ESTATE PLANNING WITH INDIVIDUAL RETIREMENT ACCOUNTS

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USING THIS REPORT

At first glance, the concept of an Individual Retirement Account (IRA) seems simple enough: a structured way to save for your golden years while deferring taxes on your growing nest egg. Unfortunately, that simple idea becomes one of the most complex areas of estate planning once IRS rules are applied. That means that not only must an estate planner consider estate tax reduction techniques, but also the amazingly complicated income tax rules the IRS has issued in its regulations. After relying on variations of the "Proposed Regulations" since 1987, the IRS issued Final Regulations in April 2002. The SECURE Act modified the landscape again in December 2019. Proposed Treasury Regulations were issued in 2022, and SECURE 2.0 became law in December 2022. In July 2024, the Treasury issued final regulations under SECURE regarding Required Minimum Distributions (RMDs) along with Proposed Treasury Regulations under SECURE 2.0.

This report is intended to provide general guidance on the income and estate tax considerations involved. It is not intended as legal advice. Only an analysis of a client's particular financial and family considerations provides a sufficient foundation for an estate planner to make appropriate planning recommendations.

CONSIDER THE COMPLEXITY AND UNCERTAINTY OF THE RULES

As will be discussed in the following sections of this report, there is considerable complexity and uncertainty in determining how the IRS and your particular IRA administrator will manage the issue of taxation in the case of the death of the owner. Some plan administrators require withdrawal of the IRA balance within a period of one to five years, even though the IRS might allow a greater number of years. You should consider that uncertainty when making your estate planning decisions.

As an example, if you simply name your spouse as the beneficiary of your IRA, you and your spouse can be assured of the maximum income deferral benefits for each of you. However, <u>if you name your spouse directly</u>, you lose many protections and cannot be certain that your children will ultimately get the assets as an inheritance.

STEPS IN THE PLANNING PROCESS

Initially, a decision must be made concerning which family members are intended to benefit from the estate plan. Each choice may have important tax consequences. For the remainder of the report, we will assume that Mr. and Mrs. Smith and their children are the family for whom we will plan. Let's look at the unique issues involved in IRA planning.

ESTATE TAX PLANNING

All to the spouse – One option available to married couples is for each spouse to name the other as the beneficiary of the owner's IRA. When the owner spouse dies, the surviving spouse will own the IRA and there will be no estate taxes imposed because bequests to a spouse are protected by the unlimited Marital Deduction. This is a simple plan that protects the surviving spouse from estate taxes or income tax uncertainty. Further, by naming the spouse directly, the surviving spouse can treat the assets as their own, *i.e.*, can do a "spousal rollover." We will discuss this later. However, there are some circumstances in which an individual might not want to name their spouse directly. Instead they may wish to name a trust, which can provide for their surviving spouse and children.

Why would you want to do this if the simple plan can work well? Because the simple plan does not provide protections that may be needed in some circumstances. Let's look at Mr. and Mrs. Smith. Mr. Smith has three children and Mrs. Smith has four children of her own. It was a second marriage for each of them. They were not involved in raising each other's children. Each spouse wants to benefit the other spouse and then their own respective children. Mr. Smith has a sizable retirement plan. If he leaves it directly to Mrs. Smith, he is concerned that she may not leave it to *his* children at her death. Instead, Mr. Smith could leave the assets in the retirement plan to a trust for the benefit of Mrs. Smith. At Mrs. Smith's death, the trust could distribute to his children. In this manner, Mr. Smith can rest assured that his wishes will be carried out. The trust can also provide creditor protection for the surviving spouse, in other words, the assets in the trust might be protected if Mrs. Smith is sued. The trust can also provide management for the assets and remarriage protection so that the assets are protected in the case of a divorce after remarriage.

As we'll see later, it's a trade-off. If Mr. Smith leaves the retirement plan assets to the trust, he gains many protections and peace of mind. However, by using the trust, Mrs. Smith will not be able to do a "spousal rollover" and distributions will have to be taken more quickly as a result.

REQUIRED MINIMUM DISTRIBUTION RULES

IRAs represent savings that have grown tax-deferred. That means that when funds are withdrawn, they are subject to ordinary income tax rates. Congress enacted the IRA rules so that taxpayers could save for their retirement. However, Congress' generosity has its limits. To ensure taxpayers ultimately pay income taxes on their IRA balances, Congress enacted the "Required Minimum Distribution (RMD) rules." These RMD rules require taxpayers to begin withdrawing their IRA balances when they reach age 73 for those reaching age 72 after December 31, 2022 (The SECURE Act, which we'll discuss later, changed this from age 70 ½, which was the age prior to 2020 to 72 which was the age until

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December 31, 2022). The final date to make the first withdrawal is April 1 of the calendar year following the calendar year when the owner reaches the required age. This is called your "Required Beginning Date (RBD)." Let's use 73 as our benchmark and apply the RMD rules to the Smiths.

