MEMORANDUM

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BENEFICIARY DESIGNATIONS FOR QUALIFIED PLANS

This memorandum generally explains several principles applicable to qualified plan beneficiary designations. This memorandum is not a guide for making beneficiary designations; rather, it is a general statement of the principles to be considered by a qualified plan or IRA participant as a part of essential and comprehensive discussions of this subject by the participant and his or her professional advisors. Qualified plan or IRA beneficiary designations should not be made without a thorough understanding of the tax rules and the integration of those rules with the participant's broader estate planning objectives.

The discussion of beneficiary designation choices in this memorandum will be set out in a series of principles, each of which will contain a set of rules that must be followed. These principles are, as stated above, generalizations that should not be applied without a thorough analysis of each participant's tax, retirement, and family circumstances. Because of the generalized presentation in this memorandum, qualified plans, including 403(b) arrangements, and IRA's will be treated in the same manner, although there are differences that must be considered when actual beneficiary designations and plan distribution decisions are made.

A. **Principle One**. A designated beneficiary should be named. If the participant is married, his or her surviving spouse should be the designated beneficiary.

1. If there is no designated beneficiary and the participant dies before his or her required beginning date, the entire plan proceeds must be distributed by the end of the fifth year following the year of death. If the required beginning date has not occurred, and there is no designated beneficiary, plan proceeds must be paid out each year over the remaining life expectancy of the participant.

2. If the participant has a designated beneficiary other than his or her spouse, and the participant dies before the required beginning date, unless the Plan document provides otherwise, the designated beneficiary must withdraw the minimum required distribution calculated using the life expectancy method, by which the designated beneficiary must withdraw annually an amount determined by dividing the remaining plan balance by the single life expectancy of the designated beneficiary. If, however, the participant dies after the required beginning date, the minimum required distributions will be calculated based on the longer of the beneficiary’s single life expectancy or the life expectancy of the deceased participant.

3. If the designated beneficiary is the participant's spouse, and the participant dies before the required beginning date, the surviving spouse can calculate the minimum required distribution based on the surviving spouse’s

single life expectancy, however, the surviving spouse is not required to begin taking distributions until the later of the year following the year in which the participant died or the year in which the participant would have reached age 70 1/2. The surviving spouse has the additional option of rolling over the plan benefits to the surviving spouse's own retirement plan. The surviving spouse thus becomes the participant and is entitled to defer withdrawing any plan proceeds until the surviving spouse attains age 70 1/2, and then to have minimum required distributions calculated based on the Uniform Life Table. Moreover, if the retirement benefits are held in an IRA and the surviving spouse chooses not to roll over the plan benefits, the surviving spouse can treat the IRA as his or her own IRA and defer the start of minimum distributions until the year in which the surviving spouse reaches the age of 70 1/2. If the participant dies after his or her required beginning date, the additional options of rolling over the retirement plan benefits or treating an IRA as the surviving spouse's own are still available.

B. **<u>Principle Two</u>**. If the participant is unmarried and has children, the children should be named as the primary beneficiaries of the plan proceeds. Unless the participant's children are young or subject to disabilities, the children should be named as the designated beneficiaries.

1. If the participant dies prior to his or her required beginning date, unless the Plan document provides otherwise, the minimum required distribution is calculated using the life expectancy method based on the life of the oldest beneficiary. The minimum required distribution is therefore determined by dividing the remaining plan balance by the single life expectancy of the oldest beneficiary. If, however, the participant dies after the required beginning date, the minimum required distributions will be calculated based on the longer of the oldest beneficiary's single life expectancy or the life expectancy of the deceased participant.

2. If children are named as beneficiaries, the plan administrator or IRA sponsor should agree in the plan documents to permit the issue of a child who dies before the participant's death to step into the shoes of the deceased child and receive the plan proceeds that the child would have received if he or she had survived the participant. Many plan administrators or sponsors use a beneficiary designation form that causes the plan proceeds to be distributed only to surviving children. This results in grandchildren being excluded from the share their parent would have taken if their parent would have survived the participant. Ordinarily this result is not consistent with the participant's estate planning objectives.

C. **<u>Principle Three</u>**. The participant's estate should not be named as the plan beneficiary. An estate cannot be a designated beneficiary. Therefore, if the participant dies before his required beginning date, all benefits must be distributed by the end of the fifth year following the year of the participant's death. A payout within five years limits the tax deferral benefits otherwise available if a designated beneficiary is named.

D. **Principle Four**. A trust should be named as beneficiary only to accomplish defined objectives that cannot be accomplished if either a spouse or children are named as the beneficiary.

1. **Defined Objectives**. The following are examples of objectives that can be accomplished only through the use of a trust as a beneficiary:

a. If the spouse or children are incapable of handling an outright distribution of plan proceeds. This situation might occur if a surviving spouse were incapacitated or children were handicapped.

b. If the participant and spouse are in a second marriage and the participant does not wish for his or her spouse to receive complete control of the plan proceeds, but wishes to qualify for the marital deduction.

c. The participant's assets other than qualified plan proceeds are not adequate to "fill up" the by-pass or unified credit trust. Filling up the by-pass trust with qualified plan proceeds can be achieved either by naming the participant revocable trust or testamentary trust as the beneficiary or naming the spouse as the beneficiary and permitting the spouse to disclaim all or a portion of the qualified plan assets which, as a result of disclaimer, will pass into the by-pass trust.

2. If a trust is named as a beneficiary of plan proceeds, the Internal Revenue Service imposes, at the present time, at least six highly technical rules that must be followed in order for the trust to be considered as a designated beneficiary. If a trust qualifies as a designated beneficiary, one of the life expectancy methods for payout of plan proceeds will be available instead of the five year payout that is applicable if there is no designated beneficiary. If one follows these technical rules, the beneficiary or beneficiaries of the trust are treated as designated beneficiaries and the life expectancy method may be used with respect to such beneficiary or beneficiaries. Consequently, the minimum distribution rules, both before and after the required beginning date, can generally be measured by the life expectancy of the oldest trust beneficiary.

