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Issues Relating to the SECURE Act - Part 2

A Focus on Leaving Retirement Plans to Children and Other Descendants

The SECURE Act. We discussed the SECURE Act, which became effective January 1, 2020, in our eight page newsletter dated January 15, 2020. The SECURE Act changed the "Minimum Distribution Rules" relating to distributions from qualified employee benefit plans (such as 401(k) plans) and IRAs. Unless otherwise noted, we will jointly refer to both qualified plans and IRAs as "retirement plans." The Minimum Distribution Rules are income tax rules that provide for the timing and taxation of distributions from retirement plans. These rules apply to (i) the employee or retiree who participates in an employee benefit plan and (ii) the named owner of an IRA (jointly referred to as the "participant"). These rules apply during the participant's life and after the participant's death, when the participant's retirement plan becomes distributable to the participant's beneficiaries.

In our newsletter dated April 14, 2022, we also discussed the proposed Treasury Regulations interpreting the SECURE Act that were released in February 2022 (the "Proposed Regulations"). We are not going to repeat in this newsletter everything we said about the SECURE Act in our prior newsletters. All of the law firm's past newsletters can be found on the firm's website, **www.gerstnerlaw.com**.

This is a long newsletter, although at least two pages have been eliminated from the original draft to try to simplify this very complex topic. If you want to skip to the "bottom line," go to the last section of this newsletter titled, "Split the Baby Approach."

Income Tax Fundamentals. In general, when distributions (or withdrawals) are taken from a qualified employee benefit plan (*other than a Roth 401(k) plan)* or from an IRA (*other than a Roth IRA)*, those distributions are subject to income taxes at "ordinary income tax rates" in the year they are taken. (We will ignore the possibility that sometimes a participant contributes after-tax amounts to his qualified plan or IRA. Therefore, if we refer to a "pre-tax retirement plan," we mean a retirement plan that was funded entirely on a pre-tax basis.) By saying, *ordinary income tax rates*, we are distinguishing those tax rates from the long term capital gains tax rates that apply to long term capital gains. Pre-tax retirement plans are "zero basis assets" and not "capital assets." That means each dollar withdrawn from that retirement plan will be subject to income taxes at the same rates applicable to compensation income. Therefore, to the extent the person who must take required distributions from a pre-tax retirement plan can "spread out" the amount of those distributions over multiple years, the amount of taxable income each year and, therefore, the amount of income taxes payable on those distributions each year, will be reduced compared to larger distributions made over a shorter time period. In addition, the amount still held inside the pre-tax retirement plan will continue to grow, income-tax deferred. COMMENT: While retirement plans are great asset accumulation vehicles, they are "problematic" wealth transfer vehicles (i.e., the income tax cost to children and other beneficiaries in lower generations who inherit these assets is very high).

The participant has to take required minimum distributions ("RMDs") from his non Roth retirement plans during his lifetime. In addition, the participant's beneficiaries must take certain required distributions from the participant's retirement plans after the participant's death. We will refer to what the beneficiaries own after the participant dies and leaves his pre-tax retirement plans to them as "inherited IRAs." Except in the case of qualified distributions from Roth IRAs and Roth 401(k) plans, income taxes will be paid on distributions from inherited IRAs taken by the participant's beneficiaries. (NOTE: Roth IRAs payable to DBs are also subject to the SECURE Act's new 10 year rule, but, because Roth IRAs hold after-tax assets, qualified distributions are not subject to income taxes.)

Participant's Beneficiaries. A major key to the Minimum Distribution Rules after the participant's death is the identity of the beneficiary or beneficiaries of the participant's retirement plan. Before the SECURE Act became law, the participant's beneficiaries were either "designated beneficiaries" ("DBs") or not ("non DBs"). In general, prior to the SECURE Act, DBs were entitled to use a life expectancy distribution method to drain their inherited IRAs after the participant's death. Non DBs either were subject to the 5 year rule (if the participant died before RBD—see below) or had to withdraw the amount in their inherited IRA over the deceased participant's "ghost life expectancy."

