newsletter

Retirement Plans: Basics of Naming a Beneficiary

Income tax deferral is a key advantage of many retirement plans. It can be maximized through an appropriate beneficiary designation—a step that might occur during estate planning. This article introduces some basic principles and terminology.

Essential Terminology

• ***Retirement Plan***—Various tax-deferred retirement accounts, including IRAs, SEPs, ESOPs, and § 401(k), § 403(b), Keogh, profit sharing, defined benefit, target benefit, money purchase, and stock bonus plans. Income tax is usually deferred until funds are withdrawn. This "fertilizes" retirement funds, helping them to grow faster.

• ***Participant***—An individual who deposits and keeps funds in a retirement plan.

• ***Designated Beneficiary (DB)***—An individual designated to receive funds from a retirement plan upon death of the participant. This is a special status. Not everyone named to receive a decedent's retirement plan qualifies as a DB. For those who do qualify as DBs, there are special tax deferral advantages.

• ***Early Withdrawal Penalty***—A 10% penalty incurred by participants who take withdrawals from retirement plans before reaching age 59 1/2. The penalty is owed, in addition to income taxes triggered by the withdrawal. (A few exceptions provide that withdrawals can be taken before age 59 1/2 without penalty.)

• ***Required Beginning Date (RBD)***—The date on which a participant must either begin taking minimum required distributions (MRDs) from a retirement plan or pay a steep penalty. The RBD is usually April 1 of the year following the year when the participant reaches age 70 1/2. For participants in 403(b) plans, the RBD is April 1 of either the calendar year following the year when the participant turns 70 1/2 or the calendar year when the participant retires, whichever occurs later. IRC § 401(a)(9)(c)(i). A similar latter-day RBD applies to participants in 401(k) plans who, in the plan year ending in the year when they turn 70 1/2, own no interest or less than a 5% interest in the employer sponsoring the retirement plan.

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• ***Minimum Required Distribution (MRD)***—The minimum that must be taken annually from a retirement plan by a participant or beneficiary in order to avoid a penalty. Failure to take full MRD causes a 50% excise tax on the amount that should have been distributed but was not. MRDs are prorated over either single or joint life expectancy of the participant and the beneficiary. The best deferral of income tax occurs when MRDs are low and slow— i.e., spread over joint life expectancy.

• ***Mandatory Distribution of Incidental Benefits (MDIB) Rule***—A rule that treats all DBs (except spouses) as no more than 10 years younger than the participant for purposes of calculating, during a participant's lifetime, the joint life expectancy of the participant and the beneficiary. This limits the advantage of naming a child as a DB. But it does not limit naming a spouse, even a much younger spouse, as sole DB.

• ***Five Year Rule***—An unfortunate rule that applies when a participant dies before an RBD without having named a DB. In this situation, there are no MRDs. Instead, all funds must be completely withdrawn—and taxed—within five years of the participant's death.

Four Suggestions

Make an early designation. A DB should be named *before* the participant passes the RBD. A brief comparison of results illustrates why.

First, suppose that a participant dies before reaching the RBD. If the participant has not named a DB, then the Five-Year Rule applies—all funds must be distributed (and taxed) within five years of the participant's death. By contrast, if a DB had been named then funds could have been paid out in MRDs calculated over the life expectancy of the oldest DB—a period usually longer than five years.

Suppose instead that a participant lives past the RBD. Without a DB named on or before the RBD, MRDs must be taken over the participant's life expectancy as determined at the RBD. By contrast, if a DB had been timely named, then MRDs could have been taken over the joint life expectancy of the participant and the oldest DB—a period usually much longer than the participant's single life expectancy. Notice that joint life expectancy calculations begin during the participant's lifetime. The participant, as well as the DB, can take smaller withdrawals and therefore maximize tax-free growth of the retirement account.

What is at stake is a limited window of opportunity. Estate planners can help by inquiring whether clients with retirement plans have passed their RBDs. Clients who have not yet passed this date should be encouraged to name DBs before the window of opportunity closes.

Consider naming spouse as DB. In most cases, married participants should name their spouses as DBs. There are many advantages. First, this is what couples often want. Second, only a surviving spouse DB is permitted to defer distributions until reaching age 70 1/2. Non-spouse DBs are required to begin withdrawals in the year following the death of the participant, regardless of age. Third, MRD joint life expectancy calculations are not limited by the MDIB rule when the sole DB is the participant's spouse, a significant advantage for participants married to much younger partners. Fourth, in taxable estate plans it is usually desirable for retirement plans to go to the marital portion, so that income taxes on retirement plan distributions do not deplete the participant's credit shelter.

Fifth, naming the spouse as the DB opens a special opportunity—a spousal rollover IRA. In brief, the surviving spouse can elect to "roll over" the participant's account into an account in his or her own name. The surviving spouse can name his or her own DBs and can calculate new MRDs based on the joint life expectancy of the surviving spouse and the oldest beneficiary (e.g., child). The surviving spouse is also permitted to defer all withdrawals until reaching age 70 1/2. This usually defers income taxes much longer than would occur under the joint life expectancy of the original participant and spouse.

Situations may exist in which naming the spouse as the DB might conflict with other estate planning objectives. For example, some taxable estates may not have sufficient other assets to fund the participant's credit shelter amount. In blended family situations, naming the spouse as the DB may fail to protect children from other relationships. In some cases the participant may want to name a qualified charity as beneficiary in order to permanently escape income taxation of retirement funds. Finally, if the surviving spouse needs continued access to poverty-based public entitlement programs such as Medicaid or Supplemental Security Income (SSI), naming the spouse as the DB may be counterproductive. These topics are covered in separate articles in this newsletter.

