal marital deduction strategy. Assuming no lifetime taxable gifts, at an estate owner's death the optimal marital deduction calls for an amount equal to the applicable exclusion amount to be placed in a credit-shelter or by-pass trust (or gift) that does not qualify for the marital deduction in the decedent's estate and is not included in a surviving spouse's gross estate. The remainder of the decedent's estate is left so as to qualify for the marital deduction. This reduces the federal estate tax on the estate of the first spouse to die to zero and diminishes the tax on the estate of the second spouse to die by the tax that otherwise would be payable on the amount in the by-pass trust or gift. When retirement plan assets are needed (and used) to fund the credit-shelter or by-pass trust, they are not available for a spousal rollover 'stretch IRA,' which offers the best income-tax-deferral result. The result can be a planning dilemma between maximum income-tax-deferral (saving) and maximum estate tax saving.

This complexity can be illustrated with the Homer Smith example. If Homer were to die soon after he retired at age 65 (in 2007), his gross estate for federal estate tax purposes would be \$3,050,000 (ignoring his DB plan). Assuming funeral expenses, estate administration expenses and debts of the estate total \$50,000, the net value would be \$3,000,000. An optimal marital (reduce to zero formula clause in his will) then would cause \$2,000,000 to be placed in a by-pass trust (presumably with Mary and the children as beneficiaries) or gift and \$1,000,000 would pass to Mary so as to qualify for the marital deduction (of which \$550,000 would be from their two homes and other jointly owned assets). But Homer's probate estate only has \$1,000,000 of assets (individually owned securities) with which to fund the by-pass trust and pay the estate's debts and expenses. Therefore, if the by-pass trust (or gift) is to be fully funded, Homer (or Mary by disclaimer) will need to have about \$1,050,000 of his IRA account balance payable to the by-pass trust (or payable to their children or to trusts for their children) to make up the full \$2,000,000 now permitted at his present asset values. In such a situation, a decision must be made either to give up part (or all) of the income-tax-deferral (or tax-free growth) advantages of a spousal rollover IRA and fully fund the by-pass trust, or to maintain the entire IRA account balance as a spousal rollover IRA with its income tax advantages but to underfund the by-pass trust or gift which may result in higher estate tax at the surviving spouse's subsequent death.<sup>18</sup> Naturally,

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this issue will depend on the size of the applicable exclusion amount at the person's death, which is uncertain at this time; the proportion of the gross estate consisting of retirement assets; and even the status (existence) of the federal estate tax itself.

*The 'Stretch IRA' Concept with Other Individuals  
as Designated Beneficiaries*

Individual beneficiaries other than a surviving spouse also may take minimum distributions over their life expectancies, but they must use the Single Life Table and the fixed-period (one year less) method. Other individual beneficiaries cannot roll over a qualified plan to their own IRA or treat a decedent's IRA as their own, but they may have 'inherited IRAs' payable over their life expectancies. This can allow them considerable 'stretch' opportunities, depending on their ages. These individuals often would be children, but they also might be grandchildren, siblings, other family members, or domestic partners or companions.

Returning to the case of Homer Smith, for example, if for some reason Mary were not in the picture (previous death, divorce, or more than adequate assets of her own), Homer could name his two children as beneficiaries of his 401(k) savings plan or of his rollover IRA. If Homer were tragically to die early, say at age 65, and assuming separate accounts are established for each child, Homer Jr.'s life expectancy at his age 36 (one year after Homer's death) would be 48.5 years (or a 2.0618 percent minimum required distribution) while Hortense's life expectancy at age 29 would be 54.3 years (or a 1.8416 percent minimum distribution). Thereafter, their expectancies would decline by one each year until the account balance for each would be exhausted in the 49th year for Homer Jr. (his age 85) and in the 55th year for Hortense (her age 84) regardless of whether they lived longer than those ages.

At Homer's death (assumed at age 65 here), if he had not yet rolled over his 401(k) qualified savings plan account balance to his own IRA and his children were the equal beneficiaries of the 401(k) plan, under the provisions of the PPA of 2006, the children (as nonspouse individual beneficiaries) could transfer their account balances to an 'inherited IRA' for each with each IRA being in Homer's name as decedent but payable over the child's life expectancy as beneficiary. If Homer had done a rollover to his own IRA prior to his death, the IRA custodian would treat each child's separate account as an 'inherited IRA' in Homer's name (as decedent) but payable over each child's life expectancy as beneficiary.

