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Estate Planning Insights

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Part One: Recent Case Law Decisions

Background. In Part One of this month's newsletter, we will summarize four important cases that were decided in the past several months. We will discuss the essence of these cases and describe why these cases are important.

- ***Loper Bright Enterprises v. Raimondo (U.S. Supreme Court, June 28, 2024).*** A forty year old precedent known as the "Chevron Doctrine" was overturned this year by the U.S. Supreme Court. By way of background, in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), the Supreme Court determined that, if a court concluded that a statute was silent or ambiguous and a government agency had interpreted that statute, the court had to defer to the construction of the statute by the applicable agency if the agency's interpretation was reasonable and permissible. However, in *Loper Bright*, the Supreme Court rejected and overruled the Chevron Doctrine, reasoning that resolving statutory ambiguity is within a court's, rather than an agency's, purview. Going forward, courts cannot simply defer to an agency's interpretation of a statute. Instead, the court must determine "the single best interpretation" of an ambiguous statute after applying all relevant interpretive tools. Bottom Line: Courts can now interpret ambiguous laws without having to defer to guidance from governmental agencies that have published their own interpretations of such laws. Estate Planning Impact: Interpreting tax laws is one of the cornerstones of estate planning. Because of *Loper Bright*, if Congress enacts a tax law that is ambiguous, courts no longer need to defer to the Treasury Department's interpretation of that law. If the court disagrees with Treasury's interpretation of a statute that is not clear, the court should render its own interpretation, which may or may not align with Treasury's interpretation. Initially, the ruling in this case will likely result in less certainty with respect to tax (and other) laws. Note that *Loper Bright* does not preclude a court from considering an agency's interpretation of a statute; however, it places the sole burden for such interpretation on the court. It is likely that the courts will still maintain a level of deference to agencies going forward. But courts cannot avoid their responsibility to interpret laws by relying on the interpretations of those agencies.

- ***Connelly v. United States (U.S. Supreme Court, June 6, 2024).*** In this case, two brothers were the shareholders of a C corporation. Pursuant to the terms of a buy-sell agreement, if one shareholder died, the other shareholder had the first right to purchase the deceased shareholder's shares in the corporation, but if the surviving shareholder elected not to do that, the corporation was obligated to buy or redeem the deceased shareholder's shares. The corporation owned life insurance policies on the shareholders' lives. On the first shareholder's death, the surviving shareholder elected not to purchase the deceased shareholder's shares, so the corporation used the insurance proceeds to buy the stock owned by the deceased shareholder. Of course, the deceased shareholder's

stock in the corporation was an asset of his estate for federal estate tax purposes. To determine the value of that stock, the value of the corporation first had to be determined. In the federal estate tax return filed for the deceased shareholder's estate, the insurance proceeds were not included as an asset of the corporation due to the corporation's obligation to buy the deceased shareholder's shares. The IRS disagreed with that position and argued that the corporation's obligation to redeem the deceased shareholder's shares did not offset the value of the insurance proceeds received by the corporation. In a unanimous opinion, the U. S. Supreme Court held that life insurance proceeds payable to the corporation to fund its obligation to redeem shares owned by the deceased shareholder must be included in determining the value of the corporation and that no reduction in value could be taken due to the corporation's obligation to purchase the deceased shareholder's shares pursuant to the buy-sell agreement. As a result of this decision, the value of the deceased shareholder's shares in the corporation for federal estate tax purposes was increased, resulting in increased estate tax liability for the deceased shareholder's estate. Bottom Line: A company's redemption obligation pursuant to a buy-sell agreement is not the type of liability that reduces the value of the company for federal estate tax purposes. Estate Planning Impact: This decision primarily impacts closely held companies with redemption buy-sell agreements funded by life insurance policies. Shareholders that desire to use life insurance to fund buy-sell agreements should consider alternative arrangements to minimize estate tax liability, such as cross-purchase agreements.

