Estate Administration for IRAs and Qualified Plans – After the SECURE Act

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SECURE ACT

THE "TEN-YEAR RULE"

EFFECTIVE DATE

January 1, 2020

SECURE ACT
TEN-YEAR RULE

Modification of

Required Minimum Distribution Rules

for Designated Beneficiaries

Basically, requires all IRAs and Qualified Plans to be distributed within 10-years of death

SECURE ACT
TEN-YEAR RULE

- Exceptions for certain beneficiaries
  ("eligible designated beneficiary")
  - Surviving Spouse
  - The employee's Children under the age of majority *(not grandchildren or any other children)*
  - Disabled
  - Chronically ill
  - Individual not more than ten years younger than employee

IRC § 401(a)(9)(E)(ii)

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Foundation Concepts

Introduction to Retirement Distribution Planning

Foundation Tax Concepts

- IRAs are not taxed until distributed
- Distributions must begin no later than one's Required Beginning Date (RBD)
- IRA elections are required after death
- Deaths on or Before December 31, 2019 – Life Expectancy Rules
- Deaths on or After January 1, 2020 – 10-Year Rule Generally
- Roth IRAs Require Special Planning
- Basis Requires Special Planning
- NUA Requires Special Planning

Foundation Property Law Concepts

- Wills control probate assets
- Trusts control trust assets
- IRAs and qualified retirement plans are controlled by beneficiary designation form or default provisions of contract

Foundation Concepts

- IRC Sec. 408(g)
- IRA rules are applied without regard to any community property laws
  - In *Morris,* the Court held that express statutory provisions of IRC §408(d) and §408(g) overrode state law. TC Memo 2002-17
- Distribution taxable to IRA owner rather than ½ to wife in community property situation
  - *Bunney*, 114 TC 259 (2000)

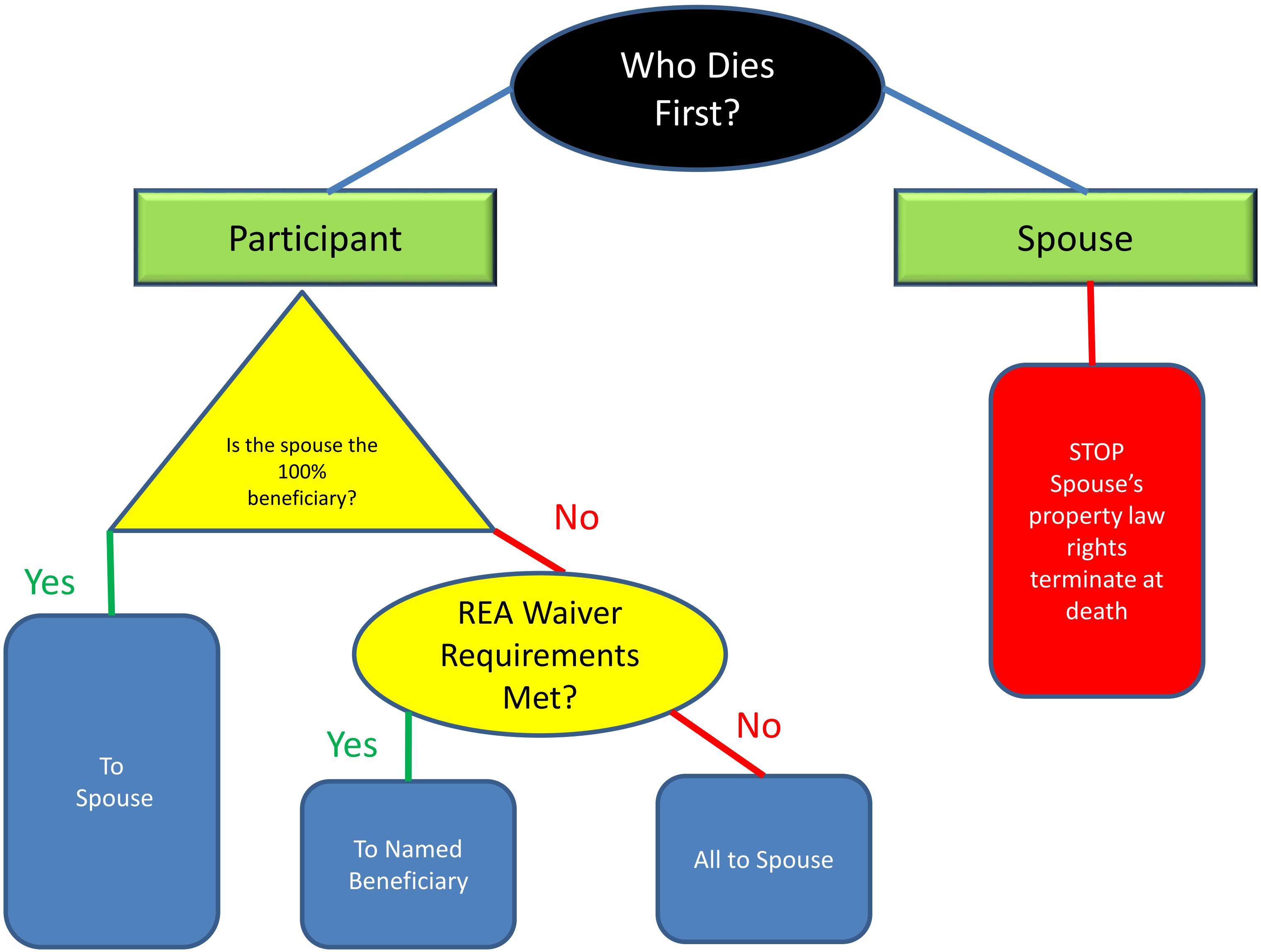
Retirement Equity Act of 1984 (REA)

- 26 USCA Sec. 417 (1984)
- ERISA covered plans
  - IRAs not covered
    - » IRA custodians, however, may require their own consent when someone other than spouse is named as beneficiary
- Plans must comply with the requirements of IRC Sections 401(a)(11) and 417 in order to remain qualified

Retirement Equity Act of 1984 (REA)

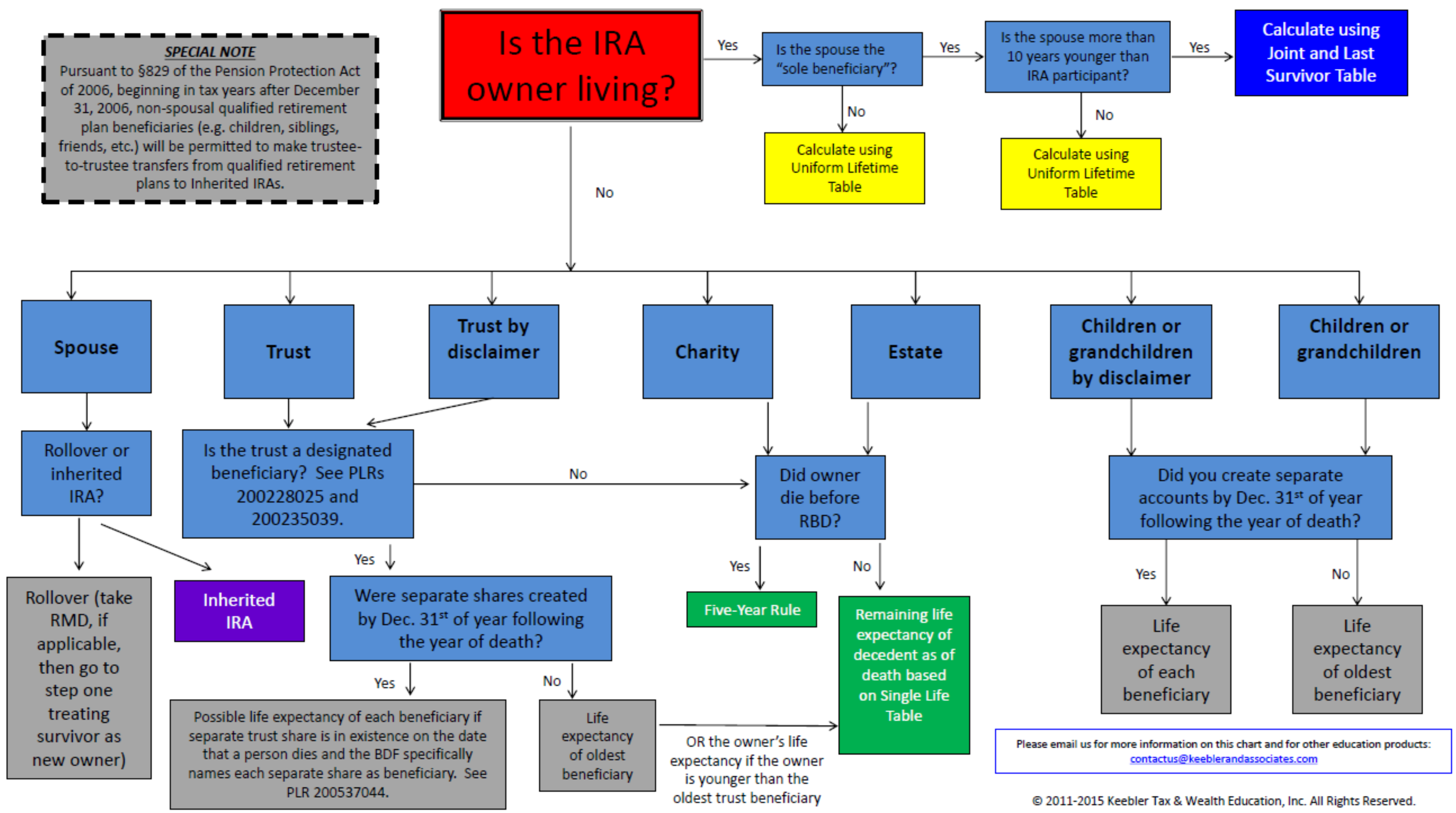
- Treas. Reg Sec. 1.401(a)-20
- Must provide both a qualified joint and survivor annuity (QJSA) and a qualified preretirement survivor annuity (QPSA) to remain qualified
- Spousal consent required to waive the QJSA or the QPSA
- Cannot be waived in prenuptial agreement because it is before marriage
- If spouse is legally incompetent to give consent, the spouse's legal guardian, even if the guardian is the participant, may give consent

PROPERTY LAW RIGHTS AT DEATH
ERISA Plans



Stretch Out IRAs
Under 2019 Law

TRADITIONAL IRA DISTRIBUTION FLOWCHART



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Stretch Out IRAs

"Inherited" IRA – Key Terms

- Required Beginning Date (RBD) – the date when distributions are required to begin
- Required Minimum Distributions (RMD) – the minimum amount that must be distributed from the account each year
- Beneficiary – person/persons/entity named as beneficiary of the account
- Designated Beneficiary – person or trust that qualifies as a designated beneficiary under the 401(a)(9) Regulations. A qualified designated beneficiary is allowed to utilize the life expectancy of a beneficiary. Term defined in Treas. Reg. Sec. §1.401(a)(9)-4, Q&A 1.

Stretch Out IRAs (Pre-Secure)

“Inherited” IRA

- An IRA is treated as “inherited” if the individual for whose benefit the IRA is maintained acquired the IRA on account of the death of the original owner.
- Under 2019 law, the IRA assets could be distributed based upon the life expectancy of the beneficiary.
- Some of these concepts continue to apply under Secure.

IRC Sec. 401(a)(9)

Stretch Out IRAs

- Two Strategies
  - Spousal Rollover
  - Inherited IRA
- Advantages
  - Rollover delays RMD until spouse's own RBD
  - Inherited IRA provisions allow beneficiary's life expectancy to be used for distributions after death of IRA owner.

Available before and after Secure

Stretch Out IRAs

"Inherited" IRA – Spousal Beneficiary – Rollover

- Exception to Inherited IRA rules.
- Only available to surviving spouse.
- Allows spouse to rollover assets received as beneficiary to a new IRA in his/her own name.
- Spouse's age used to determine when required minimum distributions must begin.
- Spouse may use the Uniform Lifetime Table to determine distributions.
- Both plans, Traditional IRAs and Roth IRAs may be rolled over.

Stretch Out IRAs

Income in Respect of a Decedent (IRD)

- **<u>Income in respect of a decedent (IRD)</u>** – is all items of gross income in respect of a decedent which were not properly included as taxable income in a tax period falling on or before a taxpayer's death and are payable to his/her estate and/or another beneficiary
- IRAs & Qualified Plans will generate IRD
- Potential 691(c) Deduction

IRC Sec. 691(a)

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401(a)(9) Regulations

Foundational Concepts

Required Minimum Distribution (RMD)

- RMDs are calculated based upon the aggregate prior year ending account balance divided by the applicable life expectancy factor

$$\text{RMD} = \frac{\text{Prior Year 12/31 Balance}}{\text{Life Expectancy Factor}}$$

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401(a)(9) Regulations

Foundational Concepts

- **Post-Mortem Distribution Amounts**
  - Uniform Lifetime Table
  - Single Life Table
  - Joint and Last Survivor Table
    - Available where the spouse is the sole beneficiary and is more than 10 years younger than the account owner
  - Five-Year Rule

New in the SECURE ACT

New Ten-Year Rule

Eligible Designated Beneficiaries

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401(a)(9) Regulations

Foundational Concepts

- Post-death RMDs based on whether “designated beneficiary” exists
- Qualifying “designated beneficiaries”
  - Individuals
  - Certain Trusts
- Non-qualifying “Non-designated beneficiaries”
  - Estates, Charities, Most Trusts
- Eligible Designated Beneficiaries

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401(a)(9) Regulations

Foundational Concepts – Pre-SECURE Law

- Death before age 70½ (changed to age 72 by the Secure Act)
  - Life expectancy distributions if you have a designated beneficiary
  - If no designated beneficiary, five-year rule
  - Distributions must begin by December 31st of the year after death
    - » Failure to do so does not automatically cause the five-year rule to apply
    - » Delayed distributions – spousal beneficiary

- Death after age 70½ (changed to age 72 by the Secure Act)
  - Life expectancy distributions if you have a designated beneficiary
  - If no designated beneficiary, ghost life expectancy rule
  - Distributions must begin by December 31st of the year after death
  - Year of death distribution – life expectancy of IRA owner

401(a)(9) Regulations

Foundational Concepts – Pre-SECURE Law

	Death Before Required Beginning Date	Death On or After Required Beginning Date
Designated Beneficiary	*Life Expectancy Rule*	*Life Expectancy Rule*
Non-Designated Beneficiary	*Five-Year Rule*	*Owner's "Ghost" Life Expectancy Rule*

Both the Five-Year and "Ghost" Life Expectancy appear to have survived the Secure ACT for non-designated beneficiaries.