The SECURE Act divided "DBs" into two classes: (1) "eligible designated beneficiaries" ("EDBs") and (2) "regular" designated beneficiaries (if we just use the term, DBs, we mean "regular" DBs). The five categories of EDBs are (i) the participant's spouse, (ii) the participant's minor child, (iii) a disabled person, (iv) a chronically ill person, and (v) a beneficiary not more than ten years younger than the participant. Only an EDB still gets to use a life expectancy distribution period when that EDB inherits the participant's retirement plan in a qualified way. NOTE: The life expectancy distribution period applicable to the participant's minor child is not a true life expectancy distribution period compared to what the other EDBs enjoy. The participant's minor child must withdraw 100% of the inherited IRA upon reaching age 31.

Per the SECURE Act, "regular" DBs are now subject to the new 10 year rule. Originally, based on wording used in the statute, everyone interpreted the new 10 year rule like the old (and still existing) 5 year rule—meaning that, if the 10 year rule applied, everyone believed no RMDs were required until the end of the 10th year after the participant's death, at which time the entire amount held in the inherited IRA had to be distributed out of the inherited IRA to the beneficiary. However, the Proposed Regulations interpreted the SECURE Act to provide for two different 10 year rules, depending on whether the participant dies before or after reaching his "Required Beginning Date" ("RBD"). In most cases, RBD under current law is April 1 of the year following the year the participant reaches age 72. If the participant dies *before* his RBD, the new 10 year rule is applied just like the 5 year rule: no RMDs are required in years 1 through 9 after the participant's death, but the entire amount held in the inherited IRA must be withdrawn by the end of the 10th year following the participant's death. In contrast, if the participant dies *on or after* his RBD, the beneficiary must take RMDs during years 1 through 9 after the participant's death, PLUS withdraw the full remaining amount in his inherited IRA by the end of year 10. In either case, the bottom line is that, when a "regular" DB inherits the participant's retirement plan and establishes an inherited IRA, 100% of that inherited IRA must be withdrawn by December 31 of the year that contains the 10th anniversary of the participant's death. Therefore, the type of income tax deferral enjoyed by all DBs prior to the SECURE Act—namely, the "stretch IRA"—is gone for "regular" DBs.

A Focus on Adult Children. Both single people with children and married people with children often name their children as the beneficiaries of their retirement plans at some point. In the case of married couples, the children are normally named as beneficiaries on the death of the surviving spouse.

Before the SECURE Act became law, many participants named Descendant's Trusts (or Child's Trusts or similar types of trusts) for their children and other descendants as beneficiaries of their retirement plans, rather than naming their adult children, individually (outright), as the beneficiaries of their retirement plans. They usually did this for tax and creditor protection reasons. In a nutshell, the four primary advantages of naming Descendant's Trusts (or similar trusts) for children and other descendants as the recipients of the parents' assets are the following: (i) the trust assets are protected from loss due to a divorce; (ii) the trust assets are protected from loss due to any other type of lawsuit; (iii) if the child's children and grandchildren are named as permissible beneficiaries of the child's trust while the child is living, subject to the distribution standard applicable to the trust, the Trustee can distribute the trust's income to any one or more of the permissible current beneficiaries of the trust, some of whom may be in low income tax brackets (income distributed out of the trust will be taxed to the recipients and not to the trust itself); and (iv) when the child dies (assuming proper drafting and administration of the trust), the assets in the trust will not be included in the child's estate and, therefore, will avoid being subject to federal estate taxes in the child's estate (and, possibly also, state death taxes in those states that have a state death tax—Texas does not). Descendant's Trusts are often created to last for multiple generations—for the primary benefit of the children, first, then for the primary benefit of the grandchildren, second, and so on. Per recently revised Texas law, Descendant's Trusts can continue (and keep family assets protected) for up to 300 years.

