SPECIAL ESTATE PLANNING REQUIRED FOR MISSOURI PUBLIC SCHOOL TEACHERS, ADMINISTRATORS AND STAFF

by

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Background

For most of the almost 200,000 active and retired Missouri public school teachers, administrators and staff (herein "educators"), their Missouri public school retirement system (herein "PSRS") or public education employee retirement system (herein "PEERS") benefits (herein "retirement benefits") constitute, or will eventually constitute, a significant portion of their financial net worth. It is therefore understandable that educators will want to ensure that their estate plans, including wills, trusts and beneficiary designations, have been prepared in a fashion which will best preserve these retirement benefits for their families, in the event of their death.

PSRS publishes a brochure titled "Protecting Those You Care About," which is intended to guide educators through the maze of survivorship planning for PSRS benefits. Unfortunately, the current Missouri statutes and regulations governing both PSRS and PEERS have made this goal of protecting the educator's family almost insurmountable for the educator to achieve in the absence of expert guidance of a qualified estate planning attorney well-versed in the PSRS and PEERS statutes and regulations, as well as in the various policies followed by the PSRS and PEERS offices with respect to the same. Most active educators simply have not been sufficiently "educated" with respect to the many challenging estate planning issues associated with their PSRS and PEERS survivorship benefits, and therefore end up with estate plans and beneficiary designations which are not responsive to their family's needs.

It is because of the above concerns that we have set about the tri-fold task of (1) studying the various complex Missouri PSRS and PEERS statutes and regulations, and interviewing PSRS in-house legal, all in an attempt to make some sense of the survivor beneficiary designation aspects of the current laws, (2) devising unique estate planning strategies for Missouri educators which are intended to mitigate the harmful effects of the current PSRS and PEERS survivor beneficiary laws

and regulations, and (3) working with Missouri legislators and regulators to cure the various problems in the current law and to eventually help enact new laws and regulations which will contain survivor beneficiary designation rules more in tune with the survivor beneficiary designation rules currently applicable to qualified retirement plans of public-held corporations.

The purpose of this article is to summarize the results of the first two prongs of our tri-fold mission. More information will follow when we have achieved the last of our three objectives.

PSRS Planning Problems for Younger Educators

For the purpose of this section, the term "younger educators" shall refer to educators who have less than 10 years of experience and who are married and/or have one or more children who are under age 18. PSRS members who have at least five years of experience and who have a spouse and/or dependent children, are entitled to have monthly dependency payments made to their spouse and dependent children, in lieu of a lump sum repayment of their accumulated contributions. Because they are not likely to have a large amount of accumulated contributions, younger educators who are also PSRS members, and who have at least five years of experience (or are approaching five years of experience), and who have a spouse and/or dependent children, should have optional PSRS dependency payments as a principal area of focus in their estate planning.

It is a common and essential practice in estate planning to protect the interests of minor and younger children against themselves, through the use of trusts. These "maturity trusts" typically range from trusts until age 25, at the shortest end, to trusts for the lifetime of the educator's children, on the other. The most common type of trust extends for a period which is somewhere in between these two extremes, for example, a trust until age 35, with partial outright distributions at age 25, 30 and 35. During the term of any of these types of trusts, the trustee is typically authorized to use and apply the income and principal of the trusts for the maintenance, support, health care and education of the children.

For younger educators in particular, PSRS discourages trusts for minors and other younger children because, in order to receive the significant "dependency payments" available under PSRS, the designated beneficiary may not be a trust for the minor children. The PSRS office recommends that the educator normally designate his or her youngest child as primary beneficiary (or as contingent beneficiary, if the educator is married and desires that his or her spouse be the primary beneficiary), thereby preserving dependency payments for all under-aged children until the youngest child has attained 18 years of age, or, if still in school, 24 years of age. Since dependency payments obviously cannot be made outright to a minor, it is hoped that the educator receives guidance in completing his or her beneficiary form to designate a custodian under the Missouri Transfers to Minors Law to receive these payments; otherwise it will be necessary to establish separate court-administered conservatorships for each of the minor children - a very cumbersome and expensive proposition. The brochure which educators certify they have read prior to executing their beneficiary designation does provide some instruction in this regard, assuming the educator has, in fact, read and comprehended the brochure.