Name alternate DBs. The exceptions just cited point to a quandary—sometimes the optimal beneficiary is not apparent during the participant's lifetime. A response to this quandary may be to name alternate DBs. Through qualified disclaimers, it may be possible to "boot up" whatever distribution scheme seems best following the participant's death.

Beware naming nonindividuals as beneficiaries. With limited exceptions, only *individuals* are recognized as DBs. (The rationale is that only individuals have life expectancies for MRD calculations.) Therefore, naming a nonindividual as beneficiary is treated as a failure to name any DB. Doing so will either trigger the Five-Year Rule (if the participant died before the RBD) or confine MRD calculations to the single life expectancy of the participant (if the participant died after the RBD). Either way, the result will be higher, faster MRDS—and loss of tax deferral that might otherwise have been available.

Estates trigger a negative and controversial application of this rule. The Internal Revenue Service regards estates as nonindividuals, even when all inheritors are individuals. So, naming an estate as the beneficiary is treated as failure to name any DB at all—with resultant waste of deferral opportunity. *But see* Natalie B. Choate, *Life and Death Planning for Retirement Benefits: The Essential Handbook for Estate Planners* 30 (3d ed 1999) (criticizing IRS position).

Trusts elicit a more favorable variation of this rule. If certain rules are followed, retirement plans can be made payable to trusts, with MRDs calculated on the joint life expectancy of the participant and the oldest trust beneficiary. Jonathan Levy explains the details in a separate article in this issue.

Charities involve a third set of considerations. It may seem unimportant that a qualified charity (named as a beneficiary) is a nonindividual, since organizations that are tax-exempt do not need tax deferral. But the existence of a charitable (or other nonindividual) beneficiary may accelerate MRDs for everyone else–for example, the participant and any co-beneficiaries who are individuals. In fact, even the charity loses, to the extent that MRDs to the participant are accelerated. Erik Schimmelbusch's article in this issue provides a closer look at making retirement benefits payable to a charity.

Conclusion

Estate planners should reckon with retirement plans. By making an appropriate beneficiary designation the participant can maximize income tax deferral for both the participant and his or her beneficiaries.

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Making Retirement Benefits Payable to Trusts

In 1997, the IRS revised Prop Treas Reg § 1.401(a)(9)-1 to permit revocable trusts to be named as beneficiaries of retirement plan accounts, including IRAs. 62 Fed Reg 67,780 (1997). As before, irrevocable trusts may also be named as retirement plan beneficiaries. This article provides an overview of when to name a trust as beneficiary and how to make such a designation.

When It Makes Sense to Name a Trust as the Beneficiary

If one jumps through the hoops in naming a trust to receive benefits, the trust qualifies as a "designated beneficiary" of the retirement plan. This is an exception to the general rule that only individuals may be designated beneficiaries. If the trust so qualifies, the estate plan can preserve assets in trust while stretching out required distributions to defer income taxes. In particular, if the employee[1] dies after the required beginning date, minimum required distributions ("MRDs") are based on the joint life expectancy of the employee and the oldest trust beneficiary. If the employee dies before the required beginning date, MRDs are based on the life expectancy of the oldest trust beneficiary.

Naming trusts as beneficiaries in this manner is not a panacea. These trusts create complexity for family members and technical traps for lawyers. Using trusts for retirement plan benefits makes the most sense when a client's family includes minors, spendthrifts, or children in unstable marriages or if a retirement plan is the only asset available to fund a credit shelter trust. However, for many married clients, the better tack is simply for each spouse to name the other as beneficiary. If the nonemployee spouse is the survivor, then he or she can roll over the account to a new IRA and name new designated beneficiaries (usually children or grandchildren), with years or decades more of income tax deferral. In contrast, with most trusts for retirement plan benefits, the surviving spouse cannot elect a rollover. For example, the IRS does permit spousal

[1] For simplicity, "employee" here refers both to participants in retirement plans and IRA owners.

rollovers when the surviving spouse is sole trustee (or can remove the co-trustee) and, by the terms of the trust, can demand payment of the entire retirement plan balance. See PLR 199943054 (Aug. 5, 1999).

Requirements Under the Revised Proposed Regulation

The basic four requirements. A trust qualifies as a designated beneficiary if, as of the later of (1) the date the trust is named as beneficiary or (2) the required beginning date, and at all later times while the trust is a plan beneficiary, the following requirements are satisfied:

- The trust is valid under state law or would be but for the fact that there is no corpus.
- The trust is irrevocable or will become revocable, by its terms, upon the participant's death.
- Trust beneficiaries are identifiable from the trust instrument within the meaning of Prop Treas Reg § 1.401(a)(9)-1, Q&A D-2.
- Suitable documentation has been timely furnished to the plan administrator.

The third and fourth requirements are discussed in more detail below, in reverse order.

