

# COMPANY PLAN ROLLOVERS TO IRAS

Prepared by

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This memorandum explains our current thinking regarding whether and when clients should roll out of company sponsored retirement plans to an IRA. The focus of the discussion is maximizing the tax deferred growth of retirement accounts. This memo contains a general discussion of the views of the attorneys in our Estate and Business Planning Group and focuses narrowly on that issue.

We do not recommend that your clients take action on the matters discussed herein without first reviewing this with their own counsel and you as their financial advisor. This is a complex issue to discuss verbally and more difficult to dissect in written form. The last page of this memo itemizes certain situations that may result in advice contra to the general advice offered in this memo.

### BACKGROUND INFORMATION

First, to put this issue in its proper context, you need to keep in mind the following. The available means of distributions to beneficiaries of company sponsored plans are those that the company has set forth in the plan document<sup>1</sup>. These plans do not need to parallel the IRA rules and, in our experience, are usually more restrictive. In many cases, the plans require either an immediate

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<sup>1</sup> This memo does not discuss options for a surviving spouse as a primary beneficiary, but this issue must also be evaluated. This memo focuses on the implications to non-spouse beneficiaries.

distribution to the beneficiary or a restricted distribution period and do not allow for the maximum distribution period that is available for IRAs<sup>2</sup>.

Companies can adopt the IRA distribution rules if they so choose and perhaps some of them have. However, we have yet to see a company that has taken this step. Therefore, it currently appears that if you want the IRA distribution rules, you need to have the investments in an IRA account.

We presume the reason companies have not adopted the IRA rules is that these plans are operated as a benefit for each employee and, when the employee has passed away, they would rather not have to deal with distribution issues for that person's beneficiaries. From their perspective, this is understandable.

The allowable distribution period became a larger issue in the beginning of 2001 when the IRS came out with new rules that allow IRA beneficiaries to more easily take withdrawals from IRAs over their life expectancies. The old rule often required IRAs to be distributed within five years of the date of death. When the five year rule was used, it was not that much different than full distribution following death. As we will see, using the beneficiary's life expectancy significantly changes this. For these reasons, our general advice is that if a roll out option is available, it should be taken<sup>3</sup>.

## **BENEFITS OF ROLLING OVER**

To understand the significance of this, let us examine what happens when the employee rolls out his account to an IRA and its impact on the beneficiaries. Instead of the beneficiaries having to take the remaining plan funds out all at once or in a limited timeframe, they can stretch the payments out over their remaining life expectancies. This drastically reduces the required minimum distribution to the beneficiaries, thereby reducing the amount of money added to their taxable income each year. Moreover, deferring payment of income taxes means that more money is available to grow tax deferred over the longer time period. There is a dramatic compounding effect.

For example, assume your client left an IRA with a balance of \$500,000 to a beneficiary who is age 43. The remaining life expectancy of this person is approximately 40 years. The beneficiary would have to take out 2.50%, \$12,500, by December 31 of the year following the year of death. The next year the required distribution would only be 2.56%. As you know, this required withdrawal grows over time because the remaining life expectancy is reduced by one year for each subsequent year.

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<sup>2</sup> These comments do not just apply to employees of company sponsored plans. This is also an important issue for professionals such as doctors and lawyers with prototype plans.

<sup>3</sup> Some companies allow for in-service distributions and this discussion would apply in that situation as well.

However, assuming an 8% growth rate for the account and a 2004 date of death, it would be around 2032 before the required withdrawal from the IRA would exceed the growth rate percentage. At this point, the remaining life expectancy of the beneficiary is 12 years, and when 12 is divided into 100 (to determine the percentage), the required distribution expressed as a percentage is about 8.3%.

**Under these assumptions, this means that the account will continue to grow for the next 28 years!**

During this entire period (2004–2032), again assuming an 8% growth rate, the account value is growing by the difference between the rate of withdrawal and the rate of growth<sup>4</sup>. At this point, the required amount of the withdrawal would be about the same as the growth rate. After this, the rate of withdrawal would exceed the assumed rate of growth causing shrinkage in the account value.

The same \$500,000 account in a company sponsored plan may have to be distributed all at once to the beneficiaries after death, or be limited to a small number of distributions. This is what happens in that situation:

- Income is piled up in a short period of time.....
- Which in most cases increases the tax rate.....
- There is a loss of the ability to grow the account on a tax deferred basis....
- Which is compounded by the loss of the investment return the account would experience on the dollars that are instead distributed out to pay taxes.

Put another way, consider the following: What would a beneficiary (i.e. your new client) prefer as an investment:

- \$300,000 outside of an IRA account<sup>5</sup> subject to taxes or.....
- \$500,000 in a tax deferred account?

## **OTHER CONSIDERATIONS**

This advice must be tempered by another consideration: asset protection planning. Company sponsored plans are protected under ERISA from being attached by creditors. While Ohio law also exempts IRAs from attachments, the protection of this statute may not be as strong as the protection granted by federal law for the owner of the plan. For clients who are in higher risk professions, such as doctors and lawyers, they must take this into consideration.

Furthermore, there may be other factors to consider before rolling into an IRA, such as the favorable taxes that might apply to net unrealized appreciation on

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<sup>4</sup> In the first year following the death of the owner, the growth rate under our assumptions would be net 6% (8% rate of growth – 2% withdrawal).

<sup>5</sup> Assumes 40% tax rate on \$500,000 distribution netting \$300,000.

company stock held within a company plan, the inability for an IRA owner to borrow from the IRA, the loss of the opportunity to exclude employer contributions to a company plan from the employee's Ohio taxable estate, the inability to take distributions prior to age 59-½ years without incurring a 10% penalty, and the possibility that the rollover of a plan for a worker over 70-½ may hasten the recognition of income and increase such worker's income.

## **CONCLUSION**

This is an evolving issue and we are continuing to monitor it and develop further our thinking. Any information or thoughts you have on this complex but important topic would be appreciated. We are sharing our thoughts with you because you, like us, do not want beneficiaries to get an ugly surprise that could have been avoided. Please feel free to contact us with any questions or comments.

## **NOTICE**

This memorandum is a general discussion that focuses primarily on the potential benefits of rolling investments in company sponsored retirement plans to IRAs. Before this is undertaken, we strongly recommend that clients meet with their estate planning attorney to evaluate all of the ramifications of a rollover.