Naturally, if Homer were to die at a more likely age, such as the previously assumed age 86, his children's life expectancies would be shorter—age

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57 and 27.9 years for Homer Jr. and age 50 and 34.2 years for Hortense. However, substantial income-tax-deferral (or tax-free growth) still would be possible. Grandchildren (none are assumed in the Homer Smith example) could also possibly be named as individual beneficiaries. However, they would be 'skip persons' to the participant or owner and so the generation-skipping transfer tax would have to be considered.

As noted earlier, children or other individual beneficiaries may have some of the same practical problems with 'stretch IRAs' as a surviving spouse as beneficiary. Wealth management professionals often comment anecdotally that children beneficiaries may want the money now (even though taxed) rather than being 'dribbled out' over their life expectancies.

### Trusts as Beneficiaries

It sometimes is desirable to have retirement benefits payable to a trust as beneficiary rather than to a spouse, children, or other individuals. This can be for all the estate planning, family, control, investment management, and allowance for discretion reasons that trusts are generally used. But when retirement benefits are made payable to trusts, income-tax-deferral and other advantages often are sacrificed at least to some degree for trust administration. Thus there are income tax and other trade-offs in using retirement benefits to fund trusts.

### Trade-offs with Trusts as Beneficiaries

One such trade-off is that income-tax-deferral often is reduced. The general minimum distribution rule is that retirement plan account balances payable to other than individual designated beneficiaries must be paid out by the end of the fifth anniversary of the participant's or owner's death. This rule applies to trusts unless a trust meets the tax law requirements to be a see-through trust.

Under the minimum distribution rules, a *see-through trust* as beneficiary allows distributions to be paid from the plan (normally an IRA) over the life expectancy of the oldest trust beneficiary (using the Single Life Table without recalculation) or over the separate life expectancy of each trust beneficiary if a separate subtrust is named for each trust beneficiary in the *plan's* beneficiary designation form (the separate accounts rule). To be a see-through trust, all trust beneficiaries must be individuals, they must be identifiable from the trust instrument, the trust must be irrevocable and valid under state law, and the trustee must supply certain documentation to the retirement plan administrator.

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Another possibility is to make a trust a *conduit trust*. To be such a trust, the trust instrument must require the trustee to distribute to an individual trust beneficiary any distribution the trustee receives from the retirement plan. In other words, unlike a see-through only trust, the trustee cannot accumulate plan distributions in the trust to be distributed later under the terms of the trust and perhaps in the trustee's discretion. For minimum distribution purposes, a conduit trust beneficiary is treated as if he or she had been named individually as the sole plan beneficiary. Therefore if, for example, a surviving spouse is beneficiary of a conduit trust, the MRDs would be over his or her life expectancy, using the Single Life Table but with recalculation. If any other person is beneficiary, the MRDs would be over his or her life expectancy but without recalculation (i.e., the fixed-period method). For a surviving spouse, this does not produce nearly the deferral possibilities as the spousal rollover 'stretch IRA.'

Another trade-off is that the effective trust income tax rates normally will be higher than those actually applying to individual beneficiaries.<sup>19</sup> Therefore, retirement plan distributions to trusts that are accumulated in the trust (i.e., not paid out currently to trust beneficiaries) normally will be taxed at a higher rate. Other trade-offs are trustees' fees (although these percentage charges may be roughly equivalent to the expense ratios of most mutual funds) and the time and costs of creating trusts. Further, if married participants of most qualified retirement plans are involved, spousal consent to any beneficiary designation other than the spouse will be required under the Retirement Equity Act of 1984 (REA).

#### Qualified Terminable Interest Property (Q-TIP) Trusts as Beneficiaries

To illustrate how alternative trust structures might work, we alter Homer Smith's situation to assume that Homer has been married before; he has a daughter, Abigail, from his first marriage; and he is divorced from his first wife. Let us further assume that Mary and her stepdaughter do not get along at all. Under these circumstances, Homer may fear that Mary will not name Abigail as an equal beneficiary (along with *their* two children) of any rollover IRA of Mary's if he names Mary as outright beneficiary of his qualified plan or IRA (the control factor). However, Homer does want his retirement plan account balance (or part of it) to qualify for the federal estate tax marital deduction.

