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Withdrawing or Consolidating Retirement Assets: Know the Rules

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Even if you're not planning to tap your retirement savings right away, be aware of the important tax and estate planning issues that will eventually affect you.

Income you receive from non-Roth retirement plans is subject to income tax (unless the income is a return of after-tax contributions). Affected plans include non-Roth 403(b)s and 401(k)s, as well as 457(b)s and Traditional IRAs. Until a withdrawal or “distribution” occurs, investments in the plan compound tax deferred. That is why a common strategy is to keep assets inside the plan for as long as possible. But, at a certain point, you are legally required to start taking withdrawals — and you will need to formulate an estate plan for any assets remaining at your death. This article summarizes many of the latest rules affecting distributions from retirement plans.

Minimum Distribution Rules Set the Deadline for Starting Income

During your lifetime, you generally can keep assets inside your retirement plan until you reach your *required beginning date*, usually April 1 following the calendar year when you reach age 70½. Or, if you have a retirement plan (other than an IRA and plans in which you have a 5% or greater interest in the plan sponsor) and are employed beyond age 70½, your required beginning date is April 1 following the calendar year when you retire. Once you reach this date, the IRS requires you to withdraw a certain amount from your plan annually, called the *required minimum distribution* amount. IRS Publication 590* includes tables to assist you in determining the required minimum distribution amounts. Each required minimum distribution is considered ordinary income subject to ordinary income tax (unless the income is a return of after-tax amounts).

To compute the required minimum distribution, divide the plan balance as of December 31 of the prior year by the appropriate divisor taken from the IRS's *Uniform Lifetime Table*.* This allows you to redetermine the divisor annually and bases distributions on the joint life expectancy of you and a hypothetical beneficiary who is 10 years younger. This table is intentionally designed to permit gradual plan distributions over your retirement years to help provide an income stream for your remaining lifetime. (The table offers only an estimate of your life expectancy; it does not guarantee that you will not outlive the payment stream.) If your spouse is younger than you by more than 10 years, use the IRS's *Joint Life and Last Survivor Expectancy Table** to calculate your required minimum distribution. Smaller required minimum distributions result.

If you have a 403(b) plan, the accumulations in your account as of December 31, 1986, are grandfathered for calculating your required minimum distributions. Even if you are retired, you

are not required to begin distributions from the grandfathered accumulations until the year when you attain age 75.

*Go to www.irs.gov. On the homepage, select Individuals, Forms & Publications, Topical Index, “I” for IRA and IRS Publication 590, which presents life expectancy tables.

Consolidating Plan Assets May Be beneficial

As you contemplate taking required minimum distributions, consider if consolidating plan assets into a single plan (or fewer plans) can help you efficiently monitor asset allocation and investment risks and returns during your retirement years. Consolidating can simplify recordkeeping and may even allow you to avoid duplicative expenses. You can roll over assets among 403(b)s, 401(k)s, public 457(b)s and IRAs. If, for example, you participate in a 403(b) supplemental retirement plan, you can usually consolidate assets, with no tax consequence, from an IRA or any previous employer’s 403(b) or 401(k) plan. Before consolidating, consider the following four factors:

1. Generally, 403(b) grandfathered amounts lose their special status when rolled over from a 403(b) plan to another eligible retirement plan, unless the amounts are directly transferred to another 403(b) plan and properly tracked.
2. If you keep working beyond age 70½, consolidating in the current employer’s qualified plan (but not IRAs or plans in which you have 5% or greater interest in the plan sponsor), may enable you to further defer minimum distribution requirements on all accumulations you consolidate in that plan until you retire.
3. If creditor protection is a concern, then consult with an attorney or tax advisor before consolidating assets. The rules may vary depending on whether the creditor is taking action through a federal bankruptcy proceeding or under your applicable state law in a nonbankruptcy proceeding.
4. Transfers may be subject to differences in features, costs and surrender charges. Nondirect transfers may be subject to taxation and penalties. Consult your tax advisor about your particular situation.

Distributions to a Spouse

If named as a beneficiary, your spouse can roll over inherited plan assets into her/his own plan (if the plan permits). If the plan assets are rolled over, then your spouse can look to the *Uniform Lifetime Table** to delay the start of required minimum distributions until he/she attains age 70½. Alternatively, your spouse can treat the plan as an “inherited” plan. In that case, your spouse would look to the *Single Life Expectancy Table*,* and the required minimum distribution would be made to your spouse either on or before December 31 of the year immediately following the calendar year when you died, or December 31 of the year when you would have attained age 70½, whichever the spouse chooses. A spouse can recalculate the divisor annually regardless of the election made.

For example, Arthur dies in 2005 at age 55. His spouse, Emily, the beneficiary of his IRA, is age 53 in 2006. She has three choices: roll over the inherited plan into her own IRA, receive required minimum distributions from Arthur's plan in 2006 or receive required minimum distributions from Arthur's plan in 2020 (when Arthur would have attained age 70½). Since Emily is under age 59½, an earlier payout may be an effective strategy if she needs income. If she rolls the plan assets into her own IRA and then decides she needs to receive a distribution, she will be subject to a 10% penalty tax on distributions (because she is younger than 59½). Emily could decide to divide the IRA so that one part remains in Arthur's plan and is accessible before she reaches age 59½, and the other part can be rolled over.

Distributions to Nonspouse Individuals

When you die, the nonspouse individual beneficiaries of your plan — including 403(b)s, 401(k)s, 457(b)s, Traditional IRAs and even Roth IRAs — must begin taking an annual distribution. The distribution amount is calculated by dividing the prior year-end account value by the applicable divisor. For all plans except Roth IRAs, the distribution is considered ordinary income (unless it is a return of aftertax contributions) and is subject to tax when received by your beneficiary. For Roth IRAs, the distribution is determined in the same manner, but it is not subject to income tax.

