

# ESTATE PLANNING ADVISORY

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*A periodic publication of our Trusts & Estates Department, the Wiggin & Dana Estate Planning Advisory is intended to inform clients and other interested persons about issues and developments in the law affecting trust and estate administration and estate and tax planning for individuals and their families, fiduciaries, investment advisors and business owners. This issue focuses on distributions from IRAs and retirement accounts.*

## Retirement Assets – The New Rules Concerning Required Minimum Distributions

For years, some of the more challenging tax and estate planning problems have involved distributions from qualified retirement plans, §403(b) annuities, IRAs and other tax-advantaged retirement vehicles. Proposed regulations issued by the Internal Revenue Service in 2001, however, made sweeping changes, substantially liberalizing the required minimum distribution rules and other technical requirements. Final regulations have now been issued, making this a good time to review all estate plans that have sizable retirement account balances.

Among the key changes are the following:

- There is a single uniform table for calculating life expectancy for almost all lifetime required minimum distributions taken by the account owner or plan participant. The one exception is where the designated beneficiary is a spouse who is more than 10 years younger than the account owner or participant.
- There is no longer a requirement that the account owner or participant irrevocably elect to either recalculate or not recalculate the minimum distribution amount each year.
- There is no longer a requirement that the account owner or participant irrevocably elect to base withdrawals on either a single life or joint life expectancy.
- In most cases, there is no longer a need to have your beneficiary irrevocably designated by your “Required Beginning Date.”
- Because the timing rules have been

liberalized, it is now easier to make post-mortem charitable gifts from retirement accounts without jeopardizing income tax deferral opportunities for other beneficiaries.

- The rules applicable to trusts as beneficiaries have been clarified, making it easier to protect heirs with trust provisions while also preserving income tax deferral opportunities.

### Public Policy Considerations

To better understand the required minimum distribution rules, it helps to understand the policy behind them. Congress enacted provisions allowing for tax-deferred retirement plans to encourage businesses and individuals to set aside funds to support themselves, their employees and their dependents during their retirement years (and, not incidentally, to lessen the burden on the Social Security system). As originally planned, the tax benefits accorded these arrangements were not intended to be used by families as a means to accumulate wealth and pass it on to later generations. Thus, generally, the tax benefit only *defers to a later date* the imposition of income taxes on the amounts set aside. The account owner or plan participant must begin taking distributions (and paying income taxes on the amount distributed) no later than at his or her “Required Beginning Date” on a schedule that is based on the account owner’s or plan participant’s life expectancy. In other words, the entire system is geared toward providing income replacement during one’s retirement years, with any assets remaining at death to be promptly distributed.

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As a practical matter, however, many people have been able to accumulate sizable retirement accounts that are more than adequate to maintain their standard of living in retirement. Others have other sources of income during retirement and do not need to rely on their retirement savings for current expenses. Also, some people die before they are able to use their retirement benefits, while others are living far longer than the life expectancy tables would predict. All of this has led to a re-thinking of the necessity and desirability of having strict pay-out and required distribution rules.

## HIGHLIGHTS OF THE NEW REGULATIONS

Described in more detail in this Advisory are some of the rules concerning distributions during the lifetime of the account owner or plan participant; inherited account balances and distributions after death; and the use of trusts as beneficiaries.

### Applicability

The required minimum distribution rules apply to qualified plans (such as §401(k) plans and profit sharing plans), individual retirement accounts (IRAs), §403(b) annuity plans (such as TIAA-CREF) and §457(b) deferred compensation plans. An owner of an IRA may use the new uniform lifetime distribution table immediately. A participant in an employer-sponsored retirement plan must wait until the plan adopts the new rules before using the new uniform lifetime table. Many plans have been amended already; those that have not, should be amended by 2003. Roth IRAs are subject to the minimum distribution rules only after the death of the account owner.

Notably, the required minimum distribution rules are default rules. Generally, one can structure distributions to be larger than those mandated by the minimum distribution rules. Also, many qualified plans, §403(b) annuities and §457(b) arrangements call for distributions to be made in life annuity forms that are designed to meet the required minimum distribution rules automatically, in equal installments over a fixed period of time (e.g., 10 years) or in a single lump sum. These distribution provisions must be complied with, regardless of whether the required minimum distribution rules might permit a longer income deferral period.

The discussion below primarily addresses IRA

and defined contribution plan accounts (including §403(b) benefits). Planning flexibility is substantially reduced with respect to traditional defined benefit pension benefits and other benefits that must be paid in a life annuity form.

