RETIREMENT DISTRIBUTIONS AND THE BEQUEST MOTIVE

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NATURE AND SIGNIFICANCE OF THE BEQUEST MOTIVE

- RETIREMENT AND ECONOMIC BACKGROUND
  - For most retirees, their main economic problem is having adequate retirement income they will not outlive
  - The logical solutions to this problem are use of life annuities, planned installment withdrawals, or a combination of life annuities and installment withdrawals. Often implied in such planning (particularly for life annuities) is that retirement assets will be consumed over the lifetimes of the retiree and his or her spouse (if any)
  - But commentators have noted the so-called “annuity puzzle” in that, despite the economic logic of life annuitization, relatively few retirees choose to do so
  - One reason (of several) for this “annuity puzzle” is the bequest motive

DEFINITION OF THE BEQUEST MOTIVE

- Use of income-tax-deferred (for most plans) or income-tax-free (for Roth plans) retirement assets as wealth transfer devices
- Planning to postpone (defer) taking distributions from these plans for long periods of time so that they continue to grow tax-deferred or tax-free over at least one generation (e.g., for children) beyond that of the original participant or owner and his or her spouse
- Use of tax-deferred retirement assets to make charitable gifts
- Implicit in such planning is that the original retiree and his or her spouse have sufficient wealth and other income that they do not need a significant part of their tax-advantaged retirement assets for retirement income

SIGNIFICANCE OF THE BEQUEST MOTIVE

Retirement Assets as a Percentage of Gross Estates for Federal EstateTax Returns Filed in 1992, 1995 and 2001

	Male Decedents	Female Decedents
1992	5.8%	2.3%
1995	7.8%	3.2%
2001	11.2%	5.5%

Sources: B.W. Johnson & J. M. Mikow, Statistics of Income Bulletin (Summer 1999) and M.B. Eller, Statistics of Income Bulletin (Summer 2005)

FORCES BEHIND INCREASING SIGNIFICANCE

- Increases in plan contribution, benefit, and compensation limits
- Increasing importance of individual account (defined contribution) type plans and lump sum distributions from defined benefit plans
- Increasing numbers of “high net worth individuals”
- Favorable economic and investment climate
- Favorable tax rules regarding distributions (particularly since 2002 IRS regulations)
- Emergence of the Roth IRA and Roth Plans

TAX POLICY AND ECONOMIC CONSTRAINTS ON WEALTH TRANSFER PLANNING

- Essential tax policy is that tax-favored (subsidized) retirement plans should be used for the participant's or owner's retirement income, not for pre-retirement consumption or for estate planning oriented wealth transfer
- In other words, retirement distributions should not be taken too early (generally before age 59½) or too late (generally should begin at age 70½)
- Tax law provisions to enforce these concepts are the 10 percent penalty tax on "premature distributions", age limits on distributions from some plans, and the minimum distribution rules and 50 percent penalty tax on "insufficient distributions"

MINIMUM DISTRIBUTION RULES

- Apply to qualified plans, 403(b) plans, IRAs and 457 plans
- Lifetime benefits for participants or owners (retirees)
  - Required beginning date (RBD)
  - Minimum required distributions (MRDs) based on Uniform Lifetime Table with recalculation which reflects joint life expectancies of owner and a theoretical person 10 years younger – produces low MRDs for many years
  - No MRDs for Roth IRAs during owner’s lifetime

MINIMUM DISTRIBUTION RULES (CONTINUED)

- MRDs after participant’s or owner’s death
  - Plan provisions control even if minimum distribution rules are more favorable
  - MRDs depend on who the beneficiary is and whether owner died before or after his or her RBD
  - Plan beneficiaries and “designated beneficiaries”
  - Surviving spouse as only designated beneficiary
  - Other individuals as only designated beneficiaries
  - No designated beneficary
  - Trusts as beneficiares
    - See through trusts
    - Conduit trusts
    - Other trusts
  - MRDs apply to Roth IRA beneficiaries

ECONOMIC AND OTHER CONSTRAINTS ON WEALTH TRANSFER PLANNING WITH RETIREMENT BENEFITS

- The economic (and investment) basis for wealth transfer planning with retirement benefits is income tax deferral (tax-free for Roth IRAs)
- Therefore, a threshold question is – how valuable is tax deferral?
- Also, what will be the future level of income tax rates – at distribution?
- Inflexibilties of tax-advantaged plans
- Possible conflicts with estate planning objectives

