Considerations when naming beneficiaries of retirement accounts

As you review your estate plans, it's important to think through the tax impact of passing on any retirement accounts to one or more beneficiaries. Unlike other inherited assets, retirement accounts will generally trigger an income tax liability to the inheriting beneficiary upon withdrawal from the plan. The extent to which the beneficiary can delay, or "stretch out," the time for paying the income tax will depend in large part on whether:

- you, as the participant, reached your "required beginning date" for taking lifetime withdrawals;
- your beneficiary qualifies as a "designated beneficiary," and
- any additional strategies, such as naming a trust as a beneficiary, have been implemented.

Before naming a beneficiary, consider the following issues with the help of your TIAA-CREF Advisor or estate planning attorney.

Understand available distribution options for each beneficiary

Leaving retirement assets to your spouse allows the option for your spouse to roll over the inherited plan into his or her own Individual Retirement Account (IRA), and then name beneficiaries who can potentially stretch the payout of the retirement account over their life expectancies. A spouse can also opt to take immediate distributions over his or her life expectancy.

Nonspousal individual beneficiaries can establish an inherited IRA to hold the inherited retirement accounts. The beneficiary can then stretch out the withdrawals from the inherited IRA by taking minimum withdrawals over his or her life expectancy.

In some instances, naming an individual beneficiary may not be appropriate if, for example, the beneficiary is a minor child, a spendthrift and/or having creditor issues, or is a special needs beneficiary. In such cases, using a trust may be more suitable and worth the extra complexity.

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Understand distribution rules and the significance of a designated beneficiary

Your beneficiary's withdrawal options depend, in part, on whether you were subject to taking required minimum distributions from your account, generally the year following the year in which you turn age 70½. Similarly, beneficiaries of an inherited retirement account must also take annual required minimum distributions, influenced by whether you reached the required beginning date at your death. If you die before your required beginning date, your plan assets must be distributed within five years of your death unless the benefits are left to a designated beneficiary (DB), in which case the benefits can be distributed over the DB's life expectancy.

If you die after your required beginning date, your plan assets must be distributed over your remaining life expectancy (based on IRS tables for this purpose) or over the DB's life expectancy. Each DB can choose.

> The term designated beneficiary has special meaning within the Internal Revenue Code, which defines it as "any **individual** designated as a beneficiary by the employee." This distinction is important because only a DB can take advantage of the life expectancy payout to stretch out distributions in order to maximally defer the payment of income tax. Other non-DB beneficiaries may be stuck with the five-year rule.

Understand technical requirements and tax issues when naming a trust as a beneficiary

A trust is not an individual and ordinarily would not qualify as a DB. However, if various requirements are met, the IRS will "look through" the trust and treat the individual beneficiaries of the trust as though the participant had named them directly. If the trust beneficiaries qualify as DBs, as a general rule, the benefits can be withdrawn and distributed over the life expectancy of the oldest trust beneficiary. If the trust does not qualify as a "look through" trust, and/or all the beneficiaries are not individuals, it may be stuck with the five-year rule.

To ensure the trust will qualify as a "look through" trust, certain technical rules that are relatively easy to comply with include:

- The trust must be valid under state law;
- The trust must be irrevocable as of the date of the participant's death;
- Certain documentation must be provided to the plan administrator; and
- The beneficiaries must be identifiable from the trust instrument.

If a trust passes all of these requirements, and all of the trust beneficiaries qualify as DBs, i.e., they are all individuals, then each individual beneficiary may make withdrawals over the life expectancy of the oldest trust beneficiary, or potentially over each of their respective life expectancies, without regard to the fact that the trust is the actual named beneficiary.

Conduit and accumulation trusts

Assuming the other requirements are met, one of the simplest ways to qualify as a "look through" trust is to include a provision that prohibits the trustee from accumulating any withdrawals from the inherited retirement account. In other words, the trustee must distribute the required minimum distribution and any additional withdrawals out to the primary beneficiary. This is referred to as a conduit trust. If a trust includes such a provision, the trustee can use the primary beneficiary's life expectancy to determine the withdrawal period, and does not need to consider other potential beneficiaries.

However, as appealing as it is to find some simplicity in this matter, sometimes a conduit trust doesn't make sense from an estate planning perspective. For example, if the primary beneficiary was receiving public benefits, mandatory distribution of the required minimum distribution (and any additional withdrawals) could cause the beneficiary to become ineligible for the public programs. Similarly, if the trust beneficiary was a spendthrift, had a substance abuse problem, or faced other issues, it may not be prudent to cause mandatory distributions out to him or her. In that case, consider an accumulation trust.

While it is possible to still qualify as a "look through" trust when the trustee has the power to accumulate withdrawals within the trust, the analysis becomes more complex. Essentially, the IRS requires that all *potential* beneficiaries be included when determining whether all trust beneficiaries are individuals and which of them is oldest.

Therefore, in order to use the life expectancy of the primary beneficiary, any contingent beneficiaries must be younger than the primary beneficiary. The results can sometimes produce unnatural planning, especially where the primary beneficiary is a minor child. For example, a participant would be precluded from naming his brother as a contingent beneficiary or else the brother's life expectancy becomes the measuring life for the withdrawal period, instead of the minor child's much longer life expectancy. The participant is also precluded from naming a charity as a contingent beneficiary. To do so would then cause inclusion of a non-individual beneficiary, thereby precluding the trust beneficiaries from qualifying as designated beneficiaries. Even if it is unlikely that the contingent beneficiary would receive property in accordance with the trust, they must still be considered a beneficiary in an accumulation trust.

Simplicity vs. complexity

Although naming individuals directly as the beneficiary of your retirement accounts is the simplest and easiest way to pass those assets, sometimes estate planning goals dictate the use of a trust despite the additional complexity. You can still obtain favorable income tax results by ensuring that the trust is structured properly for this purpose. Your estate planning attorney can guide you through making appropriate choices and adding the proper provisions to the trust.

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C2070 (12/11)