### Required Beginning Date

A person's required beginning date is the date by which a participant or account owner must begin taking at least a minimum distribution from his or her plan or account. One's required beginning date may vary depending on the type of plan or account.

- For IRA owners, your required beginning date is April 1st of the year after the year in which you attain age 70-1/2.
- For participants in employer-sponsored retirement plans, your required beginning date will depend upon the provisions of the plan and whether you are a 5% owner. A 5% owner is defined as someone who owns more than 5% of the outstanding stock or voting power of a corporation or any person who owns more than 5% of the capital or profits interest in an employer that is not a corporation. For a 5% owner, your required beginning date is April 1 of the year after the calendar year in which you attain age 70-1/2. For non-5% owners, your required beginning date is April 1st of the year after the year in which you attain age 70-1/2, unless the plan provides that you may defer commencing distributions until after you retire and you continue to work past age 70-1/2, in which case, your required beginning date is April 1st of the year after the year in which you retire.
- For Roth IRA owners, you do not have a required beginning date, although distributions must begin after your death, unless your account is rolled over to your spouse.

### Lifetime Distributions

Once you attain your required beginning date, you must begin to take distributions from your account or plan. If you take less than the amount calculated under the uniform table, you will be liable for an excise tax equal to 50% of the amount you failed to take as a taxable distribution. Most people also elect to take an initial distribution in the calendar year in which they attain age 70-1/2 (rather than by April 1st of the year after), so as to avoid having to take two distributions in the following year.

To calculate your annual minimum distribution amount from an IRA or an account balance plan, generally, you divide your account balance as of December 31st of the preceding year by the distribution period shown on the uniform table. For example, if you will attain age 72 in a given year, the distribution period is 25.6 years, so if your account balance was \$100,000 on December 31st of the prior year, your minimum distribution for the year you attain age 72 would be  $\$100,000/25.6 = \$3,906.25$ . The uniform table and the alternate table for distributions in a joint form with a spouse who is more than 10 years younger are found in Treasury Regulations and in IRS Publication 590 SUPP. (IRS Publications can be downloaded from [www.irs.gov](http://www.irs.gov).)

### **Inherited Accounts: Distributions after the Death of the Owner/Participant**

**Spousal Rollovers.** In keeping with the intent that retirement accounts are intended to provide income replacement during a worker's retirement, surviving spouses are given preferential treatment if named as the beneficiary of a retirement account. Except in cases where a joint and survivor annuity option was in place at the time of the owner/participant's death, a surviving spouse may usually elect to rollover a retirement account into his or her name, and thereafter treat it as if it were his or her own personal account. Among other things, this means that a surviving spouse can often defer taking required minimum distributions until he or she attains age 70-1/2, even if required minimum distributions had begun for the deceased spouse.

**Spousal Distributions.** Assuming no rollover is made, if a participant or account owner dies before his or her required beginning date, a surviving spouse must begin taking distributions on or before the later of the end of the calendar year immediately following the year of the participant's or account owner's death, or the end of the calendar year in which the participant or account owner would have attained age 70-1/2. If a participant or account owner dies after his or her required beginning date, the spouse must take distributions by December 31 of the year after the year of the participant's or account owner's death based upon the spouse's actual life expectancy as of the year of death, reduced by one for each subsequent year.

**Non-Spouse Beneficiaries.** When an individual other than a spouse is named as the beneficiary:

- required minimum distributions must commence to the beneficiary no later than the end of the year after the participant's or account owner's death. If this is not done, the entire account must be distributed within 5 years of the date of death.
- if the participant or account owner died before his or her required beginning date, the beneficiary may take required distributions in annual installments over a period not longer than the beneficiary's life expectancy.
- if the participant or account owner died after his or her required beginning date, the beneficiary must take required distributions in annual installments over a period not to exceed the longer of the beneficiary's

remaining life expectancy or the participant's or account owner's remaining life expectancy.

**If there is no Designated Beneficiary.** If a participant or account owner dies before his or her required beginning date, the entire account must be distributed no later than the end of the fifth year after the year of death. If the participant or account owner dies after his or her required beginning date, the applicable distribution period is the participant's or account owner's remaining life expectancy. Notably, in order to be a "Designated Beneficiary," the beneficiary must have a life expectancy. Thus, generally, if you name your estate or a charity as your beneficiary, you will be deemed to have no Designated Beneficiary for purposes of the required minimum distribution rules.