- ***Anenberg v. Commissioner, 162 T.C. No. 9 (May 20, 2024).*** In the *Anenberg* case, a surviving spouse and her stepchildren obtained a court order allowing the early termination of a qualified terminable interest property ("QTIP") trust that had been created for the benefit of the spouse by her deceased husband. A QTIP trust is a type of marital trust. QTIP trusts have been the most frequently used type of marital trust since they became an option pursuant to the Economic Recovery Tax Act of 1981. All marital trusts are irrevocable trusts designed to last for the life of the surviving spouse. On the death of the surviving spouse, the marital trust assets are includable in the surviving spouse's estate for federal estate tax purposes. In *Anenberg*, once the QTIP trust was terminated, the trust assets were distributed, outright, to the surviving spouse. After that, the surviving spouse gave some stock that was previously held in the QTIP trust to trusts created for her stepchildren. Later, she sold the remaining stock to her stepchildren's trusts in exchange for promissory notes. The surviving spouse reported only the gifts of the initial portion of stock to her stepchildren's trusts as taxable gifts. The IRS challenged that position, arguing that the termination of the QTIP trust, distribution of the QTIP trust assets to the spouse, and subsequent sale of some of those assets resulted in a taxable gift by the surviving spouse. The Tax Court held that no gift by the surviving spouse occurred upon termination of the QTIP trust and distribution of all the trust's assets to the surviving spouse since all the assets were distributed to the surviving spouse. In addition, the Tax Court held that no gift occurred when the spouse sold stock to the stepchildren's trusts because the spouse received full and adequate consideration on that transaction. Bottom Line: The transfer to the surviving spouse of all property held in a QTIP trust that is terminated pursuant to a court order does not trigger gift tax liability for the surviving spouse. In addition, the sale of property for full and adequate consideration is not a gift. Estate Planning Impact: This case provides a precedent for a surviving spouse to obtain termination of a QTIP trust while the spouse is living and distribution of all the trust assets to the spouse, outright, to enable the spouse to engage in gift and sale transactions. However, this case did not address an important additional gift tax issue arising under these facts. That separate issue was whether the remainder beneficiaries of the QTIP trust made taxable gifts of their

respective remainder interests in the trust to the surviving spouse by agreeing to the early termination of the QTIP trust and distribution of all the trust assets to the surviving spouse. That question was answered in the *McDougall* case (below).

- ***McDougall v. Commissioner, 163 T.C. No. 5 (September 17, 2024).*** As noted above, this case resolves an unanswered question in *Anenberg*. While the Tax Court in *Anenberg* found no gift tax liability for the surviving spouse resulting from the early termination of a QTIP trust, the court in that case did not address the possibility that the stepchildren, as remainder beneficiaries of the trust, were making a gift to the surviving spouse by agreeing to that termination. In *McDougall*, the surviving spouse and children entered into an agreement to terminate a QTIP trust early. As a result, all trust assets were distributed to the surviving spouse. As in *Anenberg*, the surviving spouse sold some of the assets he received from the QTIP trust to trusts created for his children in exchange for promissory notes. Also, as in *Anenberg*, the surviving spouse was found not liable for gift tax as a result of the termination of the QTIP trust and distribution of the trust assets to the spouse. However, the Tax Court found that the children, as the remainder beneficiaries of the QTIP trust, made gifts to the surviving spouse by agreeing to terminate the trust and distribute all the trust assets to the spouse. Bottom Line: An agreement between a surviving spouse and the remainder beneficiaries of a marital trust to terminate the trust and distribute its assets to the spouse will result in gift tax implications for the remainder beneficiaries. Estate Planning Impact: The type of agreement described in *McDougall* has been used routinely by estate planners for many years. Such an agreement is often called either a "Non Judicial Agreement" (because it is not an agreement entered into by the parties to settle a pending court case) or a "Family Settlement Agreement." When we have prepared these types of agreements over the years (usually representing a surviving spouse), we have advised all parties not represented by us to consult with their own tax advisors regarding the tax consequences of signing such an agreement. In addition, we have even noted that there could be gift tax consequences for the remainder beneficiaries as a result of the early termination of the trust and distribution of the trust assets to the surviving spouse. (Note that the gift tax issue for the remainder beneficiaries when an irrevocable trust is terminated early by consent or pursuant to an agreed court order is not limited to the early termination of a marital trust.) The *McDougall* case is likely to make children and other remainder beneficiaries of irrevocable trusts more hesitant to execute agreements terminating trusts early. Therefore, individuals creating irrevocable trusts as part of their estate plan should be sure they really want to create those trusts and not assume that those trusts can simply be terminated in the future with no adverse tax consequences.

