

Beneficiary Designations 101

There are two things you should never watch while they are being made: one is *sausage* and the other is *tax law*. The same can be said of most *tax law changes*. They often result in more complex rules and regulations, not to mention stiff penalties for non-compliance.

That said, the IRS *has simplified* its regulations governing



distributions from IRAs and other qualified retirement plans (QRPs) in recent years. In form, these *final regs* are intended to liberalize and lengthen payout options during the lifetimes of plan participants and, after their deaths, for their designated beneficiaries under such plans. In substance, however, there are many common pitfalls you need to avoid regarding the designation of beneficiaries for your QRP ... or your retirement assets may either plunge into the tax abyss quicker than otherwise required, or even wind up with the wrong beneficiary.

Disclaimer: This article is not an exhaustive treatise on this subject

matter. Consider it a brief primer regarding the unique nature of QRPs and an advance warning to avoid two common pitfalls regarding their post-mortem transfer.

Unique Assets

QRPs are unique assets. Their fundamental purpose is to help plan participants send some of today's dollars ahead for tomorrow's retirement. [Note: QRPs were never intended as vehicles to build large estates for heirs.] To facilitate their fundamental purpose, QRPs enjoy preferential tax treatment during their creation and as they

INSIDE

In this issue of our newsletter we shift our attention to one of the most critical, and often overlooked, aspects of retirement planning. Our lead article considers common pitfalls in the selection of a *designated beneficiary*.

On page three we explain the pension payout options you need to know now, so you can protect your financial security in retirement. You will want to make sure you (and your friends) have made appropriate arrangements before it is too late.

accumulate. They are created with pre-tax dollars and then grow tax-deferred. Consequently, through the tax-deferred annual compounding of their interest and dividends, QRPs often grow to produce rather impressive account balances. While they enjoy preferential tax treatment during their creation and accumulation stages, *all distributions* from QRPs are fully taxed as *ordinary income* (except when made to a charitable beneficiary).

Here is where plan participants and the IRS have competing goals. Plan participants often want to delay distributions from

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their QRPs and enjoy the tax-deferred compounding as long as possible. The IRS, on the other hand, requires plan participants to begin taking *Required Minimum Distributions (RMDs)* and to begin paying taxes on their distributions at ordinary income rates no later than April 1st of the year after which they turn age 70½ (and each year thereafter).

According to Benjamin Franklin, the only two certainties in life are *death and taxes*. Upon the death of a plan participant, the final regs determine how quickly the remaining QRP must be paid and taxed to the designated beneficiary(ies) based on a complex variety of factors. Now, here are two common pitfalls to avoid.

Failure to Designate

The failure to designate a beneficiary is the most common mistake you can make regarding your QRP. Period.

Consequences: 1) If you die after your RMD, then the balance of your QRP must be paid over your remaining life



expectancy, using your account balance at the end of each year, your age at death (+ 1 thereafter) and the applicable divisor found in the *Single Life Table (SLT)* in IRS Publication 590; or 2) Even worse, if you die before your RMD, then the balance of your QRP must be paid out within five years of your death.

Solution: Designate a loved one as the beneficiary, then either way your QRP may be withdrawn in a manner more favorably than if you fail to designate any beneficiary. This simple move can save thousands of dollars in taxes.

Failure to Re-Designate

If you are divorced, will your ex-spouse inherit your QRP if provided by your employer under the Employee Retirement Income Security Act of 1974 (ERISA)?

Consequence: If you fail to replace your ex-spouse, then they may inherit your ERISA QRP, even if the laws of your state automatically extinguish their interest in your estate. [See the United States Supreme Court decision in *Egelhoff v. Egelhoff*, 121 U.S. 1322 (2001) for the case facts and ruling.]



Ask Yourself ...

These Questions Regarding "Beneficiary Designations 101."