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After the SECURE Act

	Death <u>Before</u> Required Beginning Date	Death <u>On or After</u> Required Beginning Date
Eligible Designated Beneficiary	*Life Expectancy Rule*	*Life Expectancy Rule*
Designated Beneficiary	*10-Year Rule*	*10-Year Rule*
Non-Designated Beneficiary	***Five-Year Rule***	***Owner's "Ghost" Life Expectancy Rule***

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401(a)(9) Regulations

Foundational Concepts – Critical dates

- September 30 of the year following the year of death
  - Date at which the beneficiaries are identified
- October 31 of the year following the year of death
  - Date at which trust documentation (in the case where a trust is named as a designated beneficiary) must be provided to the custodian
- December 31 of the year following the year of death
  - Date at which the first distribution must be made by each IRA beneficiary
  - Date at which separate shares must be created

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Disclaimer Planning

- 2019 Deaths
- 2020 Deaths

Disclaimer Planning

Overview

- Disclaimer must be "qualified"
  - In writing
  - Within nine months
  - No acceptance of the interest or any of its benefits
  - Interest passes without any direction on the part of the person making the disclaimer
- A disclaimer of plan benefits or IRA is neither a prohibited assignment or alienation

IRC § 2518; GCM 39858

Disclaimer Planning

- Example
  - Alex dies at age 70. Alex's wife disclaims amount of Alex's unified credit to bypass trust for benefit of herself and their children
    - Disclaimer must occur within nine months from date of death
    - Disclaimer must be served to the IRA custodian
    - Disclaimer must be fractional to avoid immediate income taxation

Disclaimer Planning

Revenue Ruling 2005-36

- A beneficiary's disclaimer of a beneficial interest in a decedent's IRA is a qualified disclaimer even though, prior to making the disclaimer, the beneficiary receives the required minimum distribution for the year of the decedent's death from the IRA.

Disclaimer Planning

Post-Secure Ideas

- A Designated Beneficiary (10-year Rule Beneficiary) may be able to disclaim to:
  - An Exempted Designated Beneficiary, capturing a period of life expectancy distributions
  - A Non-Designated Beneficiary, capturing "Ghost" life expectancy distributions
  - A Designated Beneficiary subject to lower income tax rates

Spousal Rollover From Estates and Trusts

Spousal Rollover

Spousal Rollover Planning Through Estate

IRA → Estate

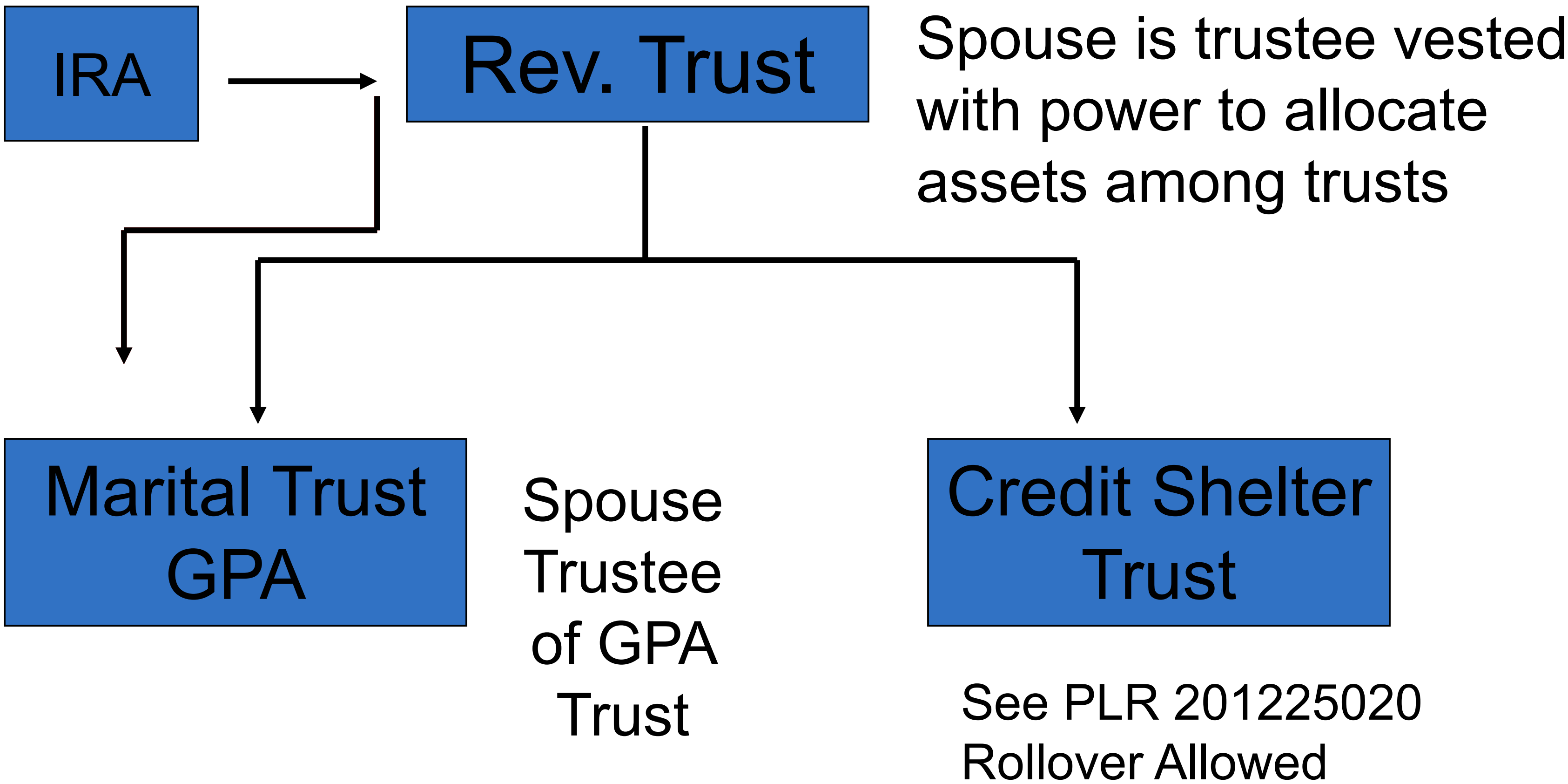
Surviving spouse is executor

Spouse sole residuary beneficiary

PLR 201618011

Spousal Rollover

Spousal Rollover Planning Through Trust



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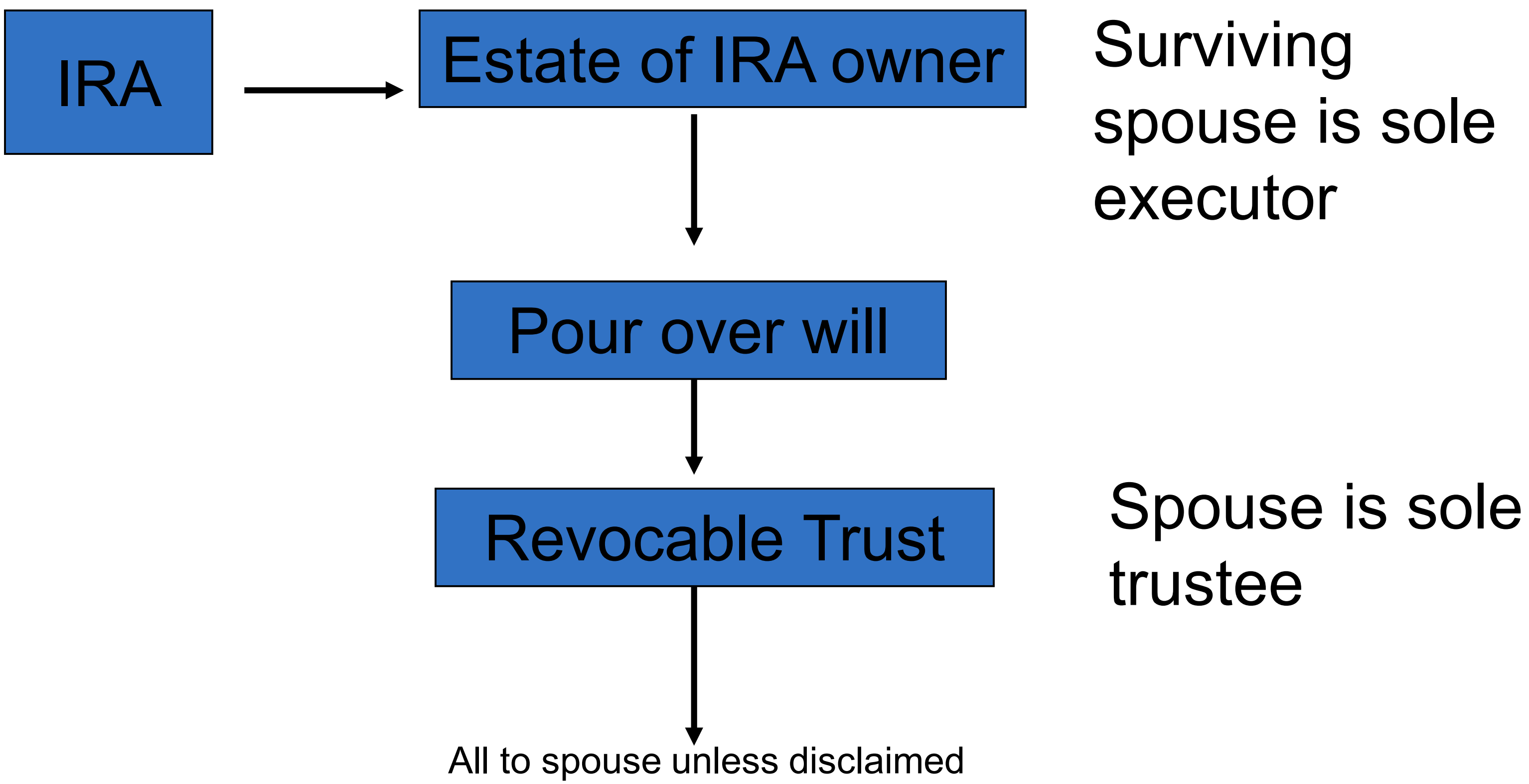
Spousal Rollover

Spousal Rollover Planning Through Trust



Spousal Rollover

Spousal Rollover Trap

- **Spousal rollover before age 59½**
  - Will cause pre-59½ distributions to be subject to the 10% early distribution penalty
    - » See *Sears v. Commissioner*, TC Memo 2010-146
  - If no rollover occurred, pre-59½ distributions can be taken penalty free
- **Solution**
  - Do not perform spousal rollover until spouse reaches age 59½

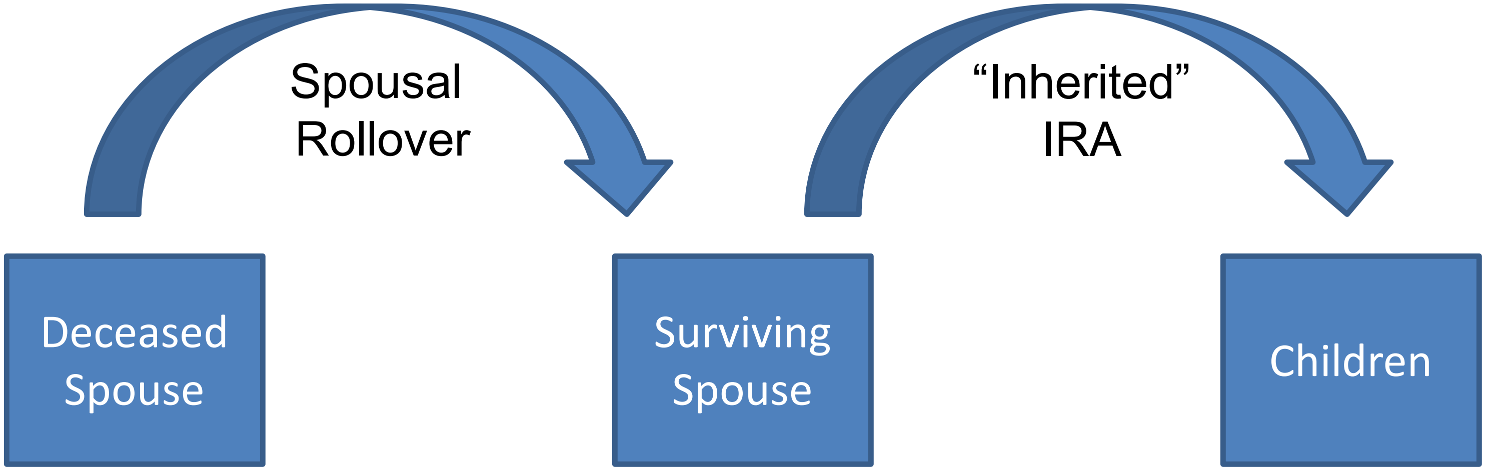
THE NEW SPOUSAL ROLLOVER TRAP

- Prior to SECURE Act, a spousal rollover was generally the best practice to preserve the IRA

- However, for many it may now be better to begin distributing the IRA earlier in order to minimize exposure to higher tax brackets