Before the SECURE Act became law, if the Descendant's Trust was drafted as a "qualified see-through trust" pursuant to the Minimum Distribution Rules, then a life expectancy distribution period applied to the inherited IRA that belonged to the trust, just the same as if the child (or other primary beneficiary of the trust) had been named as the outright beneficiary of the retirement plan. In other words, a Descendant's Trust drafted to qualify under the Minimum Distribution Rules was able to take distributions from the inherited IRA that belonged to the trust at the same rate as the participant's child (or, in some cases, the participant's oldest child), but the Descendant's Trust had the four advantages described above that the child did not necessarily have if the child was named as the outright beneficiary of the participant's retirement plan.

As a reminder, before the SECURE Act (and the new life expectancy tables) became effective, if the participant's child who inherited the participant's retirement plan was age 40, that child had a life expectancy of 43.6 years. Thus, before the SECURE Act, whether the child himself or a qualified Descendant's Trust for the benefit of the child was named as the beneficiary of the participant's retirement plan, RMDs after the participant's death could be spread out over 43.6 years. The RMD in the first distribution year was 1 ÷ 43.6 (0.02294), in the second distribution year was 1 ÷ 42.6 (0.02347), and so on. As already noted, that very lengthy "distribution period" (referred to as the "stretch IRA") is no longer possible in the case of an adult child of the participant unless that child is disabled or chronically ill. (This newsletter will not discuss planning for disabled or chronically ill beneficiaries, two of the new EDB categories. This newsletter will also not discuss planning for minor children of the participant. Stay tuned for future newsletters on those topics.)

Background: Estate Tax Exemption. In December 2017, the Republicans in Congress were able to pass the Tax Cuts and Jobs Act, which amended the federal estate tax laws to set the basic exclusion (or, exemption) from the federal estate tax at $10 million, adjusted for inflation each year. Inflation adjustments start from a base year of 2011. Thus, the estate tax exemption for the year 2022 is $12,060,000. Unfortunately, the provisions in the Tax Cuts and Jobs Act, which was passed as a reconciliation bill, will expire at the end of 2025 (unless future Congressional action changes that). Under existing law, on January 1, 2026, the basic exclusion amount will drop to $5 million. The $5 million exclusion amount will be adjusted for inflation, with the base year for inflation adjustments being 2011. Thus, the exemption in the year 2026 *could* be in the range of $6.5 to $6.9 million.

Because the estate tax exemption amount is currently at a historically high level, and will even be at a pretty high level after 2025 (older clients may recall that it took *forever* for the estate tax exemption to reach $1 million—which finally happened in 2002), estate planning lawyers and their clients have been focusing more on income tax considerations (versus estate tax considerations) during the past 5 years. Very few estates are subject to the federal estate tax these days. However, *everyone* is subject to federal income taxes.

Background: Income Tax Consequences of Distributions from Pre-Tax Retirement Plans Made to Descendant's Trusts. Most Descendant's Trusts *that become effective on the parent's death* are designed as "complex trusts" for federal income tax purposes. The term *complex trust* basically refers to a trust in which the Trustee is given discretion whether to retain or distribute the trust's income each year. In other words, the Trustee has the power to distribute all or any part of the trust's income to any one or more of the current permissible beneficiaries of the trust each year, based on the distribution standard included in the instrument that created the trust and the relevant facts. Likewise, the Trustee has the power of retain all or any part of the trust's income in the trust each year. Income retained in the trust will be taxed to the trust at the trust's income tax rate. Income distributed out of the trust to one or more permissible recipients will be taxed to the recipients at the recipients' respective income tax rates.

In addition, as noted above, distributions from pre-tax retirement plans are subject to income taxes at ordinary income tax rates in the year those distributions are received (or taken). And while 100% of the distribution from a pre-tax retirement plan is taxable income for federal income tax purposes, it is not 100% “trust accounting income” for fiduciary accounting purposes (*see* next section).

