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Planning Opportunities for Inherited IRAs

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Why Practitioners Need to Focus on the Secure Act in 2022

The SECURE Act of 2019 created important planning opportunities for inherited IRAs, but many clients still haven't considered these changes because IRA planning has been overshadowed by planning for potential tax changes by the Biden Administration. Practitioners should now remind clients of the need to revisit beneficiary designations to see if they could benefit from changes made by the SECURE Act. For some clients, these changes may require a complete reconsideration of their estate and insurance plans.

Overview of the Secure Act

The SECURE Act requires most beneficiaries of inherited IRAs to withdraw 100% of the IRA account by the end of the 10th year following the death of the plan holder. This can push income into higher tax brackets than distributions over life expectancy. If the beneficiary is a trust, those tax brackets quickly reach the maximum income tax rate at about $13,000 of income. Worse, if the income tax surcharges passed by the House in its version of the Build Back Better Act are eventually enacted, a 3% surtax could apply to trust income over $200,000 and an 8% surtax to trust income over $500,000. The result may be the equivalent of giving back most of the income tax deferral benefits accumulated over the prior 10 years. Additionally, unless an accumulation

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[1] Kenneth Horowitz is a Principal of Integrated Benefit Consultants and a Registered Representative and Financial Advisor of Park Avenue Securities LLC (PAS). Securities products and advisory services offered through PAS, member FINRA, SIPC. Financial Representative of The Guardian Life Insurance Company of America® (Guardian), New York, NY. PAS is a wholly owned subsidiary of Guardian. Integrated Benefit Consultants is not an affiliate or subsidiary of PAS or Guardian. CA insurance license # 0C37308. The information in this presentation is designed to be general in nature and for educational purposes only. All scenarios mentioned herein are purely fictional and have been created solely for training purposes. Any resemblance to existing situations, persons or fictional characters is coincidental. The information presented should not be used as the basis for any specific investment advice. The Guardian Life Insurance Company of America, its subsidiaries, agents, and employees do not give tax, legal, or accounting advice. You should consult their own tax, legal, or accounting advisors regarding their individual situations.

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Prior to the SECURE Act, inherited IRAs could be distributed over the life expectancy of the designated beneficiary (“DB”). In many cases the beneficiaries were children or grandchildren of the IRA owner which meant distributions, and the income taxes on those distributions, could potentially be spread out over several decades. This strategy was commonly referred to as the “Stretch IRA” technique. No more… Now that stretch out is limited to 10 years unless the beneficiary is an Eligible Designated Beneficiary (“EDB”).

Eligible Designated Beneficiaries May Still Stretch

Certain beneficiaries are exempt from the 10-year rule:

- Spouses
- Children until age 21
- Chronically ill beneficiaries
- Disabled beneficiaries
- Beneficiaries no more than 10 years younger than the IRA owner

Practitioners should keep in mind that the definitions of “chronically ill” and “disabled” are rigid and many with significant challenges may not qualify.
The restriction of the stretch to only this limited class of EDBs is a dramatic change that creates a need for alternative planning strategies to transfer retirement plan wealth to future generations on a tax efficient basis. This type of planning can add substantial value for professionals in many different disciplines: estate planning attorneys, CPAs, wealth advisors, and insurance consultants.

Importantly, there is loss of asset protection when beneficiaries take ownership of the IRA assets after ten years. Absent the use of trust beneficiaries, the lack of post-death control means the assets will now be subject to creditors, divorce, and ill-advised decisions of beneficiaries receiving the plan assets outright.

Post-Death control is a high priority for many clients. They want to be sure these assets end up with the intended beneficiaries of their choosing and stay with those beneficiaries (and not be lost to creditors or divorcing spouses of those beneficiaries). Consequently, there is now a need for alternative planning strategies to manage the income tax and asset protection implications of these changes.

Proposed Regulations

The IRS issued Proposed Regulations on February 23, 2022, to reflect the changes to the Internal Revenue Code made by the SECURE Act. The Proposed Regulations are likely to be modified before they are finalized, but they do provide the best window into the IRS’s thinking on a variety of issues.
The new Proposed Regulations would split Non-EDBs into two groups, each with its own set of post-death distribution rules. One group would be comprised of Non-EDBs who inherited from retirement account owners who died prior to their RBD. This group of beneficiaries would have

to receive the full balance from the IRA within ten years after the death of the IRA owner but wouldn't be required to take pre-SECURE Act RMDs for the first nine years.

Non-EDBs who inherited from retirement account owners who died on or after their RBDs would comprise the second group. This group of beneficiaries would be subject to both the 10-Year Rule and RBDs for the first nine years. In other words, beneficiaries who inherited retirement accounts from owners who died on or after their RBD would have to comply not only with the 'stretch' distribution rules in place before the SECURE Act was passed for nine years, but they would also have to empty the account by the end of the 10th year after death.