Part Two: A Closer Look at Distributing Pre-Tax IRAs and Qualified Employee Benefit Plans to Accumulation Trusts for Adult Children in view of the SECURE Act

Introduction. For many years, it was very common for estate planning lawyers to advise clients who were the titled owner of an IRA or the participant in a qualified employee benefit plan (such as a 401(k) plan, profit-sharing plan or stock bonus plan) to name as the beneficiary of those retirement assets one or more irrevocable trusts for the benefit of their adult children (and their children's descendants). These trusts are usually (but not always) called "Descendant's Trusts." Before discussing why these recommendations should be reconsidered in view of the provisions in the SECURE Act, we need to discuss some preliminary matters.

Some Basics. First, a few basic matters should be noted. It is common to refer to both the titled owner of an IRA and the employee or retiree who participates in a qualified plan as the "Participant." But there are some differences between qualified plans and IRAs, so sometimes that term should not be used. Qualified plans are protected from creditors' claims by a federal statute: ERISA. However, when an employee or retiree participating in a qualified plan dies and the beneficiary of his qualified plan is someone other than his spouse, that beneficiary cannot usually remain in the qualified plan as a beneficiary. Thus, in those cases, what is established for the beneficiary of that qualified plan is an "inherited IRA." In addition, in the case of the titled owner of an IRA (including an IRA rollover from a qualified plan), the beneficiary of that IRA also establishes an *inherited IRA* after the IRA owner's death. Inherited IRAs are subject to very different required distribution rules than IRAs owned by a living IRA owner. In addition, there is no federal statute that protects inherited IRAs from creditors' claims. But there are some state statutes that do (more on that later).

The SECURE Act. The SECURE Act became effective on January 1, 2020. We have already published seven newsletters dealing with the SECURE Act. The SECURE Act made significant changes to the rules applicable to distributions from qualified plans and IRAs (the "RMD Rules"). Subsequent to passage of the SECURE Act, the Treasury Department published Proposed Regulations in February 2022, final Regulations in July 2024, and new Proposed Regulations in July 2024. In addition, the IRS published at least three major Notices delaying implementation of certain provisions in the SECURE Act. We are not going to repeat in this newsletter all the information about the SECURE Act that was included in our prior newsletters because we want to focus on just one particular situation relating to the SECURE Act. However, all our prior newsletters are on the firm's website, www.gerstnerlaw.com.

A Typical Estate Plan. Ignoring the RMD Rules for a moment, over the years, many clients with moderate to significant sized estates have provided in their estate planning documents for distribution of their assets on their death (or on the death of the surviving spouse in the case of married couples) to "Descendant's Trusts" for their descendants (i.e., the clients' children, grandchildren and great-grandchildren). We focused on Descendant's Trusts in our newsletter dated October 31, 2018 (which is on the firm's website). Descendant's Trusts are irrevocable "spendthrift" trusts (the spendthrift provision in the trust instrument protects the assets in the trust from creditors' claims). In many cases, each adult child is not only the primary beneficiary of his/her Descendant's Trust but also the Trustee of his/her Descendant's Trust (although, in some cases, an independent Trustee serves as Co-Trustee with the child or as sole Trustee if the child is not able to be appointed as a Trustee of his/her trust).

Benefits of Descendant's Trusts. The four primary benefits of Descendant's Trusts created for the benefit of an individual's child and his/her descendants (or other beneficiaries) are (i) the assets held in the child's trust are protected from being allocated to the child's spouse in a divorce; (ii) the assets held in the child's trust are protected from being allocated to a plaintiff who obtains a judgment against the child in any other type of lawsuit; (iii) to the extent a sufficient amount of the parent's/parents' "GST exemption" was allocated to the assets that went into the child's trust, those assets still held in the child's trust when the child dies (regardless of how much those assets have grown in value) will not be subject to estate taxes in the child's estate; and (iv) if the trust is drafted to allow distributions to the child's descendants (children and grandchildren), the income earned by the assets held in the trust can be distributed to one or more of the child's descendants, who are often in lower income tax brackets than the child, which will result in fewer income taxes being paid on that income. These benefits to the child also apply to the other beneficiaries of the trust (i.e., the child's children and other descendants). Descendant's Trusts can continue for each

generation pursuant to the applicable "Rule Against Perpetuities." Texas law was recently changed to increase the time period for retaining assets in a Texas trust to 300 years. In a way, using and conservatively managing Descendant's Trusts that are designed to continue for multiple generations can be viewed as a "family endowment," a source of highly protected assets that produce income for the support of the applicable family members for a very long period of time.