Mr. Smith has just turned 73 and will be considered 73 under IRS rules. Mr. Smith has to make some decisions soon about withdrawing funds from his IRA. He has several choices. He can take all the funds at one time. However, that would require the deferred income taxes to be paid all at once, so typically he won't want to do that. Another choice is for Mr. Smith to withdraw the minimum amount required under the Regulations. Mr. Smith has chosen this option to defer the income taxes for as long as possible.

HOW MUCH MUST MR. SMITH WITHDRAW?

We know how long Mr. Smith has to withdraw his IRA, but how much does he have to withdraw in any one year? Mr. Smith simply divides the balance of his IRA, at the end of the prior year, by the number of years indicated under the table provided by the IRS. For the first year, he divides the balance by 26.5. For the second year, he divides the balance by 25.5, and so on, as the IRS Uniform Lifetime Table provides. As an example, assume Mr. Smith's IRA had a balance of $1 million in the first year. He divides $1 million by 26.5 and finds he must withdraw $37,736. We now know how much Mr. Smith must withdraw, but when does he have to make a withdrawal?

WHEN MUST WITHDRAWALS BE MADE?

If Mr. Smith turns 73 in 2031, there is a RMD due for 2031, which he must withdraw by April 1 of 2032, his RBD. Should Mr. Smith wait until 2032 to take his first RMD, then he must take *two* distributions in 2032, one for 2031 and the other for 2032. Now that we have covered the RMD rules, let's revisit the estate tax planning part of the report.

Remember that naming Mrs. Smith as the beneficiary is a "simple" plan for the IRA, but may increase estate taxes on the inheritance left to the Smith children and have other disadvantages discussed above. If Mr. and Mrs. Smith want to protect their children's inheritance (from unnecessary estate taxes or from being directed elsewhere), they could use a trust as part of their estate plan. They may also use the "simple" plan of naming the spouse as beneficiary and purchasing a second-to-die life insurance policy. Let's look at the rules for trusts as beneficiaries of IRAs.

USING TRUSTS AS THE IRA BENEFICIARY

A trust may be the beneficiary of an IRA without causing a loss of most of the income deferral opportunities if the criteria below are met. However, the IRS is interpreting these rules in an inconsistent manner and there is always a risk that the IRS may challenge a trust for a minor infraction. The requirements are:

1. The trust is irrevocable or, by its terms, becomes so at the death of the IRA owner.

2. The trust is a valid trust under state law, or would be if it were funded.

3. The beneficiaries of the trust who have a right to the IRA benefits are identifiable by the terms of the trust, by no later than one year after the IRA owner's date of death.

4. A copy of the trust, or a certificate containing certain information, is provided to the IRA Administrator.

Generally, a copy of the trust or the certificate must be provided to the IRA Administrator no later than September 30th of the year after the IRA owner's death. If the trust meets these qualifications, the rules governing IRAs consider the trust beneficiaries the beneficiaries of the IRA. As an example, if Mr. Smith's trust provided that Mrs. Smith was the beneficiary of his trust at his death, and his children received his property at her death, Mrs. Smith and her children are considered to be the beneficiaries of Mr. Smith's IRA. Because Mrs. Smith *and* the children are considered beneficiaries, the IRS limits valuable income deferral benefits for inherited IRAs payable to trusts.

The trust as beneficiary will receive the RMDs from the IRA, but not exactly in the same way as Mrs. Smith would have, if she had been the beneficiary. The next section explores the IRA minimum distribution rules for inherited IRAs.

IRA DISTRIBUTIONS TO A BENEFICIARY

The IRS rules for RMDs to beneficiaries of inherited IRAs are some of the most complicated in estate planning. Generally, most distributions to a beneficiary follow the 10-year rule discussed below, however, if the 10-year rule does not apply, then the following rules apply:

1. If the beneficiary is an *individual*, or a qualified trust, the beneficiary may elect to withdraw the IRA balance over the beneficiary's life expectancy by beginning withdrawals in the calendar year following the year of the owner's death; or

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2. If the beneficiary is *not an individual*, or if an individual or qualifying trust beneficiary **did not begin taking withdrawals by the end of the calendar year following the year of death**, the beneficiary *must* withdraw the entire balance of the IRA by the end of the calendar year which contains the fifth anniversary of the owner's death. However, if the plan owner died after beginning to take RMDs, the beneficiary can continue taking RMDs using the deceased plan owner's remaining life expectancy under the IRS' Tables.