Documentation. Employees have the choice of furnishing plan administrators with either a copy of the trust or a certification of the trust. However, a plan may elect to limit employees to furnishing either the trust document itself (which is easier for most employees) or a certification of the trust (which is easier for plan administrators and therefore more likely). The details are contained in Prop Treas Reg § 1.401(a)(9)-1, Q&A D-7. If the employee survives until the required beginning date, he or she must furnish either (1) a copy of the trust instrument (along with a promise to provide copies of later trust amendments as they occur) or (2) a trust certification (with a similar promise of updates if the trust is amended, plus a promise to provide a copy of the trust itself on demand). The heart of the certification is a list of all trust beneficiaries, including contingent and remainder beneficiaries "with a description of the conditions on their entitlement."

If the employee dies before the required beginning date, the trustee must provide either (1) a copy of the trust named as retirement-plan beneficiary, as of the date of death, or (2) a trust certification similar to that described above. Here, either disclosure (1) or (2) is due by the end of the ninth month beginning after the date of death.

It is unclear who must receive these disclosures if the retirement plan is an IRA. Arguably, it is enough for the IRA owner to retain a copy of the trust document and its amendments. However, the safest course is to make the disclosures to the IRA trustee, custodian, or issuer.

Trust Beneficiaries Must Be Identifiable from the Trust Document

The basic rule is straightforward: Trust beneficiaries are identifiable if they are named or can be determined as of the applicable time. The life expectancy of the oldest beneficiary is then used to measure MRDs. Behind this simple rule lurk some potential traps. Three likely ones involve contingent remainder beneficiaries, estate expenses, and spray powers or powers of appointment. *See* Natalie Choate, *Life and Death Planning for Retirement Benefits* 241-73 (3d ed 1999); Virginia Coleman, *Preserving the "Designated Beneficiary" if a Trust Is Named as Beneficiary of a Qualified Plan or IRA*, 25 ACTEC Notes 137 (1999).

It is difficult to tell which contingent remainder beneficiaries count. The stakes are high, since the presence of an ineligible remainder beneficiary, such as a charity or a decedent's estate, taints the entire trust, so that the employee is deemed to have no designated beneficiary. The proposed regulation, in opaque fashion, excludes a beneficiary whose "entitlement to an employee's benefit is contingent on the death of a prior beneficiary." Prop Treas Reg § 1.401(a)(9)-1, Q&A E-5(e)(1). This apparently permits one to ignore beneficiaries who take only if the preceding beneficiaries die prematurely, before reaching their life expectancies. Thus, if Wilbur leaves his IRA and other assets in trust to "my spouse Charlotte for life and then outright to our children Joy, Aranea and Nellie who survive me, and if none survive to the National Arachnid Charitable Foundation," the charity is not counted as a beneficiary. Children normally outlive their parents. Similarly, one can ignore contingent remainder beneficiaries named in a trust that requires the trustee to pay (rather than retain within the trust) each year's MRDs to one or more named individuals during the life expectancy of the oldest. If one such individual

survives the measuring life expectancy, the retirement plan will be exhausted.

The trust document should prohibit retirement plan assets from being used to pay estate taxes, debts, and expenses. Otherwise, the IRS may argue that the estate, a nonindividual, is a beneficiary. If there are not enough other assets to pay taxes and expenses, an alternative is to earmark a separate account in a retirement plan (or a separate IRA) for that purpose.

If the trustee has a spray power, or a beneficiary has a power of appointment, the potential takers under the power should be limited to the employee's spouse, children, or descendants. This minimizes the risk of an IRS challenge to the trust for permitting nonindividual beneficiaries or a change of beneficiaries after the employee's death. See Prop Treas Reg § 1.401(a)(9)-1, Q&A E-5(f). Either challenge would leave the employee without a designated beneficiary.

QTIP Trusts

With a qualified terminable interest property ("QTIP") trust, a person may leave a life interest in property to his or her spouse while keeping control of the ultimate disposition of the property. Under IRC § 2056(b)(7)(B)(ii), it is sufficient that (1) the surviving spouse is entitled to all income from the property, payable at least annually, and (2) no person may appoint any part of the property to any person other than the spouse. QTIP trusts are often used in second marriages to ensure that assets ultimately pass to children of the first marriage.

Until recently, IRS rulings suggested that when QTIP assets consisted of retirement plan accounts, both the trust and the retirement plan had to require that all plan income be paid annually from the plan to the QTIP trust. See Rev Rul 89-89, 1989-2 CB 231; TAM 9220007 (Jan. 30, 1991). However, this year the IRS relaxed its position. Rev Rul 2000-2, 2000-3 IRB 305. It is now sufficient if the trust complies with IRC § 2056(b)(7) and the surviving spouse can compel the trustee to withdraw plan income annually. Thus the spouse may elect to accumulate, within the retirement plan, plan income that exceeds the MRD.

The IRS's new, gentler treatment of QTIP trusts does not eliminate the deadly duo of the MRD rules and the QTIP rule giving the spouse the right annually to all trust income. MRDs will still exhaust the retirement plan if the spouse reaches his or her life expectancy. Even if the spouse permits the trustee to retain plan distributions, earnings on the retained sums will be taxed at high trust rates. And, as noted earlier, the spouse will be ineligible to roll over the retirement plan to his or her own IRA.

In light of these problems, it may be better to split a client's retirement plan, with the second spouse named as beneficiary for one part and the children of the first marriage named as beneficiaries of the other part. Alternatively, the client might leave the entire retirement plan to the spouse, while buying cash-value life insurance to fund an inheritance for the children. See Emily Karr, *Distributions of IRAs or Qualified Retirement Plans to or for the Benefit of Spouse: Comparison of Outright Dispositions and QTIP Trusts*, OR EST PLAN & ADMIN SEC NEWSL (Apr. 1998).

