By Bruce D. Steiner

Ten Common Errors

Getting older is hard enough—at least avoid making these mistakes in retirement benefits planning

For many clients, retirement benefits are their largest asset. For others, they are important even if not determinative. For all, the rules governing retirement benefits are complicated. There's also a potential for tension between income tax planning and estate tax planning.

So let's at least be sure to avoid these 10 common errors when planning for retirement benefits:[1]

(1) STAYING OUT OF THE GAME

Qualified plans and individual retirement accounts allow tax-free compounding of income and gains over long periods of time. At an 8 percent annual return, an employee who contributes $15,500 per year to a 401(k) plan will have nearly $5 million after 40 years, without regard to matching contributions, other employer contributions, future increases in the permissible contributions or catch-up contributions after age 50.

A common misconception is that by contributing to a retirement plan, you are converting capital gains to ordinary income, or giving up the opportunity to take advantage of the 15 percent tax rate on qualified dividends and capital gains. But the effective tax rate on income and gains in an IRA is zero. Suppose you contribute $5,000 to an IRA. Over some period of time, it grows to $50,000. If you are in a 30 percent tax bracket, and you withdraw the $50,000, you will have $35,000 remaining after income taxes. Suppose you instead paid $1,500 tax at the beginning, and invested the remaining $3,500 in your taxable account. In order for your $3,500 taxable account to grow to the same $35,000, you would need a zero percent tax rate on your investment income and gains.

Bruce D. Steiner is an attorney with Kleinberg, Kaplan, Wolff & Cohen, P.C., in New York City

(2) FAILING TO CONVERT TO A ROTH IRA

If you have non-retirement funds with which to pay the tax on the conversion, converting to a Roth IRA is effectively the same as making a substantial additional contribution to your IRA.

Suppose you have a $100 IRA and $30 in other money. You convert your IRA to a Roth IRA, and use your $30 of other money to pay the income tax on the conversion. You now have a $100 Roth IRA. Over some period of time, it grows to $200, which you (or your beneficiaries) can withdraw free of income tax.

Over the same period of time, if you did not convert to a Roth IRA, your $100 IRA will grow to the same $200. If you withdraw the $200, you will pay a $60 tax, and will have $140 after income taxes. You would need a zero percent tax rate on your investment income and gains in order for your $30 taxable account to grow to the same $60.

The Roth conversion offers other tax benefits as well.

There are no required distributions from a Roth IRA during lifetime. Since many people live well beyond age 70½, the ability to avoid required distributions during lifetime can be significant.

The Internal Revenue Code Section 691(c) deduction for income in respect of a decedent only covers the federal, but not the state income tax. By converting to a Roth IRA, all of the income tax is removed from the estate for estate tax purposes, while preserving the ability

1 9/17/08 10:26:09 AM

to stretch out the IRA distributions.

A Roth IRA is a more valuable asset than a traditional IRA with which to fund a credit shelter trust or a generation-skipping transfer tax exempt disposition.

If an IRA owner leaves a traditional IRA in trust rather than outright, distributions from the IRA are generally subject to the compressed income tax brackets for trusts. This is not an issue with a Roth IRA.

To be able to convert to a Roth IRA, an IRA owner's modified adjusted gross income cannot exceed $100,000, without regard to the income from the conversion. Required distributions from an IRA do not count for this purpose. Beginning in 2010, the $100,000 income cap will no longer apply. This will enable more IRA owners to convert to Roth IRAs.

(3) WITHDRAWING BENEFITS TOO SOON

Qualified plan participants and IRA owners must generally begin taking benefits at age 70½. But the benefits can be stretched out over a long period of time, both during the IRA owner's lifetime and after the IRA owner's death.

By using their other assets first, participants and IRA owners can preserve the income tax benefits of their retirement plans and IRAs.

(4) FAILING TO COORDINATE THE BENEFICIARY DESIGNATION WITH THE ESTATE PLAN

Many participants and IRA owners have sophisticated wills that contain detailed provisions for the disposition of their assets. But retirement benefits pass in accordance with the beneficiary designation, not the will.

Participants and IRA owners should coordinate their beneficiary designations with the rest of their estate plan.

(5) FAILING TO LEAVE RETIREMENT BENEFITS TO THE SPOUSE

There will be cases when leaving the IRA to the spouse is not appropriate. But there are income and estate tax benefits to leaving qualified plan and IRA benefits to the spouse. The benefits qualify for the estate tax marital deduction. Spouses can roll them over into their own IRA, name new beneficiaries, possibly convert to a Roth IRA and obtain a longer income tax stretchout.