Most 403(b)s, 457(b)s and IRAs permit beneficiaries to use their own age to determine the applicable divisor. Sometimes called “stretch-out” planning, this allows the beneficiaries of inherited plans the flexibility to achieve maximum compound tax deferral inside the plan. An important key to stretch-out planning is to carefully tailor the beneficiary designation forms. Since IRS regulations can be complex, consider using the services of an attorney or tax advisor. Also, check with your plan administrator to make sure that stretch-out planning is an option.

Beneficiaries of many TIAA-CREF contracts have this tax-planning opportunity, but some other plan providers do not permit stretch-out planning, such as many for-profit companies with 401(k) plans. In those plans, beneficiaries must take distributions over a shorter default term or even in a lump sum. For this reason, participants in more restrictive plans sometimes roll plan assets into other eligible qualified plans or IRAs after retirement. Under the recently passed Pension Protection Act of 2006, beginning in 2007 it will be possible for individual nonspouse beneficiaries to arrange a direct transfer, after the employee's death, from retirement plans (which don't allow stretch-out planning), to an inherited IRA (which does allow it).

If you name more than one individual or qualified trust as beneficiary (“my children,” for example), then the applicable divisor from the *Single Life Expectancy Table** is based on the age of the oldest member of the group. If, instead, you identify each beneficiary by name and assign a percentage or fraction of the plan to them, then each beneficiary can establish a separate account after your death and apply the divisor from the *Single Life Expectancy Table** that is applicable to her/his own age, rather than using the divisor of the oldest group member. Each year thereafter, the divisor is reduced by one; it is not recalculated annually.

Distributions to a Qualified Trust

When you name a trust as the beneficiary of a retirement plan, the trustee controls and manages the plan assets for the benefit of the trust beneficiary. If the trust is considered a qualified trust, then the trustee can also elect to stretch out required minimum distribution amounts. A trust is *qualified* if it meets all of the following criteria:

- A copy of the trust or a summary of the trust in affidavit form is given to the plan administrator by October 31 of the year following death
- The trust is valid under state law
- The trust is irrevocable or becomes irrevocable upon death
- Trust beneficiaries are identifiable.

When considering whether to name a trust as the beneficiary of a retirement plan, carefully consider your wording choices within the trust provisions, as well as on the beneficiary designation form, because separate account treatment does not apply to trust beneficiaries. Instead, the trustee must use the divisor applicable to the oldest trust beneficiary to determine the required minimum distribution amount for all trust beneficiaries. If you want a retirement plan to be divided into separate trust accounts for the benefit of multiple loved ones, then consider creating a separate sub-trust for each person within the trust instrument. Then specifically identify by name each sub-trust on the plan's beneficiary designation form, assigning a percentage or fraction of the plan to it. In this way, the trustee of each subtrust can use that beneficiary's age, rather than the age of the oldest beneficiary, to determine the required minimum distribution amount.

Carefully review the trust provisions to make sure the trustee can use the divisor applicable to the intended beneficiary when determining the required minimum distribution amount. For example, assume that you establish a trust for the benefit of your only son for life and then direct the trustee to distribute remaining trust assets upon your son's death to your sister or her descendants. In this case, your sister's age, rather than your son's age, would be used to determine required minimum distribution amounts. Thus, identity of the contingent trust beneficiaries is important to the analysis when determining how long the trustee can stretch out required minimum distribution amounts. Contingent beneficiaries can be problematic — such as charities, and individuals who are older than the primary beneficiary, not readily identifiable, or subject to change via a power to appointment.

The rules and regulations governing the use of a trust for plan distributions are complex, so it is advisable to use the services of an attorney to set up a trust.

Distributions to Your Estate

This is generally not a tax-efficient option. If you die before your required beginning date, inherited plan assets must be distributed from the plan to your estate by December 31 of the 5th anniversary of your death. If you die after your required beginning date, inherited plan assets must be distributed from the plan to your estate using your remaining divisor. For example, Arthur dies at age 78 on May 1, 2006 and names his "estate" as the beneficiary of his retirement

plan. Arthur's will names Michael, age 48, as beneficiary of his estate. Michael would likely be required to take required minimum distributions based on Arthur's Single Life Expectancy Factor for 2006, which is 11.4. Michael's first distribution would occur in 2007 using a 10.4 factor and reducing by 1 each year thereafter. If Arthur had named Michael or a trust for his benefit as beneficiary on the plan's beneficiary designation form, then Michael could have deferred distributions over the applicable divisor of 35.1, which is based on Michael's age in 2007.

Tax-Free Charitable Gifts From IRAs

Effective for 2006 and 2007 only, the Pension Protection Act of 2006 permits taxpayers age 70½ or older to make direct distributions from a traditional or a Roth IRA to a charity, while excluding the distribution from gross income. The maximum distribution allowed is \$100,000 per taxpayer per year. The IRA, rather than the IRA owner, must make the distribution directly to the charity. The distribution must qualify under the general charitable deduction rules of section 170 of the Internal Revenue Code, and the charity must be a public charity or conduit private foundation.

Next Steps

Consult your plan administrator, personal attorney or tax advisor, TIAA-CREF consultant or wealth management advisor to better understand how the distribution requirements apply to you. Integrate your beneficiary designations with your objectives, and educate your beneficiaries about their options. To learn more, go to www.tiaa-cref.org/retirementincome.

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