

Abstract: After years of hard work, many people have managed to accumulate large balances in their retirement plan accounts. But what is the best way to dispose of those assets, both during life and after death? This article discusses distribution rules, lifetime distribution options and estate planning options.

Planning with your retirement account money

After years of hard work, you've managed to accumulate a large balance in your retirement plan accounts. Now you're concerned about how to best plan for the disposition of the assets, both during your life and after your death. The good news is that you have options available to you with respect to your IRA, 401(k) and other retirement funds.

Distribution rules

Starting at age 59½, and even sooner in certain circumstances, you may withdraw funds from your retirement plans without being subject to the penalty for early distributions. Once you reach age 70½, you generally must start taking annual required minimum distributions (RMDs) from your traditional IRA and employer-sponsored retirement plans such as 401(k)s. You aren't, however, required to take distributions from your Roth IRA. If you have a Roth 401(k), you may be able to roll it over into a Roth IRA to avoid RMDs.

In limited circumstances, you won't be required to withdraw funds from your 401(k) account. If you continue to work after age 70½, and you own less than 5% of your company, you aren't required to take any distributions until after you retire. And, you're still eligible to contribute to your 401(k) for as long as you continue to meet this exception.

This can be a tremendous benefit: You may be able to accumulate significant additional funds tax-deferred. The more you accumulate, the more opportunities you'll have for planning with the funds.

Lifetime distribution options

During your life, you basically have two options for the funds in your retirement accounts:

1. Start withdrawing after age 59½ and/or take more than the RMD after age 70½. Generally, this is the less palatable option because you lose the benefit of tax-deferred growth on whatever you withdraw, paying tax sooner than necessary. Depending on your circumstances, though, it might actually be better for you to take distributions sooner (but still after age 59½ to avoid penalties) or take a larger distribution to draw down your retirement plan balance.

If, for instance, you're currently in a low marginal income tax bracket but you expect to be in a higher tax bracket in future years or you expect tax rates will go up, it may make sense to pull out more money now at a lower tax rate. Also keep in mind that having to take larger RMDs in the future could push you into a higher bracket.

2. *Defer distributions until age 70½ and then take only the RMD.* If you don't have a need for the funds, this may be the better course of action. After all, the longer you can defer distribution, the more funds that can continue to grow tax-deferred — or, in the case of a Roth account, tax free. Plus, you won't have to pay tax sooner than necessary.

Estate planning options

Any funds remaining in your IRA and other retirement plans generally will be includible in your taxable estate and subject to estate taxes if your estate exceeds the estate tax exemption. But if your surviving U.S. citizen spouse receives the funds, the transfer will qualify for the unlimited marital estate tax deduction and, thus, only what remains at your spouse's death could be subject to estate tax.

(Note that, although an estate tax repeal went into effect Jan. 1, 2010, the estate tax is scheduled to return in 2011. Congress may even take action to repeal the repeal, perhaps retroactively to Jan. 1. Check with your tax advisor for the latest information.)

Estate tax isn't the only concern. When retirement funds are distributed, they're subject to income tax — unless the funds are from a Roth account or the beneficiary is a qualified charity.

The combined estate and income tax rate can be rather high, especially if the beneficiary immediately withdraws the funds. If, however, your beneficiary can defer distributions, the effect of the income tax bite is dramatically reduced. And, rather than allowing the funds to be treated as a “throwaway” asset subject to an oppressive tax rate, you may actually be helping your beneficiary to build his or her own retirement nest egg, especially if your beneficiary is young — such as a grandchild or great-grandchild.

You may even wish to discuss with your heirs their needs. You might decide to allocate all of your IRA to your child who doesn't have an immediate need for funds, for instance, and other assets to another child who has an immediate need. That way the bulk of the assets can continue to grow tax-deferred.

If you've started taking your RMDs, your beneficiary will be required to continue to take distributions on the schedule you've been using. If you haven't taken any distributions because you haven't reached your required beginning date, your

beneficiary will be able to take distributions over his or her life expectancy. If you have a Roth IRA, distributions also will be based on your beneficiary's life expectancy. The Roth distributions are income-tax free.

You're also permitted to name a trust as beneficiary. But before doing so, be sure to consult an expert because there are numerous rules to which you must adhere, and, thus, there are multiple traps into which you could fall.

Another popular use for retirement plan money, particularly in light of the potentially burdensome combined estate and income tax rate, is charitable bequests. Let's say, for instance, that you wish to make a substantial gift at your death to your favorite charity. All you need to do is change your IRA's beneficiary designation. Plus, it's just as simple to make a change if you decide to allocate a different amount to your charity.

If you're concerned that the charity might get a bigger percentage of your estate than you want, you may be able to put other restrictions on the beneficiary designation form, such as limiting the dollar amount that goes to the charity.

Consider your options

The bottom line is that you have many choices with respect to your IRA and other retirement plan money. Knowing your options can help you find the best solution for your estate plan.