3. **The Six IRS Rules**. The following rules governing minimum required distribution from a qualified retirement plan or IRA are included in regulations issued by the Internal Revenue Service and are known as the “minimum distribution trust rules”.

a. **Rule One**. Trusts must be valid under state law.

b. **Rule Two**. The trust beneficiaries must be identifiable. Although the word "identifiable," has not been thoroughly defined by the Internal Revenue Service, it is generally thought to mean that there must be an ascertainable "oldest" beneficiary whose life expectancy can be the period for determining minimum plan distributions.

Therefore, on the beneficiary finalization date, the oldest member of the possible class of beneficiaries must be identifiable. In order to avoid that class expanding, language can be included in the trust agreement stating that persons who are older than the oldest beneficiary on the date of the participant's death cannot be added to the class by any means, including legal adoption after the participant's death. Moreover, if a power of appointment is given to any trust beneficiary, that power of appointment cannot be exercised in favor of persons who would be unknown and older than the oldest beneficiary on the date of the participant's death.

c. **Rule Three**. The trust must be irrevocable or will, by its terms, become irrevocable upon the death of the employee. Although questions remain as to how this rule would affect a testamentary trust created under a will, this should not be a difficult test with which to comply.

d. **Rule Four**. Specific documents must be supplied to the trust administrator. This rule requires that either the trust document itself or summary information about the trust beneficiaries be supplied to the plan administrator by October 31 of the year after the year of the participant's death.

e. **Rule Five**. Only individuals may be named as beneficiaries of the trust. This rule appears deceptively straightforward. However, hidden traps exist.

(i) An estate cannot be an individual. Even if the beneficiary is entitled to all of the income from the trusts for the beneficiary's lifetime, if at the time of the beneficiary's death the trust property passes to the beneficiary's estate, there will be no designated beneficiary. Moreover, the participant's own estate cannot be a beneficiary. The participant's estate may be considered to be the beneficiary if any portion of the plan benefits may be used to pay the deceased participant's debts, administration expenses, or taxes. Some advisors have, therefore, suggested that a separate trust be created to receive qualified plan proceeds, and that the language of the trust specifically state that no portion of the trust can be used to pay the participant's debts, administration expenses, or taxes. Alternatively, the language may be included in the by-pass trust prohibiting the use qualified plan or IRA proceeds passing into the trust from being used for such purposes. Such a prohibition may be awkward in a by-pass trust in which the assets of that trust are to be used for such purposes in order to avoid using the marital deduction by having debts, administration expenses, or taxes paid from the surviving spouse's share. The illogic of the Internal Revenue Services position that the participant's estate taxes cannot be paid from qualified plan benefits if the life expectancy method is to be used is apparent since under most estate planning arrangements, estate taxes are to be paid from qualified plan proceeds. Otherwise, a significant tax allocation burden would be imposed on recipients of the estate who do not enjoy any portion of the qualified plan proceeds.

(ii) The life expectancy payout arrangement will not be permitted if the trust is to be distributed to a charity following the life income beneficiary's death.

(iii) Complex rules apply if there is more than one beneficiary, which, is usually the case because the Internal Revenue Service asserts that all contingent and remainder beneficiaries must be considered beneficiaries for applying the minimum distribution rules. Only if a beneficiary's entitlement to a participant's benefit is contingent on the death of a prior beneficiary will the contingent beneficiary not be considered a beneficiary for purposes of determining who is the designated beneficiary with the shortest life expectancy or whether a beneficiary is an individual. Similarly, difficult problems exist if a beneficiary may exercise a power of appointment over the trust property. In that case, all potential appointees are treated as beneficiaries and must be individuals.

f. **Rule Six**. The first distribution of plan proceeds must be made by December 31 of the year following the participant's death. This rule is not applicable, however, if the designated beneficiary is a spouse.

E. **Principle Five**. Not only must the tax rules be followed, but also the requirements of each plan sponsor must be determined. Failure to determine the rules of plan administrators and sponsors might result in naming the trust as a beneficiary but finding, following the death of the participant, that the plan administrator or sponsor will not pay out the plan proceeds over the minimum distribution rules with respect to the trust beneficiary. If such a result occurs, the proceeds may be paid out in one sum to the trust, possibly frustrating the deferral benefits that might occur if the payments were made pursuant to the life expectancy method.

F. **Principle Six**. Relative income tax deferral or estate tax savings must be considered. Although one might conclude that because the estate tax rates are generally higher than the income tax rates, estate tax savings should be a priority, the benefits of income tax deferral are significant. Consequently, if a trust is named as a beneficiary in order to fill up the credit shelter trust or prevent the surviving spouse from having full access to qualified plan proceeds, the rules described above for designating a trust as beneficiary must carefully be considered. Moreover, because distributions from a qualified plan to a trust are considered as principal under general trust accounting rules, the trust may be required to pay income tax at high rates on the distributions from the plan, unless the trust permits those distributions to be paid to the trust beneficiary as income. If the trust is a credit shelter trust, the income tax consequences to the trust, if the payments are retained in the trust, or the distributions to the beneficiary if he or she is the surviving spouse, obviate many of the primary reasons for creating a credit shelter trust in the first place. Those reasons are to prevent the trust property from being taxed in the survivor's estate, and, in many situations, to protect the trust property from creditors. If the plan proceeds are paid through the trust, which simply becomes a conduit, the surviving spouse will have those proceeds in his or her estate unless he or she dies well in advance of normal life expectancy.