The Proposed Regulations also clarify who can be considered an EDB. They provide that the account owner's children are considered minors until they reach their 21st birthday. This means that minors would use the 'stretch' RMD rules until their 21st birthday, and then be subject to the 10-year rule and potential continued RMDs (if the decedent had died before reaching the RBD).

<u>Revise Client Wills and Trusts</u>

One revision to consider making to an IRA owner's will (or revocable trust if that is the primary dispositive document) would be to change the conduit trust that had been designed to hold IRAs and distribute the RMDs to the beneficiary to an accumulation trust. The problem with a conduit trust is that it requires the trustee to immediately distribute all assets received from the plan to the beneficiary. When a stretch was permitted it protected the plan assets over the life expectancy of the oldest beneficiary. However, with a conduit trust, the plan assets must now be distributed to the trust, and hence out to the beneficiary, at the end of the 10th year following the death of the plan holder. There is no protection from taxation or claimants at that point.

Thus, for some clients, the use of an "accumulation trust" may be preferable to protect assets. An accumulation trust can hold the distributions from the plan, and in particular the large distribution at the end of the 10th year following death for as long as the trust (or governing state law) permits. As discussed above, this creates an income tax problem of bunching income into that year which may result in higher taxes. So, if the accumulation trust is to be used, the client may want to reconsider steps to potentially reduce that taxation. Unfortunately, in some cases, the client may have to accept the tax costs to obtain the protection desired for the beneficiary involved.

But there is another change some IRA owners might want to consider, and that might include an almost complete revamping of the estate plan.

Example: The IRA owner might have had IRA assets held in trust and the remainder of the estate distributed outright without any trust to heirs. The thought might have been that the IRA distributions would be stretched, so why not give the remaining assets outright. Now that the "stretch" is limited to about 10-years, the plan owner might consider keeping a conduit trust to hold IRA assets for that 10-year period and then bequeathing the remaining estate into another trust so that those assets can be held longer in the trustee's discretion. That might amount to a "flip-flop" of the dispositive scheme with all assets previously bequeathed outright now going into trust. The trustee of the non-retirement assets could make discretionary distributions to perhaps approximate what the prior plan might have accomplished. This might require modification of the plan's beneficiary designation to provide for distribution outright to the beneficiaries, elimination of the conduit trust provisions provided for in the client's current revocable trust that had been named beneficiary, and adding a new trust for descendants to which assets of the estate could pour over. Also, beneficiary designations for non-retirement assets would have to be evaluated as those that might have to be changed to leave assets to the estate to pour into the new trust for descendants. Practitioners should bear in mind when evaluating these types of changes that in most instances holding all assets in protective trusts for as long as possible is generally the best answer to protect assets subject to the income tax considerations that trusts, especially for retirement assets, create.

Example: The IRA owner might revise the beneficiary designation for his plan to designate a charitable remainder trust ("CRT") as beneficiary. On the death of the plan holder, the IRA could be paid to the CRT. No current taxable income would be realized. Payments would be made to the intended beneficiary pursuant to the terms of the CRT, but with a minimum 5% payout, and each payment would carry out a portion of the income. This might accomplish something approximating the intended stretch (deferral) before the SECURE Act.

Example: The IRA owner in the above example might also purchase life insurance on himself or herself to replace the estimated assets passing to charity at the end of the CRT term. This amount would have to be at least 10% of the value of the assets under the CRT rules. The insurance might be held by an insurance trust (e.g., as a spousal lifetime access trust or "SLAT" designed to also hold life insurance) to avoid having the insurance included in the plan holder's estate. If the client does not have an existing irrevocable life insurance trust ("ILIT") but does have a SLAT that can hold the insurance that may entice the client to use a trust, as no new trust will need to be created. This is a similar planning concept to the "wealth replacement trust" that has commonly been used to replace the wealth that might pass to charity under a general CRT plan, but now applied in the new post-SECURE Act context to be coupled with a plan to mimic the no-longer-available stretch.

Of course, if a CRT is added to the plan the costs of creating and administering the plan and the life insurance must be considered. But as noted above, if the client already has a well-funded SLAT (e.g., created in the 2020-2021 planning frenzy) there may be little or no additional cost to create or administer a trust and no need to make gifts to the trust to pay for life insurance premiums as the assets contributed to the SLAT to use exemption may be redeployed for this purpose.

What Can Be Done About Old Conduit Trusts if the IRA Owner Dies Before Changing the Trust Terms?