A special timing rule exists for spousal beneficiaries. If Mr. Smith named Mrs. Smith as the named beneficiary, then she may defer taking RMDs until Mr. Smith would have reached 73. The IRS has taken the position that if a trust is named as the beneficiary, the spouse is *not* able to defer taking payments until the deceased owner would have attained age 73. (Therefore, even if the spouse is the beneficiary of the trust, and the IRA is made payable to the trust, the trustee must begin withdrawing the RMDs by the end of the calendar year following the calendar year of the owner's death or be subject to the 5-year rule. This is a very restrictive position by the IRS and can be a good reason to simply name Mrs. Smith as beneficiary. But the income tax benefits of doing so must be weighed against other concerns outlined earlier.) This is the first IRS complication which arises from using a trust as the beneficiary to protect the children.

As will be discussed later, trust income tax rates also complicate the decision to use a trust as the beneficiary of an IRA. Don't forget, some IRA Administrators have adopted plans more restrictive than the IRS rules, in which case, the IRA Administrator may ignore the IRS rules and insist on a faster payout of the entire IRA if the trust is used as a beneficiary.

INCOME TAX CONSIDERATIONS WHEN NAMING A TRUST AS THE BENEFICIARY

What about the income tax consequences of naming the trust as a beneficiary? Trust tax rates are "compressed." The income tax brackets are indexed and, in 2025, a trust pays 37% of each dollar of taxable income in excess of $15,650. In 2025, a single taxpayer does not pay income taxes at the 37% rate until taxable income exceeds $626,350. Prior to reaching $626,350, the individual pays lower rates on lesser amounts.

As a simple example, if a single taxpayer has a taxable income of $50,000, the income tax bill is approximately $5,914. However, a trust with a taxable income of $50,000 has a tax bill of approximately $16,487. Therefore, assuming the $50,000 taxable income was a RMD, and assuming there weren't distributions from the trust which carried the income out to the beneficiaries, using the trust as the beneficiary to protect the Smith children from estate taxes costs the Smith family over $10,000 in increased income taxes in 2025. Trust income tax rates are the biggest problem with using trusts as beneficiaries.

BALANCING THE TAX RATES

Very few surviving spouses are going to want to have their economic security decreased by the loss of over $10,000 per year in increased trust income taxes. Is there anything that can be done about it? Yes, if the trustee of the trust distributes the $50,000 RMD to Mrs. Smith within 65 days of the end of the year in which the trust received the RMD, the trust is allowed a deduction and Mrs. Smith pays taxes at the individual income tax rate. Of course, the after-tax income will be in her estate and subjected to estate taxes prior to passing to her children. This is a decision the family will need to discuss each year.

Finally, let's look at the rules for rollovers.

ROLLING OVER AN INHERITED IRA

By "rollover" we mean that the beneficiary of an IRA may elect to treat the IRA as their own. Only a spouse may rollover an IRA inherited from a spouse. If a child or trust inherits an IRA, the IRA must remain in the name of the decedent or the entire balance will be taxable when the name is changed to the child's or trust's IRA. A spousal rollover can be used to create a "stretch" IRA.

By "stretch" we mean that Mrs. Smith may treat the IRA as her own and name, as an example, her daughter, age 42, as her beneficiary. Mrs. Smith may use the IRS Uniform Table to determine RMDs during Mrs. Smith's lifetime. However, when Mrs. Smith dies, the IRA payment period will be determined based on the daughter's situation. Under the SECURE Act, discussed below, the daughter would need to pull all the assets out by December 31st of the year including the 10th anniversary of Mrs. Smith's death. Mrs. Smith's ability to stretch the assets over her own life before the application of the beneficiary payout rules for her daughter is a considerable benefit.

SECURE ACT

As mentioned earlier, in December 2019 Congress altered the IRA landscape yet again. Also as previously noted, the age at which you need to start taking RMDs was increased from age 70½ to 72 (and later 73). That was good news. However, the Act brought bad news for most people trying to maximize deferral of IRA distributions after their death.

The SECURE Act sits on top of the old rules, which are still in effect, except as explained below. The biggest change takes place after your death.