Funding a Descendant's Trust. The best assets to place in Descendant's Trusts are after-tax assets. Roth IRAs and Roth designated accounts *can* be left to Descendant's Trusts because they are after-tax assets. However, the issue discussed in this newsletter does not apply to Roth IRAs or Roth designated accounts—only to qualified plans and pre-tax IRAs.

Sometimes an individual has a very large qualified plan or a very large pre-tax IRA (sometimes jointly referred to as a "Pre-Tax Retirement Plan") and that individual likes the benefits provided by Descendant's Trusts and believes his/her Pre-Tax Retirement Plan should be distributed to Descendant's Trusts created on his/her death (or on the death of the surviving spouse if he/she is married). That was a typical estate planning approach for many years before the SECURE Act became law. However, each owner of a Pre-Tax Retirement Plan who wants to continue this longstanding practice must now consider that the changes made by the SECURE Act produce a much more negative income tax result compared to the result under prior law.

Descendant's Trusts are Usually Accumulation Trusts. As a reminder, pursuant to the RMD Rules, there are two types of trusts that can be named as beneficiaries of qualified plans and IRAs that can qualify for *either* "designated beneficiary treatment" or "eligible designated beneficiary treatment": (i) conduit trusts and (ii) accumulation trusts. Conduit trusts are frequently created for the benefit of the surviving spouse in a second marriage. A conduit trust must require that all withdrawals from the inherited IRA that belongs to the trust be distributed, upon receipt, out of the trust to the current beneficiary (or beneficiaries) of the trust. Thus, no withdrawals from the inherited IRA that belongs to a conduit trust may be accumulated in the trust. In many cases, a conduit trust would not be consistent with the estate planning goals of a Participant who owns a Pre-Tax Retirement Plan. We will not discuss conduit trusts in this newsletter.

Descendant's Trusts have almost always been drafted as accumulation trusts under the RMD Rules. Why? Because one of the goals of clients who create Descendant's Trusts is to be able to retain the distributions from the inherited IRA that belongs to the trust in the trust because it is only the distributions *retained in the trust* that will obtain the first three benefits that Descendant's Trusts provide (i.e., divorce protection, lawsuit protection and estate tax avoidance for the amounts still held in the trust when the beneficiary dies).

Other income tax rules besides the RMD Rules apply to Descendant's Trusts. Descendant's Trusts in the form of accumulation trusts are technically "complex trusts" for federal income tax purposes because the Trustee of the trust has discretion whether to retain the trust's "ordinary income" in the trust or distribute that income to one or more permissible current beneficiaries of the trust. Distributions from Pre-Tax Retirement Plans are taxable as ordinary income in the year of receipt. (Compensation paid for personal services is another type of ordinary income. However, long term capital gains are not ordinary income.) That means that amounts withdrawn from the inherited IRA that belongs to an accumulation trust that are retained in the trust will be subject to income taxes at the trust's ordinary income tax rate.

State Statutes Protecting Inherited IRAs. Before we look at some examples focusing on the income tax issues, consider the fact that assets held in irrevocable spendthrift trusts are protected from creditors' claims. As noted above, qualified plans are protected from creditors' claims by