For unexplained reasons, the PSRS office only partially honors an express provision in the Missouri statutes which permits any "designated beneficiary" of a lump sum (i.e., including,

presumably, a trustee of a trust for the educator's minor children) to elect dependency payments for the educator's children in lieu of the receipt of the lump sum, by only allowing an individual (i.e., not the trustee of a trust for the children) to make this election. There is nothing in the Missouri statutes which requires that the designated beneficiary be an individual and not a trust. In fact, at one point the Missouri statutes clearly include an educator's "estate" within a listing of "designated beneficiaries." Yet per our discussion with legal counsel for the Missouri PSRS office, the office has apparently adopted this rule as policy. This position of the Missouri PSRS office is untenable, and makes the estate planning attorney's primary job of protecting the interests of the educator's minor children much more difficult.

In order to increase the likelihood that dependency payments will be available after the educator's death, the PSRS office encourages educators to name their youngest child as the sole primary or first contingent beneficiary of their PSRS benefits, followed by the next oldest child as next contingent beneficiary. The reasoning is that if the educator designates all of his or her children as primary or secondary beneficiaries of his or her PSRS benefits, and one or more of the children does not qualify for the dependency payments at the time of the educator's death, i.e., either because he or she is over 24 years of age or is over 18 years of age but is not enrolled in school, then none of the children will qualify for dependency payments.

The problem with this approach is that the educator's employer will not always explain to the educator that his or her minor child or children may not legally accept the dependency payments, under Missouri law. The educator needs to be instructed to designate a custodian under the Missouri Transfers to Minors Law to accept the dependency payments on the minor children's behalf; otherwise the dependency payments will be made to court-appointed conservators on behalf of the minor children - a very cumbersome and expensive ongoing process in Missouri - until the children attain age 18. Again, the brochure which educators certify that they have read prior to signing their beneficiary designation form does provide some guidance in this regard, assuming the educator has, in fact, read and comprehended the brochure.

Even if the educator has been sufficiently informed to designate a custodian to accept payments on behalf of a minor child, the educator may not be aware of (or at least remember) the harsh Missouri statutory rule which voids any beneficiary designation made by the educator which predates the birth or adoption of an additional child. When a new child is born or adopted, the educator's spouse, if any, is automatically deemed to be the educator's primary beneficiary, and *all* of the beneficiary's children are deemed to be equal beneficiaries in the event there is no surviving spouse. Thus, if at the time of the educator's death he or she is not married, or if the educator and his or her spouse should die in a common accident, and all of the educator's multiple children have previously been unwittingly designated equal beneficiaries as a result of this automatic voiding rule, and if at least one of those children is 24 years of age or 18 years of age and not in school at the time of the educator's death, no dependency payments will be available to the educator's other dependent children. This not uncommon fact situation demonstrates the punitive nature of the automatic voiding rule, a rule which needs to be quickly erased from the Missouri statutes. The fact that the educator was made aware of the automatic voiding rule at the time he or she initially completed his or her beneficiary form should not be viewed as sufficient warning of the potentially harsh consequences of not updating the beneficiary form upon the occurrence of a life changing event, perhaps many years later.

PSRS and PEERS Planning Problems for Experienced Educators

For purpose of this section, the term "experienced educators" shall refer to educators who have more than 10 but less than 25 years of service, and who have not attained 55 years of age. Experienced educators usually focus less on dependency payments, and more on lump sum and so-called "Option 2-type" payment options (i.e., monthly survivor payments extending for the life of the designated beneficiary). The reason dependency payments are less relevant to an experienced educator is that the experienced educator's accumulated contributions to PSRS will typically exceed what his or her spouse and/or children could receive in the way of dependency payments, and of course dependency payments are not available to PEERS members in any event.

The more significant issue the experienced educator will need to address is whether his or her surviving spouse or children would be better off receiving their survivor benefits in the form of a lump sum, or as so-called "Option 2-type" deferred monthly survivor payments for life. If an educator dies before attaining age 55 and before he or she has acquired 25 years of creditable service, the beneficiary may generally elect to either take a lump sum amount equal to the educator's accumulated contributions or wait and receive "Option 2-type" monthly survivor benefits beginning on the date the educator would have first been eligible to receive Option 2 benefits if he or she were then living.

