COMMENTARY

Revisiting Estate Planning With IRAs and Qualified Retirement Plan Benefits

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October 27, 2022 at 11:55 AM

Trusts and Estates

By Rebecca Rosenberger Smolen and Amy Neifeld Shkedy | October 27, 2022 at 11:55 AM

Over the last 30 years there have been significant changes in the applicable law that impacts considerations in estate planning with individual retirement accounts (IRAs) and tax-qualified retirement plan benefits. Overall, the law has been simplified quite a bit (for example, decisions no longer must be made about whether to "recalculate" or use the "subtraction method" when a taxpayer reaches the required beginning date). Despite the various simplifications, this special category of assets remains more complicated to plan for than most of the other assets that we must help our clients incorporate into their estate plans. Because these assets comprise a very significant portion of the asset base for nearly all of our clients, it is important to make sure they are properly addressed.

Until recently, when the Secure Act became law in December 2019, a key focus in planning was to preserve the opportunity for a client's beneficiaries to "stretch out" the distribution of these tax deferred accounts for as long as possible to maximize the potential investment return after tax. Because the beneficiaries could take distributions over their life expectancies, this often led clients to consider making the designated beneficiary (after a surviving spouse) their youngest potential beneficiaries (typically grandchildren) and trusts for their benefit. Now, under the Secure Act, the life expectancy of nearly all beneficiaries, other than a surviving spouse, is irrelevant to the payout calculation so selecting the youngest beneficiary possible is no longer a consideration in the estate planning process for tax planning purposes.

The standard distribution period for most beneficiaries now is limited to 10 years after the death of the IRA owner or retirement plan participant. Under the Secure Act, the initial presumption of planners, based on a reasonable interpretation of the applicable statutory language, was that beneficiaries were not required to take any distributions until the expiration of the 10-year period, but, could take a distribution sooner if desired. However, that interpretation was called into question by some tentative guidance by the IRS indicating that distributions would actually be required for each and every year during the 10-year period.

Recently, in IRS Notice 2022-53, as an acknowledgement that taxpayers have a reasonable basis for uncertainty on the proper interpretation of the statutory language, the IRS essentially waived any possible annual requirement for distributions for 2021 and 2022 for beneficiaries who would be subject to the 10-year distribution period. So, if in fact it will be concluded that annual distributions are required during the 10-year period, the deadline for the first annual distribution under the new Secure Act rules wouldn't be until Dec. 31, 2023. Without the waiver of this requirement for 2021 and 2022, taxpayers faced the risk of a 50%

tax penalty on required annual distributions that were not timely made.

Before the Secure Act, in order to guarantee the maximum stretch-out period for the next generation (i.e., children and grandchildren), common guidance to clients in a single marriage with common children was to name the surviving spouse as primary beneficiary and a trust for the sole benefit of the next generation as the contingent beneficiary. This was the case even when the general advice to the clients otherwise, for tax and creditor protection purposes, was to strive to send as close to 50% of the couples assets to a trust structure on the first death (for the sole use of the surviving spouse during the survivorship period, with the remainder passing for the benefit of the next generation). The reasoning being that on the death of the surviving spouse the next generation could use their longer life expectancy to "stretch-out" the deferral period, whereas if a trust structure were instead used, the next generation would be "stuck" with the life expectancy of the surviving spouse for determining the payout period since the surviving spouse was naturally the oldest trust beneficiary with the shortest life expectancy. Now that the next generation is limited to the 10-year payout period, it is often appropriate to direct the account directly to a trust structure rather than naming the surviving spouse as the primary beneficiary. Note that for qualified retirement benefits (but not IRAs), under the applicable provisions of ERISA (as amended by the Retirement Equity Act), this will mean making sure that the surviving spouse properly waives his rights to be the primary beneficiary in favor of the designation of the trust instead.

Also, it is now worthwhile for families to consider naming a charitable remainder trust as beneficiary of a tax deferred retirement account to approximate the tax deferred compounding benefits that had been available over the life expectancy of children (or grandchildren) under the prior law. The charitable remainder trust will be able to reinvest taxable funds received over the lifetime of the noncharitable beneficiaries and will result in the conversion of some of the post death investment return from being ordinary income to capital gains and qualified dividends, which are taxed at lower rates. The amount calculated to pass to charity after the lifetimes of the noncharitable beneficiaries must be at least 10% of the funding amount.

A final key change in planning is that there generally is no longer a compelling reason to use the conduit trust structure to maximize the tax deferral period for an inherited IRA passing to the next generation. Under the pre-Secure Act law, the use of a conduit trust structure where any distribution was required to be distributed out of the trust to a designated beneficiary gave clarity to whose life expectancy, among the various trust beneficiaries, would govern the distribution period for the IRA. Now that the life expectancy of the beneficiary with the shortest life expectancy is no longer relevant under the 10-year rule, in most cases it will be fine to use the accumulation trust structure instead, under which distributions from an inherited IRA can remain in the trust for reinvestment rather than being required to be distributed as they are received to a conduit beneficiary. Moreover, using a conduit trust structure going forward can be problematic because it would force the distribution of the IRA benefit to the conduit beneficiary within the 10-year post-death period, when the goal of using a conduit trust in the first place would likely have been to maintain the IRA benefits within the trust structure for the much longer period of the beneficiary's life expectancy.

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