A classic estate planning solution for this kind of situation is to leave property to the spouse (here, Mary) in a qualified terminable interest property (Q-TIP) trust with trust income payable to the spouse (Mary) for life, and at Mary's death the remainder (the trust corpus) presumably

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going to Homer's three children equally in this case. Such a Q-TIP trust qualifies for the marital deduction at Homer's death and so is deductible by his executor in determining any federal estate tax liability (which will be reduced to zero under the previous assumptions), but leaves to Homer (in drafting the trust terms) where the property goes after Mary's death.

The difficulty with having an IRA account balance (as opposed to other, non-IRD property) payable to a Q-TIP trust is a significant loss of income-tax-deferral (or tax-free growth).<sup>20</sup> For example, assume Homer does name such a Q-TIP trust as beneficiary of his IRA (i.e., life income to Mary remainder to his three children), and the trust is a *see-through trust* but not a conduit trust. In this case, if Homer dies at age 86 with Mary being age 83 the next year, the MRDs would be based on Mary's life expectancy under the Single Life Table on a fixed-period basis (no recalculation). Therefore, the IRA account balance at Homer's death would have to be paid out to the trust in only 8.6 years. Further, MRDs in excess of the income earned inside the IRA would be taxed to the trust at its likely higher tax rate.<sup>21</sup> But under this scenario, these after-tax excess MRDs will accumulate in the trust and be available for distribution to the remainder beneficiaries (the children) after the surviving spouse's death. Therefore, there will be a bequest potential here, but once the distributions leave the IRA, there will no longer be income-tax-deferral or tax-free growth advantages.

If, however, the Q-TIP trust is structured as a *conduit trust*, all distributions from the IRA will be passed through the trust to the surviving spouse. The advantages of this are somewhat longer deferral (because the MRDs are calculated using the Single Life Table but *with recalculation*) and probably lower income tax rates because the distributions all will be taxable to the surviving spouse.<sup>22</sup> But the disadvantage here from a bequest point of view is that, assuming the surviving spouse lives a reasonable period of time, very little will be left in the Q-TIP trust at his or her death to go to the remainder beneficiaries (the children).

### By-Pass Trusts as Beneficiaries

As noted previously, it may be necessary for estate tax reasons to have retirement plan benefits payable to a by-pass or credit-shelter trust. But the disadvantages of doing so are that income-tax-deferral likely will be substantially reduced, higher trust income tax rates may apply, and any income tax paid by the trust on IRA distributions that are not currently paid out as income to trust beneficiaries (i.e., are accumulated in the trust) will reduce trust corpus and hence lessen the estate tax skipping advantage of these trusts.

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How fast MRDs must be paid to any see-through trust depends on who the trust beneficiaries are. In general, the MRDs will be based on the life expectancy of the oldest trust beneficiary (unless there are subtrusts for each beneficiary). For many by-pass trusts, the beneficiaries will be the surviving spouse and the children and so the surviving spouse normally will be older and his or her life expectancy under the Single Life Table without recalculation will govern the amounts of the MRDs. This is because in most cases (like that of Homer Smith, e.g.) the estate is not so large that a surviving spouse can live comfortably on just the income from the marital share and his or her own assets. Planners often want the income (and perhaps the corpus subject to an independent trustee's discretion or an ascertainable standard) of the by-pass trust at least available to a surviving spouse. In the instant case, if Homer dies at age 86 and Mary is 83 in the next year, the IRA would have to be emptied into the trust in 8.6 years.

If only the children are beneficiaries of a see-through by-pass trust, the life expectancy of the oldest child would govern (unless subtrusts are created). For example, if Homer Smith were to die at age 86, and had named only Homer Jr. (age 57 the next year) and Hortense (age 50 the next year) as beneficiaries of his by-pass trust, Homer Jr.'s life expectancy under the Single Life Table with no recalculation would govern and the IRA would have to be paid out to the trust over 27.9 years. This offers substantially more deferral than when Mary was also a beneficiary but possibly at the price of Mary's economic security.

This discussion illustrates how naming Q-TIP trusts or by-pass trusts for spouses and children can very substantially reduce 'stretch possibilities.' Therefore, such trusts may not be desirable beneficiaries for retirement plan accounts. Yet dependent on the circumstances, their use may be a necessary trade-off of income-tax-deferral for other estate planning or family advantages.