Trust Distribution Provisions. Most Descendant’s Trusts allow the Trustee to distribute both the *income* of the trust and the *principal* of the trust to one or more current beneficiaries of the trust pursuant to the distribution standard included in the instrument that created the trust. Frequently, the oldest beneficiary of the trust (usually a child of the parent who created the trust) is deemed to be the primary beneficiary of the trust for his or her lifetime, but that beneficiary’s descendants (children and grandchildren) are permissible beneficiaries of the trust while that beneficiary is living. With respect to the distribution provisions in the trust instrument, the words *income* and *principal* refer to what constitutes income versus principal for “trust accounting” or “fiduciary accounting” purposes and not what constitutes taxable income under the federal income tax laws. Despite the flexibility granted to the Trustees of most trusts to distribute both income and principal of the trust out of the trust to the current beneficiaries, keep in mind that a longstanding goal of parents and others who create Descendant’s Trusts is preserving the *principal* of the trust for their children and other descendants for many generations. People who create Descendant’s Trusts normally do not intend for the Trustee to distribute most or all of the principal of the trust out of the trust to the beneficiaries “willy nilly” (i.e., without a compelling reason or, at least, good justification). In other words, regardless of the distribution provisions applicable to the trust, distributions of *principal* from a trust are usually intended to be “more limited” than distributions of *income* from a trust. This is consistent with the idea of living off one’s income, first, before spending one's principal.

Allocation of Receipts from Retirement Plans to Income and/or Principal. For purposes of this newsletter, we will not discuss how the Trustee of a trust allocates receipts from retirement plans owned by the trust between income and principal for trust accounting purposes. Suffice it to say that, in many cases, a large amount withdrawn from the inherited IRA that belongs to the trust will be treated as principal, and not income, for trust accounting purposes, even though 100% of such receipts will be treated as ordinary income for federal income tax purposes

Income Tax Considerations. The top ordinary income tax rate in 2022 is 37%. Compare the level at which a particular taxpayer reaches the top bracket in 2022 (references to an "Irrevocable Trust" mean a *complex trust*):

Married Filing Jointly: $647,850

Single Individual: $539,900

Irrevocable Trust: $13,450

Ignoring the benefits of Descendant’s Trusts for a moment, it is clear that if a sizeable distribution is made from the inherited IRA that belongs to a Descendant’s Trust and none of it (or only a modest portion of it) can justifiably be distributed out of the trust to one or more current beneficiaries of the trust based on the trust distribution provisions and applicable facts, significant income taxes will be paid on the portion of that distribution that is retained in the trust. Remember that, in the case of pre-tax retirement plans, 100% of the distribution is taxable as ordinary income in the year of the withdrawal. Also remember that, per the new 10 year rule, all “regular” DBs must withdraw 100% of the amount in their inherited IRA by December 31 of the year that contains the 10th anniversary of the participant’s death. That full distribution in year 10 is likely to be a significant amount in many cases. And even in the case where RMDs must be taken in years 1 through 9 after the participant’s death (because the participant died after reaching his RBD), if the only amount withdrawn in those years is the RMD, the amount that must be withdrawn in year 10 will often still be a significant amount. Perhaps DBs who are not required to take any distributions until year 10 (in cases where the participant dies before reaching his RBD) or even those required to take RMDs in years 1 through 9 will decide to take 1/10 of the inherited IRA in each of the 10 years anyway (to spread out the income taxes).

<u>Example</u>: If the inherited IRA has a value of $200,000, and the beneficiary decides to withdraw $20,000 per year, compare the income taxes payable by an individual DB and the income taxes payable by a trust DB on that distributed amount, assuming the Trustee is not simply going to distribute 100% of the amount withdrawn from

the inherited IRA that belongs to the trust out of the trust to the current beneficiaries of the trust (especially since the amount withdrawn in that case might be deemed to be mostly principal and not income for trust accounting purposes). Below are the income taxes payable by the recipient solely on the $20,000 withdrawal from the inherited IRA, *assuming no applicable deductions*:

Income Taxes on $20,000 withdrawal from Inherited IRA:

Married Filing Jointly: $2,000.00

Single Individual: $2,194.50

Irrevocable Trust: $5,662.50

So, in view of the 10 year rule imposed by the SECURE Act on "regular" DBs, including trusts for the benefit of "regular" DBs, it now appears that naming a trust as the beneficiary of a pre-tax retirement plan could very well lead to *significantly higher income taxes being paid on that retirement plan*. QUESTION: Are the benefits of Descendant's Trusts (such as protection from creditors' claims, including claims made by the trust beneficiary's spouse in a divorce, and avoidance of estate taxes on accumulated retirement plan distributions) worth the high income tax cost?