Many problem areas associated with the PSRS/PEERS system of survivor benefits stem from the fact that, if the designated beneficiary elects to receive the survivor benefits in the form of a lump sum, he or she will most likely receive *much* less, in the long run, than what he or she would have received had he or she elected Option 2-type deferred monthly benefits instead. This is because a designated beneficiary electing the lump sum benefit option will only be entitled to the educator's accumulated contributions. Matching contributions made by the educator's employer are only "indirectly available" (i.e., through the deferred monthly benefits) if the designated beneficiary elects to receive Option 2-type benefits in lieu of the lump sum. Several significant estate planning issues ensue as a result of this preferential treatment towards Option 2-type benefits.

1. Unlike lump sum payments, Option 2-type benefits may only be paid to a single individual having an insurable interest in the life of the educator. They may not, for example, be paid to a trust or trusts for the benefit of the educator's children, even though the children beneficiaries of the trust or trusts obviously have an insurable interest in the educator's life, and even though the children may be minors. To the contrary, Option 2-type payments for a minor child beneficiary must be paid either to a custodian selected by the educator in his or her beneficiary designation or, if none has been selected, to a guardian or conservator for the minor child's benefit. Once the child attains the legal age of majority, all monthly Option 2-type payments must be made outright to the child, even though the child may be barely over 18 years of age. The educator is thus unable to protect the Option 2-type payments from the decisions of an immature child.

Fortunately, because Option 2-type payments to the educator's child cannot begin until the educator would have been entitled to Option 2-type payments himself or herself, i.e., if he or she had retired on that date, in most cases it will be unlikely that the Option 2-type payments will be made to minor children. Nevertheless, it will still be possible for Option 2-type payments to be made to immature children, at an age when most educators would not want their children to receive monthly

payments outright, and would prefer a trust instead. Again, the PSRS/PEERS system forces this predicament onto the educator, because the system will most likely pay out a much larger actuarial benefit under Option 2, than it would under the lump sum option.

2. Another perhaps even more significant problem with the PSRS/PEERS system is that Option 2-type benefits may not be paid to multiple individuals. Although this situation does not present a problem if the educator's desire is to designate his or her spouse or only child as beneficiary, it is a problem for unmarried educators (including widowed and divorced educators), if the educator's marriage is a second marriage and as a consequence the educator desires that his or her PSRS/PEERS benefits be paid to his or her children from his or her first marriage. It is also a problem if the educator and his or her spouse should die in a common accident, leaving more than one children surviving them.

Educators with two or more children must thus decide which of their children will be the primary or contingent beneficiary of their PSRS/PEERS survivor benefits. The significant problems associated with this system requirement are self-evident. Not only do all survivor benefits cease if the child selected as the sole designated beneficiary should die before one or more of his or her siblings, but the child designated as the sole beneficiary may at any point choose not to share the monthly benefits with his or her siblings. Further, if the designated beneficiary does share benefits with his or her siblings, he or she will be regarded as having made annual taxable gifts for federal gift tax purposes, i.e., because he or she is not required by law to share the benefits with his or her siblings. Finally, and perhaps most importantly, the child designated as beneficiary will be required to pay federal and Missouri income taxes on all of the Option 2-type payments, despite the fact that he or she voluntarily shares the same with his or her family.

3. Lastly, and as already discussed above in reference to the younger educator, if the experienced educator should divorce, remarry, have another child or adopt another child, any survivor beneficiary designation previously executed by the educator is automatically voided, and the PSRS/PEERS system then automatically replaces the previous beneficiary designation with one of its own - the surviving spouse, if any, otherwise all of the educator's children, in equal shares. In addition to the obvious problems associated with automatically voiding an educator's previously well-thought-out survivor beneficiary designation, most likely with the educator not even realizing the same, the PSRS/PEERS automatic voiding system may actually have the unintended effect of eliminating the potential for Option 2-type benefits for the educator's children, unless the educator remembers to update his or her beneficiary designation after the applicable life-changing event. This is because, as discussed above, Option 2-type benefits are only available to a single individual beneficiary, and the automatic voiding rule may have the effect of changing a single child beneficiary designation into a multiple child beneficiary designation.

The ultimate irony of the current PSRS/PEERS system is that not only does it fail most educators by not permitting them to designate multiple children as beneficiaries of Option 2-type benefits, but if an educator properly designates only one child as primary or secondary beneficiary, but then later has another child, the PSRS/PEERS system will automatically void the qualified form of Option 2-type beneficiary designation and substitute a disqualified multiple beneficiary designation in its place. The PSRS/PEERS office typically recommends that the educator designate his or her youngest child as beneficiary, followed by his or her next youngest, etc., and that the educator not

designate all of his or her children as beneficiaries. Yet this is *exactly the opposite* of what the current PSRS/PEERS statutes potentially force on the educator under the automatic voiding rule, i.e., a multiple beneficiary designation which will not qualify for Option 2-type benefits.