#### *Trusts for Other Individuals (Children) as Beneficiaries*

Such see-through trusts are governed by the same general principles as just described for by-pass trusts for children only. They really offer essentially the same deferral (or tax-free growth) opportunities as when children are named directly. As noted above, the naming of comparatively young (and healthy) children directly or in see-through trusts as beneficiaries can offer very substantial income-tax-subsidized bequest opportunities.

#### *Charitable Remainder Trusts (CRTs) as Beneficiaries*

An attractive deferral strategy, in some situations, would be to have retirement plan benefits payable to a CRT at the participant's or owner's death

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with individuals (children, spouse and children, or others) as the unitrust or annuity trust noncharitable income beneficiaries during their lifetimes. A charity will then be the remainder beneficiary after the death of the last noncharitable income beneficiary. The CRT strategy can be particularly attractive when there are at least some younger noncharitable beneficiaries who are in reasonably good health and the participant or owner is charitably inclined. Thus, a CRT can provide income, for example, over the lifetimes (not just life expectancies) of spouse (who may be older) and then of children who normally will be younger.

This strategy provides deferral because when the participant or owner dies, the retirement plan account balance is paid to the CRT, which is a tax-exempt entity, and hence no income tax is payable. Thus the full account balance remains undiminished in the CRT to provide a unitrust or annuity trust income to the noncharitable beneficiaries for their lifetimes. A unitrust income interest from a charitable remainder unitrust (CRUT) is a fixed percentage of each year's value of the trust corpus, while an annuity trust interest from a charitable remainder annuity trust (a CRAT) is a fixed dollar amount each year. CRUTs generally are more flexible, and if the investment performance of a CRUT is good, the unitrust amount may increase over time thus providing some protection to the beneficiary against long-term inflation.<sup>23</sup> The unitrust rate must be at least 5 percent and cannot be more than 50 percent. When a CRT is created (at the death of the participant or owner), the actuarial value, using IRS tables, of the charity's remainder interest must be at least 10 percent of the trust's value. When the income interest is paid out to the beneficiaries, it is taxable to them under a four tier system. This normally results in the income being taxable as ordinary income when retirement plan benefits are used to fund a CRT.

For illustrative purposes, let us return to the Smith case. Now suppose Homer is charitably inclined and decides to leave \$500,000 of his rollover IRA to a 6 percent CRUT payable to Mary for her lifetime and then to their children for their lifetimes; finally, when the last noncharitable beneficiary has died, the remainder is to go to a charity (e.g., the University of Pennsylvania). He does this instead of naming a by-pass trust as beneficiary.<sup>24</sup> At Homer's death, say at age 86, 6 percent of the CRUT corpus (initially \$30,000) will be payable as ordinary income to Mary for as long as she actually lives (not just for her 8.6 years life expectancy as assumed in the by-pass trust example).<sup>25</sup> Then upon Mary's death, say at age 86, the CRUT payout will continue for the children's lifetimes. If each child dies, say, at age 90, this will be for 37 more years since Hortense will be 53 at Mary's death. This would result in deferral for Homer's surviving family of 41 years.

Retirement plan benefits may also be made payable to a charitable gift annuity plan. This approach would provide the noncharitable human



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beneficiary(ies) with a fixed life-annuity income (guaranteed by the charity) and based on the ages of the noncharitable beneficiaries and the gift annuity rates offered by the charity.

### *Lump-Sum Distributions from Qualified Plans Containing Appreciated Employer Securities*

This strategy can be attractive and defer considerable wealth when a participant's qualified retirement plan individual account contains a substantial amount of appreciated employer securities. While some income tax must be paid at the time of the distribution, there can be substantial deferral of tax on most of it and the part represented by net unrealized appreciation (NUA) of employer securities will be taxed as long-term capital gains (rather than ordinary income) when the securities are finally sold. NUA is the difference between the value of the employer securities at distribution and their *basis to the plan* (value when acquired by the plan for the participant's account).

As an example, let us assume that Homer Smith's 401(k) account balance is allocated \$250,000 in a bond fund, \$250,000 in a guaranteed investment contract (GIC), and \$1,000,000 in his employer's (XYZ Corporation's) common stock. The basis of this employer stock to the plan is \$300,000. Homer has no income tax basis in his qualified retirement plan account balance because none of his contributions (made before-tax), employer matching contributions, or investment earnings on his account have ever been taxed to him.

