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For Trusted Advisors

Taxation - Income, Estate and Gift

Strategies for IRA distributions following enactment of the SECURE Act.

By Robert S. Keebler, CPA/PFS, MST, AEP® (Distinguished)

One of the key changes made by the SECURE Act is a new 10-year rule for distributions from most non-spousal inherited IRAs.[1] All distributions from these accounts must now be distributed to beneficiaries within 10 years after the IRA owner dies. This eliminates the "stretch IRA" which allowed non-spousal beneficiaries to stretch out distributions over their lifetimes. A young beneficiary could be named, allowing the account assets to grow at their pre-tax rate of return for a long period of time. For beneficiaries who didn't need the money, stretch IRAs could be used as an inheritance vehicle to accumulate large amounts for future generations of the family.

This review of suggested strategies that owners of large IRAs might use to maximize the wealth that can be accumulated from their IRAs for their families following enactment of the SECURE Act looks at:

1. Charitable remainder trusts,
2. Multi-generational accumulation trusts,
3. IRC Section 678 trusts,
4. Incomplete gift non-grantor trusts,
5. Life insurance, and
6. Roth IRA conversions.

Charitable Remainder Trust as IRA Beneficiary

The stretch IRA was the ideal method for maximizing the time during which IRA assets could grow tax-free for non-spouse beneficiaries. Although the SECURE Act eliminated this strategy, its long tax deferral period can still be replicated to a large extent by transferring IRA assets to a charitable remainder trust (CRAT or CRUT).

Spreading out distributions

If a charitable remainder trust (CRT) is named the beneficiary of a traditional IRA, there is no tax when the funds in the IRA are distributed to the trust.

Tax is only payable when the beneficiaries receive distributions from the CRT. These distributions can be spread out over a term of years not to exceed 20, or for the life or lives of a named individual or individuals, creating a long deferral period.

1 An exception is made for "eligible designated beneficiaries." These include beneficiaries who are disabled, chronically ill, or less than 10 years younger than the IRA owner and minor children of an IRA owner.

Charitable intent

Internal Revenue Code Sections 664(d)(1)(D) and 664(d)(2)(D) require that the present value of the charitable remainder interest must be at least 10% of the initial value of the trust assets. Thus, charitable intent might be necessary to make this strategy work.

Multi-generational Accumulation Trusts

If an accumulation trust is named the beneficiary of an IRA, all the IRA funds would have to be paid to the trust by the end of the 10-year period, but the trustee would have the discretion to decide how much, if any, to pay to the beneficiaries and how much to keep in the trust.

Although accumulation trusts increase costs and add complexity, they also create important non-tax advantages for a family. They limit beneficiary access to funds, protect assets from creditors, provide professional management of trust assets, and may enable the trustee to manage tax brackets. They also may provide divorce protection and dead-hand control and facilitate estate planning and planning for beneficiaries with special needs.

The trust would be structured as a spray trust, naming a broad group of family members as beneficiaries and spraying distributions across the group according to instructions provided by the grantor to the trustee. These beneficiaries could include more than one generation of the IRA owner's family. This would give the family the flexibility to vary the amount of income in respect of a decedent (IRD) distributed to minimize income tax obligations. Thus, a spray trust could be used to combine the tax benefits of low tax rates with the non-tax advantages of an accumulation trust.

IRC Section 678 Trust

As noted above, accumulation trusts can provide important non-tax benefits for a family. To get these advantages, however, the assets must stay in the trust instead of being distributed to the trust beneficiaries. Unfortunately, any amounts retained in the trusts would ordinarily be taxed at the high trust tax rates. For 2020, all trust income above $12,950 is taxed at the top individual income tax rate of 37%. By contrast, if the required minimum distributions (RMDs) are distributed to the trust beneficiaries, they will be taxed at the beneficiaries' individual tax rates, which might be substantially lower.

Under IRC Section 678, a person other than the trust's grantor is treated as the owner of a trust if that person is given a power to withdraw trust assets without the consent of any other person. If a trust beneficiary is treated as the owner of a trust under Section 678, all items of income, deductions, and credits against tax of the trust would be reported on the beneficiary's Form 1040 instead of on the trust's tax return. This would enable the trust to retain and accumulate the RMDs in the trust without paying the high trust rates. The family of the IRA owner would get the best of both worlds, the advantages of leaving the assets in the trust with the lower tax rates of the individual beneficiaries.