Conclusion

Naming a trust as the beneficiary of a retirement plan can be helpful or essential for some clients. This article describes the broad features of the legal topography. However, if you wish to venture further with clients, be sure to study closely the crags and crevasses of the proposed regulation and IRS rulings. *See Estate Planning for Retirement Benefits with Natalie Choate* (OSB CLE 2000); Louis A. Mezzullo, *An Estate Planner's Guide to Qualified Retirement Plan Benefits* (2d ed 1998); Noel Ice, *Hot Topics and Recent Developments in the IRA/Qualified Plan Distribution Arena*, 25 ACTEC Notes 226, 233-45 (1999).

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Charitable Planning with Retirement Benefits

With the combined tax effects of federal estate tax and income tax to which retirement plan assets can be subject, retirement plans are natural targets for charitable planning; both taxes can be avoided or reduced through charitable gifts. As discussed below, several charitable planning techniques are available to retirement plan owners. This article assumes a familiarity with the basic rules and terminology pertaining to retirement plans. For an overview of those rules and terms, see Bob Casey's article in this issue.

The Retirement Plan as a Tax Trap

Since retirement plan assets are usually subject to income tax when plan assets are distributed, the combined effects of federal and state income taxes (at combined rates of up to 50%) and estate tax (at rates of up to 55%) can consume most of the plan assets, leaving little for the beneficiaries. Not realizing the impact of these combined taxes, many individuals accumulate large balances in their IRAs or other retirement plans that far exceed their personal needs.

Many clients have charitable inclinations and include charitable gifts as some component in their estate plans. When clients with large retirement plans are faced with the prospect of leaving such a large portion of the plan assets to the government and a very small portion to their beneficiaries, they are quickly motivated to make charitable gifts a larger part of their estate plan.

Lifetime Gifts

Several restrictions apply to lifetime gifts of plan assets to charity. These restrictions include the requirement that plan assets be distributed only to the plan owner, implicitly requiring that the plan owner be taxed on all lifetime distributions. With limited exceptions, retirement plan benefits cannot be assigned or transferred other than through the beneficiary designation and transfer process at the plan owner's death. In addition, if distributions are made before the plan owner reaches the age of 59 1/2, the distributions are subject to the 10% early distribution penalty.

Notwithstanding the restrictions discussed above, a lifetime gift of retirement plan assets may be desirable in some situations. For example, a plan owner who must take minimum distributions because he or she has passed the required beginning date may want to donate some or all of the distributions to charity. The donor can offset the income tax liability for the distribution with an income tax deduction for the charitable gift. Depending on the donor's circumstances, however, the amount of that deduction may be limited by the percentage limitations on charitable deductions, limitations on itemized deductions, and other factors.

Proposals have been made in Congress to permit gifts of retirement plan assets to charities or charitable trusts without subjecting the donor to income tax liability. For a discussion of efforts to have such legislation enacted, see Natalie B. Choate's, *Life and Death Planning for Retirement Benefits* 287-88 (3d ed 1999), and Frank M. Burke's, *Why Not Allow Lifetime Charitable Assignments of Qualified Plans and IRAs?* Tax Notes 121 (July 7, 1997). Until such legislation is passed, however, charitable planning options for retirement plans tend to be limited to testamentary dispositions.

Gifts at Death

The standard method of leaving retirement plan assets to charity at death is to name the charity as a beneficiary of the retirement plan. Alternatively, a plan owner can name a charitable remainder trust as beneficiary. In either case, the charitable beneficiary can withdraw all of the assets from the retirement plan without incurring income tax liability, and the decedent's estate receives a charitable deduction based on the fair market value of the assets (although in the case of a charitable remainder trust the deduction is for the present value of the remainder interest). See Choate, *supra*, at 275 for a discussion of the charitable remainder trust as beneficiary of a retirement plan.

If a charity or charitable remainder trust is named as primary beneficiary as of the required beginning date, the plan owner will not be able to have minimum distributions calculated over the joint life expectancy of the plan owner and a designated beneficiary, since a designated beneficiary can only be an individual. One method of avoiding this problem is to name an individual (e.g., a spouse) as primary beneficiary and a charity or charitable remainder trust as contingent beneficiary and rely on the primary beneficiary to disclaim the benefits at the plan owner's death. Minimum distributions can then be calculated over the joint life expectancies of the plan owner and the primary benefi-

ciary, and the retirement plan assets can pass to charity. This method can be very effective but gives the primary beneficiary the ultimate say in determining whether the charitable plan is carried out. In addition, disclaimers always present a risk that the individual receiving benefits will withdraw a portion of the benefits or otherwise exercise ownership over them so that the ability to disclaim will be inadvertently lost.