At age 65, Homer decides to take a lump-sum distribution of his entire 401(k) plan account balance in one taxable year. The tax result of this would be as follows:

<b>Lump-Sum Distribution</b>	\$1,500,000
Less:	0
Homer's Basis in Plan Account	<u>−700,000</u>
Net Unrealized Appreciation (NUA) on Employer Securities (\$1,000,000 − \$300,000)	<u>\$800,000</u>
Potentially Taxable Amount	

However, Homer also is able to do a partial rollover of the non-XYZ stock portion of the total distribution (or \$500,000) to his own traditional IRA.<sup>26</sup> Thus, assuming such a partial rollover, Homer would only be taxed (as ordinary income) on \$300,000 (the basis to the plan of the XYZ stock) in the year of the total distribution. He would have received \$1,000,000 worth of XYZ stock with an income tax basis to him of \$300,000 (because he paid tax

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on this amount) and \$500,000 in a traditional rollover IRA (which he could 'stretch' as discussed previously). Presumably, he would take the tax on the \$300,000 of ordinary income from other non-retirement-plan assets so his rollover IRA could remain undiminished for future tax deferral and he would not have to sell any of the XYZ stock now and recognize capital gains.

Homer could then hold the XYZ stock as long as he wished and would only recognize tax on the NUA (and any subsequent appreciation) when he sold the stock and then at long-term capital gains rates, assuming he held the stock for more than one year. If Homer dies before selling the XYZ stock, it does not get a stepped-up income tax basis at death. Therefore, his heirs also will recognize long-term capital gain when they later sell the stock. Thus, there could be a long period of tax deferral possibly extending into future generations.

### *Charitable Rollovers and Other Charitable Giving*

The PPA of 2006 introduced an interesting approach to allowing direct lifetime transfers of retirement assets to qualified charities. For 2006 and 2007 only, the law allows persons aged 70<sup>1</sup>/<sub>2</sub> or older to distribute up to \$100,000 per year from their IRAs to qualified charities without recognizing taxable income, but also without being able to take a charitable income tax deduction for the contribution. Such distributions also count toward the person's minimum required distribution for that year. Whether this lifetime charitable giving provision will be extended beyond 2007 is uncertain. It is strongly favored by the nonprofit charitable community.

In addition to CRTs and charitable rollovers, participants and owners can name charities as beneficiaries or partial beneficiaries of non-Roth retirement plan account balances. As noted previously, this is perhaps the most tax-efficient way to make desired charitable contributions at death because (other than Roth IRAs) the retirement plan death benefits are IRD. Thus, when payable to non-tax-exempt beneficiaries, they are included in the decedent's gross estate for federal estate tax purposes and are also ordinary income when paid out to the beneficiaries (with an itemized income tax deduction for any estate taxes paid on the benefit). In contrast, most capital assets get a stepped-up income tax basis at death and hence pass no accumulated capital gains to heirs.

## **Conclusions**

The general objective of present tax law is to use tax incentives to encourage the provision of retirement income, not for tax-subsidized wealth transfer or charitable giving. The main mechanism for enforcing this

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policy is the minimum distribution rules. In practice, however, these rules and other tax law provisions now permit significant tax-favored wealth transfer and charitable giving strategies. Hence, once there are adequate resources for retirement, these strategies often are important in planning retirement plan distributions. Strategies for using tax-favored retirement plans as wealth transfer devices include spousal and nonspousal rollover ‘stretch IRAs’ strategy with its possible income-tax-deferral (or tax-free growth) over two or more generations. Also, as minimum distribution rules do not apply to Roth IRAs during the owner’s lifetime, this greatly enhances their tax-free growth potential. Making retirement plan distributions payable to charities or charitable entities can also offer substantial tax advantages. These and other interesting options have been extended by the 2006 PPA.

Au: We have placed the ‘Appendix’ before the notes in this chapter and in subsequent chapters of this volume. Please check.