The reality is that most taxpayers ignore warnings and recommendations from the media and even their own advisers. Few enjoy discussing planning for death, and even fewer enjoy the professional fees their advisers will charge to update documents. So, it is likely that many taxpayers will not revise their wills and or trusts to modify pre-SECURE Act conduit trusts, for example, changing them into accumulation trusts to prevent a large lump sum distribution to a beneficiary after about 10 years, or engage in other planning to address the SECURE Act as discussed elsewhere in this article. All may not be lost as even post-death there may be ways to modify the trust and provide a safer result.

- Many states permit a non-judicial modification of a trust by agreement of those involved, but if the plan holder whose will or trust is involved is deceased that may not be a viable option. Practitioners should consider what applicable state law permits, and if state law is not as flexible as desired, determine whether the governing law and situs of trust administration can be moved to a state with more favorable laws.

- Courts might reform an existing conduit trust into an accumulation trust if it can be demonstrated that the SECURE Act changed the result that the testator or trustor intended at the time of executing the instrument creating the conduit trust.

Planning For Young Beneficiaries

The problem for minor children who might inherit an IRA is obvious. Too much money might have to be distributed to the beneficiary at age 31 (age 21 plus ten additional years under SECURE), or earlier if the minor is not a child of the plan holder. The latter rule may apply because only a plan holder's child obtains the deferral to age 21 before the new SECURE Act 10-year rule kicks in. Many plan holders (parents, or other benefactors) will not want that result.
The answer for some plan holders will be to revise their estate planning documents and substitute an accumulation trust in place of the conduit trust. But the result will be that after the 10th year the entire IRA plan balance will have to be distributed to the trust bunching that income into a single high trust tax year. Since trusts face compressed income tax brackets, much of that income may be pushed into the highest tax bracket, as discussed above.

Another option is a variation on what was discussed above. The plan holder may revise his/her estate plan to leave non-retirement assets or life insurance to the minor beneficiary in a long-term trust, and plan assets to beneficiaries for which there may be less concern. This would constitute a complete restructuring of the client's plan.

Strategies to Address the Elimination of the Stretch

ROTH conversions involve paying income tax now in exchange for receiving distributions income tax-free in later years. The assets however will still be owned outright by the beneficiaries without additional planning. They will still be reachable by their claimants or their ex-spouse and will also be included in their estates. This may become more concerning as estate taxes are expected to increase while the estate tax threshold is expected to decrease with a reduction of the exemption by half in 2026.

Example: Modified Roth Conversion

Below is a summary of a study comparing a more traditional approach clients take by deferring growth then taking RMDs at age 72 to life expectancy, passing the remaining balance to their beneficiaries at age 95 with an alternative technique that may be referred to as a "modified Roth conversion." With the modified Roth conversion, the after-tax proceeds are reallocated to an income tax efficient plan using life insurance over a 10-year period. Alternative periods can also be used. The policy is owned inside an irrevocable life insurance trust allowing the proceeds to pass income and estate tax free. Using the ILIT is where this technique can mimic the traditional "stretch" strategy. It is possible with this approach that the following benefits might be realized:

- Over 50% less paid in income taxes;
- Over 25% more assets passed on to next generations outside the estate;
- Additional protection from creditors, divorce, and other potential unexpected wealth eroding events; and
- Some clients might be motivated to reconsider life insurance options given the vagaries of the investment markets

<u>Two Hypothetical Scenarios Based on a $3,000,000 IRA</u>

1. A more traditional approach of taking RMDs from an IRA from age 72 to 95 vs.

2. An IRA paydown over 10 years at age 60, then funding an income tax efficient account through a whole life survivorship insurance policy:

	Scenario #1: Traditional IRA	Scenario #2: IRA Paydown
Total Income Taxes Paid	$3,787,498	$1,600,412
Net Account Value @ age 95	$1,234,888	$4,652,834
Income Received	$3,394,277	-0-
Legacy Value	$1,234,888	$5,867,288

Assumptions: Assets grow @ 4%; 45% tax rate

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<u>Charitable Remainder Trust Coupled with Wealth Replacement Trust</u>

The CRT technique mentioned above may be of interest to those clients who have charitable intent. This strategy mimics the traditional "stretch" in two ways by using a CRT and a wealth replacement trust.

Using this approach, the donor names a CRT as beneficiary of his IRA, which enables the assets to provide an income stream to the child beneficiary of the CRT for a specified period (the maximum period is 20 years). When the CRT terminates, the assets pass to the charitable remainderman. Then, using an ILIT, the life insurance proceeds replace the assets passing to charity.