ERISA. IRAs, including IRA rollovers from qualified plans, are not protected from creditors' claims by ERISA. (Creditors' claims can arise in a bankruptcy proceeding or in a tort or contract lawsuit filed against a defendant.) Some states, including Texas, have statutes that provide that inherited IRAs are not subject to the claims of creditors made against the owner of the inherited IRA. Upon review of a multi-state survey done over 6 years ago, it appears that at least 27 US states definitely had or likely had such a statute at that time. In another 17 states, the survey respondents indicated that it was "uncertain" at that time whether their state would exempt inherited IRAs from creditors' claims. It is possible that some of those uncertain states have subsequently enacted legislation to make inherited IRAs exempt from creditors' claims. In any event, Texas has one of the best statutes in the country because the Texas statute clearly makes inherited IRAs exempt from creditors' claims. Thus, if the desired beneficiary of a Pre-Tax Retirement Plan lives in Texas (or one of the other 26 states having a statute that makes inherited IRAs exempt from creditors' claims), it may not be necessary to name a trust for that individual as the beneficiary of the Participant's Pre-Tax Retirement Plan in order to protect the inherited IRA from creditors' claims.

Marital Property Issues. The other type of potential "creditor" that causes concern is a spouse suing for a divorce. The majority of US states follow the common law in regard to their marital property rules. As a result of a very incomplete survey of common law states that we have conducted, it appears that, in the majority of common law states, an inherited IRA received by one spouse is not considered "marital property" that can be allocated to the other spouse in a divorce, although portions of that inherited IRA can be at risk in a divorce in some states in certain cases. Of course, Texas is a community property state and not a common law state. Even in the nine community property states, assets received by one spouse by inheritance are the separate property of that spouse and not community property. However, three of the nine community property states, including Texas, have a rule that provides that all income earned during the marriage, including income earned by the separate property of one spouse, is community property. Thus, if one spouse owns an inherited IRA as separate property, the income (i.e., interest and dividends) earned by the assets inside that inherited IRA during the marriage will be community property. In view of the fact that most adult beneficiaries who inherit a qualified plan or IRA will now be subject to the 10 Year Rule, it should not be that hard to trace and quantify (and keep separate, if desired) the income earned inside the inherited IRA during the 10 years of its existence. In any event, even in the three community property states that have this income rule, the bulk of the inherited IRA will be the separate property of the spouse who inherited it. In some cases in which both spouses are likely to inherit a qualified plan or IRA from their respective parents, the spouses might want to execute a simple marital property agreement in which they agree that the income earned inside a spouse's inherited IRA will be the separate property of that spouse. The bottom line is that it may not always be necessary to name a trust for an individual as the beneficiary of a Pre-Tax Retirement Plan simply to protect an inherited IRA from claims made by that individual's spouse in a divorce.

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Let's look at some examples that focus on the income tax consequences of naming certain types of irrevocable trusts (such as Descendant's Trusts) as beneficiaries of Pre-Tax Retirement Plans. These will be "over-simplified" examples, but they should be sufficient to make our point.

BASIC FACTS FOR ALL EXAMPLES: Dad (who is not married) dies at age 78 with a pre-tax IRA worth $500,000. Dad's only child is Son. Son is married and has two children, both of whom are in high school.

TWO EXAMPLES BEFORE THE SECURE ACT BECAME LAW:

Example 1: Dad dies on December 31, 2018, having named Son as the outright beneficiary of his pre-tax IRA. Per applicable law, Son must take his first "required minimum distribution" ("RMD") from his inherited IRA in 2019. Son is age 44 in 2019. Son's life expectancy per the Single Life Table in effect in 2019 is 39.8. (Before the SECURE Act, the initial life expectancy factor was referred to as the "divisor" and the adjusted life expectancy factor used to calculate RMDs in future years was referred to as the "applicable divisor.") To calculate the RMD in a particular year, the prior year end balance of the inherited IRA is divided by the applicable divisor. Thus, Son's RMD in 2019 is $12,563 ($500,000 ÷ 39.8). That is a withdrawal rate of 2.5% in 2019. Son must take an RMD from his inherited IRA in each subsequent year for the rest of his life. The applicable divisor to calculate the RMD in each subsequent year is reduced by the whole number 1 from the prior year's divisor. For approximately the first 14 years after Dad's death, the RMD is less than 4% of the value of the inherited IRA. Absent a significant decline in the value of the investments held in the inherited IRA, it is likely that the inherited IRA will continue to grow above its initial value during that period due to the relatively low withdrawal rate. The type of inherited IRA subject to this withdrawal method prior to the SECURE Act was often referred to as a "stretch IRA."