**Appendix**

TABLE 6-A1 Life Tables Used for Computing Minimum Required Distributions

<i>Single Life Table</i>		<i>Single Life Table Cont.</i>		<i>Uniform Lifetime Table</i>	
<i>Age</i>	<i>Life Expectancy</i>	<i>Age</i>	<i>Life Expectancy</i>	<i>Age of Employee</i>	<i>Distribution Period</i>
0	82.4	20	63.0	70	27.4
1	81.6	21	62.1	71	26.5
2	80.6	22	61.1	72	25.6
3	79.7	23	60.1	73	24.7
4	78.7	24	59.1	74	23.8
5	77.7	25	58.2	75	22.9
6	76.7	26	57.2	76	22.0
7	75.8	27	56.2	77	21.2
8	74.8	28	55.3	78	20.3
9	73.8	29	54.3	79	19.5
10	72.8	30	53.3	80	18.7
11	71.8	31	52.4	81	17.9
12	70.8	32	51.4	82	17.1
13	69.9	33	50.4	83	16.3
14	68.9	34	49.4	84	15.5
15	67.9	35	48.5	85	14.8
16	66.9	36	47.5	86	14.1
17	66.0	37	46.5	87	13.4
18	65.0	38	45.6	88	12.7
19	64.0	39	44.6	89	12.0

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TABLE 6-A1 (Continued)

<i>Single Life Table</i>		<i>Single Life Table Cont.</i>		<i>Uniform Lifetime Table</i>	
<i>Age</i>	<i>Life Expectancy</i>	<i>Age</i>	<i>Life Expectancy</i>	<i>Age of Employee</i>	<i>Distribution Period</i>
40	43.6	76	12.7	90	11.4
41	42.7	77	12.1	91	10.8
42	41.7	78	11.4	92	10.2
43	40.7	79	10.8	93	9.6
44	39.8	80	10.2	94	9.1
45	38.8	81	9.7	95	8.6
46	37.9	82	9.1	96	8.1
47	37.0	83	8.6	97	7.6
48	36.0	84	8.1	98	7.1
49	35.1	85	7.6	99	6.7
50	34.2	86	7.1	100	6.3
51	33.3	87	6.7	101	5.9
52	32.3	88	6.3	102	5.5
53	31.4	89	5.9	103	5.2
54	30.5	90	5.5	104	4.9
55	29.6	91	5.2	105	4.5
56	28.7	92	4.9	106	4.2
57	27.9	93	4.6	107	3.9
58	27.0	94	4.3	108	3.7
59	26.1	95	4.1	109	3.4
60	25.2	96	3.8	110	3.1
61	24.4	97	3.6	111	2.9
62	23.5	98	3.4	112	2.6
63	22.7	99	3.1	113	2.4
64	21.8	100	2.9	114	2.1
65	21.0	101	2.7	115+	1.9
66	20.2	102	2.5		
67	19.4	103	2.3		
68	18.6	104	2.1		
69	17.8	105	1.9		
70	17.0	106	1.7		
71	16.3	107	1.5		
72	15.5	108	1.4		
73	14.8	109	1.2		
74	14.1	110	1.1		
75	13.4	111+	1.0		

Source: Federal Register (2002).

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<sup>1</sup> See, for example, Horneff et al. (2007: 1) where the authors view life annuities, phased withdrawal plans, and blended portfolios of annuities and withdrawal plans as means of converting retirement assets into income flows 'so as not to exhaust their funds too soon.' Also see Bernheim (1991) and Hurd and Smith (1999) for data on anticipated bequest motives of the elderly.

<sup>2</sup> As discussed later, the income-tax-deferral ('stretch') strategy in some circumstances may come into conflict with estate planning goals that may call for retirement benefits to be payable to a trust or trusts at the owner's death. Thus, income-tax-deferral may have to be sacrificed for estate tax savings or trustee administration and control in some cases.

<sup>3</sup> Reichenstein (2006) does not couch the analysis in terms of wealth transfer, but rather focuses on lengths of possible lifetime distributions assuming the retiree's objective is to spend down a specified inflation-adjusted, after-tax annual amount over an ~30-year period. Interestingly, the strategy of sequencing lifetime distributions, first from taxable accounts and then from retirement accounts, does produce longer distribution periods under the study's 'base case' assumptions after about 30 years. But the difference in periods between (a) taxable first then retirement plan distributions second (for a period of 30 years) and (b) retirement plan first then taxable second (for a period of 27.4 years) turns out to be 2.6 years (or about 8.67 percent less than the 30 years); this gap does not seem particularly great to the present author considering the time period involved. Further, when Reichenstein changes his assumptions, so that common stocks are passively invested (in index mutual funds or exchange traded funds) and assuming no stock turnover (with no realized and recognized capital gains) until the end of the 30-year period, the difference in periods narrows to 1.9 years or about 6.33 percent less than 30 years.