Even if an IRA owner is leaving the marital share of his estate to the spouse in a qualified terminable interest property trust, he should consider leaving the retirement benefits to the spouse outright, unless it would be inappropriate to do so in a given case.

(6) FAILING TO COORDINATE WITH A CREDIT SHELTER TRUST

Some participants and IRA owners do not have enough non-retirement assets to fully fund a credit shelter trust. This situation is more common now that the estate tax exempt amount has increased to $2 million, and will be even more common beginning in 2009 when the estate tax exempt amount increases to $3.5 million.

These clients must choose between the income tax benefits of leaving the IRA to the spouse and the potential estate tax benefit of fully funding a credit shelter trust. State estate taxes also may be a factor in decoupled states.

Such a client can leave to the credit shelter trust, or to or in trust for their children or grandchildren, the portion of the IRA necessary to fully utilize the exempt amount, after taking into account her other assets. Or she can leave the retirement benefits to the spouse, who can (but need not) disclaim them to the extent necessary to fill the credit shelter trust.

(7) LEAVING RETIREMENT BENEFITS TO CHILDREN OR GRANDCHILDREN OUTRIGHT INSTEAD OF IN A DISCRETIONARY TRUST

There are several reasons to provide for children or grandchildren in trust rather than outright. Assets in a trust are better protected against the beneficiary's potential creditors (including spouses), and will not be included in the beneficiary's estate.

The same reasons for leaving other assets in trust apply to retirement benefits. Thus, it is often desirable to leave retirement benefits to children or grandchildren in trust rather than outright. But it should be noted that the stretchout is limited to the life expectancy of the oldest beneficiary of the trust. In other

2 9/17/08 10:26:09 AM

words, no accumulated IRA benefits can ever go to anyone older than the designated beneficiary.[2]

Trusts for children and grandchildren often mandate distributions to the beneficiary. To the extent distributions are required, the protection of the trust is lost. Clients should consider making these trusts discretionary, giving the beneficiary the desired degree of control over the trust at a specified age or ages.

(8) COLLECTING BENEFITS UPON DEATH

A beneficiary can generally stretch the benefits out over his life expectancy. But sometimes a beneficiary collects the benefits before realizing that he could have stretched them out over his life expectancy.

Unfortunately, there is no provision allowing a beneficiary other than a spouse 60 days to roll the benefits over into an IRA. Advisors should make sure that their clients' beneficiaries are aware of the potential stretchout before they collect the retirement benefits.

(9) NOT CONSIDERING A DISCLAIMER

There are often advantages to having the named beneficiary disclaim the benefits. If the named beneficiary disclaims, the retirement benefits go to the contingent beneficiaries. If there are no contingent beneficiaries, then the benefits will be distributed in accordance with the default provisions of the plan or IRA. If there are no default provisions, then the benefits go to the participant's or IRA owner's estate.

A beneficiary may be able to disclaim even after receiving distributions from the IRA.[3]

(10) FAILING TO CONSIDER A SPOUSAL ROLLOVER EVEN IF THE SPOUSE IS NOT THE NAMED BENEFICIARY

As mentioned, there are significant benefits to naming the spouse as beneficiary. The spouse can roll the benefits over into her own IRA, name new beneficiaries and possibly convert to a Roth IRA. But sometimes the spouse is not the named beneficiary.

The Internal Revenue Service has issued numerous private letter rulings allowing a spousal rollover when the spouse was not the named beneficiary.[4] For example, the retirement benefits may pass to the spouse under the default provisions of the qualified plan or IRA. Or the IRA may go to the spouse as a result of disclaimer, by intestacy, by reason of the elective share, as community property, or through an estate or a trust in which no one other than the spouse can cause the retirement benefits to be payable to anyone other than the spouse. TE

Endnotes

1. This article is based upon several continuing education presentations by the author. A version of that presentation appeared as an article in Steve Leimberg's *Employee Benefits and Retirement Planning Newsletter* #442 (Feb. 20, 2008), *www.leimberg.com.*
2. *See* Private Letter Rulings 200828025 and 200335038.
3. Revenue Ruling 2005-36, 2005-26 I.R.B. 1368.
4. Bruce D. Steiner, "Postmortem Strategies to Shift Retirement Plan Assets to the Spouse," 24 *Estate Planning* 369 (1997).

Well-heeled—"A Family Concert on the Terrace of a Country House: A Self Portrait of the Artist with his Family" by David Teniers II sold for US $1,871,131 at Sotheby's Old Masters auction on July 9, 2008, in London.

3 9/17/08 10:26:12 AM