Frequently a plan owner desires to leave a portion of the plan assets to one or more individuals and another portion to charity. If not structured properly, this seemingly harmless distribution plan can lead to problems. Under IRS Proposed Regulations, if any of the beneficiaries of a retirement plan is not an individual, the plan will be deemed to have no designated beneficiary. This would ordinarily require that if a charity is designated as a beneficiary (even as to a small portion of the plan benefits) together with one or more individuals, then distributions to an individual beneficiary cannot be made over the life expectancy of that beneficiary but must be taken over a period of five years. Prop Treas Reg § 1.401(a)(9)-1, Q & A E-5(a)(1). The proposed regulations contain an exception to this rule, however. If the retirement plan is divided into "separate accounts," then each beneficiary's life expectancy may be used for that beneficiary's share of the plan benefits. The proposed regulations define a "separate account" as "a portion of an employee's benefit determined by an acceptable separate accounting including allocating investment gains and losses, and contributions and forfeitures, on a pro rata basis in a reasonable and consistent manner between such portion and any other benefits." Prop Treas Reg § 1.401(a)(9)-1, Q & A H-2A(a). Some commentators and practitioners believe that the separate account exception can be met if a beneficiary designation lists beneficiaries' interests in terms of a fraction or percentage, since the proposed regulations require that the separate accounts be established as of the plan participant's date of death and a physical separation of the plan can be made following death that is effective as of the date of death. See *Estate Planning for Retirement Benefits with Natalie Choate* 1-8 (OSB CLE 2000), and Louis A. Mezzulo, *An Estate Planner's Guide to Qualified Retirement Plan Benefits* (2d ed 1998).

A physical separation of IRA accounts during lifetime should satisfy the proposed regulations and is the conservative planning approach. Furthermore, if the plan participant desires to name a charity as one of several beneficiaries on or after the required beginning date, he or she will probably need to create physically separate accounts, since the separate account rules under the proposed regulations require that the accounts be established as of the required beginning date. Prop Treas Reg § 1.401(a)(9)-1, Q & A H-2(b). In the case of a qualified plan that is not an IRA (e.g., 401(k)), however, physical division into separate accounts may not be possible because of limitations in the particular plan.

Book Review

***Life and Death Planning for Retirement Benefits*. Natalie B. Choate. ATaxPlan Publications, P.O. Box 1093-K, Boston, MA 02103. Third edition, 535 pages, $89.95.**

Major proportions of estate assets are composed of retirement benefits. Understanding the landscape of the distribution rules can help the estate planner achieve the dual goals of asset preservation and maximum income tax deferral of retirement resources. Natalie Choate's book addresses the federal tax laws governing retirement benefits and also highlights areas in which state law may have a significant impact (using the laws of the author's home state, Massachusetts, to illustrate).

The book consists of 10 topical chapters plus an eleventh chapter presenting case studies that apply the planning principles presented earlier. Chapter One covers the minimum distribution rules, analyzing in particular the widely variable ramifications of beneficiary selection. Chapter Two focuses on the income tax treatment of retirement benefits. Of importance here are issues attendant to the death of a plan participant and the tax consequences of lump-sum distributions. Chapter Three examines the generally (but not universally) favorable tax results that accrue by naming one's spouse as the primary beneficiary of retirement benefits. Issues surrounding simultaneous death are also explored.

Other chapters cover topics such as Roth IRAs (Chapter Five), charitable giving from retirement benefits (Chapter Seven), tax penalties accompanying early distributions (Chapter Nine), and life insurance issues (Chapter Ten). Each chapter concludes with a useful summary of key points. Of considerable assistance are the appendices, including various tables, sample forms, and checklists. A glossary and index round out the package.

Ms. Choate's book is full of information containing considerable detail of benefit to the professional, presented in a most accessible, easily graspable style. The set of case studies are well drawn and effectively illustrate the application of the major planning tools. This is an impressive work that will be well used by estate planners in developing retirement strategies for their clients.

This book review by Professor Nancy E. Shurtz, University of Oregon School of Law, was originally published in the July 2000 issue of Estate Planning magazine.

A beneficiary designation in favor of charity that is expressed in terms of a pecuniary amount should be avoided, since such a formulation likely does not qualify under the "separate account" rule of the proposed regulations. This may result in the plan being deemed to have no designated beneficiary under the rules discussed above.

Estate planners must also exercise caution where a trust is designated as beneficiary of a retirement plan and the trust includes charitable beneficiaries. Under the rules governing the naming of a trust as beneficiary of a retirement plan, to use the life expectancy of individuals for determining minimum distribution requirements, all of the trust's beneficiaries must be individuals or the trust document must prohibit retirement plan assets from being used to fund any charitable bequest. Alternatively, the trust instrument might provide that the retirement plan assets are to be paid exclusively to charity. When naming a trust as beneficiary of a retirement plan, it is important to ensure that the trust meets all of the requirements applicable to trusts as plan beneficiaries. See Jonathan Levy's article in this issue for a detailed discussion of those requirements.

Conclusion

Charitable gifts play an important role in many estate plans. In addition to the satisfaction that comes from leaving a legacy to charity, charitable planning with retirement plan assets can achieve significant tax savings and give clients more choices with respect to who benefits from the assets the client accumulates during life. As with other aspects of retirement plans, charitable planning with these assets can be complicated and includes potential traps. When implementing any charitable strategy involving retirement plan assets, it is important to examine all the tax and practical ramifications of that strategy. In addition, the client should be educated so that he or she has a basic understanding of the plan and how it must be maintained.

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1 For purposes of this discussion, "retirement plan" refers to a qualified retirement plan, traditional IRA, and 403(b) plan. Roth IRAs are excluded from this discussion. Although they may be the subject of charitable gifts, distributions from Roth IRAs are generally not subject to income tax, so the charitable planning incentives that exist with respect to a traditional IRA often will not apply to a Roth IRA.