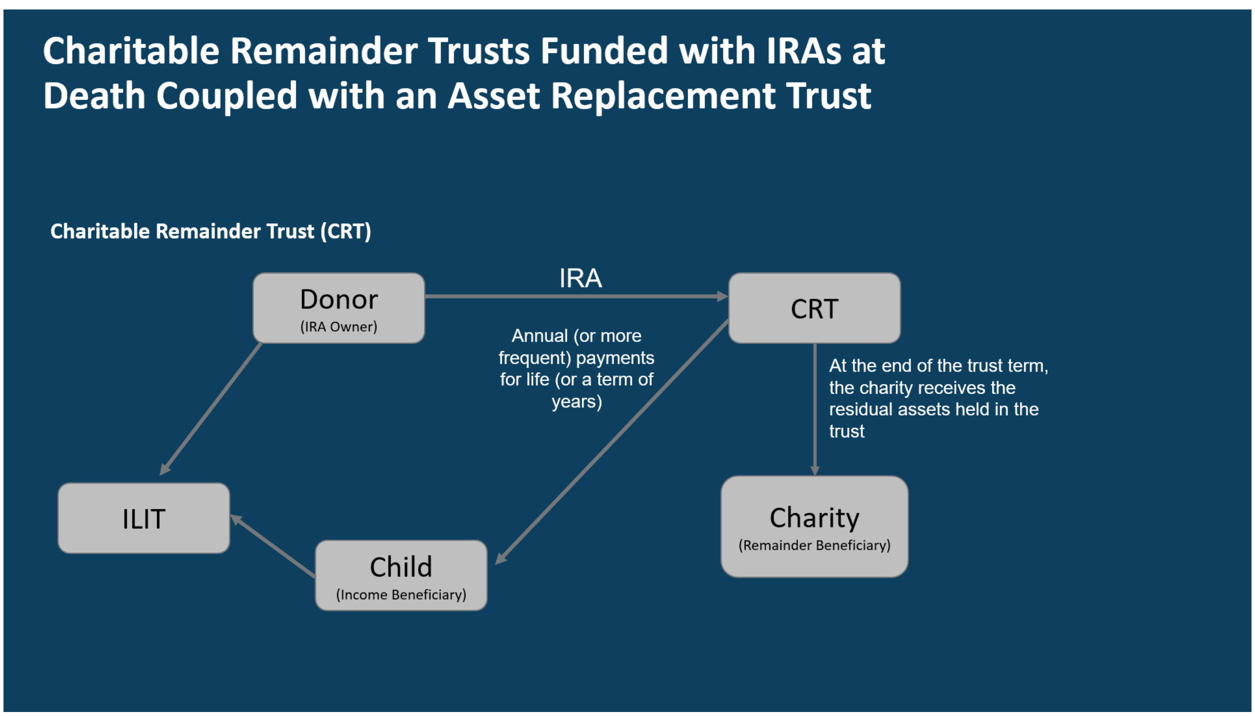
The client may mitigate most of the income taxes typically paid on these assets, other than the CRT distributions, making this potentially a tax efficient strategy to pass assets. In addition, the client receives an estate tax deduction for the remainder interest passing to the charity.

However, the client may be concerned by the projected payment to the charity receiving the remainder of the IRA proceeds upon termination of the CRT if there is no charitable intent. This loss of value to charity may be offset in part by the tax benefits the CRT provides. In addition, as noted above, a "wealth replacement trust" component can be added to the plan if desired. Practitioners might consider recommending that the client at least evaluate the use of a wealth replacement trust technique even if these concerns are not significant. Why? Because the evaluation of the economics of the transaction and potential option of the wealth replacement technique may serve to explain and illustrate the planning better to the client and provide another planning option for the client to consider.

Moreover, all of this may be useful education to the client even if the client does not opt to proceed in this manner. It is also protective of the practitioner regardless as to whether the client opts to use the life insurance and trust approach as it will corroborate that an additional option was provided and that a second adviser (the insurance adviser) reviewed the planning with the client.

While alive, the IRA owner may use some IRA distributions or other assets to fund the ILIT (or as noted above, an existing SLAT if it suffices) to pay the policy premiums. In addition, or alternatively, the child can use some or all of the CRT income stream to fund the irrevocable life insurance trust to pay premiums.

For example, if a donor would normally have left an IRA to grandchildren, which may no longer be available under the SECURE Act due to the 10-year rule and elimination of the "stretch, the donor can leave the IRA to a CRT at death, and the child beneficiary of the CRT can fund an ILIT that owns a life insurance policy on the child which will benefit the grandchildren when the child dies and the remaining assets in the CRT pass to charity.



Conclusion

Revise old wills and trusts – consider replacing conduit trusts with accumulation trusts for greater control and flexibility of IRA assets after the 10-year stretch period ends. Keep in mind, trust income over $13,000 is subject to maximum ordinary income tax rate.