Incomplete Gift Non-Grantor (ING) Trusts

The benefits of using an accumulation trust as a beneficiary of an IRA can be enhanced by making the trust an incomplete gift non-grantor trust in a state that doesn't tax trust income. The leading states for creating these ING trusts are Delaware, Nevada and Wyoming. They also can be created in several other states.

Life Insurance

Beneficiaries who don't need the required minimum distributions they receive from their inherited IRAs during the 10-year SECURE Act period may be able to increase the amounts that can be accumulated for heirs by using some or all of the distributions they receive from the IRA to buy life insurance, provided they have an insurable need. The proceeds of the policy would be paid income tax-free to the beneficiary's heirs or to a trust for their benefit.

Life insurance has two advantages: First, assuming that the contract meets the definition of life insurance, there is no tax on the build-up of the policy's cash surrender value. Moreover, there is generally no income tax payable when the insured dies. Thus, as a general rule, the insurance proceeds are never subject to income tax.

Key factors when considering whether life insurance is a favorable strategy include tax deferrals and longevity of the insured.

Roth IRA Conversions

An important advantage of a Roth IRA is that there are no RMDs. This enables the entire value of the IRA to grow tax-free until the beneficiary's death, facilitating accumulation of wealth for the family.

If the beneficiary doesn't need distributions, the Roth IRA could be viewed more as a wealth transfer tool than as a retirement income vehicle.

Roth IRA conversion vs. other strategies

An advantage of a Roth conversion over a transfer to a CRT is that there is no need to transfer 10% of the value to charity. The full value can go to heirs.

The advantage of transferring the IRA assets to an irrevocable non-grantor trust would be that distributions to beneficiaries could be spread out and state income tax could be avoided. The Roth IRA could not only avoid state income tax, but also federal income tax.

Conclusion

There are many strategies to consider when it comes to IRA distributions.

Unique personal and financial objectives must be considered in light of ever-changing legislation. Individuals are urged to consult with financial professionals who can provide the expertise necessary to help them choose the best course to navigate this complex arena.

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Estate Planning

Revocable living trusts: advantages, drawbacks and misconceptions.

By Eva Stark, JD, LL.M.

While working on an estate plan or revising an existing plan, clients are often baffled by a common estate planning tool: the revocable living trust. How is it different from a will? What exactly does it accomplish? What are its advantages and drawbacks?

Wills vs. Revocable Living Trusts

Clients are likely familiar with the idea of a will — a document that governs how an individual's assets will pass at death. Executing a will can ensure that the decedent's wishes will be carried out instead of having assets distributed in an unintended manner under default laws set by the state.

However, as important as a will is, it might not determine how all—or most—of an individual's assets will pass at death. Many assets, known as "non-probate" assets, pass outside of the will. Assets passing outside the will generally include those held in trust (including a revocable living trust) or assets that pass by beneficiary designation, right of survivorship, or a similar method.

A revocable living trust is an arrangement where a trustee is selected to hold legal title to assets and to manage the assets for the benefit of the trust's beneficiaries. Unlike a will, which takes effect only at death, a revocable living trust takes effect immediately upon execution. While the settlor is alive, the settlor is usually the trustee and beneficiary of the trust and the settlor generally may revoke the trust or withdraw assets from the trust at any time. At the settlor's death, the trustee distributes assets to (or continues to manage assets for the benefit of) the settlor's beneficiaries, who are most typically the surviving spouse or descendants. A revocable living trust only governs the management or disposition of assets that are transferred to the trust (technically, to the trustee). Settlors typically transfer ownership of various assets to their trust during their lifetime. In addition, a "pour-over" will may be used to channel probate assets to the trust through the probate process.

Advantages of Revocable Living Trusts

A distinctive advantage of a revocable living trust is that assets transferred to the trust during lifetime escape probate. At the settlor's death, assets in a revocable living trust can be immediately distributed by the trustee under the provisions of the trust instrument instead of having to undergo a potentially drawn-out and costly probate process.

Another benefit of a revocable living trust is that it allows for privacy in estate disposition. While a will is filed with the probate court and may become public, a trust instrument is generally not filed in court and is rarely shared in its entirety with third parties. We all periodically see sensationalized news stories about how a recently deceased high-profile celebrity may have disinherited a child or died owning this or that. While the average person's probate proceedings will not attract such levels of scrutiny, there might still be peace of mind to knowing that one's estate plan will generally remain private.