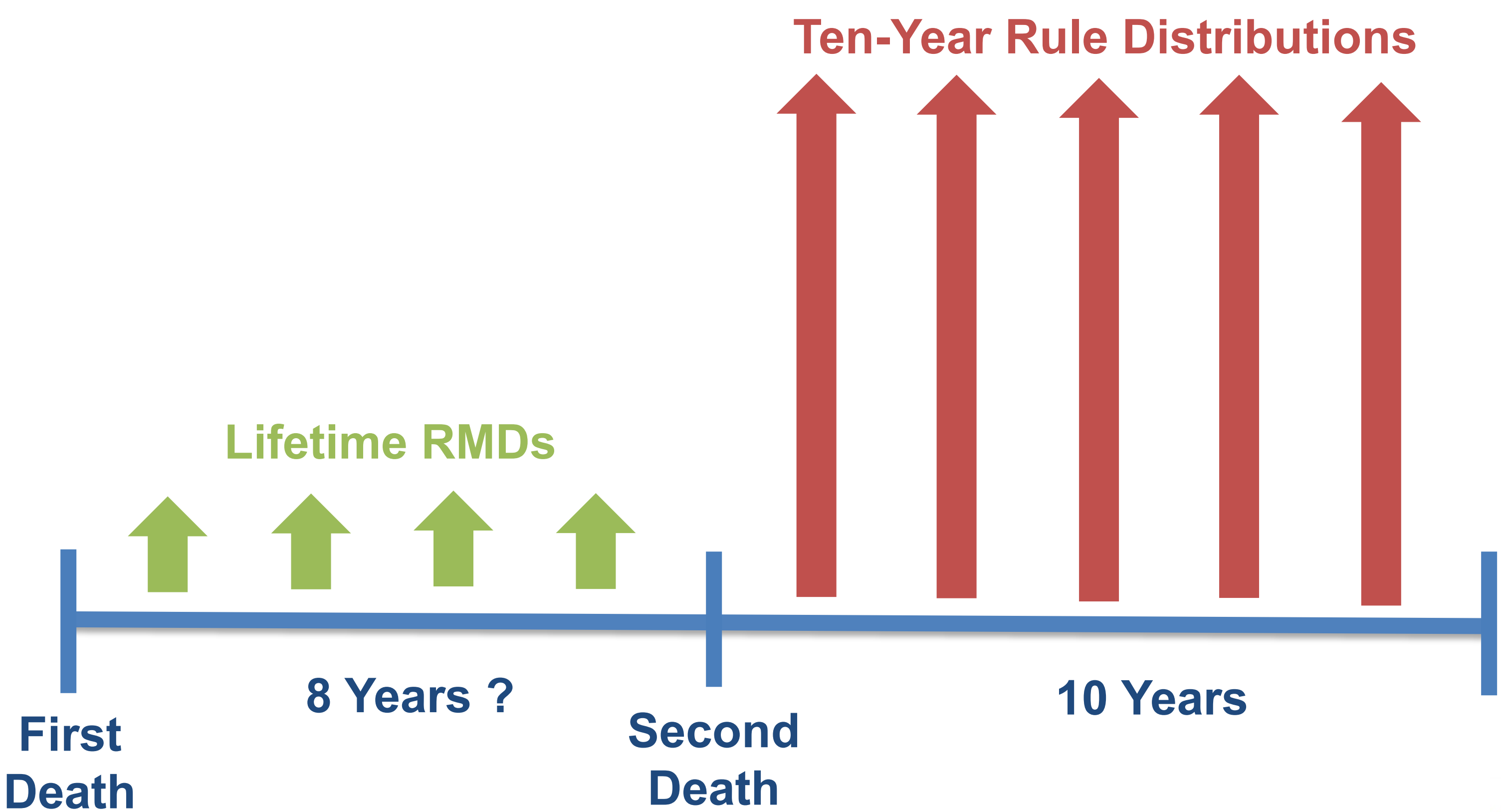
THE NEW SPOUSAL ROLLOVER TRAP

Old Best Practice



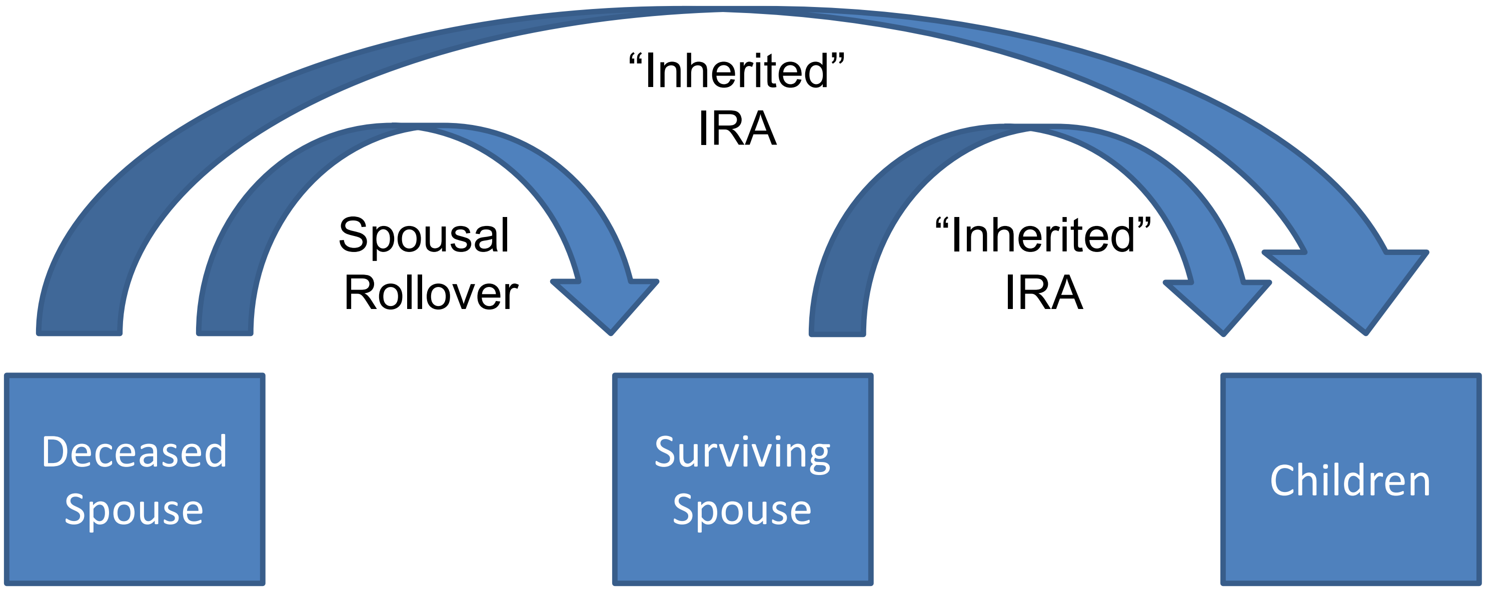
THE NEW SPOUSAL ROLLOVER TRAP

Old Best Practice &
the New Spousal Rollover Trap



THE NEW SPOUSAL ROLLOVER TRAP

New Best Practice



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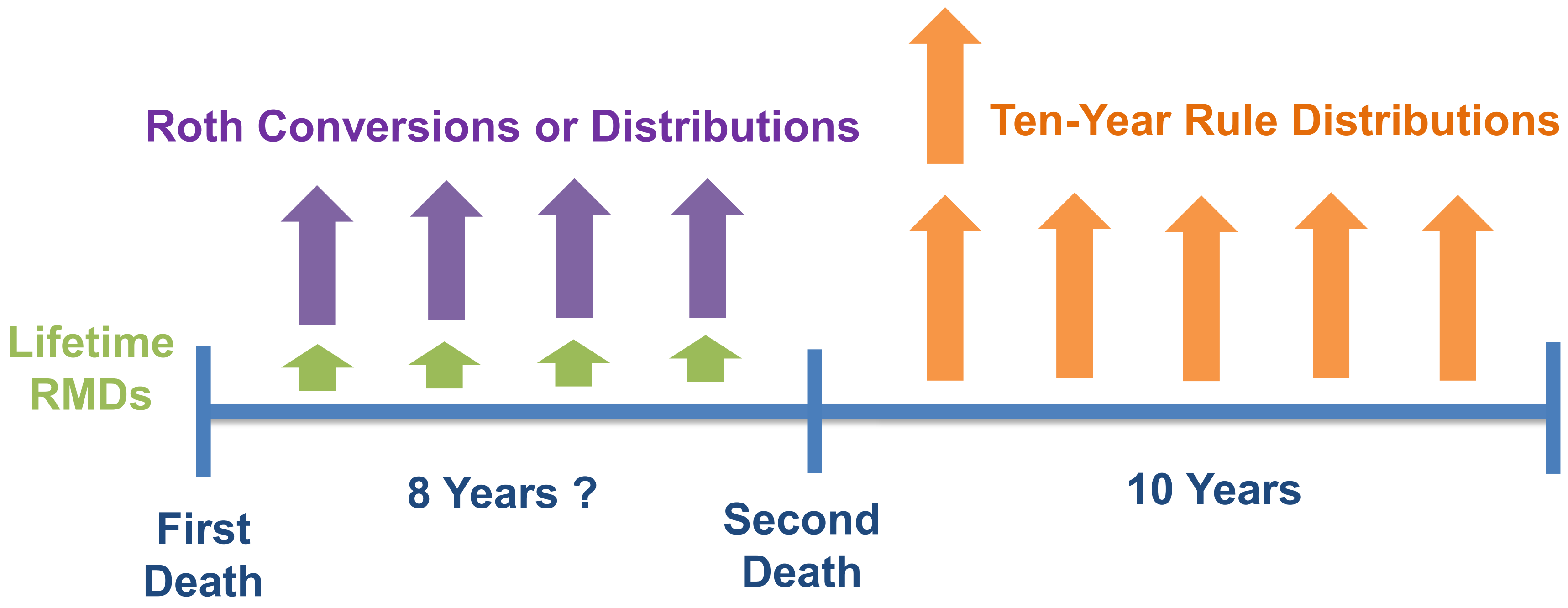
THE NEW SPOUSAL ROLLOVER TRAP

New Best Practice



Charitable Planning with IRAs

Charitable Planning with IRAs

Basic Overview

- Available Options to Transfer IRD Assets of Charity
  - **Name the charity as the designated beneficiary of the assets**
  - Specific Bequest of IRD assets to charity under a will
  - Power of Executor to make a non-pro rata distribution to Residuary Beneficiaries
  - Assignment of IRD to charity to satisfy a Pecuniary Bequest
  - Recognition of income with § 642(c) charitable deduction
  - **Recognition of income without a § 642(c) charitable deduction**

Charitable Planning with IRAs

Basic Overview

§ 642(c)(1) General rule

In the case of an estate or trust, there shall be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in section 170(c)

Charitable Planning with IRAs

Basic Overview

§ 642(c)(2) Amounts permanently set aside

There shall also be allowed as a deduction in computing its taxable income any amount of the gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, permanently set aside for a purpose specified in section 170(c).

*Applies <u>only to estates</u> – <u>not to trusts</u> funded later than 1969

See the remainder of the statute for details.

Managing the Income Tax Consequences of the Ten-Year Rule

SOLUTIONS TO ANALYZE

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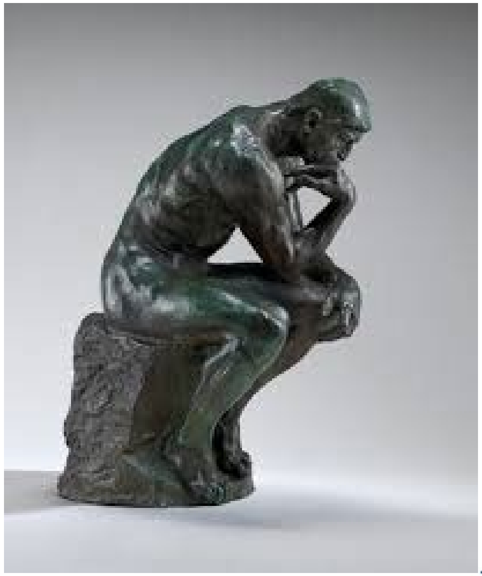
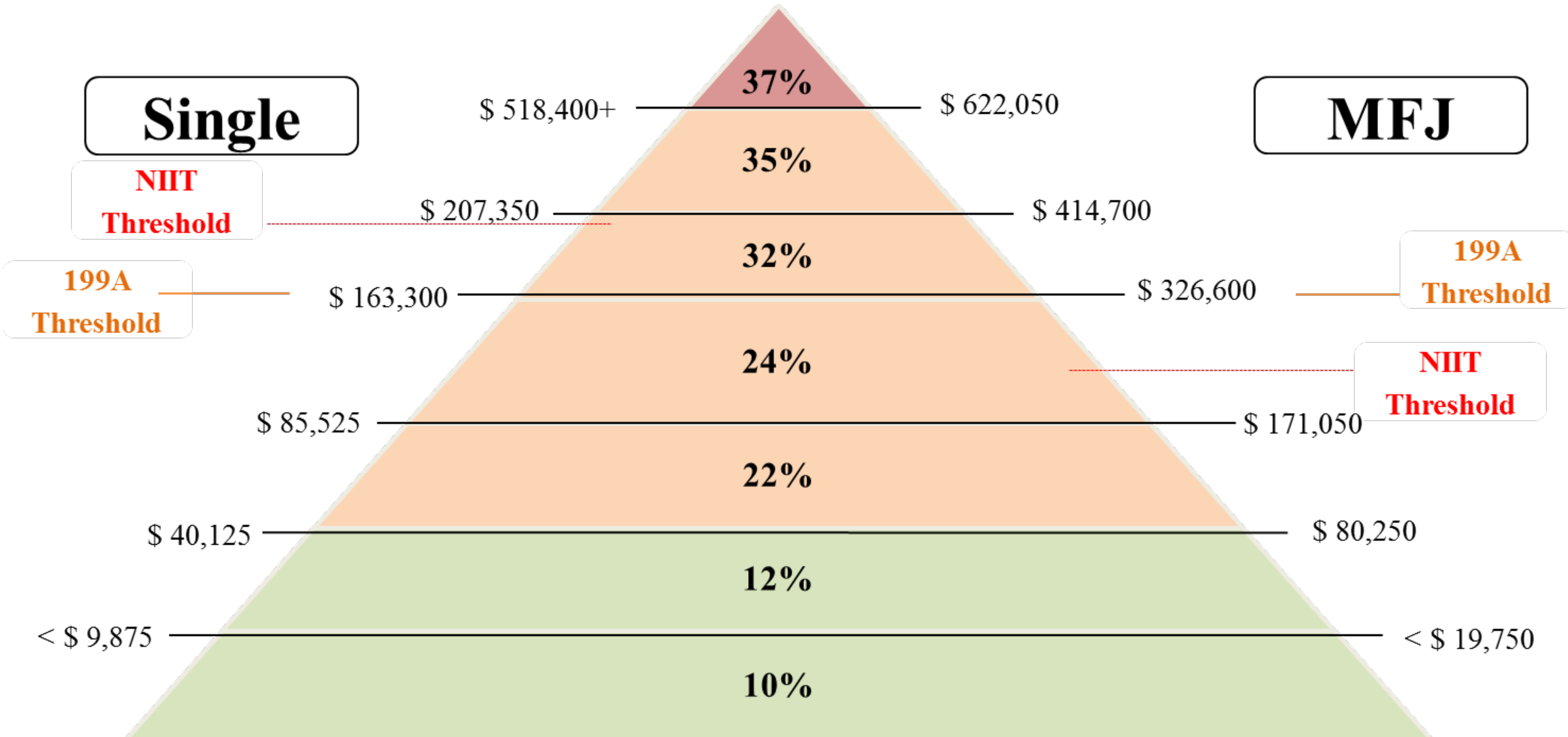
Solutions – Key Concepts