Planning Issues for Educators Approaching Retirement and Those Already Retired

Educators approaching retirement age will have a lesser need to worry about establishing trusts for their younger children, although often educators are still of the mind set that their children still in their 20s and even in their early 30s should not be given automatic monthly streams of benefits upon the death of the educator following retirement. There may also be a special needs child in the family who requires a trust for protection. Outside of these situations, however, the larger concern for educators approaching retirement should be the fact that, similar to the Option 2-type survivor benefits situation already described above, the PSRS/PEERS system does not allow educators to designate all of their children as monthly payment survivor beneficiaries if they were to die after retirement (Options 2 through 6, under the statute), nor does the system allow educators to designate as a monthly payment survivor beneficiary a trust or trusts for the benefit of their children. The significant potential problems associated with this prohibition against designating multiple children as monthly payment survivor beneficiaries are similar to the problems already discussed above for Option 2-type survivor benefits.

Unlike an active educator, a retired educator is also permitted to designate a residual beneficiary in the event the educator and his or her monthly payment survivor beneficiary both die prior to receiving the educator's full accumulated contributions. Here the educator is free to designate as residual beneficiary all of his children or even a trust or trusts for their benefit. The tradeoff, however, is that, except where (i) the educator designates his or her spouse as monthly payment survivor beneficiary after his or her death, (ii) the spouse predeceases the educator, and (iii) the educator later remarries, the educator is not permitted to designate a successor monthly payment survivor beneficiary in the event the original beneficiary predeceases the educator.

Finally, in some instances a retiring educator who has accumulated a significant number of years of creditable service will also have the option to take a partial lump sum distribution of his or her accumulated contributions (the so-called partial lump sum option, or "PLSO") and roll the same into an IRA. The educator could then designate a qualified trust or trusts for his or her children as the primary or contingent beneficiary of the rollover IRA, if desired. If the educator chooses the PLSO, he or she will have his or her monthly retirement benefit reduced, actuarially, for the partial lump sum distribution.

Recommendations

When representing PSRS and PEERS active educators, the estate planner's ultimate goal should be to develop a solution which will not have to be changed as the educator moves through the various stages described above. Experienced estate planners know that it is not practical to assume educators will have their personal estate planning foremost on their minds as they transition through the various stages of their career and life. What is need therefore is a drafting solution which will account for all potential eventualities. Of course, because PSRS/PEERS automatically voids active educators' beneficiary designations whenever a life change occurs, educators who have not yet retired

will need to be constantly reminded of this fact by their estate planning counsel, at least until the law is changed. Retired educators will not have the latter concern, however, because the automatic voiding law does not apply to them.

The recommendations we have for active educators include taking the following steps:

1. Young and experienced educators alike should consider purchasing term life insurance (e.g., 10, 20 or 30 year term) to cover the years prior to the educator becoming vested in Option 2-type benefits. For example, a 40-year old educator needing 10 more years of creditable service before his or her family will be entitled to receive the larger Option 2-type benefits might want to consider purchasing a 10-year term life insurance policy, to cover the years while his or her family would have to wait to receive the Option 2-type benefits. An educator needing 20 more years of creditable service might consider a 20-year term policy, etc.

2. Thinking even further ahead, the active educator might even want to consider adding a so-called "convertibility rider" onto the term life insurance policy he or she purchases, to provide the educator with an option to automatically convert the term product to a cash value product upon retirement. The addition of the convertibility rider would allow the educator to elect the larger Option 1 retirement benefits payable only for the life of the educator, knowing that tax free life insurance proceeds would be available to his or her surviving spouse and/or children, in the event of a premature death. The amount of the premium would obviously be higher after the conversion of the policy from term to a cash value product, but the educator would have the larger Option 1 retirements benefits to help pay the additional premium. The significant benefit of this approach is that the death benefit payable to the surviving spouse and/or children under the life insurance policy would be income tax-free, whereas Option 2 benefits would be taxable.