A revocable living trust also allows for property management by the trustee or successor trustee in the event of the settlor's incapacity. While management of an incapacitated person's assets may otherwise be accomplished through a durable power of attorney, relying on a durable power of attorney may be more burdensome in certain circumstances.

A decedent's will must generally be probated in every jurisdiction he or she owned real property at death. Depending on the nature of the probate process in the jurisdictions involved and the number of jurisdictions or properties at issue, this may be relatively painless or more drawn-out and costly. In contrast, the trustee continues to just hold assets under the terms of the trust at the settlor's death—generally no probate is required anywhere.

Drawbacks

One potential drawback of a revocable living trust is the upfront cost and hassle. In addition to executing the trust document, assets generally need to be transferred to the trust upon its creation or as the settlor acquires new assets. This may entail drafting and filing deeds for the transfer of real estate, documenting the transfer of closely-held business interests, updating account ownership documents, changing beneficiary designations, or similar tasks, all of which necessitate not only the client's time and attention but may require the time and advice of attorneys.

Creating a revocable living trust may also add unnecessary complexity in certain circumstances—especially where the client's objectives can be accomplished through other methods. For example, a testamentary trust (i.e., a trust outlined in a will to take effect at death) may be used to provide for the client's desired property disposition, create trusts for surviving spouses and descendants, or to incorporate basic estate tax planning strategies.

Common Misconceptions

When clients think of their assets being placed into a revocable living trust, they often mistakenly assume that the trust will provide creditor protection. A revocable living trust generally does not protect assets from the settlor's creditors. Upon the settlor's death, the trust becomes irrevocable and the trust might offer creditor protection for the beneficiaries if assets remain in trust and the trust is drafted with provisions for creditor protection under applicable laws.

Another common misconception is that creating and funding a revocable trust will place assets outside the settlor's taxable estate or will reduce estate taxes. Assets held in revocable living trusts are generally part of the settlor's taxable estate. As previously noted, assets held in trust are not part of the settlor's probate estate, an entirely different concept. The probate estate is the part of the estate that must undergo the probate process to be disposed of under the will or intestacy laws.

Many clients also mistakenly believe that once a revocable living trust is properly executed, their intended plan is fully in effect and nothing more is needed to implement it. However, if assets intended for trust ownership are not properly transferred to the trust during the settlor's lifetime, they will remain part of the client's probate estate (assuming the asset is a probate asset), will undergo probate, and will be distributed under the client's will and not necessarily the revocable living trust. As a result, if the trust is not properly funded during lifetime, the intended benefits and advantages for having created the trust may be lost.

Clients should discuss with their attorneys exactly what assets should be transferred to their revocable living trust during their lifetime and how to properly implement any intended transfer.

The Importance of Professional Advice

For some clients, a revocable living trust-based estate plan may offer important added benefits as compared to a will-based estate plan. For others, the drawbacks of a revocable living trusts may outweigh potential benefits. When devising an estate plan, it will be important for clients to understand and weigh the benefits and drawbacks of revocable living trusts with their advisors in light of their particular goals and circumstances.

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Understanding the probate process.

By David R. Toups, JD, MBA, CFA®, CFP®, CTFA

With the COVID-19 virus sweeping throughout the world, many people will, unfortunately, experience the probate process in order to administer the estates of those who succumbed to the global pandemic.

This article is provided to help demystify probate and explain the procedural steps that normally occur in the probate process; and perhaps also to inspire those who may have developed a greater respect for the frailty of human life as a result of the pandemic to undertake the estate planning process in earnest — clarify your wishes and ease the legal obligations your death will impose on your loved ones.

PROBATE. The probate process is an established set of state procedures to officially determine the successor ownership of property and rights held by a decedent.

According to the law, property always has a rightful owner; what remains to be determined is who that successor owner is after the death of the existing owner, and to have the successor officially declared for later transactions and third parties. If not identified by the decedent with a will, the heirs to the decedent must also be determined and officially established. During the pendency of the estate, or the period of time awaiting the settlement, the probate court will:

- Appoint a personal representative to marshal and protect the decedent's property;
- Provide an inventory;
- Notify creditors and beneficiaries; and
- Administer and distribute the estate to its rightful owners upon successful completion of all the tasks to be accomplished.