If your beneficiary is in one of the classes outlined below, then the rules above still apply. In other words, after your death, they'd look at their divisor under the IRS tables based on their life expectancy and each year they'd take out their RMD.

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But, most of your beneficiaries will be subject to a new 10-year rule and if you died after your RBD, they will need to continue taking distributions from the inherited IRA. Additionally, they must take everything out by the end of the year including the 10th anniversary of your death. Let's say you die in July 2023 and name your daughter as beneficiary of your IRA. Your daughter is age 42 at your death. If you died after your RBD, then we look at the IRS table to determine the RMD. Regardless of the annual RMDs, she'll need to take everything out of the IRA she inherited from you by December 31, 2033, the end of the 10th year. This substantially shortens the distribution period for most beneficiaries. This also applies when a trust is the beneficiary of the IRA, except if the trust meets certain additional requirements and the beneficiary of the trust is "eligible" as outlined below.

Who are the "eligible" beneficiaries who still get to use their life expectancy under the old rules rather than the 10-year rule?

1. **Your spouse**. If you name your spouse as beneficiary, they can rollover the IRA into their own IRA and stretch the payout. In other words, they wouldn't have to start taking RMDs until after they reached their own RBD after age 73. If you left the IRA to them in a trust with only them as the lifetime beneficiary and meeting other rules, the trust could take the benefits over your spouse's life expectancy.

2. **Your minor child.** If you name your child and they are a minor at your death, they would be required to take distributions over their life expectancy until they reached age 21. After that, they'd be under a 10-year rule, just like other beneficiaries. If you leave the IRA to a trust for your minor child that meets certain requirements, the trust would take distributions over your minor child's life expectancy until they reach majority, and then the 10-year rule would apply, just like if you named them individually. It's important to note this exception only applies to your minor child, not your grandchild, nephew, niece, or any other minor.

3. **A beneficiary who is disabled or chronically ill**. If you name a beneficiary who is disabled or chronically ill, as defined by law, they are not subject to the 10-year rule and would take RMDs annually over their life expectancy. If you name a trust for their benefit which meets certain requirements, the trust would be treated the same and would use the disabled or chronically ill beneficiary's life expectancy for RMDs.

4. **A beneficiary who is not more than 10 years younger than you**. If you leave your IRA to a beneficiary who is less than 10 years younger than you (like your younger brother), they would not be subject to the 10-year rule, but would take the RMDs over their life expectancy, just like before the SECURE Act. Again, a trust meeting certain requirements would take RMDs based on their life expectancy, too.

If one of these "eligible" beneficiaries dies (or the minor reaches majority), the 10-year rule would commence at the death of the "eligible" beneficiary.

STRATEGIES TO STRETCH AFTER THE SECURE ACT

After the SECURE Act, there are a number of planning strategies to help minimize the tax burden your heirs may have.

One of these possible solutions is to name a Charitable Remainder Trust as beneficiary. There are a lot of strict rules with this type of trust, but it could be a great solution if you are charitably inclined, have a large amount of retirement assets, and want to defer income taxation for your beneficiaries as much as possible. It’s important that this type of plan only be done by someone who is experienced in this area.

Another solution is to work with your financial planner or advisor to “Roth” your IRA. Rothing your IRA means converting your traditional IRA or 401k into a Roth IRA. Doing this would allow your beneficiaries to get a maximum deferral and take distributions in the 10th year without paying any tax. Without a Roth conversion, your beneficiaries would need to spread their distributions over several years to avoid a possible spike in income tax rates.

Another solution is to use distributions from your IRA to pay premiums on life insurance. This could be done with a policy you own or using an Irrevocable Life Insurance Trust. Generally, life insurance proceeds received by your beneficiary due to your death wouldn’t be included in your beneficiary’s gross income and wouldn't have to be subject to income tax.

Finally, another solution is to leave your IRA to an “eligible” beneficiary who isn’t subject to the 10-year rule and could stretch distributions over their life expectancy and then leave other assets (other than IRA assets) to a beneficiary who would not be “eligible” but would be subject to the 10-year rule on IRA assets. For example, let’s say your assets consist of your IRA worth $500,000, home worth $500,000, and $1 million in other assets. You want to leave about ½ your assets to your spouse and ½ to your adult child. If you leave the IRA to your adult child, they’d be subject to the 10-year rule, but your spouse could do a rollover of the assets or stretch them over their life expectancy. So, you could leave your home and the IRA to your spouse and the other assets to your adult child.

Planning for IRAs can be complicated. But a qualified estate planning attorney can help you navigate this complex area.

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ABOUT THE ACADEMY

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