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|---|-----|----|----------|
| 1. I understand that IRAs and other Qualified Retirement Plans (QRPs) are unique assets, requiring careful planning to avoid unnecessary taxation upon my death. | Yes | No | Not Sure |
| 2. I understand that the failure to designate a beneficiary (and even a successor beneficiary) for my QRP can enrich the IRS at the expense of my loved ones. | Yes | No | Not Sure |
| 3. While I cannot foresee when I will die, I understand that my failure to designate a beneficiary will have greater adverse tax consequences if I die <u>before</u> I begin taking Required Minimum Distributions. | Yes | No | Not Sure |
| 4. I understand that, if I am divorced and my ex-spouse is still the designated beneficiary of my ERISA QRP, then my ex-spouse may inherit such funds upon my death, despite any state laws to the contrary. | Yes | No | Not Sure |
| 5. I generally find the whole prospect of planning (on my own) for the protection and preservation of my QRP rather overwhelming. | Yes | No | Not Sure |

PENSION MAXIMIZATION

That long-awaited day will soon be a reality. Yes, your retirement ship is almost ready to set sail. Before you climb aboard, however, there are a few crucial decisions to make regarding your pension, especially if you are married. To assist you in this process, we will consider your general options, propose a common win-win alternative and then temper that alternative solution with some due diligence.

Your General Options

If you have a defined benefit plan (i.e., a retirement plan through your employer that will pay a monthly income to you), then you will be asked how you want the payouts calculated. For example, do you want payouts to be calculated to last as long as you live (*single life option*) or until the later of your death or the death of your spouse (*joint and survivor option*)? This decision must be weighed very carefully.

If you choose a single life option, then the monthly payout will be higher ... but it will end upon your death. This could leave your surviving spouse without needed income. On the other hand, if you choose the joint and survivor option, then the monthly payout will be reduced to cover the actuarial risk of the payouts extending over an additional life. Nevertheless, with the joint and survivor option, if your spouse predeceases you, then you are stuck with the lower payout for the rest of your life.

A Win-Win Alternative

Would you prefer to have the higher payout afforded by the single life option, while providing for the continuation of at least that payout amount for your spouse should you predecease? If so, then you will need to determine the present value of a lump sum

invested at a safe interest rate to generate that payout amount. Question: Once this lump sum is determined, how is it most efficiently created?

Answer: life insurance. In fact, life insurance is the only financial tool that provides a predetermined lump sum of cash at just the moment it is needed. Remember, however, that while the policy death benefit is *income tax-free* when paid in a lump sum, it is part of your estate value for estate tax purposes. Nevertheless, even the estate taxation of life insurance death benefits can be avoided by careful legal planning.

Due Diligence

Unfortunately, more life insurance is *sold* than is *bought*. Accordingly, when considering the purchase of this important financial asset, make sure the insurance company is *financially stable*, that the insurance premiums will be *affordable* (regardless of changes in interest



rates) and that you are healthy enough to be *insurable*. Never, ever make any irrevocable decision regarding your retirement finances without properly weighing the pros and cons!

Conclusion

Retirement should be a time to enjoy the fruits of your labors. Careful planning now can help ensure greater financial security over the long haul.

POCKET PROTECTORS

Tips to help you protect your pocket!

Retirement Distribution Help

If you want to watch your computer melt before your very eyes, then use your favorite internet search engine to search the world wide web for information about "retirement distribution planning." You will register in excess of 640,000 hits! That can be overwhelming, especially when you are looking for practical, plain-English answers.

Here are three tips to help you navigate these important decisions. First, since your retirement funds represent just that—your retirement funds—be very selective regarding the financial advisors you hire to help you make it last (and maybe even grow). If you do not have a financial advisor, contact us and we will help you make the right connections. Second, make sure your estate plan is coordinated with your financial plan ... and that both are coordinated with your retirement distribution plan. Third, and finally, do not try to go it alone when it comes to these important decisions. Otherwise, you may pay too much in taxes, disinherit your loved ones or even run out of money.

“Everything
in the world may
be endured
except continued
prosperity.”

— Johann
Wolfgang
von Goethe

Note: Nothing in this publication is intended or written to be used, and cannot be used by any person for the purpose of avoiding tax penalties regarding any transactions or matters addressed herein. You should always seek advice from independent tax advisors regarding the same. [See IRS Circular 230.]
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