Retirement Plans: Naming a Beneficiary Who Is Receiving Public Assistance

There are special considerations involved when a client wishes to name a chronically ill spouse, an adult disabled child, or another recipient of public assistance as a beneficiary of a retirement plan. The same concerns arise when a beneficiary is likely to need assistance in the future. To qualify for public benefit programs based on financial need, such as Medicaid and Supplemental Security Income ("SSI"), a person cannot have resources or income in excess of the program's standards. For these programs, a single person cannot have "countable resources" of more than $2,000. Certain resources specified in the programs' rules, such as the person's home, are not counted in determining eligibility. If the person does have more than $2,000 in resources, he or she will not be eligible for benefits until the excess funds have been spent.

Similarly, in the year 2000, an individual cannot have "countable income" above the Federal Benefit Rate (the FBR") of $512 per month and still get SSI benefits, or above $1,536 per month and still get Medicaid assistance to pay for long-term care. For the SSI program, countable income of more than $512 results in complete disqualification, whereas countable income below this threshold reduces the amount of benefits. Income in excess of the $1,536 income cap results in ineligibility for Medicaid assistance for long-term care unless the person (or someone acting for the person) establishes an Income Cap Trust.

A person who has assets in excess of the program limits and who gives them away or transfers them for less than fair market value will also be disqualified from receiving benefits. The Medicaid program has consistently penalized such transfers. Congress reinstated the SSI transfer of assets penalty as section 206 of HR 3443, the Foster Care Independence Act of 1999. The SSI provision applies to transfers made on or after December 14, 1999. Both programs utilize a basic look-back period (the period of time for which the Medicaid or SSI applicant is required to disclose transfers) of 36 months on transfers. For Medicaid, the look-back period is extended to 60 months if the transfer was to a trust rather than to an individual. A few types of transfers identified in the statutes and

rules, such as transfers between spouses, will not affect eligibility.

For SSI, the penalty period or period of ineligibility is calculated by dividing the uncompensated value of the asset transferred or given away by the FBR plus the state supplement applicable to the individual's living arrangement. In Oregon, the current figure for an individual living in the community is $513.70. The result is the number of months during which the claimant will not be eligible for SSI benefits. The disqualification begins with the month in which the transfer occurred. There is a maximum penalty period of three years.

A similar method is used to calculate the period of ineligibility for Medicaid assistance for long-term care. If the person (or the person's spouse) gives an asset away or transfers it for less than fair market value, the penalty period is calculated by dividing the amount that was given away by the average monthly private pay care cost. The average rate set by the state rules in Oregon is currently $3,320. The resulting whole number is the number of months of ineligibility. For example, if Mr. Smith gave his granddaughter $40,000 for college in October 1999, he would be ineligible for Medicaid assistance until October 2000 ($40,000 divided by $3,320 per month equals 12.05 months, which is rounded down to 12 months of ineligibility, beginning with October 1999).

Because of the ramifications of the rules discussed above, a client deciding whom to name as the beneficiary of a retirement plan should be counseled to consider whether the spouse, child, or other prospective beneficiary is receiving public assistance or may need to apply for assistance in the future. Nursing home care can cost upwards of $4,000 per month. An SSI recipient who loses his or her benefits as a result of receiving a modest distribution may spend more than a year reestablishing his or her eligibility through the SSI appeals process.

Estate planners should not rely on disclaimers to solve this problem. Although at one time disclaimers might have been used effectively to cause assets to skip over a beneficiary who was receiving public assistance, this is no longer the case. A public assistance applicant or recipient who disclaims an inheritance or a distribution is treated as transferring the asset. Ineligibility for assistance based on the value of the property or cash disclaimed will result.

Most estate planners are familiar with the concept of using a testamentary supplemental needs trust to provide for the adult disabled child of a testator. The client could name a trust as the beneficiary of the retirement plan as long as it qualifies as a *designated beneficiary*. If the trust does not qualify, certain tax penalties explained elsewhere in this newsletter will apply, and the client will have to weigh the tax ramifications of naming an unqualified trust against the impact on the beneficiary of losing access to public benefits.

The client can establish a supplemental needs trust for the beneficiary in a will or an inter vivos instrument and name the supplemental needs trust instead of the individual as beneficiary of the retirement plan. A properly drafted supplemental needs trust can shelter money and property that would otherwise be counted as the beneficiary's assets and cause ineligibility for public assistance. The assets that pass to the trust can be used for a long list of needs that a disabled beneficiary may have and that are not covered by public assistance. The trustee of a supplemental needs trust is prohibited from paying funds directly to the beneficiary and from using them to provide food, clothing, shelter, and other items covered by public benefits. However, the trust can pay for transportation, telephone and cable service, education, training, adaptive equipment, communication equipment, entertainment, recreation, mobility aids such as electric wheelchairs, hair and nail care, expenses for a companion, medical and dental procedures not otherwise available to the trust beneficiary, and other expenses aimed at improving the quality of the beneficiary's life.

If the client does decide to name a supplemental needs trust as the beneficiary of a retirement plan, the attorney's responsibilities will include verifying the assistance programs involved and checking the rules regarding transfers of assets and treatment of trusts for those programs. Some programs, such as SSI, are operated by the federal government. Others, including Medicaid, are administered by the states using federal and state statutes and rules. The rules and standards change from time to time, so it is important to check the current requirements when drafting a supplemental needs trust.