<sup>4</sup> This conclusion is reinforced by the author's work using a model projecting accumulated wealth from age 65 to 95, starting with portfolios of \$2 million in a traditional IRA and \$2 million in a taxable account containing stocks and bonds; both accounts were allocated 60 percent to stocks and 40 percent to bonds, respectively. The model assumed a 9 percent average annual return on stocks (6 percent long-term capital gains and 3 percent qualified dividends) and 6 percent return on bonds, a 35 percent tax rate on ordinary income, a 15 percent rate on qualified dividends and long-term capital gains, 75 percent unrealized capital gains on the common stocks as of age 65, a 100 percent turnover rate on the stocks over the first 20 years with none thereafter, a step-up in basis at death at age 95, and no MRDs for the sake of convenience. We assumed that the retiree needed a \$400,000 after-tax distribution for some purpose at age 65 from one of these accounts. We found that the sequencing of the distribution from the taxable account and not from the IRA (rather than the reverse) produced the best wealth accumulation results, but the difference was only 4.22 percent more by age 95. This difference would have been even less, if required minimum distributions had been taken from the IRA.

<sup>5</sup> A combination of these elements lies in having retirement plan assets payable to a charitable remainder trust (CRT) with family members the noncharitable unitrust or annuity trust beneficiaries. This approach is described *infra*.

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<sup>6</sup> A federal estate tax return must be filed by the executor or administrator of the estate of a deceased US citizen or resident alien when the value of his or her gross estate exceeds a threshold amount, which is the applicable exclusion amount for the year of death less any taxable gifts made after 1976. In recent years, this applicable exclusion amount has ranged from \$600,000 in 1987; \$1,000,000 by 2002; \$2,000,000 in 2006, 2007, and 2008; and is scheduled to increase to \$3,500,000 in 2009, with the estate tax being repealed in 2010, and then the estate tax returning in 2011 with an applicable exclusion amount of \$1,000,000, unless there are legislative changes in the meantime. Thus, the number of estate tax returns actually filed has declined over these years.

<sup>7</sup> The person may take his or her first MRD by December 31 of the year in which he or she attains age 70<sup>1/2</sup> (his or her first distribution calendar year) or wait until April 1 of the following year in which case he or she must take two distributions that year.

<sup>8</sup> The minimum distribution rules apply to defined benefit (DB) plans as well as defined contribution (DC) plans. However, the life-annuity payouts under DB pension plans typically meet these rules.

<sup>9</sup> If the actual sole beneficiary is the participant's or owner's spouse, who is more than 10 years younger than the participant or owner, the MRD may be calculated using a Joint and Last Survivor Table that will produce lower divisors (hence lower MRDs) than the Uniform Lifetime Table.

<sup>10</sup> If the deceased spouse died before his or her RBD, distributions to the surviving spouse beneficiary must begin by the later of December 31 of the year following the year of the decedent's death or December 31 of the year the decedent would have attained age 70<sup>1/2</sup>. If the deceased spouse died on or after his or her RBD, distributions to the surviving spouse must begin by December 31 of the year following the decedent's death and may be payable over the longer of the surviving spouse's life expectancy or what would have been the decedent's life expectancy. It may also be noted that the tax law and the IRS do not use the term 'inherited IRA' in the case of a spousal beneficiary. But that term is commonly used in the case of any individual beneficiary and is so used here.

<sup>11</sup> See, for example; Kennedy, Kent, and Weger (2006); Blyskal (1993); and Hoyt (2005).

<sup>12</sup> Only a *surviving spouse* can roll over or treat as his or her own account balance as just described. Other *individual (nonspouse) beneficiaries* can transfer a decedent's qualified plan account balance to an inherited IRA for the beneficiary (potentially payable over the beneficiary's fixed period single life expectancy) but in the name of the decedent, or can have the decedent's IRA treated as an inherited IRA for the beneficiary in the same fashion. But for nonspouse beneficiaries, this is not the same as the spouse's rolling over to or treating as his or her own IRA.

<sup>13</sup> Homer could wait to take his first minimum distribution until April 1 of the calendar year following his 70<sup>1/2</sup> years and then take another distribution for that year by December 31 of that year. However, he decides not to 'double up' distributions for that year and to take his first minimum distribution by December 31 of his 70<sup>1/2</sup> years.