Son and his wife have compensation income in 2019 of $170,000, which puts them slightly above the lower end of the top 10% of earners in 2019 (that category began at $154,589). Suppose the only income Son and his wife have in 2019 is their compensation income plus Son's $12,563 RMD from his inherited IRA. Ignoring adjustments, deductions, credits, exemptions, etc., Son and his wife would owe income taxes on their $182,563 in "ordinary income" for 2019 of $32,164. If the only income of Son and his wife in 2019 had been their compensation income, their ordinary income tax for 2019 would have been $29,149. Thus, the difference of $3,015 ($32,164 - $29,149) can be attributed to the $12,563 RMD Son took in 2019. Thus, the marginal tax rate on the 2019 RMD in this example is approximately 24%.

Example 2: Dad dies on December 31, 2018, having named a "Descendant's Trust" created for Son and his descendants as the beneficiary of his pre-tax IRA. Dad named Son as sole Trustee of the Descendant's Trust. The Descendant's Trust was drafted as a "qualified see-through trust" in the form of an "accumulation trust" pursuant to the RMD Rules in effect before the SECURE Act became law. In the case of an accumulation trust, the Trustee of the trust has discretion whether to retain all or any portion of the RMD withdrawn from the inherited IRA that belongs to the trust in the trust or to distribute all or any portion of that withdrawn RMD out of the trust to any current permissible beneficiary of the trust. Keep in mind, however, that, before the SECURE Act, the reason many clients wanted the trust named as beneficiary of their pre-tax IRA to be an accumulation trust and not a conduit trust is that they wanted the Trustee of the trust to be able to retain all or at least a portion of the RMD in the trust because *only RMDs retained in the trust would enjoy the major benefits provided by a Descendant's Trust* (such as divorce and creditor protection for the retained RMD amounts and avoidance of estate taxes on Son's death for the retained RMD amounts). As already noted, a Descendant's Trust drafted to give the Trustee discretion whether to distribute the trust's ordinary income out of the trust or retain that income in the trust would be classified as a "complex trust" for federal income tax purposes.

Upon analysis of all "countable beneficiaries" of the Descendant's Trust named as beneficiary of Dad's IRA, it is determined that (i) all countable beneficiaries of the trust are identifiable individuals and (ii) Son is the oldest countable beneficiary of the trust. That results in the trust qualifying for *designated beneficiary treatment* and Son being deemed to be the *designated beneficiary* per the RMD Rules. Therefore, based on the law in effect prior to the SECURE Act, RMDs from the inherited IRA belonging to the Descendant's Trust would be calculated based on Son's single life

expectancy, not recalculated, with RMDs commencing by December 31 of the year following the year of Dad's death.

As noted above, in 2019, Son was age 44 and Son's life expectancy factor (divisor) from the Single Life Table was 39.8. Therefore, the 2019 RMD from the inherited IRA belonging to Son's Descendant's Trust would be $12,563 ($500,000 ÷ 39.8). [Note that the RMD is the same in Example 2 of this section as it was in Example 1 of this section.] If Son, as Trustee, decided to retain that entire 2019 RMD in his Descendant's Trust, assuming the Descendant's Trust had no other income in 2019 and ignoring adjustments, deductions, credits, exemptions, etc., the trust would have owed income taxes on that RMD in the amount of $3,010 per the tax rates applicable to complex trusts that year. That is a tax rate on the RMD of about 24%. In addition, the net after-tax income of $9,553 ($12,563 RMD - $3,010) would thereafter be considered part of the principal of the trust and could be invested for long-term growth.

As is apparent, based on the RMD Rules in effect prior to the SECURE Act, which provided for a life expectancy distribution period even when a trust like a Descendant's Trust was the beneficiary of the Participant's Pre-Tax Retirement Plan, the income taxes on RMDs retained in a Descendant's Trust structured in the form of an accumulation trust were not that onerous. In addition, because the Trustee could also distribute all or any portion of the RMD out of the trust to any permissible current beneficiary of the trust, carrying out that income to the recipients, to be taxed to them in their applicable tax brackets, there was little downside to this common, longstanding approach and certainly nothing of "huge significance" to consider with this approach.