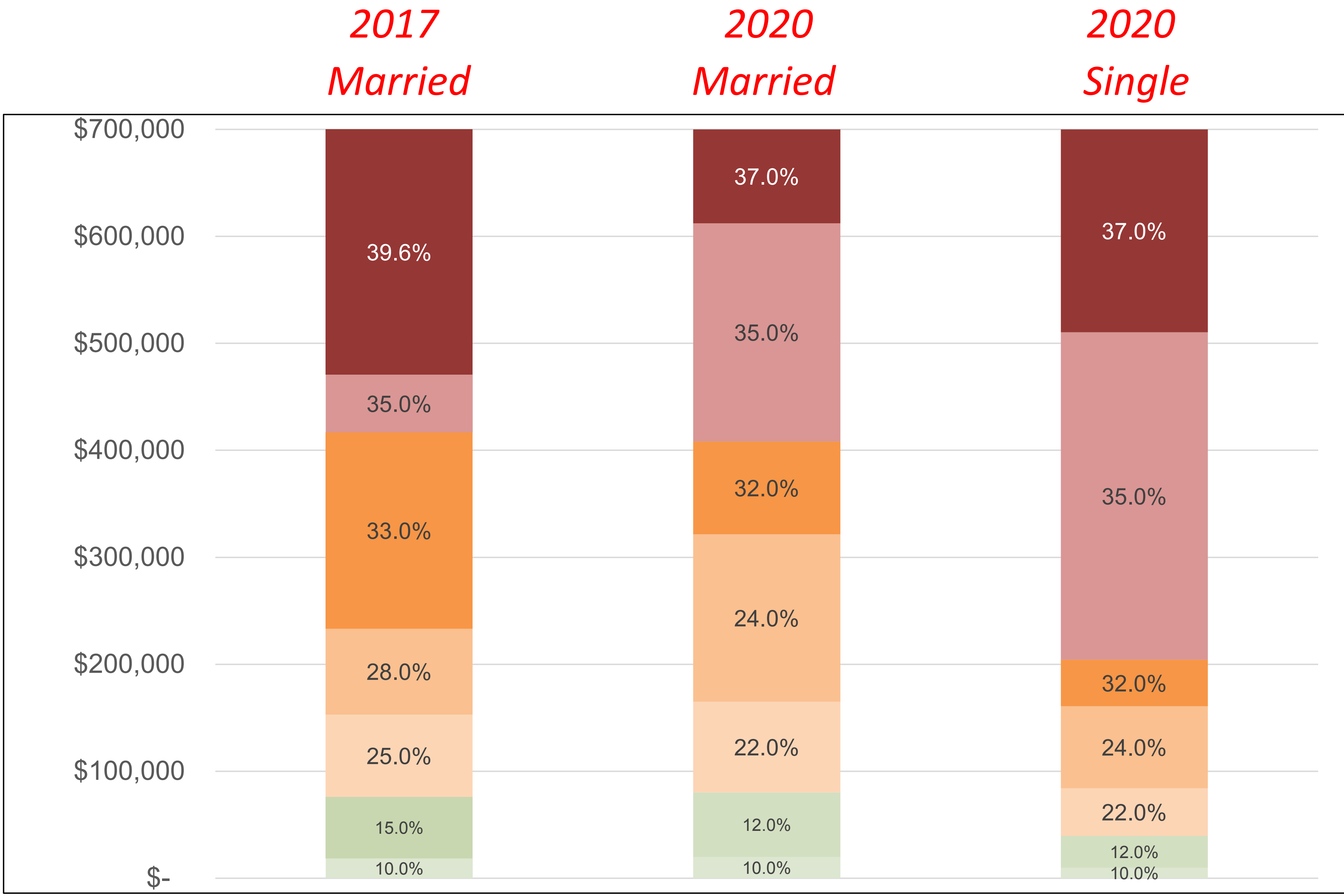
- Retain Income Tax Deferral
- Bracket Management within a Family
- Fulfill Charitable Goals with IRD
- Manage State Income Taxes
- Fiscal Year Planning

The professional's expertise must include an understanding of Fiduciary Accounting & Income Taxation



2020 Ordinary Income Tax Rates





2017
Married
2020
Married
2020
Single
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$-
39.6%
35.0%
33.0%
28.0%
25.0%
15.0%
10.0%
37.0%
35.0%
32.0%
24.0%
22.0%
12.0%
10.0%
37.0%
35.0%
32.0%
24.0%
22.0%
12.0%
10.0%

Foundational Concepts

General Fiduciary Tax Concepts

- Income taxed to either the estate/trust or the beneficiaries
  - If income is accumulated, then the income is taxed to the trust/estate
  - If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income

IRC §§ 661-663

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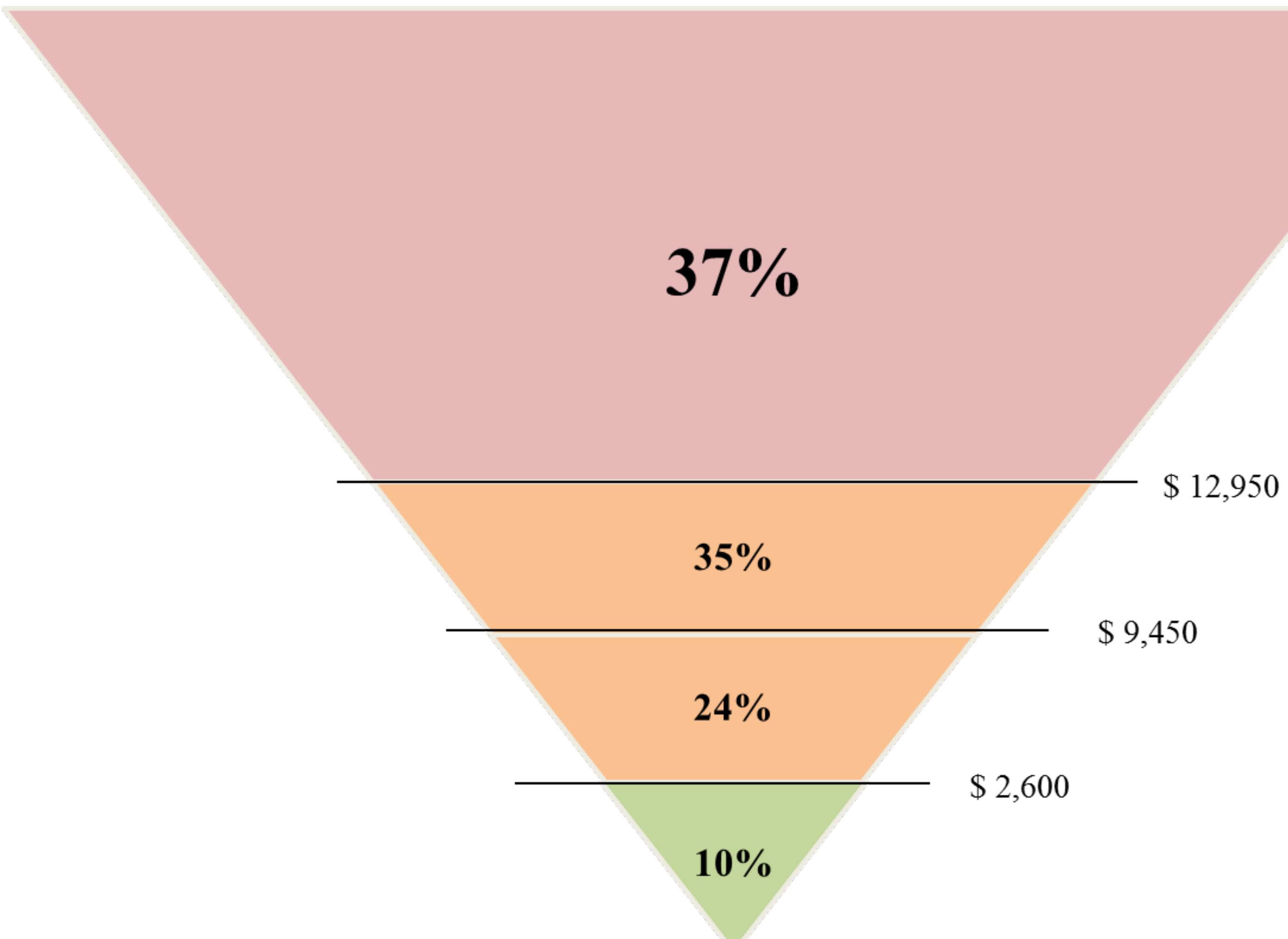
Foundational Concepts

2020 Ordinary Income Tax Rates for Estates & Trusts



Foundational Concepts

Types of "Income"

- Fiduciary accounting income
  - Governed by state law and the trust instrument
  - Determines the amount that may or must pass to the trust's or estate's beneficiaries
- Tax accounting income
  - Governed by the federal income tax law
  - Determines who is taxed on the income

Foundational Concepts

Typical Types of "Income" Under Traditional Fiduciary Accounting

- Interest
  - Taxable
  - Tax-exempt
- Dividends
- A portion of IRAs and/or RMDs (varies by state law)
  - RMD rule
  - 10% rule
  - 4% rule

Foundational Concepts

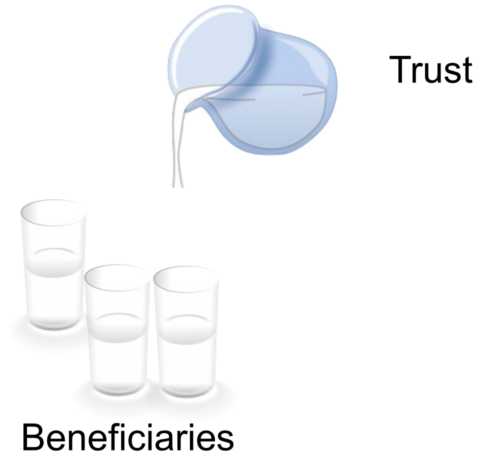
Typical Types of "Principal" Under Traditional Fiduciary Accounting

- A portion of IRAs and/or RMDs (varies by state law)
- Increases in asset value (i.e. growth)
- Realized long-term capital gain
- Realized short-term capital gain

Foundational Concepts

Distributable Net Income (DNI)

- Determines the amount of the trust's or estate's income distribution deduction.
- Determines how much the beneficiaries must report as income on their tax returns.
- Determines the character (e.g. interest, dividends, IRAs etc.) of the taxable income in beneficiaries' hands.

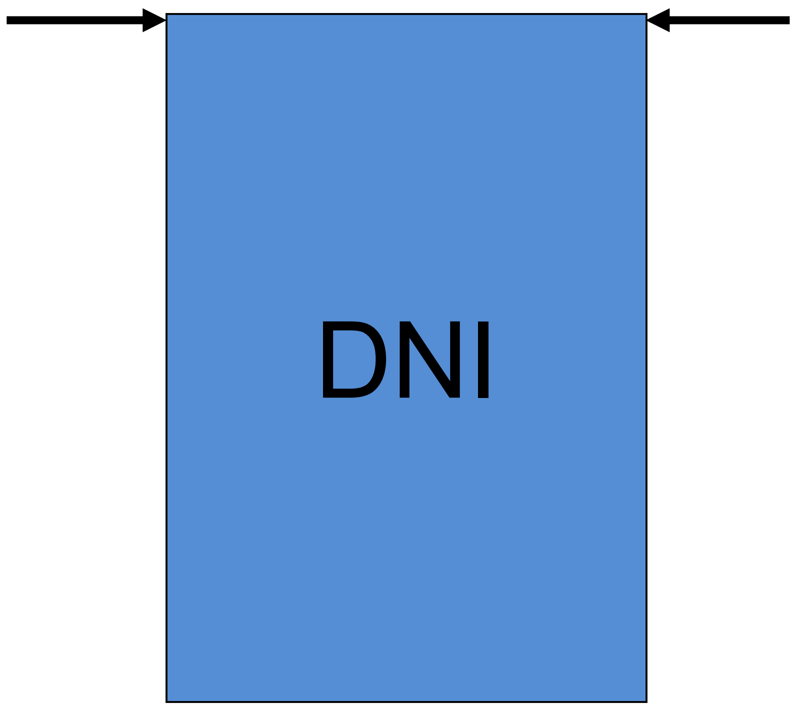


IRC §§ 661-663

Foundational Concepts

Distributable Net Income (DNI)

<u>Trust/Estate</u>
DNI acts as a ceiling for purposes of the allowable deduction



<u>Beneficiary</u>
DNI acts as a ceiling for the total amount of income the beneficiary must report on his/her tax return

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts
▶ Go to www.irs.gov/Form1041 for instructions and the latest information.
2019 OMB No. 1545-0092

For calendar year 2019 or fiscal year beginning , 2019, and ending , 20

A Check all that apply:
- ☐ Decedent's estate
- ☐ Simple trust
- ☐ Complex trust
- ☐ Qualified disability trust
- ☐ ESBT (S portion only)
- ☐ Grantor type trust
- ☐ Bankruptcy estate—Ch. 7
- ☐ Bankruptcy estate—Ch. 11
- ☐ Pooled income fund

Name of estate or trust (If a grantor type trust, see the instructions.)
C Employer identification number

Name and title of fiduciary
D Date entity created

Number, street, and room or suite no. (If a P.O. box, see the instructions.)
E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions.
☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . ▶ ☐
☐ Described in sec. 4947(a)(2)

City or town, state or province, country, and ZIP or foreign postal code

B Number of Schedules K-1 attached (see instructions) ▶

F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Net operating loss carryback ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in fiduciary's address

G Check here if the estate or filing trust made a section 645 election . . . . ▶ ☐ Trust TIN ▶

Income	1	Interest income	1	
	2a	Total ordinary dividends	2a	
	b	Qualified dividends allocable to: **(1)** Beneficiaries **(2)** Estate or trust		
	3	Business income or (loss). Attach Schedule C (Form 1040 or 1040-SR)	3	
	4	Capital gain or (loss). Attach Schedule D (Form 1041)	4	
	5	Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040 or 1040-SR)	5	
	6	Farm income or (loss). Attach Schedule F (Form 1040 or 1040-SR)	6	
	7	Ordinary gain or (loss). Attach Form 4797	7	
	8	Other income. List type and amount	8	
	9	**Total income.** Combine lines 1, 2a, and 3 through 8 ▶	9	
Deductions	10	Interest. Check if Form 4952 is attached ▶ ☐	10	
	11	Taxes	11	
	12	Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12	
	13	Charitable deduction (from Schedule A, line 7)	13	
	14	Attorney, accountant, and return preparer fees. If only a portion is deductible under section 67(e), see instructions	14	
	15a	Other deductions (attach schedule). See instructions for deductions allowable under section 67(e)	15a	
	b	Net operating loss deduction. See instructions	15b	
	16	Add lines 10 through 15b ▶	16	
	17	Adjusted total income or (loss). Subtract line 16 from line 9	17		
	18	Income distribution deduction (from Schedule B, line 15). Attach Schedules K-1 (Form 1041)	18	
	19	Estate tax deduction including certain generation-skipping taxes (attach computation)	19	
	20	Qualified business income deduction. Attach Form 8995 or 8995-A	20	
	21	Exemption	21	
	22	Add lines 18 through 21 ▶	22	
Tax and Payments	23	Taxable income. Subtract line 22 from line 17. If a loss, see instructions	23	
	24	**Total tax** (from Schedule G, Part I, line 9)	24	
	25	2019 net 965 tax liability paid from Form 965-A, Part II, column (k), line 3	25	
	26	**Total payments** (from Schedule G, Part II, line 17)	26	
	27	Estimated tax penalty. See instructions	27	
	28	**Tax due.** If line 26 is smaller than the total of lines 24, 25, and 27, enter amount owed	28	
	29	**Overpayment.** If line 26 is larger than the total of lines 24, 25, and 27, enter amount overpaid	29	
	30	Amount of line 29 to be: **a Credited to 2020** ▶ ; **b Refunded** ▶	30	

IRA Income

DNI Deduction

Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.
Signature of fiduciary or officer representing fiduciary | Date | EIN of fiduciary if a financial institution
May the IRS discuss this return with the preparer shown below? See instr. ☐ Yes ☐ No

Paid Preparer Use Only Print/Type preparer's name | Preparer's signature | Date | Check ☐ if self-employed | PTIN
Firm's name ▶ | Firm's EIN ▶
Firm's address ▶ | Phone no.