STRATEGIES FOR WEALTH TRANSFER PLANNING WITH RETIREMENT BENEFITS

- Spouse as designated beneficiary – “Stretch IRA” concept (classic strategy)
  - Assume retiree, his or her spouse, and their children; rollover to spouse’s IRA at retiree’s death
  - Potential deferral (minimum distributions) – retiree’s lifetime, spouse’s lifetime (using Uniform Table with recalculation) and children’s life expectancies (using Single Life Table with fixed period). For multiple beneficiaries, use oldest’s life expectancy or each beneficiary’s if separate accounts.
  - Potential deferral period in example in paper – 55 years (30 years for children)
  - Possible problems

STRATEGIES FOR WEALTH TRANSFER PLANNING (Continued)

- Other individuals (e.g., children) as designated beneficiaries – “Stretch IRA” concept
  - Potential deferral (minimum distributions) – beneficiaries’ life expectancies (using Single Life Table with fixed period). Multiple beneficiary rule applies.
  - Potential deferral period in example in paper – assume at retiree’s death (at age 86) children’s ages are 57 and 50 and their fixed period life expectancies are 27.9 years and 34.2 years
  - Possible problems

STRATEGIES FOR WEALTH TRANSFER PLANNING (Continued)

- Trusts as beneficiaries
  - Why have trusts as beneficiary?
  - Tradeoffs with trusts as beneficiaries
- Qualified Terminable Interest Property (Q-TIP) trusts as beneficiaries
  - See through but not a conduit trust
    - Potential deferral (minimum distributions) – surviving spouse’s life expectancy (using Single Life Table with fixed period)
    - Potential deferral period in example – assumes at retiree’s death (at age 86) surviving spouse’s age is 83 and her fixed period life expectancy is 8.6 years
  - Conduit trust
    - Potential deferral (minimum distributions) – surviving spouse’s life expectancy (using Single Life Table with recalculation)
    - Potential deferral period in example – for surviving spouse’s lifetime but probably little will be left for remainder beneficiaries (children)

STRATEGIES FOR WEALTH TRANSFER PLANNING (Continued)

- See through by-pass (credit shelter) trusts as beneficiaries
  - Surviving spouse and children are trust beneficiaries
  - Potential deferral (minimum distributions)
    - Oldest beneficiary’s (probably surviving spouse’s) life expectancy (using Single Life Table with fixed period)
  - Children (or other individuals) are trust beneficiaries
  - Potential deferral (minimum distributions)
    - Oldest beneficiary’s life expectancy (using Single Life Table with fixed period) unless subtrusts for each beneficiary
  - See through trusts for children or other individual beneficiaries – same situation as for by-pass trusts for children

STRATEGIES FOR WEALTH TRANSFER PLANNING (CONTINUED)

- Charitable remainder trusts (CRTs) as beneficiaries
- Individuals (spouse, children or others) are unitrust (CRUT) or annuity trust (CRAT) income beneficiaries, usually for their lifetimes
- A charity (e.g., the University of Pennsylvania) is remainder beneficiary after the last individual’s death. Remainder interest at creation must have actuarial value of at least 10% of initial corpus
- Potential deferral – over individual beneficiaries’ actual lifetimes
- Potential deferral period in example – 41 years

STRATEGIES FOR WEALTH TRANSFER PLANNING (CONTINUED)

- Lump-sum distributions from qualified retirement plans containing appreciated employer securities
- Net unrealized appreciation (NUA) on employer securities to the plan is not currently taxed
- When employer securities are subsequently sold (by the participant or his or her heirs), the NUA will be subject to capital gains tax rates then
- Non-employer-security plan balance can be rolled over to an IRA for deferral (a partial rollover)

CHARTIBLE GIVING OF RETIREMENT PLAN BALANCES

- CRTs
- Partial (or full) beneficiaries of non-Roth retirement accounts
  - Attractive assets to give because in gross estate for federal estate tax purposes and are income in respect of a decedent (IRD) for income tax purposes
  - Can be “cashed out” before application of minimum distribution rules
- Lifetime charitable rollovers
  - Created by Pension Protection Act of 2006 for 2006 and 2007 only

SUGGESTIONS FOR TAX POLICY

- Let's return to the original tax policy concept that income-tax-subsidized retirement accounts should be used for the participant's or owner's (and his or her spouse's) retirement income, not for wealth transfer purposes
- Some recent legislation actually seems to be working against this concept
- Specific ideas
  - Eliminate the NUA exclusion
  - Eliminate life expectancy payouts for individual nonspouse beneficiaries (with perhaps payouts over, say, 10 years)
  - Perhaps eliminate surviving spouse rollover to his or her own IRA (have "inherited IRA" payouts instead)
  - Minimum distribution rules should apply to Roth IRAs during an owner's lifetime
  - Do not extend lifetime charitable rollovers from IRAs beyond 2007
  - Perhaps use a single life table (with recalculation) for lifetime payouts