TWO EXAMPLES AFTER THE SECURE ACT BECAME LAW:

Example 1: Dad dies on December 31, 2023, having named Son as the outright beneficiary of his pre-tax IRA. As a result of the SECURE Act, Son is a "plain old Designated Beneficiary" (simply referred to as a "DB"). Per the SECURE Act, all DBs are subject to the new 10 Year Rule. The 10 Year Rules provides that 100% of the inherited IRA must be withdrawn by December 31 of the year that contains the 10th anniversary of the Participant's death. As explained in our prior newsletters discussing the SECURE Act, only "Eligible Designated Beneficiaries" ("EDBs") are still entitled to take withdrawals from the qualified employee benefit plans and IRAs they inherit using some sort of life expectancy distribution method (not the same for each type of EDB). Adult children who are not disabled or chronically ill and trusts for adult children (or other individuals who are not EDBs) are now subject to the 10 Year Rule. Pursuant to the 10 Year Rule applicable to Son, Son must withdraw 100% of the amount held in his inherited IRA by December 31, 2033. In addition, because Dad died after his "required beginning date" ("RBD"), pursuant to the final Treasury Regulations, Son must take an RMD from his inherited IRA in years 1 through 9 following the year of Dad's death. [The final SECURE Act regulations provide that this rule will not be enforced until the year 2025, but we are ignoring that so that we can use the 2024 income tax rates in our examples.]

Son is required to take his first RMD in 2024. Son is age 44 in 2024. Pursuant to the currently applicable Single Life Table (which became effective on January 1, 2022), Son has a life expectancy in year 2024 of 41.9. Therefore, Son's RMD for the year 2024 is $11,933 ($500,000 ÷ 41.9). Son could just take the RMD each year for the years 2024 through 2032, but, then, in 2033, Son would have to withdraw the entire remaining amount still held in his inherited IRA. As previously noted, all withdrawals from Son's inherited IRA are subject to income tax as ordinary income in the year taken. Because Son's rate of withdrawal each year if he only takes the RMD in years 1 through 9 after Dad's death will be less than 4%, absent a huge market crash, it is likely that the inherited IRA will still have a value around $500,000 in 2033. If Son only takes RMDs

each year prior to 2033 and then withdraws the entire amount in the inherited IRA in 2033, he will surely pay income taxes on most of the amount withdrawn in 2033 at a very high rate, especially if the top income tax rate increases from 37% (current top rate) to 39.6% (the rate that will apply when the provisions in the Tax Cuts and Jobs Act expire at the end of 2025). Therefore, Son decides to withdraw 10% per year from his inherited IRA to spread out the income taxes. In addition, Son's children currently attend an expensive private high school and will soon be attending college, so Son and his wife could use that extra income before 2033.

In 2024, Son and his wife have total compensation income of $180,000, which puts them a little above the lower end of the top 10% of income earners (that category begins at $173,176). If Son withdraws 10% of his inherited IRA in 2024, amounting to $50,000, Son and his wife will have total ordinary income in 2024 of $230,000. Assuming Son and his wife have no other income and ignoring adjustments, deductions, credits, exemptions, etc., Son and his wife will owe income taxes for 2024 in the amount of $41,285. That is an effective tax rate on $230,000 of around 18%. If Son and his wife had only had ordinary income in 2024 of $180,000 (i.e., their compensation income), their 2024 income taxes would have been $29,706, an effective tax rate of 16.5%. Adding the $50,000 withdrawal from the inherited IRA caused additional income taxes of $11,579 ($41,285 - $29,706). That is a tax rate of a little over 23% on the withdrawal from the inherited IRA.

In this case, withdrawing 10% from the inherited IRA in 2024 does put Son and his wife into a higher marginal tax bracket. But keep in mind that we are using in our example a couple that is in the top 10% of income earners. That will not be true in the majority of cases and, therefore, in many other cases, withdrawing 10% a year from the inherited IRA may not cause the child who inherits his/her parent's pre-tax IRA to end up in a higher marginal tax bracket.