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Basics of Medicaid Planning

The April issue of the *Newsletter* described the basics of Medicaid law. As discussed in that issue, a person applying for Medicaid must meet both an income test and a resource test before qualifying for long-term health care services under Medicaid. Generally speaking, the income test is met when the Medicaid applicant's monthly income does not exceed $1,536 per month or when the applicant has established an Income Cap Trust if the applicant's income exceeds that amount. The resource test is met for a single person when the applicant has no more than $2,000 in nonexempt resources, plus his or her exempt resources. The resource test is met for a married couple when the only resources the couple has are the amount allowed for the community spouse resource allowance, the Medicaid applicant's $2,000 resource allowance, and the exempt resources. The balance of the resources must be spent down or protected before the resource test will be met.

The following are planning techniques for preserving assets for the Medicaid applicant's spouse and possibly for other family members.

Transfer and Wait

General rule. The transfer of assets for less than fair market value to anyone other than the community spouse is considered a disqualifying transfer under Medicaid law. The period of disqualification (in number of months) is determined by taking the uncompensated value of the transferred assets and dividing by $3,320, rounded down to the nearest full month. OAR 461-140-0296. Note: The transfer penalty figure for transfers made between October 1, 1993 and September 30, 1998 is $2,595. OAR 461-140-0295. There is a three-year "look back" period in determining the disqualifying period. A 60-month look back period applies to transfers to an irrevocable trust of which the funds transferred into the trust are unavailable for the benefit of the applicant. OAR 461-145-0540(9), 461-140-0210(2)(c)(D). The starting date for the period of ineligibility is the first day of the first month in which the transfer took place. OAR 461-140-0296.

For example, if on November 1, 1999 the applicant gave away $150,000 in assets to his daughter, and if he applied for Medicaid benefits on December 1, 1999, then he would be disqualified from receiving Medicaid benefits for 45 months (3 years and 9 months) from the date of the transfer. However, if on November 1, 1999, the applicant gave away $150,000 in assets to his daughter, and if he applied for Medicaid benefits on November 2, 2002, then the look back period (3 years) will have already passed with respect to that $150,000 transfer and the applicant would not have to report it on the Medicaid application. Therefore, if the applicant makes any gifts, he should wait until after the disqualification period or until the 36-month look back period (whichever is shorter) has expired before applying for Medicaid benefits.

Exceptions to general rule. There are transfers that will not result in a period of Medicaid ineligibility. OAR 461-140-0242. Unlimited transfers to the community spouse are permissible. Transfers to a blind or disabled child are also permissible. The applicant may transfer his or her primary residence without the transfer resulting in a period of Medicaid ineligibility under specified circumstances. The applicant may transfer the home to the community spouse or to a minor (under age 21), blind, or disabled child. The home can be transferred to an adult child who has resided with and provided care to the applicant for a period of at least two consecutive years immediately before the date the applicant became institutionalized. In addition, the applicant can transfer the home to a sibling with an equity interest who has resided in the applicant's home (no caregiving required) after a period of 1 year immediately before the applicant's admission to long-term care.

Spend Down

Any resources over and above the $2,000 resource allowance for the Medicaid applicant and the exempt resources must be spent down or protected in some way before the applicant will qualify for Medicaid. However, the resources do not have to be spent on the care needs of the applicant. So long as the individual receives fair market value for the resource, the expenditure will be considered legitimate. The adviser can assist in a wise "spend down" by doing the "Resource Assessment" before the applicant starts spending the countable resources. In addition, the applicant's share of countable assets should be spent on noncountable assets that will be of benefit to the applicant and spouse. Steps to consider include:

- Pay off debt.
- Make repairs to home, e.g., new roof, carpet, etc.
- Buy a newer car for the spouse or repair old one.
- Buy a more expensive home.
- Purchase burial plans and merchandise for the applicant and the spouse, the applicant's children, siblings, and/or parents (see OAR 461-145-0050).
- Purchase an irrevocable annuity for the spouse.
- Pay family members for their care-providing services.

- Purchase an interest in the home of an adult child if the couple is living with the child. Note: Be aware of potential estate recovery claims.
- Purchase long-term health care insurance or buy into a continuing-care retirement community for the community spouse.

Increase of Community Spouse Resource Allowance (“CSRA”)

The amount of the CSRA, as determined on the first day of continuing care, can be increased by two methods.

First, Senior and Disabled Services Division (“SDSD”) rules allow an increase in the CSRA if ordered by the court. A community spouse may petition the court for support from an institutionalized spouse under ORS 108.110. In some cases, the applicant’s entire one-half share of the countable resources can be shifted to the community spouse, thus eliminating any spend down. However, a petition for support, depending on the requested CSRA, may be closely scrutinized by SDSD. OAR 461-160-0580(1)(f)(C).

In addition, the Medicaid rules allow a transfer of additional resources to the community spouse when the couple’s combined monthly income is insufficient to bring the community spouse’s monthly income up to the minimum monthly maintenance needs allowance (“MMMNA”). The current MMMNA is $1,407 per month (effective April 1, 2000), plus an excess shelter allowance equal to the amount by which the community spouse’s monthly shelter costs exceed $422 (effective April 1, 2000). OAR 461-160-0620(5). If the gross monthly income of the community spouse, plus the income allowed to be transferred to the community spouse from the applicant, is less than the community spouse’s MMMNA, then the community spouse is allowed to retain additional resources to generate sufficient income to reach the MMMNA. OAR 461-160-0580(1)(f)(D).