**Multiple Beneficiaries.** Generally, if a participant or account owner has more than one beneficiary, all of the beneficiaries must use the life expectancy of the oldest designated beneficiary to calculate required distributions. However, there is an exception to this rule if separate shares or accounts are established; in that case, each beneficiary's life expectancy is used to determine the minimum distributions for his or her separate share. The separate accounts must be established no later than the last day of the year following the calendar year of the participant's or account owner's death. Separate account rules do not apply where a trust is named the beneficiary of the account.

**Trusts as Beneficiaries.** Generally, a beneficiary without a life expectancy, such as a trust, triggers an accelerated distribution period. However, if done correctly, a trust can be the named beneficiary, with the trust beneficiary or beneficiaries serving as the Designated Beneficiary. This allows for the use of longer distribution periods based on the life expectancy of the trust beneficiary, or of the oldest trust beneficiary, if there are multiple beneficiaries. In order to qualify for this exception the trust must meet the following requirements:

- the trust must be valid under state law;
- the beneficiaries must be identifiable from the trust instrument and be individuals;
- the trust must be irrevocable or become irrevocable upon the death of the participant or account owner; and

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- documentation must be provided to the plan administrator or IRA custodian no later than October 31 of the year after the year of the participant's or account owner's death.

This technique can be particularly useful in second marriage situations. For example, a "QTIP" marital trust for the surviving spouse can receive retirement distributions over the surviving spouse's lifetime and then pay over any remaining assets to the children of a first marriage.

#### **Post-Mortem Planning Opportunities**

Among the most welcome changes under the

new regulations are provisions giving greater flexibility to executors and trustees to eliminate on-going account obligations to multiple beneficiaries by disclaimer or distributions. This can enable remaining beneficiaries to take advantage of longer distribution periods. For example, if an account owner named a charity and a family member as beneficiaries, the charity's share could be distributed promptly, leaving the family member as the sole Designated Beneficiary, who could then take distributions over the applicable life expectancy. If this were not done, because the charity had no life expectancy, the entire account would have to be distributed within 5 years of the account owner's death.

## IN FOCUS

### Legislative Tax Changes in Connecticut

In connection with the 2002-2003 budget act, the Connecticut General Assembly enacted several revenue enhancement provisions, two of which are highlighted below.

#### **Business Entity Tax – Limited Liability Companies and Limited Partnerships**

Effective July 1, 2002, and applicable *retroactively* to taxable years commencing on or after January 1, 2002, the State of Connecticut now imposes an annual tax of \$250 on the following entities, if the entity is required to file an annual report with the Connecticut Secretary of the State: S corporations, limited partnerships, limited liability partnerships, and limited liability companies that are treated as partnerships (if it has two or more members) or disregarded as an entity separate from its owner (if it has a single member). The tax is payable to the Department of Revenue Services by the entity on or before the fifteenth day of the fourth month following the close of each taxable year of the entity determined for federal income tax purposes. If your entity's tax year ends on December 31, the tax would be due on April 15. Clients who have formed Connecticut entities such as LLCs or FLPs which are not being utilized should consider dissolving them to avoid the imposition of this tax each year.

#### **Gift Tax Phaseout Postponed**

In 2002, the Connecticut gift tax exemption for taxable gifts was scheduled to increase to \$50,000. Effective July 1, 2002 and applicable *retroactively* to gifts made on or after January 1, 2002, the gift tax rate reductions for calendar years 2002 and 2003 have been postponed. As a result, the gift tax schedule in effect for 2001 will remain in effect through 2003. This means that if you make taxable gifts in 2002 and 2003 in excess of \$25,000, the entire amount from the first dollar will be subject to Connecticut gift tax. In other words, if your total taxable gifts are \$24,000, the Connecticut gift tax due would be \$0, but if your total taxable gifts are \$26,000, the Connecticut gift tax due of \$270 would be based on your total taxable gifts (not just the excess over \$25,000). This legislation is particularly unfortunate for those individuals who made taxable gifts early in 2002 between the amounts of \$25,000 and \$50,000 and did not expect to pay Connecticut gift tax.

Assuming no further legislative action, higher exemption amounts are scheduled to be effective as follows: \$50,000 in 2004, \$75,000 in 2005, \$100,000 in 2006, \$950,000 in 2007, and \$1 million in 2008 and thereafter.