Example 2: Dad dies on December 31, 2023, having named a Descendant's Trust for Son and Son's descendants as the beneficiary of his pre-tax IRA. Son's Descendant's Trust is an accumulation trust per the RMD Rules. In addition, Son's Descendant's Trust is a DB per the RMD Rules and, therefore, it is subject to the 10 Year Rule put into effect by the SECURE Act. Son's trust is also a "complex trust" for federal income tax purposes. Because Dad died after his RBD, RMDs must be taken in years 1 through 9 after Dad's death and 100% must be withdrawn from the inherited IRA that belongs to the trust in 2033. Son is the oldest countable beneficiary of the trust. That means Son's life expectancy would be used to calculate RMDs that must be taken from the inherited IRA that belongs to the trust.

Let's assume that Son, as Trustee of his Descendant's Trust, decides to withdraw more than the RMD each year in years 1 through 9 following the year of Dad's death. In fact, to compare apples to apples, assume Son plans to withdraw 10% per year from the inherited IRA that belongs to the trust, to spread out the income taxes over the period of the 10 Year Rule. In addition, Son plans to retain the entire amount withdrawn from the inherited IRA in the trust, in order for those retained withdrawals to obtain certain benefits provided by the trust (i.e., divorce and creditor protection for the retained withdrawals and avoidance of estate taxes on the retained withdrawals when Son dies).

Assuming Son's Descendant's Trust has no other income in 2024 and ignoring adjustments, deductions, credits, exemptions, etc., if the trust retains the $50,000 withdrawal from the inherited IRA it owns, the trust will owe $16,536 in income taxes for 2024. That's an average tax rate of 33%! Note that, in 2024, married couples filing jointly reach the top income tax bracket (37%) at an income threshold of $731,200, while complex trusts reach the top income tax bracket at an income threshold of $15,200. That is a significant difference. In addition, as already noted, once

the top tax rate goes back up to 39.6%, the effective tax rate on withdrawals from the inherited IRA that are retained in the trust will be even higher. Presumably, the reason Dad named Son's Descendant's Trust as the beneficiary of his pre-tax IRA was to protect the withdrawals from the inherited IRA from being lost due to a divorce or other lawsuit and to avoid estate taxes on those accumulated withdrawals on Son's death. But look at the income tax cost of doing that! It is hard to quantify the risk of creditors' claims, including claims made by a spouse in a divorce, but there is no "risk" when it comes to income taxes—income taxes will be paid on withdrawals from Pre-Tax Retirement Plans! Comparing Examples 1 and 2 in this section in an overly simplistic way that ignores other types of income, potential increases in compensation, inflation adjustments to the income tax brackets, and changes in income tax rates, ten years of income taxes on the IRA withdrawal retained in the trust in Example 2 totals $165,360, while ten years of income taxes on the IRA withdrawals taken by Son in Example 1 totals $115,790, for a difference of $49,570. That is not a theoretical decline in net value due to a potential creditor's claim—that is a real decline in value.

If the goal of naming Son's Descendant's Trust as the beneficiary of Dad's IRA (rather than naming Son as the outright beneficiary of Dad's IRA) is to be able to retain in the trust amounts withdrawn from the inherited IRA that belongs to the trust, then at least some portion of the amounts withdrawn from the inherited IRA would need to be retained in the trust and taxed to the trust. Otherwise, if the full amount withdrawn from the inherited IRA belonging to the trust is going to be distributed out of the trust to Son or his descendants each year, why name the trust as beneficiary of Dad's pre-tax IRA in the first place? All that does is add ten years of complication while only securing the benefits the trust provides on the unwithdrawn amounts for a maximum of ten years.

Summary. Now that the SECURE Act applies, the tax cost of naming as the beneficiary of a Pre-Tax Retirement Plan an accumulation trust that is treated as a DB per the RMD Rules is so much higher than it was before (compare Examples 1 and 2 in the *after* the SECURE Act section with Examples 1 and 2 in the *before* the SECURE Act section). Plan participants and IRA owners can still name trusts like Descendant's Trusts as the beneficiary of their Pre-Tax Retirement Plans if they wish, and that may be the best thing to do in certain cases, but it seems to us there needs to be at least *some* discussion and consideration of the income tax cost of doing that. No one should simply assume that continuing to name accumulation trusts as beneficiaries of Pre-Tax Retirement Plans will produce the same overall result that was obtained before the SECURE Act became law.

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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