<sup>14</sup> This is simply one divided by the applicable distribution period or 27.4 at age 70.

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<sup>15</sup> Using the favorable Uniform Lifetime Table, in this case the required minimum distributions will be less than the 6 percent investment return from the IRA until Homer reaches age 83. This will be true as long as 100 divided by the investment return inside the IRA is less than the applicable distribution period. In this case,  $100 \div 6 = 16.67$ . The distribution period for age 82 is 17.1 years.

<sup>16</sup> As is discussed later under the heading 'Possible Problems with Spousal Rollover "Stretch IRAs",' since the IRA balance represents such a large part of Homer's gross estate for federal estate tax purposes, it is possible that there will not be enough nonretirement probate assets in his estate to fund fully the credit-shelter trust for an optimal marital in this case. As described later, this represents a planning dilemma and the solution may be either to use some of the retirement assets to fund the credit-shelter trust or gift (and thus not have them payable to the surviving spouse) or to underfund the credit-shelter trust or gift.

<sup>17</sup> It may be noted that while we assume both Homer and Mary died at age 86 (which was their life expectancy at age 65), and left a substantial IRA account balance for their children, had they lived beyond age 86 and continued taking minimum distributions, they would never have completely exhausted the IRA. This is because under the Uniform Lifetime Table their life expectancy is recalculated at each age.

<sup>18</sup> Still another possibility under these circumstances is for the amount (or part of the amount) of retirement plan assets that otherwise would go into a by-pass or credit-shelter trust to be made payable to a CRUT or annuity trust (CRAT) with the surviving spouse and then the children as noncharitable beneficiaries of the charitable remainder trust for their respective lifetimes (Hoyt 2002*b*).

<sup>19</sup> Trust income tax rates are the same as individual rates, except trusts do not have a 10 percent bracket. However, trust income tax brackets are very compressed and so the taxable income of trusts reaches the top 35 percent rate much more quickly than for individual taxpayers. For example, as of 2007 trust tax rates reach the top 35 percent rate after only \$10,450 of taxable income, while individuals do not reach the top bracket until after \$349,700 of taxable income.

<sup>20</sup> In this case, Homer probably would roll over his qualified 401(k) plan account balance to his own IRA before naming the Q-TIP trust as beneficiary. IRAs are not subject to REA so Mary would not have to consent to a beneficiary designation other than herself.

<sup>21</sup> The trustee of the Q-TIP trust must withdraw each year from the IRA the larger of the MRD or the income inside the IRA for that year for estate tax reasons. The surviving spouse must receive the larger of the income inside the IRA or the trust's income. However, at Mary's age the MRDs would likely exceed the IRA income.

<sup>22</sup> In this case, the surviving spouse will receive the larger of the MRD or the income inside the IRA each year, and at Mary's age this will very likely be the MRD.

<sup>23</sup> Of course, if the reverse is true, the CRUT income stream will decline.

<sup>24</sup> A CRUT can be made to qualify for the federal estate tax marital deduction if the surviving spouse is the only noncharitable beneficiary. It then can be used instead of, say, a Q-TIP trust. But in this case a charity and not the children would be the remainder person after the spouse's death. If the children are also named as CRT beneficiaries as just described, there would be no marital deduction for the CRT at

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Homer's death, but there would be a small estate tax charitable deduction for the actuarial value of the charitable remainder interest as of the date of Homer's death. Thus, planners may recommend a CRUT for spouse and children as a substitute for a by-pass trust since a by-pass trust does not qualify for the marital deduction anyway. See Hoyt (2002*b*). Of course, if the estate is not large enough to attract federal estate tax, this factor does not matter.

<sup>25</sup> If the net investment income inside the CRUT (which would be income-tax-free to the CRUT) exceeds the unitrust payout (6 percent assumed here), the value of the CRUT corpus will grow and so will future unitrust payouts. But if CRUT net investment income does not match payouts, CRUT corpus will be used to make up the difference, and the reverse will be true. Thus, there is some investment risk, as well as opportunity, in this strategy.

<sup>26</sup> After the Pension Act of 2006, he could also roll over part or all of this amount to a Roth IRA, if he meets the eligibility requirements to convert to a Roth, but then he would be taxed on the amount being rolled over to the Roth.

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Au: Please provide more detail for 'Horneff, Wolfram et al. (2007)' and for all such cases of 'forthcoming'.



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