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 11370H Form **1041** (2019)

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Foundational Concepts

“65-Day” Rule – IRC 663(b)

- Applies to estates and complex trusts
- Allows fiduciary to treat distributions made within 65 days after year-end to be treated as if they were made as of December 31st of the prior year
  - Limited to DNI (reduced by distributions made during the prior year)
- Election must be made by the due date of the tax return
  - Election is irrevocable
  - Annual election

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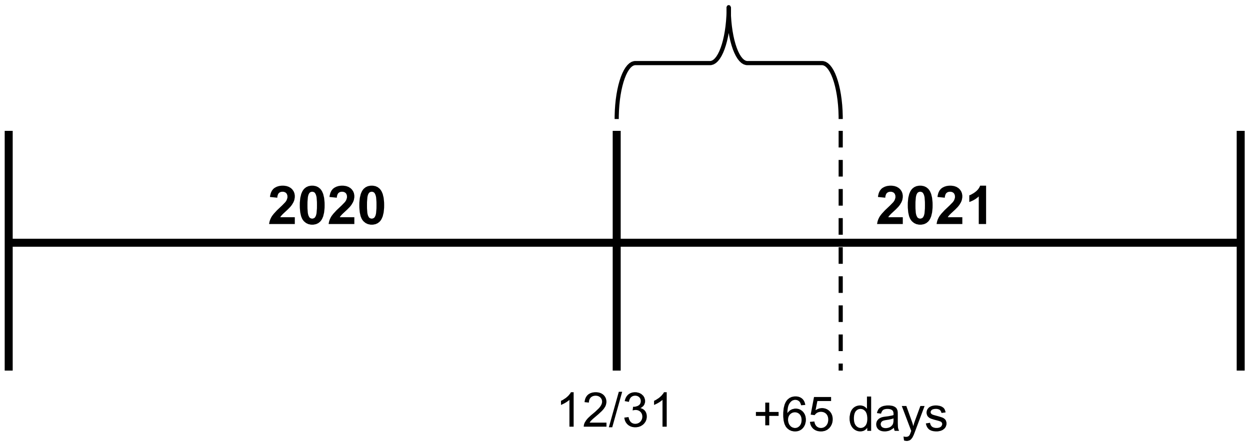
Foundational Concepts

“65-Day” Rule – IRC Section 663(b)

Distributions made during this period will be treated as have been made as of 12/31/2020 (if a timely election is made)



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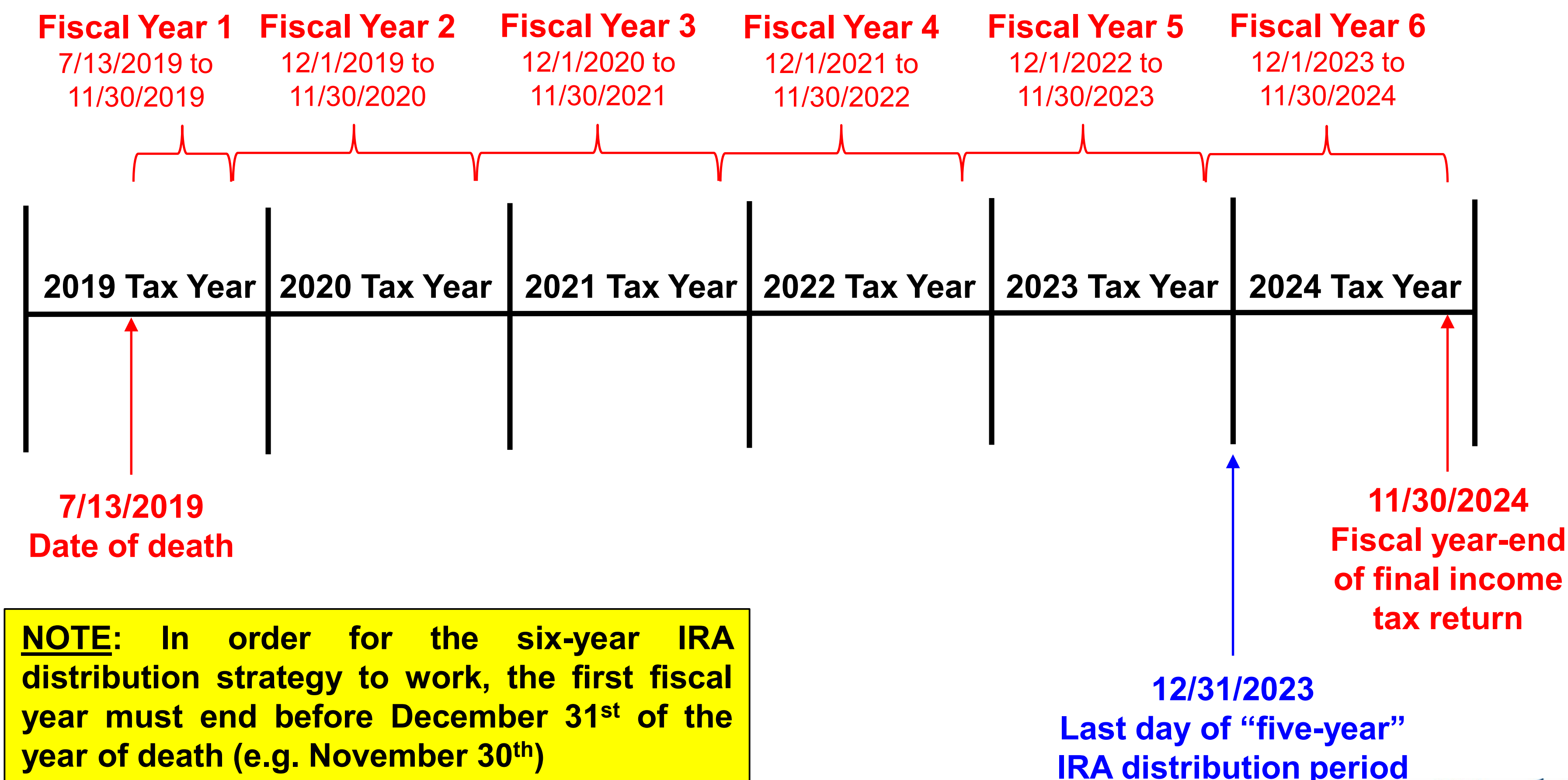
FISCAL YEAR PLANNING

FISCAL YEAR PLANNING

- An estate (and/or “filing trust” under an IRC §645 election) may opt for a fiscal year-end not to exceed 12 months.
  - A “filing trust” is the decedent’s Qualified Revocable Trust (QRT) prior to death.
  - A probate estate does not need to exist in order to make an IRC §645 election. Instead, the “filing trust” becomes the estate for income tax purposes.
  - The IRC §645 election (using IRS Form 8855) must be made by the due date (including extensions) for the first income tax return.

FISCAL YEAR PLANNING

- By electing a fiscal year for the estate/QRT, the five-year IRA distribution period is allocated over six tax years.



<u>NOTE</u>: In order for the six-year IRA distribution strategy to work, the first fiscal year must end before December 31st of the year of death (e.g. November 30th)

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FISCAL YEAR PLANNING

- Example

IRA Distributions (Assuming $1,000,000 IRA at Death)

	Normal Fiscal Year	Six-Year Strategy
2019 Tax Year	$200,000	$166,667
2020 Tax Year	$200,000	$166,666
2021 Tax Year	$200,000	$166,667
2022 Tax Year	$200,000	$166,666
2023 Tax Year	$200,000	$166,667
2024 Tax Year	$0	$166,667
TOTAL*	$1,000,000	$1,000,000

* Assumes 0% growth of the IRA

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FISCAL YEAR PLANNING

- Planning considerations
  - An IRC §645 is only valid for *the later of*: (a) two years from the date of the decedent's death or (b) six months after the "final determination of estate tax" (if an IRS Form 706 was filed).
  - If an estate is open for more than two years, then an explanation must be made on the IRS Form 1041 as to why the estate is being held open (see IRS Form 1041, Page 2, Other Information, Question 8).

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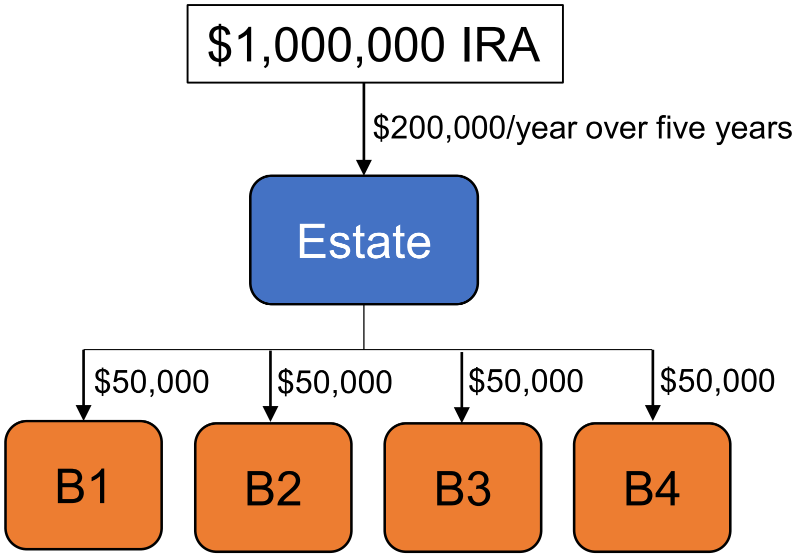
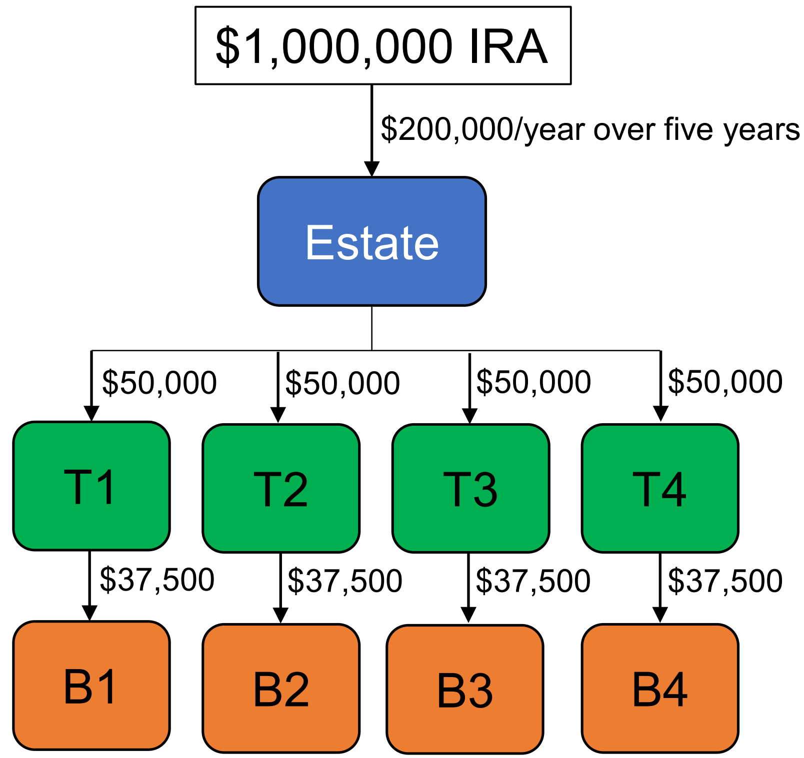
FISCAL YEAR PLANNING

- By having an estate paid to multiple trusts, IRA distributions would be allocated over a great number of distributees, thus lowering overall taxable income.

<u>OPTION 1 – Outright to Beneficiaries</u>



<u>OPTION 2 – Paid in Trust</u>



Estate Administration for Roth IRAs after the SECURE Act

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The "Basics" of Roth IRA Estate Administration
General Concepts

- 100% of growth is tax-exempt
- No required minimum distributions at age 72
  - NOTE: Distributions from Roth IRAs <u>cannot</u> be used to fulfill the RMD from a traditional IRA
- RMDs on Inherited Roth IRAs
  - 10 Years for Designated Beneficiaries
  - 10 Years for Designated Beneficiary Trusts
  - Special Rules for Eligible Designated Beneficiaries
  - Special Rules for Certain Eligible Designated Beneficiary Trusts
  - Special Rules for Conduit Trusts
  - Five-Year Rule for Non-Designated Beneficiary Trusts and Estates

Roth Conversions of Inherited Accounts

- Inherited IRA
  - Spouse Beneficiary
    - » Can convert inherited traditional IRA to inherited Roth IRA
    - » Can perform spousal rollover to Roth IRA
  - Non-Spouse Beneficiary
    - » Cannot convert inherited traditional IRA to inherited Roth IRA
    - » Can convert inherited qualified plan to inherited Roth IRA (see Notice 2008-30)

Excess Accumulation Penalty

Excess Accumulation Penalty

- A 50% penalty is assessed to the extent that a taxpayer has not taken his/her RMD for the tax year

- *Example*
  - Assume Peter was required to take out $30,000 from his inherited IRA in 2021, but only withdrew $20,000. In this case, Peter would be subject to a $5,000 [($30,000 - $20,000) x 50%] excess accumulations penalty. Further, Peter would still be required to withdraw the $10,000 deficiency from his inherited IRA.