INTESTACY. A decedent may leave a last will and testament that specifies who the successor owners to the property shall be; however, some decedents fail to do so. When a person dies in intestacy — without a legal will — distributing their assets becomes the responsibility of a probate court. As a result, each state will apply a default set of statutes called intestacy statutes, which determine where property passes for those not leaving a will. These statutes vary in the percentages or priority in each state, but most leave the property to spouses, children, parents, and siblings.

In scenarios where a person's loved ones fall outside of these familial classifications, it is imperative to create a will prior to death or loved ones will receive none of the property which passes through the probate system.

Another alternative in these scenarios is to structure the property's title in a manner that it transfers directly to the intended beneficiary without using the probate process. These assets are referred to as non-probate property.

NON-PROBATE PROPERTY. Not all property passes through probate. Assets that pass or transfer under a contractual agreement, or property owned with title that passes as a matter of law upon the death of a titleholder, are referred to as non-probate assets. These assets generally do not require a will to direct their disposition, so they do not pass through probate. Assets such as right-of-survivorship property, retirement plans, pensions, annuities, life insurance policies, and pay-on-death accounts at financial institutions are typical non-probate assets.

However, non-probate does not mean that these assets never pass through probate. If the decedent's estate is specifically named as a beneficiary, or the original beneficiary designations or the successor titleholder fails due to death or the designation being voided by statute (such as former spouses in certain states), the non-probate assets can pass through the probate process. When this occurs, the assets typically become subject to public disclosure and potential estate creditors. In the case of retirement plans or tax-deferred assets, detrimental income tax consequences may result. For estate tax purposes, the IRS includes the value of non-probate assets in the decedent's gross estate when assessing estate tax liability.

Considering the types of assets comprising an estate is an important component when planning for their disposition. Many beneficiaries have been surprised to learn that an estate divided equally among the decedent's loved ones expressly provided for in a will, is in fact, overly lopsided due to a substantial insurance policy or a pay-on-death account with a designated beneficiary.

TRUSTS. Assets owned by a trust also do not pass through probate at the death of the decedent, unless the trust language provides for such a transfer or disposition. A trust is the separation of legal and equitable or beneficial title. A trust is not an entity but rather a bifurcated ownership interest in property. Such a separation can create opportunities for asset protection and tax benefits in some cases; however, if the trust is improperly funded, the property will pass through probate, subjecting those assets to both disclosure and estate creditor claims.

A decedent does not outright own property properly transferred to a trust, so his or her death would not subject those assets to his or her probate estate. The decedent's death may serve as a trigger for a transfer or distribution from the trust, but only as the language of the trust directs.

THIRD PARTIES. When a person dies, active contracts for which the decedent was a party must be reconciled, transferred, or closed out. Also, the obligations and debts of the decedent must be addressed and settled. For example, a common third party in estates are secured lenders for vehicles and real estate. Probate provides the procedure and forum for this to occur.

If insufficient assets remain to pay all creditors, then a multi-tiered creditor classification system exists to prioritize the creditors' claims until the assets are exhausted. State governments have been increasingly looming large in decedent's estates with Medicaid recovery claims.

PROTECTED ASSETS. If creditor claims exceed the estate's assets, the estate is considered insolvent, and the decedent's beneficiaries would ordinarily receive nothing since the payment of creditor claims will exhaust all of the property. However, most states provide for family allowances and exemptions for certain assets passing to spouses or dependent children.

Allowances and exemptions are protected set-asides which help prevent leaving surviving spouses and dependent children destitute upon the death of their spouse or parent. These allowances and exemptions may not be automatically applied, depending upon the state, but if available should generally be requested.

Conclusion

Although much maligned, many states' probate processes provide effective and efficient administration at minimal costs, provided the decedent had a competently drafted and executed will.

Many states have streamlined the probate process and permit independent administrations to limit court appearances and keep legal costs down. Some states even permit abbreviated or minimal requirements for smaller estates where the typical administration expenses would consume the bulk of the modest estate.

When a loved one's death occurs, consultation with trusted advisors familiar with your state's probate and estate planning opportunities is a solid first step to avoid costly errors and chart an optimal course through the probate process.

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