Split the Baby Approach. Ever since the SECURE Act became law, many of the firm's clients who previously named Descendant's Trusts as beneficiaries of their pre-tax IRAs and qualified employee benefit plans have been willing to switch to a "Split the Baby" approach. In the case of these clients who are willing to "split the baby," their estate plan provides that their *after-tax* assets (including their Roth IRAs) will be distributed on their death (or on the death of the surviving spouse) to Descendant's Trusts for their children and other descendants, but their pre-tax IRAs and employee benefit plans will be distributed (per the applicable beneficiary designation) to their adult children, in equal shares, *outright* (not in trust). These are adult children who are not disabled or chronically ill and who do not have any "serious" financial management issues or other problems that might cause a trust for them to be the better choice to receive pre-tax retirement plans on their parent's death. Normally, of course, the beneficiary designation for the parent's retirement plan will also provide for contingent beneficiaries in case a child named as beneficiary predeceases his/her parent. This contingent designation is usually a *per stirpes* designation in favor of the predeceasing child's descendants. Any share of the retirement plan distributable to a grandchild whose parent predeceases and who is either a minor (under age 18) or otherwise "too young" to receive a sizeable share of the retirement plan outright could be made subject to the new age 31 trust (to be discussed in a future newsletter) or the provisions of the Uniform Transfers to Minors Act (UTMA). Even though the firm's clients want to protect inherited assets from loss due to divorce and other lawsuits and also want to keep assets out of the estate tax system for as long as possible, *most of our clients are very income tax averse*. If our clients continue to do what they did *before* the SECURE Act became law, the new 10 year rule is likely to cause a large portion of their pre-tax retirement plans to be taxed at the top income tax rate when a "standard" Descendant's Trust is the beneficiary of those plans. (Some commentators have proposed giving the primary beneficiary of a Descendant's Trust a withdrawal right over the taxable income of the trust, to make that income taxable to the beneficiary, individually, but there are some "issues" with that approach that need to be thoroughly considered first.)

Going back to the Trustee's management of the Descendant's Trust and the relevant tax issues, if the Trustee of the trust that owns the inherited IRA is simply going to distribute to the adult child who is the primary beneficiary of the trust, upon receipt, all amounts withdrawn from that inherited IRA--whether the amount is the RMD or the final amount in year 10 or some other amount--then there really isn't much difference between that and the participant naming the adult child as an outright beneficiary of his pre-tax retirement plan *EXCEPT in cases where state law does not protect inherited IRAs from creditors' claims*. The income tax result will usually be better if each distribution from the inherited IRA is taxed to the child and not (to any extent) taxed to the trust. (*See* income tax discussion, above.) Further, income tax reporting will be much simpler if the adult child is the outright beneficiary of the parent's retirement plan.

So what about the creditor protection benefits provided by Descendant's Trusts? There are two different aspects of creditor protection: (i) protection for the inherited assets in the event the beneficiary and his spouse get divorced and (ii) protection for the inherited assets in the event the beneficiary is sued for any other reason (such as personal injuries or death allegedly caused to others in a car accident by the beneficiary's negligent driving). We will discuss the second type of creditor first.

Texas has a statute that protects inherited IRAs from creditors' claims. In addition, many other states have similar statutes. This means it may not be necessary in many cases to name a "spendthrift trust" like a Descendant's Trust as the beneficiary of the participant's retirement plan to provide the beneficiary with protection from creditors' claims for the inherited IRA. Of course, other assets, such as after-tax investments not held inside a retirement plan, would not have creditor protection pursuant to these statutes that protect retirement plans, including inherited IRAs, from creditor's claims. Therefore, many clients still want their *after-tax assets* to be distributed to Descendant's Trusts on their death.