Review prior year income tax returns for RMD issues

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Excess Accumulation Penalty

- If decedent was past his RBD, ensure that RMD for year of death was/is taken by end of that year
  - Payable to beneficiary
  - Request waiver if not timely taken
- RMDs required for Roth IRAs inherited by non-spouse

Excess Accumulation Penalty Requesting a Waiver

- Under IRC §4974(d), the tax may be waived if the taxpayers can establish that the shortfall in distributions was due to reasonable error and reasonable steps are being taken to remedy the shortfall. An accumulation occurs because of “reasonable error" when it occurs through no fault of the plan participant.
- Complete Form 5329
- Attach letter requesting waiver
- Protecting the executor

Stretch Out IRAs – In Depth

Stretch Out IRAs

"Inherited" IRA

<u>Old Law Objective</u>: Prolong IRA and Roth payments over the longest possible period of time (including Life Expectancy), thus increasing wealth to future generations

<u>New Law Objective:</u> Prolong IRA and Roth payments over the longest possible period of time (including Life Expectancy), thus increasing wealth to future generations

- Generally only 5 Years for Non-Designated Beneficiaries
- Generally only 10 Years for Designated Beneficiaries
- Special Rules for Eligible Designated Beneficiaries
- Special Rules for Conduit Trusts

Secure Act - Overview

- Changes to Post-Death Distributions
  - Non-Designated Beneficiaries
    - Five-Year Rule
    - “Ghost” Rule
    - Guidance Needed from IRS or Treasury
  - Designated Beneficiaries
    - Ten-Year Rule
  - Eligible Designated Beneficiaries
    - Spouses – Life Expectancy
    - Minor Children – Life Expectancy (modified)
    - Disabled Beneficiaries – Life Expectancy
    - Chronically ill Beneficiaries – Life Expectancy
    - Person within Ten Years of the IRA Owner’s Age – Life Expectancy

IRC §401 (a)(9)(H)

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Secure Act-Overview

Eligible Designated Beneficiaries

- Minor Child
  - As described in IRC §409(a)(9)(F), a child may be treated as having not reached majority if they have not completed a **"specified course of education"** and is under the age of 26.
  - If both of the requirements are met, the minor child beneficiary may use the Life Expectancy until 26 years of age.

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Secure Act-Overview

Eligible Designated Beneficiaries

- Disabled Persons
  - As described in IRC §72(m)(7), "an individual shall be considered to be disabled if they are unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."
  - An individual must provide proof of their disability.
  - If an individual is deemed disabled, they are allowed to use the Life Expectancy rule.

Secure Act-Overview

Eligible Designated Beneficiaries

- Chronically ill
  - As described in IRC §7702B(c)(2), a "chronically ill individual" means an individual who has been certified by a licensed health care practitioner as:
    - Being unable to perform at least two activities of daily living for a period of at least 90 days due to loss of functional capacity,
    - Having a level of disability that is to the level of the bullet point described above, or
    - Requiring substantial supervision to protect such individual from threats to health and safety due to cognitive impairment.
  - If an individual is deemed chronically ill, they are allowed to use the Life Expectancy rule.

Trusts for Disabled and Chronically Ill Beneficiaries

- Life Expectancy Treatment is Available with a "Eligible Designated Beneficiary Trust"
- Need to Draft an Accumulation Trust
- Roth IRAs may work better because the Income Tax was already paid
- Use two Trusts if you have both a traditional IRA and a Roth IRA – this avoids "trapping" the taxable IRA income

Secure Act Beneficiary RMD Summary

Tax Terminology	Designated Non-Eligible Beneficiary	Surviving Spouse	Eligible Minor Child	Person Less Than 10 Years Younger	Disabled or Chronically Ill Person
Outright Beneficiary	10-Year Rule	Life Expectancy Rule	Life Expectancy Rule (Until Majority then 10-Year Rule)	Life Expectancy Rule	Life Expectancy Rule
Conduit Trust	10-Year Rule	Life Expectancy Rule	Life Expectancy Rule (Until Majority then 10-Year Rule)	Life Expectancy Rule	Life Expectancy Rule
Designated Beneficiary Trust	10-Year Rule	10-Year Rule	10-Year Rule	10-Year Rule	Life Expectancy Rule
Non-Designated Beneficiary Trust	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule	Before RBD: 5-Year Rule
	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule	After RBD: Ghost Life Expectancy Rule

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Stretch Out IRAs

"Inherited" IRA

Child / Grandchild Beneficiary

- Pre-Secure Act Deaths – Generally Life Expectancy if outright Beneficiary
- Post-Secure Act Deaths – Special Rules for minor Children
- Post-Secure Act Deaths – Ten-Year Rule for Adult Children and Grandchildren

Stretch Out IRAs

"Inherited" IRA

Pension Protection Act of 2006

- Beginning in 2007, non-spousal beneficiaries (e.g. children, grandchildren, friends, etc.) are permitted to roll over a qualified retirement plan (e.g. 401(k)), via a trustee-to-trustee transfer, into an "inherited" IRA
- "Designated beneficiary" trusts are also permitted to roll over qualified retirement plans to "inherited" IRAs
- Notice 2007-7

Still Available after the SECURE Act

Stretch Out IRAs

Roth Conversion of "Inherited" Qualified Plan

- Notice 2008-30 – Section II, Q&A 7, allows non-spouse beneficiaries to convert inherited qualified plans to inherited Roth IRAs.

Continues to apply after the Secure Act

Stretch Out IRAs

"Inherited" IRA

Common Mistakes to Avoid

- Incorrect titling
- Failure to take RMDs
- Failure to utilize disclaimers when appropriate
- Failure to analyze contingent beneficiaries when utilizing disclaimers
- Planning Opportunity for 2019 Deaths
  - Disclaimers to "Lock-in" Life Expectancy
- Taking a lump-sum distribution
- Not using the 10-Year "Roth Coast"

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Stretch Out IRAs

"Inherited" IRA

Common Mistakes to Avoid

- **Spousal rollover before age 59½**
  - Will cause pre-59½ distributions to be subject to the 10% early distribution penalty
    - » See *Sears v. Commissioner*, TC Memo 2010-146
  - If no rollover occurred, pre-59½ distributions can be taken penalty free
- **Solution**
  - Do not perform spousal rollover until spouse reaches age 59½

This strategy holds true after the SECURE Act

Stretch Out IRAs

"Inherited" IRA

Common Mistakes to Avoid

- For non-spousal beneficiaries, it is <u>critical</u> to keep the inherited IRA in the name of the deceased IRA owner

- **<u>Example (Individual)</u>**
  - *"John Smith, deceased, IRA for the benefit of James Smith"*
- **<u>Example (Trust)</u>**
  - *"John Smith, deceased, IRA for the benefit of James Smith as Trustee of the Smith Family Trust dated 1/1/2020"*

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Stretch Out IRAs

Income in Respect of a Decedent (IRD)

- **Income in respect of a decedent (IRD)** – is all items of gross income in respect of a decedent which were not properly included as taxable income in a tax period falling on or before a taxpayer's death and are payable to his/her estate and/or another beneficiary

IRC Sec. 691(a)

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Stretch Out IRAs

Income in Respect of a Decedent (IRD)

- **Specific Items of IRD**
  - IRAs and other qualified retirement plans
  - Unpaid salaries/wages at the time of death
  - Dividends and interest earned, but not taxed, prior to death
  - Unrecognized capital gain on an installment note at the time of the seller's death
  - Net Unrealized Appreciation (NUA) on employer securities

NUA strategies to avoid the ten-year rule

Paying IRAs to Trusts

The Conduit Trust Disaster

- A conduit (“safe–haven”) trust requires all RMDs to be distributed to the beneficiaries annually as received
- This worked well under the life expectancy rules
- However, it can be a property law disaster under the ten-year rule

The Conduit Trust Disaster

Years after Death	Age	RMD Current Method	10-Year Rule Options Equal Schedule	Full Deferral
0	30	$18,762	$142,378	$0
1	31	$20,100	$142,378	$0
2	32	$21,535	$142,378	$0
3	33	$23,072	$142,378	$0
4	34	$24,720	$142,378	$0
5	35	$26,486	$142,378	$0
6	36	$28,379	$142,378	$0
7	37	$30,409	$142,378	$0
8	38	$32,584	$142,378	$0
9	39	$34,917	$142,378	$0
10	40	$37,417	$142,378	$1,967,151

Assumes $1,000,000 IRA at death & a 7% growth rate

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Modifying a Conduit Trust

- When to Consider
  - Death occurs after the effective date
  - The long-term benefits of a trust are required
  - The 10-year period is locked in
- Reform or Decant
  - Remove the conduit language
  - Replace with accumulation type language
- Income Tax Planning
- Why reformations have less tax-risk

Paying IRAs to Trusts

Naming a Trust as a "Designated Beneficiary"

An IRA or Roth IRA Can Be Payable to a Trust

IRA

Beneficiary Designation Form

Trust

- Conduit Trust
- Accumulation Trust
- Non-designated Beneficiary Trust
- Designated Beneficiary Trust

Spouse

Children

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Issues to Review

- Designated Beneficiary Trust Status
- IRC § 642(c) Charitable Issues
- *Kenan* Issues
- IRC § 691(a) Issues
- IRC § 691(c) Issues
- Eligible Designated Beneficiary Trust Status

Legal Principals and Definitions

- Formula bequests / dispositions:
  - *Pecuniary* – gift denominated in money rather than by property; often uses formula where the amount of the gift equals a certain amount (such the estate tax exemption amount).
    - "I leave the maximum amount which will result in no estate tax to the Family Trust and the residue to the Marital Trust."
    - Pecuniary bequests are treated as a sale or exchange of the asset distributed and causes a recognition event for the estate. *Kenan v. Comm*, 114 F.2d 217 (2d Cir. 1940); Rev. Proc. 64-19.

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Legal Principals and Definitions

- Formula bequests / dispositions:
  - *Fractional* – gift by a formula which splits property by value between two takers.
    - "I leave to my spouse the residue of my estate multiplied by fraction with a numerator equal to smallest amount which will result in no estate tax and the denominator equal to the entire value of the residue."
    - Gain or loss is not recognized upon the distribution of property to satisfy a fractional disposition.

Four Requirements for <u>ALL</u> Designated Trusts

1. Trust is valid under state law
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(1)
2. Trust is irrevocable upon death of owner
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(2)
3. Beneficiaries of the trust are identifiable from the trust instrument
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(3)
4. Documentation requirement is satisfied
    - Treas. Reg. § 1.401(a)(9)-4, Q&A 5(b)(4)

Types of Trusts

- Accumulation Trusts
- Conduit Trusts
- Treas. Reg. § 1.401(a)(9)-4, Q&A 5 requirements apply to both types

Conduit Trust

- A trust in which all distributions from the IRA are immediately distributed to the trust beneficiary(ies)
- Very limited asset protection

Accumulation Trust

- A trust in which distributions from the IRA are allowed to accumulate within the trust
- Stronger asset protection than a conduit trust
- The key issue in analyzing an accumulation trust is to determine which beneficiaries are "countable"
- All beneficiaries are countable unless such beneficiary is deemed to be a "mere potential successor" beneficiary

The End

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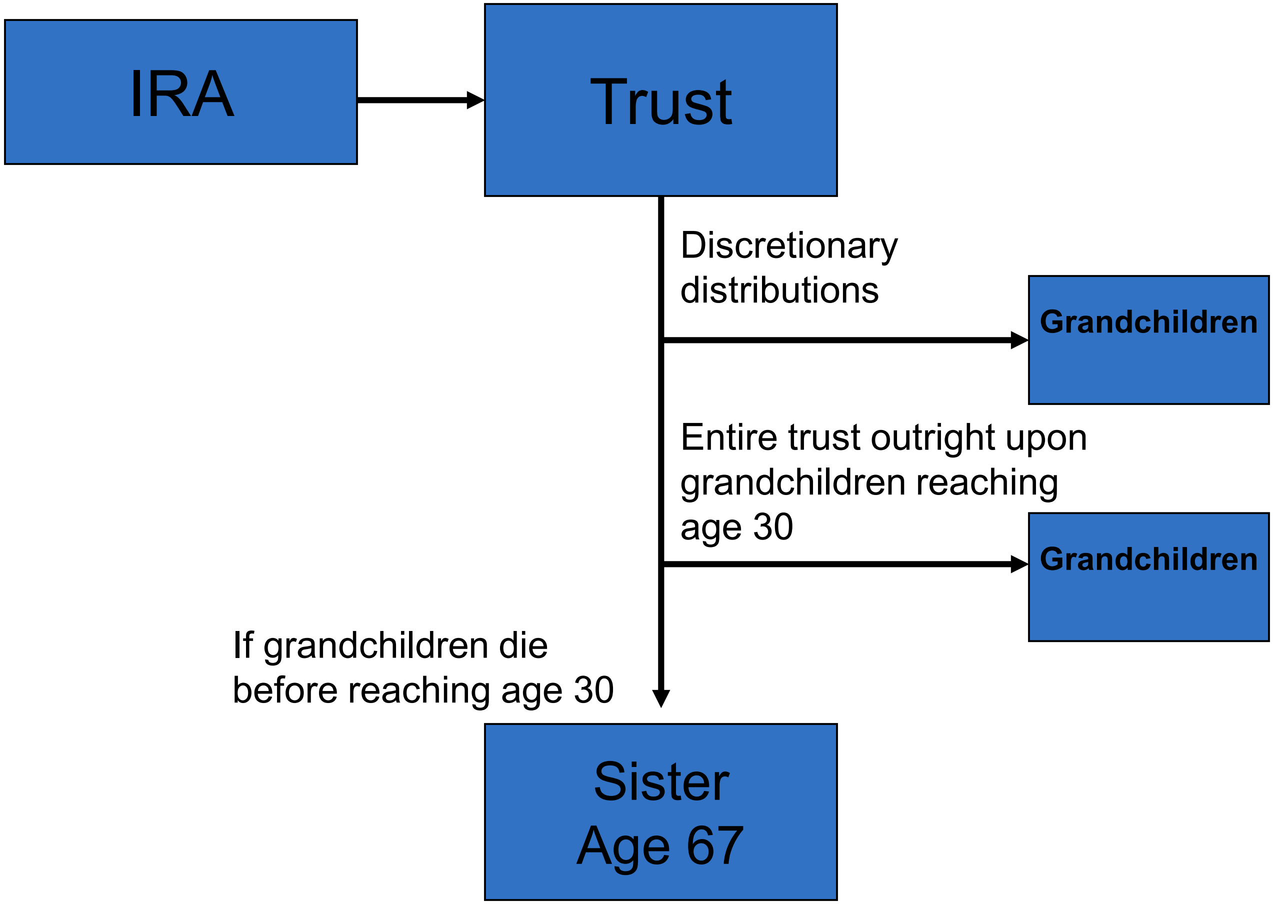
Appendixes