3. Because it is impossible to predict which election - dependency, lump sum or Option 2 - will definitely be the best election for the designated beneficiary to make after the educator's death, the educator should generally designate his or her revocable trust as the first contingent beneficiary of the survivor benefit (or as the primary beneficiary if the educator is not married or does not wish to designate his or her spouse as the primary beneficiary).

4. The second contingent beneficiary (or the first contingent beneficiary if the educator is not married or does not wish to designate his or her spouse as primary beneficiary) should be the educator's youngest child or, if the child is a minor, a designated custodian for his or her benefit under the Missouri Transfers to Minors Law. If possible, additional contingent beneficiaries should include each of the educator's remaining children (or custodians for their benefit), in reverse order of age.

5. The trustee of the revocable trust will then be given the following specific directions and powers under the terms of the trust document:

a. The trust document should give the trustee the sole and absolute discretion to determine whether to accept the lump sum payment or disclaim the same and allow it to pass to the contingent beneficiary. For younger educators the trustee might then elect to disclaim the lump sum and have it pass to a custodian for the educator's youngest child, since the position of the PSRS

office is that this is the only way the educator's children could receive dependancy payments. For more experienced educators, on the other hand, major factors to be considered by the trustee in exercising the trustee's sole and absolute discretion will include the number of years, if any, the contingent beneficiary would need to wait to receive Option 2-type benefits if the trustee were to disclaim the lump sum, as well as the amount of life insurance and other assets payable to or owned by the trust at the educator's death. The shorter the waiting period and the more there are other assets available to the trustee for the needs of the children, the less likely the trustee will need to accept the smaller lump sum payment.

b. If the trustee determines to accept the lump sum benefit, the Missouri PSRS/PEERS offices have confirmed that the trustee may also elect to roll the lump sum into an inherited IRA on behalf of the trust or trusts, thereby effectively allowing the beneficiaries of the trust or trusts to defer income tax on the lump sum payment over their life expectancies. (Note that the trust document must also be prepared properly to allow for this income tax deferral. In this regard see our article published in the February, 2010 issue of *Trusts & Estates,* entitled "Consider the MAT," an acronym which stands for the "Modified Accumulation Trust.")

c. In conjunction with the trustee's exercise of the trustee's authority to disclaim the lump sum benefit, the trustee can be given the sole and absolute discretion to determine whether, as a prerequisite to making the disclaimer:

i. the contingent beneficiary should be required to agree up front to share the Option 2-type benefit with his or her siblings and the descendants of any sibling who is then deceased or who dies subsequent to the educator but before the designated beneficiary child; or

ii. if the children are still too young to receive Option 2-type unrestricted payments, either in the eyes of the law (i.e., because they are still minors) or in the eyes of the educator and/or trustee, the children and/or their legal guardians can be required to agree up front to redeposit the Option 2-type payments into a trust or trusts for the benefit of the children which is/are established under the educator's trust document.

d. The arrangement described in paragraph c, above, should not create gift or income tax problems for the trustee or for the designated beneficiary. From a potential gift tax perspective, the trustee and the designated beneficiary would simply be agreeing to do what effectively would have happened anyway if the trustee had not disclaimed the lump sum benefit, i.e., they would be sharing the albeit potentially larger Option 2-type benefits with all of the siblings or their descendants. From a potential assignment of income or constructive receipt income tax perspective, the designated beneficiary should not be treated as having constructively received and/or assigned income to his or her siblings (or to trusts for their benefit), because the designated beneficiary would have not even been entitled to receive the Option 2-type benefits if he or she had not agreed up front to share the same with his or her siblings or their descendants (or with trusts for their benefit).

6. Finally, and perhaps most importantly, a system needs to be in place to ensure that the educator remembers to reinstate his beneficiary designation in the event it is automatically voided by the PSRS/PEERS statutes, e.g., if the educator has another child, becomes divorced, or remarries. This requirement may actually turn out to be the most challenging aspect of the special estate

planning recommendations for educators, because it is simply a fact that the typical educator does not "live and breath" the PSRS/PEERS handbook, which is probably the only place the typical educator would know of this "reinstatement" requirement. The PSRS/PEERS offices do at least frequently remind educators that their beneficiary designations need to be updated whenever one of these life changing events occurs, but that is the extent of the guidance the educators receive. Note also that the PSRS/PEERS statutes due not automatically void a beneficiary designation when the designated beneficiary dies; thus, the educator must also be cautioned to changed his or her beneficiary designation in the event this circumstance should arise.