What about ownership claims in a divorce proceeding made by the spouse of an adult child who inherits a retirement plan outright? Three states, Texas, Idaho and Louisiana, have laws that can lead to problems in that regard. An asset inherited by a married person domiciled in Texas is that spouse's separate property BUT all income earned by that asset during the marriage is community property. That means there can be "commingling" inside the inherited IRA if 100% of the "income" earned by the assets held inside the inherited IRA is not distributed out of the inherited IRA each year. In this case, the reference is not to *taxable* income—the entire amount distributed from the inherited IRA will be taxable income when distributed. The reference is to income earned inside the inherited IRA on the assets owned by the inherited IRA—such as interest and dividends paid with respect to the stocks and bonds inside the inherited IRA. In contrast, if a Descendant's Trust for the benefit of the child owns the inherited IRA, then the rule is different (based on the *Sharma* case). In that case, the inherited IRA is a trust asset and income earned by trust assets is *not* community property income—it's trust income. Therefore, in a divorce, the spouse of the trust beneficiary has no ownership claims to any part of the inherited IRA that belongs to the trust, including the income earned by the assets inside the inherited IRA. So does the Texas marital property issue described in the above paragraph mean that it would always be better to name a Descendant's Trust for an adult married child who lives in Texas, rather than naming the adult child himself as the outright beneficiary of a retirement plan? Not necessarily. As discussed above, the income tax cost of naming a Descendant's Trust, rather than the child himself, as the beneficiary of a pre-tax retirement plan can be very high. But don't forget: In most states where adult married children live, a retirement plan inherited by the child will be considered to be owned 100% by that child (i.e., the child's spouse will not *own* an interest in that inherited IRA under applicable state law).

So what can an adult married child who lives in Texas and inherits his parent's retirement plan outright do to protect his inherited IRA in the event of a divorce? One option is for both spouses to execute a Marital Property Agreement in which they agree that income earned by a spouse's inherited IRA (and other separate property) during the marriage will be that spouse's separate property. If both spouses are likely to inherit a retirement plan from their parents, this type of agreement is not controversial. Or, if both spouses are not willing to execute a Marital Property Agreement to address the "income from separate property issue," the married child living in Texas who individually owns an inherited IRA can withdraw all "income" earned by the assets inside the inherited IRA each year, resulting in the unwithdrawn inherited IRA still constituting an inherited asset (i.e., the child's separate property).

As indicated above, parents who are doing estate planning now that the SECURE Act applies can adopt a "Split the Baby" approach if they wish—arranging for their *after-tax* assets to go into Descendant's Trusts for their children and other descendants, but naming their adult children as the *outright beneficiaries* of their pre-tax retirement plans. In many cases, this approach will protect at least a portion of the inherited assets from creditors' claims and estate taxes, while not causing excessively high income taxes on pre-tax retirement plans.

One thing some parents should consider, especially this year, in view of the top income tax rate being "only" 37% and the total value of many pre-tax retirement plans having dropped due to the bear market, is a Roth conversion. Converting at least a portion of a pre-tax retirement plan to a Roth IRA fits in with the "Split the Baby" approach.

Bottom Line: Even though it was very common before the SECURE Act became law to name properly drafted Descendant's Trusts (or similar trusts) as beneficiaries of pre-tax retirement plans, that practice needs to be reconsidered and, perhaps, abandoned.

Conclusion. Estate planning with respect to pre-tax retirement plans is more difficult now than it was before the SECURE Act became law. The income taxes payable with respect to inherited retirement plans will be much larger now as the older generation passes away and trillions of dollars are distributed from those retirement plans to the children and other descendants of that older generation. Estate taxation has become less of a concern for many people, so focusing on income taxes is the new "linchpin" of estate planning. Other issues are important, too, but income taxes are now more important than ever.

We will discuss other aspects of the SECURE Act and planning for other beneficiaries in future newsletters.

Stay Tuned for Part 3 in this Series.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone (713-520-5205), fax (713-520-5235) or email sent to:

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