I. Paying IRAs to Trusts
II. Roth IRAs
III. Net Unrealized Appreciation

Paying IRAs to Trusts

Paying IRAs to Trusts

Accumulation Trust – Pre-SECURE Guidance
Example #1



- Accumulation Trust
- Sister measuring life for determining required minimum distributions
- Facts same as PLR 200228025

Paying IRAs to Trusts

Accumulation Trust – Pre-SECURE Guidance

Example #2

IRA → Trust —Discretionary Distributions→ Child #1

Trust ↓ At Child #1's death

To Red Cross

- Contingent beneficiary must be counted
- Non-individual contingent beneficiary
- No designated beneficiary status
- Treas. Reg. § 1.401(a)(9)-5 Q&A 7

Paying IRAs to Trusts

Accumulation Trust – Pre-SECURE Guidance

Example #3

IRA → QTIP Trust → (All income) → Spouse

At spouse's death

Issue of IRA owner in such a manner (in trust or otherwise) as the surviving spouse appoints by will

- Contingent beneficiaries must be counted
- Possible non-individual contingent beneficiaries
- General Power of Appointment disqualifies accumulation trust

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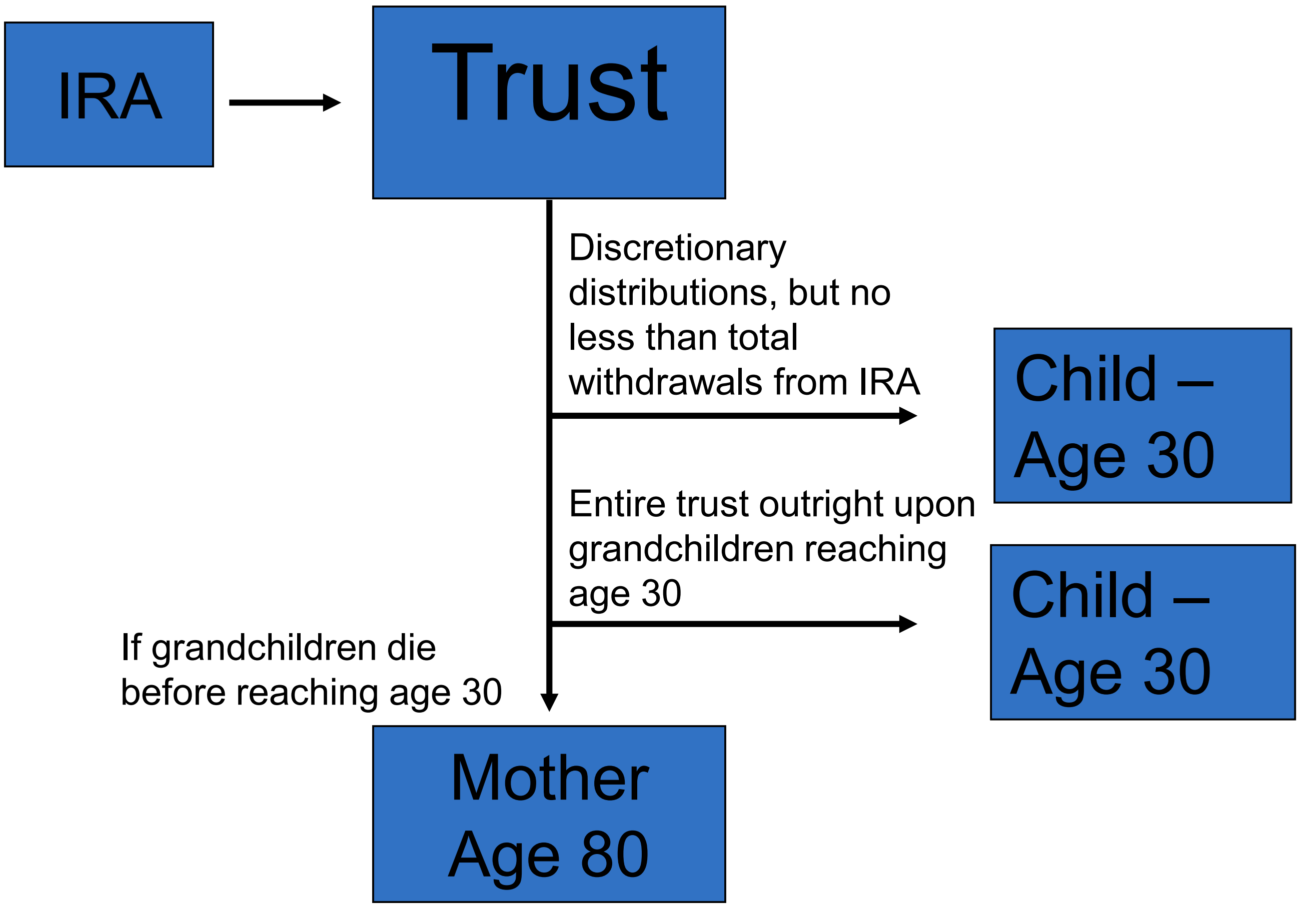
Conduit Trust

- Allows for easier identification of beneficiaries
- Where a conduit trust is used, potential appointees under a power of appointment can be ignored
- If an accumulation trust, all potential takers under a power of appointment must be considered

Paying IRAs to Trusts

Conduit Trust – Pre-SECURE Guidance

Example #1



- Mother is not “countable” for determining applicable life expectancy
- Treas. Reg. § 1.401(a)(9)-5 Q&A 7

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Paying IRAs to Trusts

Conduit Trust – Pre-SECURE Guidance

Example #2

IRA → Trust

All distributions from IRA → Child #1

At Child #1's death ↓

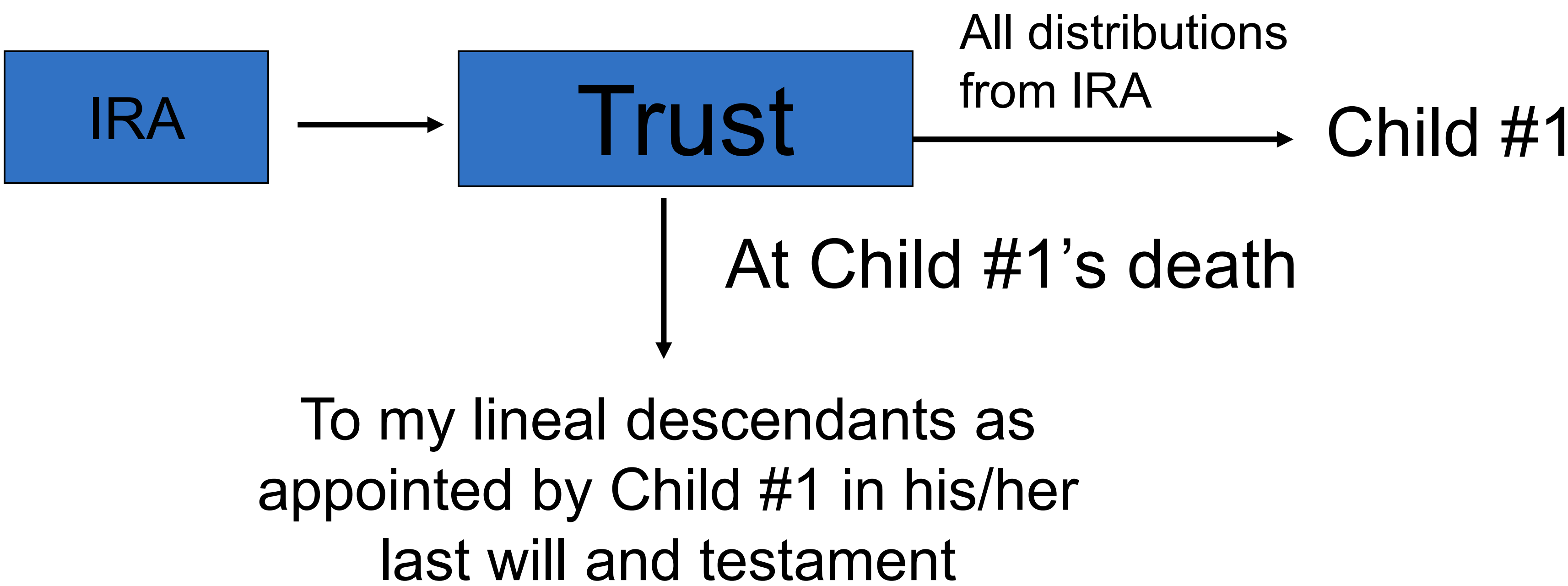
To Red Cross

See Treas. Reg. § 1.401(a)(9)-5 Q&A 7

Paying IRAs to Trusts

Conduit Trust – Pre-SECURE Guidance

Example #3



Paying IRAs to Trusts

Separate Share Rule

Payable to single trust

↓

No separate shares identified in the beneficiary designation form

↓

IRA paid over oldest life expectancy

Paying IRAs to Trusts

Separate Share Rule

IRA payable to multiple trusts

↓

Each trust named in
beneficiary designation form

↓

IRA paid over each separate trust beneficiary's life expectancy

PLR 200537044

Paying IRAs to Trusts

Post-Mortem Trust Reformations

- In the past, IRS has respected post-mortem trust reformations that modified the trust to qualify as a designated beneficiary. See PLRs 200235038-41
- IRS no longer appears to follow post-mortem reformations
- Reformations of Conduit Trusts to Accumulation Trusts

Paying IRAs to Trusts

PLR 201021038

- Service ruled that the retroactive reformation of a trust would not be respected for purposes of section 401(a)(9) and the related regulations.
- The trustee reformed the trust pursuant to a state court order to remove charities under a limited power of appointment granted to first tier beneficiaries.
- The adverse ruling means the trust was not treated as a "designated beneficiary trust" ("DBT") and that the trust beneficiary's life expectancy could not be used for determining required minimum distributions.

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Post-Mortem Checklist

- Deadlines
  - December 31 of year of death
    - » Year of death RMD
  - Nine months after death
    - » Disclaimer
  - September 30 of year following year of death
    - » Beneficiary Designation determination
    - » Pay off undesirable beneficiaries
  - October 31 of year following year of death
    - » Documentation requirement for trusts
  - December 31 of year following year of death
    - » Separate shares created
    - » Begin RMDs (exception for spouse beneficiary)
- Obtain copy of beneficiary designation form
- Review beneficiary trust for potential problems/solutions
- Ensure correct titling and transfer of inherited account
- Review Disclaimers

Roth IRAs

Roth IRAs

Taxation of Distributions

- Types of Distributions
  - Qualified distributions are not subject to income tax
  - Non-qualified distributions are subject to income tax
- Basis
  - Basis can be withdrawn Tax-Free (FIFO Method)
  - Distributions are not subject to income tax if they do not exceed aggregate contributions and/or conversions to the Roth IRA

Roth IRAs

Taxation of Distributions

- Application of the 10% early withdrawal penalty
  - Withdrawals made within five years of conversion if owner is under age 59½ and no exception applies
  - Death Exception

Roth IRAs

Taxation of Distributions

- Income Taxation of Distributions – **the five-year rule**
  - Distributions which consist of growth of the original contribution from accounts less than five years are taxable
  - The 5-year period for all of a participant's Roth IRAs starts on January 1 of the first year for which a contribution was made to any Roth IRA owned by that participant
  - A surviving spouse treats an inherited Roth IRA as one of her own for purposes of the five-year rule
  - The 5-year period continues to run after the participant dies

Roth IRAs

Taxation of Distributions

Roth IRA - Application of 10% Early Withdrawal Penalty

("Ordering Rules")

- Step 1: **Gross Distribution**
- Step 2: **Net contributions**[1]
- Step 3: **Conversion amounts > 5 years**[2] **(taxable portion)**
- Step 4: **Conversion amounts > 5 years**[2] **(non-taxable portion)**
- Step 5: **Conversion amounts <= 5 years**[2] **(taxable portion)**
- Step 6: **Conversion amounts <= 5 years**[2] **(non-taxable portion)**
- **"Earnings"**

10% early withdrawal penalty applies (Unless exception applies)

FOOTNOTES:

1. "Net contributions" is: (a) the sum of all prior Roth IRA contributions *reduced by* (b) the sum of all prior Roth IRA distributions (i.e. "basis first" rule)
2. Distributions attributable to prior conversion amounts are determined on a "first-in, first-out" ("FIFO") basis with the taxable portion of each prior year conversion coming out first followed by the non-taxable portion

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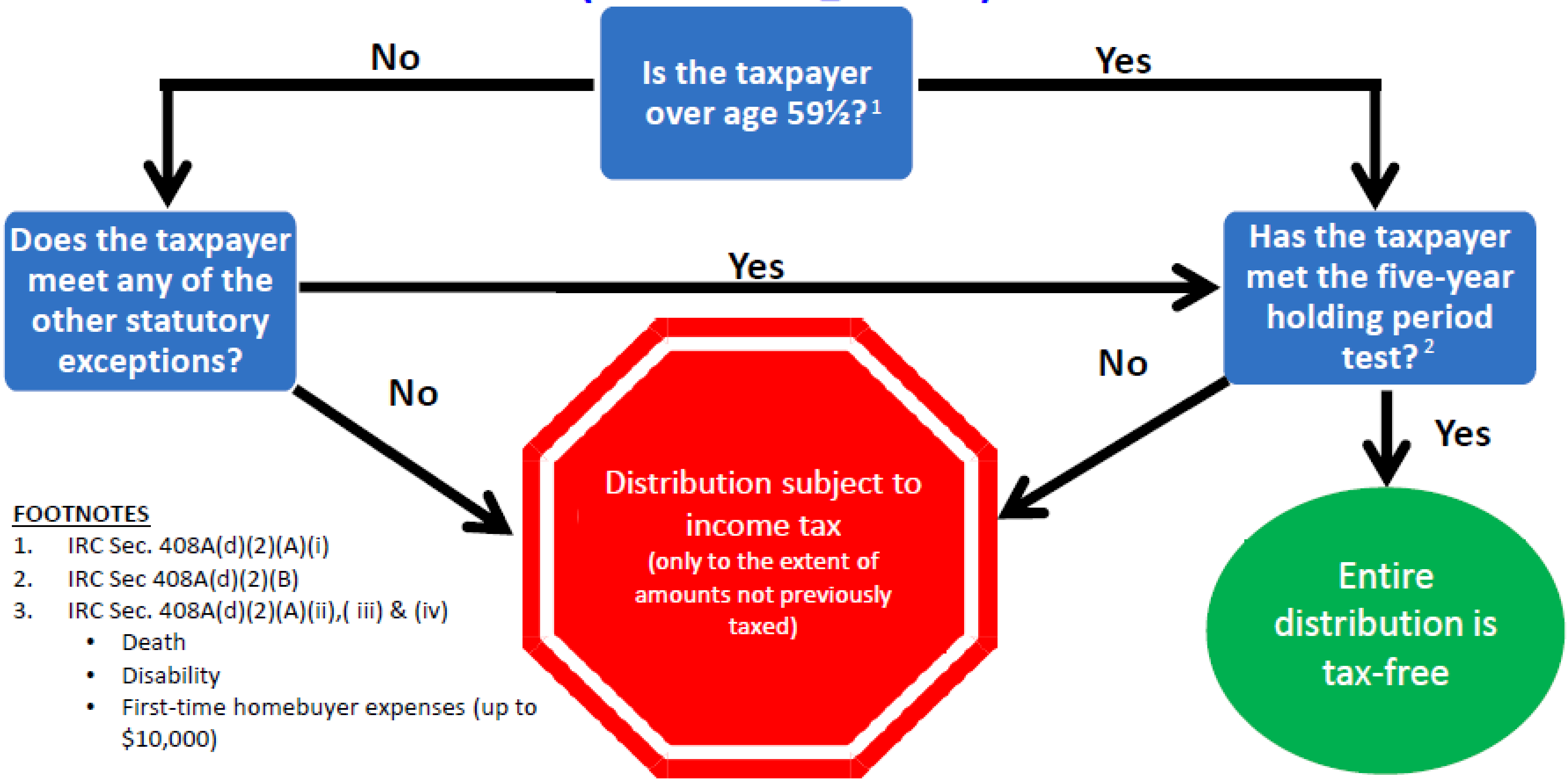
Roth IRAs