Converting Resources to Income

Once the resource assessment is completed and the applicant’s spend-down requirement has been determined, the nonexempt resources may be converted into income so that they are not treated as countable resources. This planning technique may be accomplished by use of one (or both) of the following options.

If the resource is a rental house or vacation home, or if the countable resource can be used to purchase a rental or vacation home, then the home can be sold on contract. Because an income-producing sales contract is an exempt resource under the Medicaid rules, only the monthly payment is counted. If real property is transferred into the sole name of the community spouse before it is sold, then the monthly income will only be counted as income for the community spouse. It will not affect the eligibility of the Medicaid applicant, although it will affect the amount of income that can be transferred from the institutionalized spouse to the community spouse.

Part or all of the required spend-down amount can be used to purchase an annuitized annuity. Under the Medicaid rules, if the irrevocable immediate annuity is owned by the applicant or the applicant’s spouse, and if the principal and income are required to be paid in full over the life expectancy of the owner, then the annuity is an exempt resource. The SDSD Annuity Life Expectancy Tables are on-line at www.sdsd.hr.state.or.us/resources/workergd/e.1_ann.htm.

Divorce/Legal Separation

Although not a common or popular technique, a court-ordered legal division of assets in a divorce or legal separation may protect the community spouse’s resources from both the spend-down requirement and an estate recovery claim.

Purchase Long-Term Care Insurance

The purchase of long-term care insurance for an individual or a married couple may avoid the need for a Medicaid application.

Conclusion

In applying the above planning techniques, keep in mind that SDSD keeps track of the amount of the Medicaid assistance it provides to the recipient. ORS 414.105(2) authorizes the Oregon Department of Human Resources to recover paid medical assistance from the estate of a Medicaid recipient who was age 55 years or older or from the estate of the recipient’s spouse. Under prior law, the state was able to collect the paid Medicaid benefits from the entire estate of the surviving spouse. However, under current law, if the recipient has a surviving spouse at the time of the recipient’s death, then the estate recovery is delayed until the death of the surviving spouse and limited to the assets that the surviving spouse inherited or received from the recipient as a result of the recipient’s death. ORS 414.105(2). Therefore, when applying the above techniques with married couples, it is important to ensure that excluded resources are placed in the sole name of the community spouse so that the Medicaid recipient has no ownership interest in the resources at the time of his or her death.

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CALENDAR OF SEMINARS AND EVENTS

- July 13, 2000 (Sponsored by Washington State Bar Association) **Advanced Probate**, Seattle, WA. Telephone: (206) 727-8292.

- July 14, 2000 (Sponsored by Professional Education Systems, Inc.) **Estate and Gift Tax Workshop**, Portland, OR. Telephone: (800) 826-7155.

- July 14, 2000 (Sponsored by The Southern California Tax & Estate Planning Forum) **The Family Limited Partnership and Limited Liability Company**, Los Angeles, CA. Telephone: (800) 332-3755.

- July 15, 2000 (Sponsored by The Southern California Tax & Estate Planning Forum) **The Family Limited Partnership and Limited Liability Company**, San Francisco, CA. Telephone: (800) 332-3755.

- July 20, 2000 (Sponsored by Washington State Bar Association) **Advanced Probate**, Mt. Vernon, WA. Telephone: (206) 727-8292.

- July 21, 2000 (Sponsored by Professional Education Systems, Inc.) **Estate and Gift Tax Workshop**, Bend, OR. Telephone: (800) 826-7155.

- August 3-4, 2000 (Sponsored by ALI-ABA) **International Trust and Estate Planning**, San Francisco, CA. Telephone: (800) CLE-NEWS.

- August 10-12, 2000 (Sponsored by ALI-ABA) **Estate Planning for the Family Busines**s, Renaissance Stanford Court, San Francisco, CA. Telephone: (800) CLE-NEWS.

- September 7-8, 2000 (Sponsored by ALI-ABA) **Sophisticated Estate Planning**, Westin Copley Place, Boston, MA. Telephone: (800) CLE-NEWS.

- September 21-22, 2000 (Sponsored by Practising Law Association) **31st Annual Estate Planning Institute**, New York City, NY. Telephone: (800) 260-4PLI.

- October 5-6, 2000 (Sponsored by Practising Law Association) **31st Annual Estate Planning Institute**, San Francisco, CA. Telephone: (800) 260-4PLI.

- October 16-17, 2000 (Sponsored by Washington State Bar Association) **Estate Planning**, Seattle, WA. Telephone: (206) 727-8292.

- October 19, 2000 (Sponsored by the Oregon State Bar) **Administering Trusts in Oregon**, Oregon Convention Center, Portland, OR. Telephone: (503) 620-0222.

- October 26-28, 2000 (Sponsored by The Southern California Tax & Estate Planning Forum) **The 20th Annual Southern California Tax & Estate Planning Forum**, San Diego Paradise Point Resort, San Diego, CA. Telephone: (800) 332-3755.

- October 30 - November 1, 2000 (Sponsored by Chaminade University Tax Foundation and Chaminade University of Honolulu) **Estate and Gift Tax Planning**, Hawaiian Regent Hotel, Honolulu, HI. Telephone: (808) 946-2966.

- November 10, 2000 (University of Southern California) **Probate & Trust**, Los Angeles, CA. Telephone: (213) 740-2646.

- November 17, 2000 (Sponsored by the Oregon State Bar) **Estate Planning**, Oregon Convention Center, Portland, OR. Telephone: (503) 620-0222.

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