Taxation of Distributions

Roth IRA - Taxability of Distributions
("Seasoning Rule")

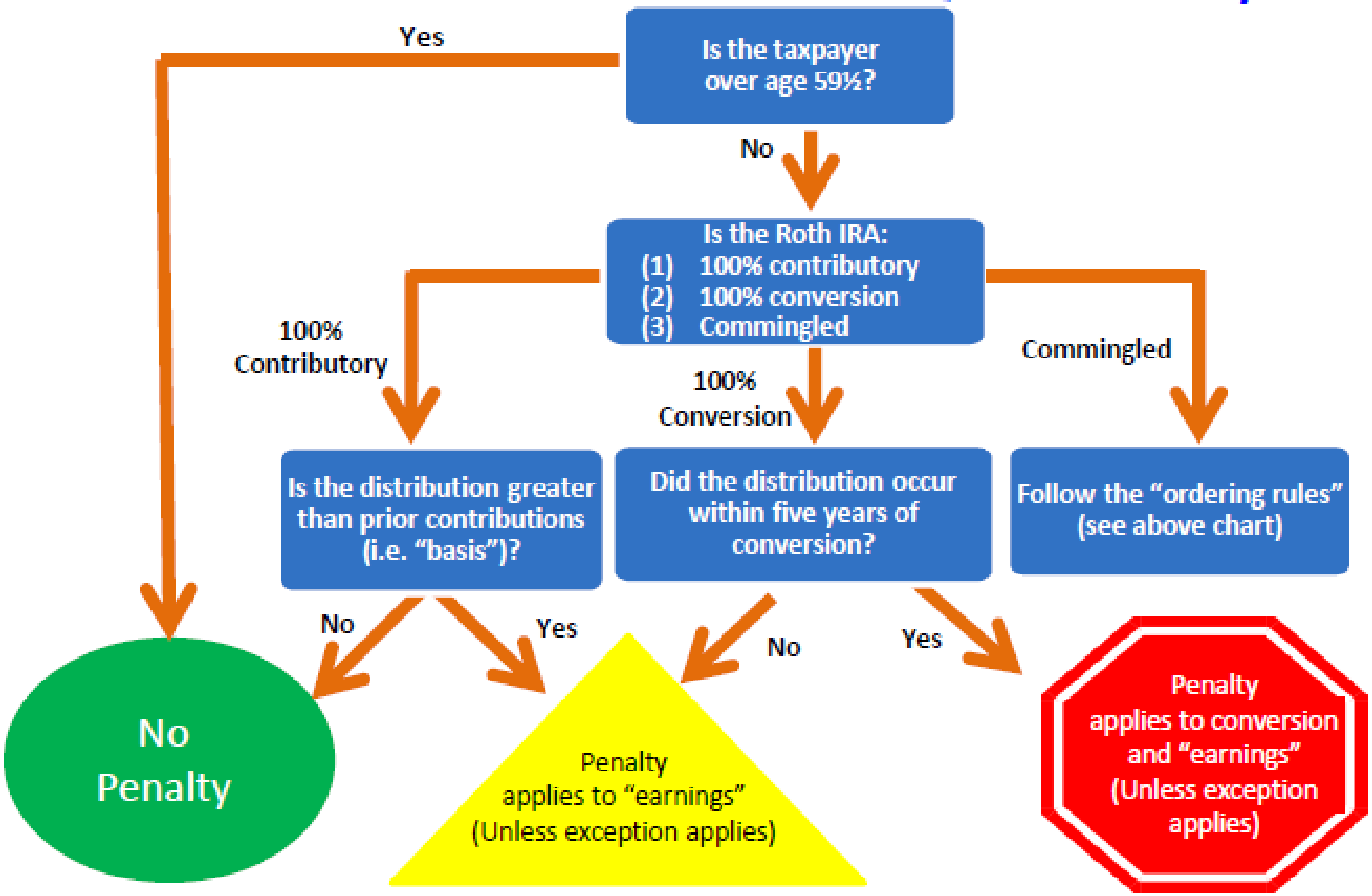


FOOTNOTES
1. IRC Sec. 408A(d)(2)(A)(i)
2. IRC Sec 408A(d)(2)(B)
3. IRC Sec. 408A(d)(2)(A)(ii),(iii) & (iv)
   - Death
   - Disability
   - First-time homebuyer expenses (up to $10,000)

Roth IRAs

Taxation of Distributions

Roth IRA - Application of 10% Early Withdrawal Penalty
("Penalty Box Rule")



Exceptions to 10% early withdrawal penalty :

1. Death
2. Disability
3. Series of substantially equal periodic payments
4. Medical expenses greater than 7.5% AGI
5. Health insurance premiums for unemployed individuals
6. Higher education expenses
7. First-time homebuyer expenses (up to $10K)

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Roth IRAs

Taxation of Distributions

	Distribution within 5 years	Distribution beyond 5 years
Age < 59½	**Income Tax: Yes (earnings only)** **10% Penalty: Yes (earnings & taxable portion of prior conversion amounts)**	**Income Tax: Yes (earnings only)** **10% Penalty: Yes (earnings only)**
Age ≥ 59½	**Income Tax: Yes (earnings only)** **10% Penalty: No**	**Income Tax: No** **10% Penalty: No**

Roth IRAs

Conversion Basics

- Reasons to Convert
  1. Bracket arbitrage
  2. Increase tax-free savings by paying conversion tax with non-qualified funds
  3. Surviving spouse beneficiary is young and will not need the conversion amount for retirement – can be allowed to grow

Roth IRAs

Conversion Basics

- Reasons to Convert
  4. No RMDs (in case of spouse beneficiary) prevent draining of qualified account or IRA and increase tax planning flexibility
  5. Favorable tax treatment for surviving spouse – compressed single tax rates will not apply to RMDs
  6. Reduces size of taxable estate
  7. Ten-year payout rule for Roths allows for additional deferral

Advanced Roth IRA Planning

Understanding the Mechanics

- In simplest terms, a traditional IRA will produce the same after-tax result as a Roth IRA provided that
  - The annual growth rates are the same
  - The tax rate in the conversion year is the same as the tax rate during the withdrawal years (i.e. A x B x C = D; A x C x B = D)

Advanced Roth IRA Planning

Understanding the Mechanics

	Traditional IRA	Roth IRA
Account Balance	$ 100,000	$ 100,000
Less: Income Taxes @ 40%	-	(40,000)
Net Balance	**$ 100,000**	**$ 60,000**
Growth Until Death	300.00%	300.00%
Account Balance @ Death	$ 300,000	$ 180,000
Less: Income Taxes @ 40%	(120,000)	-
Net Account Balance to Family	**$ 180,000**	**$ 180,000**

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Advanced Roth IRA Planning

Understanding the Mechanics

- Critical decision factors
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of “outside funds” to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - Time horizon

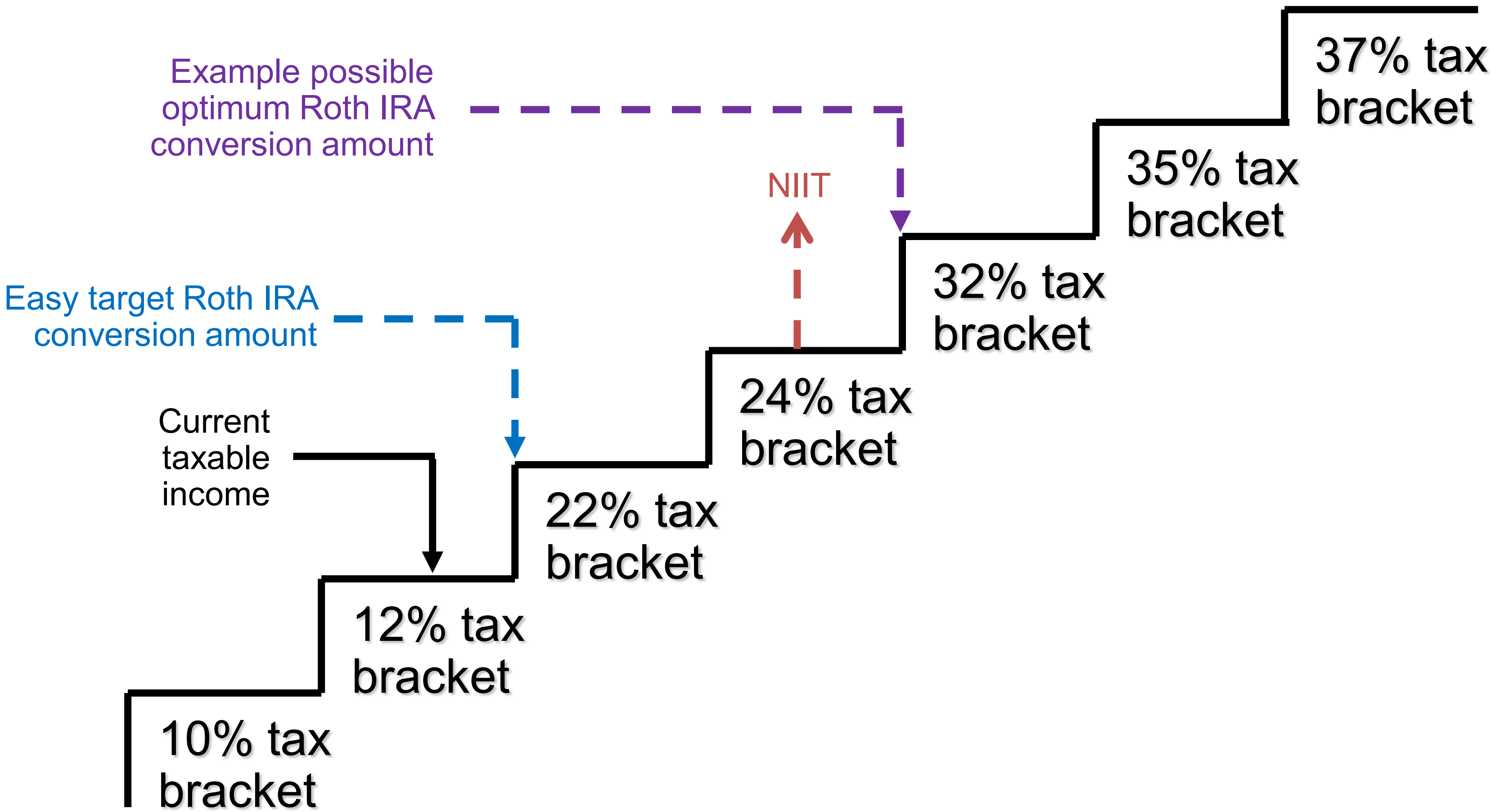
Advanced Roth IRA Planning

Understanding the Mechanics - Tax Rate Differential

- The key to successful Roth IRA conversions is often to keep as much of the conversion income as possible in the current marginal tax bracket
- However, there are times when it may make sense to convert more and go into higher tax brackets

Advanced Roth IRA Planning

Understanding the Mechanics - Tax Rate Differential



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Net Unrealized Appreciation (NUA) Planning & Other Issues

Tax Law Overview

- Qualified dividends are currently taxed at long-term capital gains tax rates
- Long-term capital gains tax rates
  - 0%
  - 15%
  - 20%

Tax Planning Opportunities When a Qualified Plan Has Employer Securities

- Key issues
- Income tax
- Estate tax
- Excise tax

NUA allows the Conversion of Ordinary Income to Long-Term Capital Gains

IRC § 402(d)(4)(D) Triggering Event

- On account of employee's death
- After the employee attains age 59½
- On account of employee's separation from service
- After the employee has become disabled (within the meaning of section 72(m)(7)

Net Unrealized Appreciation

- Spouse may utilize NUA
- Converts ordinary income into long-term capital gains

Taxation of Rollout

- Ordinary income recognized on basis
- Difference between Fair Market Value (FMV) at rollout and basis is Net Unrealized Appreciation (NUA)
- NUA is taxed long-term capital gain tax rates

Taxation of Net Unrealized Appreciation

Fair Market Value (FMV) of stock	$ 750,000
Employer basis	$ 150,000
Net Unrealized Appreciation (NUA)	$ 600,000
Amount taxable if stock is rolled out	**$ 150,000**

The $600,000 of NUA is Deferred Until the Stock is Sold

Additional Taxation of Rollout

- If under age 55 a 10% excise tax penalty is imposed on the basis of the securities

A Key Issue is the Proper Holding Period to Obtain Capital Gain Treatment

Post Distribution Gain

- 1 year or less -- Short-term
- Greater than 1 year -- Long-term

Treatment at Death

- The $600,000 of rollout gain does not receive a step-up in basis
- Subsequent gain (above $600,000) should receive a step-up in basis

Treatment at Death

- If the estate or trust contains NUA stock, a fractional funding clause must be used. Otherwise, the NUA will be subject to immediate taxation.

IRA Distributions are Taxed at the Taxpayer's Marginal Tax Bracket

Lump-Sum Distribution Treatment

- Generally a 100-percent lump sum is **not** feasible from a financial planning perspective

Post-Mortem Rollover Solution

- Surviving Spouse Rolls over
- Easy to implement
- Easy to understand
- Allows Surviving Spouse to create a balanced portfolio

Rollover Solution

- Disadvantages
  - Pre-59½ rules
  - No capital gain treatment
  - Limits estate tax planning options