Multigenerational Retirement Distribution Planning

Maximizing the Family Wealth Planning Benefits of Qualified Plans and IRAs

Overview

- Qualified plans, IRAs, and other tax-deferred plans often constitute significant family wealth
- Without careful planning, income and estate taxes can significantly erode the value of these assets
- Required minimum distribution rules are complex, so professional advice remains essential
- Plan beneficiary selection must be coordinated with the rest of the estate plan
- SECURE Act creates new traps and opportunities
- SECURE 2.0 Act adds further complexities

Prioritizing Planning Objectives

- Retirement and estate planning objectives may conflict with one another
  - Retirement accounts may be consumed by the senior generation as a major source of lifetime income
  - They may also serve as an important vehicle for intergenerational transfers of family wealth
- Beneficiary selection is influenced by the desired level of testamentary control
- Employer-sponsored plans may offer greater asset protection but less flexibility than IRAs in many cases

Preserving Flexibility

- Key decisions must be made during the planning process
  - Primary beneficiaries
  - Contingent beneficiaries
  - Use of a trust as primary or contingent beneficiary
  - Single accounts vs. multiple accounts
- Distributions from employer-sponsored plans are governed by the plan document
- For IRAs, use of a custom beneficiary designation provides greater flexibility than standard forms

Basic Concepts

- Distributions are generally ordinary income
  - Capital gain treatment for distributions of employer stock with net unrealized appreciation (NUA)
  - Qualified Roth IRA distributions are tax-free
- Required minimum distributions (RMDs) must begin by the required beginning date (RBD)
  - April 1 in the year following the year of reaching age 70½, 72, 73, or 75, depending on the participant's date of birth
  - For employer plans RBD may be delayed until retirement
- Undistributed balances at death are generally includible in the gross estate

Designated Beneficiary

- Term of art defined in the tax regulations
  - Individuals only—estates and charities do not qualify
  - Qualifying "see-through" trusts allow trust beneficiaries to be treated as designated beneficiaries
- Identity of DB may affect calculation of RMDs
- September 30 in the year following participant's or account owner's (P) death is the determination date, which facilitates postmortem distribution planning
  - Disclaimers, creating separate accounts and/or cashing out certain beneficiaries may be beneficial

SECURE Act Basics[1]

- Setting Every Community Up for Retirement Enhancement Act of 2019
  - Effective after 2019 (and for deaths occurring after 2019)
- Changes RBD for lifetime RMDs from age 70½ to age 72 (April 1 in the year following the relevant age)
- Repeals prohibition of making contributions to traditional IRAs after age 70½
- Replaces postmortem stretch-out QRPs/IRAs with 10-year full distribution for most nonspouse beneficiaries
- New term of art: eligible designated beneficiary (EDB)

SECURE Act Basics[2]

- EDBs include the following:
  - P’s surviving spouse
  - Chronically ill individual (defined in the IRC)
  - Disabled individual (uses Social Security total disability definition in the IRC)
  - P’s minor child (NB: not a grandchild)
  - Individual no more than 10 years younger than the deceased
- Determination of who is an EDB is made on the date of P’s death, if after 2019 (n/a for pre-2020 deaths)
- The new 10-year rule can apply to EDBs by election

SECURE Act Basics[3]

- Minor child as EDB
  - EDB status maintained until reaching the age of majority
  - Once minor child reaches the age of majority the 10-year rule applies, so that the plan/IRA must be distributed in full by the end of the 10th year following P's death
- Following the death of an EDB the 10-year rule applies to the successor beneficiary, so that the IRA must be distributed within 10 years of the EDB's death
- In some situations (e.g., P dies at age 73), having a non-EDB beneficiary not qualify as a DB may offer a longer postmortem distribution period than 10 years

SECURE Act Basics[4]

- Proposed Regulations published by Treasury in Feb 2022 clarify and/or modify RMD rules
- In some areas, the additional SECURE Act-related guidance is welcome; in others it is unfavorable
  - For DBs (including EDBs) subject to the 10-year rule, annual distributions are required in years 1-9 if P had reached the RBD at the time of death (surprise!)
  - Age of majority is 21 in all cases, simplifying its application
  - EDBs must use the life expectancy payout method (i.e., annual RMDs) if P reached the RBD at the time of death—even if the 10-year rule also applies by election

SECURE 2.0 Act Basics[1]

- SECURE 2.0 Act of 2022
- RBD for lifetime RMDs (April 1 after relevant year)
  - Age 72 if P turns 72 by 12/31/2022
  - Age 73 if P turns 73 after 12/31/2022 but before 1/1/2033
  - Age 75 if P turns 73 after 12/31/2032
- Repeals RMDs for Roth 401(k)s after 2023
- SIMPLE IRA and SEP IRA contributions can be made on an after-tax basis to Roth accounts starting in 2023
- Indexes IRA catchup contribution limit for inflation starting in 2024

SECURE 2.0 Act Basics[2]

- Adds second tier of catchup contributions for P between ages 60 and 63, starting in 2025
  - Greater of $10K and 150% of first tier (i.e., for P ages 50 and older) catchup contributions for 401(k) plans
  - Greater of $5K and 150% of first tier catchup contributions for SIMPLE IRAs
  - $10K/$5K limits indexed for inflation after 2025
- Catchup contributions to QRPs must be made after taxes to Roth accounts starting in 2024
- Employer matching contributions can be made in after-tax dollars to Roth accounts starting in 2023

SECURE 2.0 Act Basics[3]

- Excess accumulations in a 529 College Savings Plan account can be rolled over to a Roth IRA
  - Must be a trustee-to-trustee transfer
  - $35K lifetime rollover limit per beneficiary
  - Annual limit equals the Roth IRA contribution limit ($6,500 in 2023), reduced by contributions to IRAs and Roth IRAs
  - 529 plan must have been open for at least 15 years
  - Funds contributed to the 529 plan (and earnings thereon) within five years prior to the rollover are ineligible
  - 529 plan rollovers to Roth IRAs is effective for 529 plan distributions made after 12/31/2023

CARES Act Basics

- Coronavirus Aid, Relief, and Economic Security Act
  - Enacted March 2020 and effective for years after 2019
- Designed as an economic stimulus and tax relief package for individuals and businesses, in response to the novel coronavirus (SARS-CoV-2) pandemic
- Includes several key provisions affecting distributions from qualified retirement plans and IRAs in 2020
  - Waiver of RMDs, including those with April 1, 2020, RBD
  - 10% early withdrawal penalty exception for up to $100K
  - 3-year pro rata gross income inclusion for up to $100K

Lump-Sum Distributions[1]

- Distribution of entire balance in employer plan upon the occurrence of a triggering event
  - Separation from service
  - Age 59½
  - Death or disability of participant
- May qualify for special tax treatment for participants born before January 1, 1936
  - 10-year averaging may lower effective tax rate
  - Capital gains for pre-1974 plan participation
- Other rules for distributions of employer stock

Lump-Sum Distributions[2]

- LSD is an eligible rollover distribution
  - Participant or surviving spouse may roll over all or a portion of the distribution to an IRA
  - Rollover preserves tax-deferred status of plan
  - Rollover of any portion of distribution bars 10-year averaging and/or pre-74 capital gains treatment on the amounts retained
- 10-year averaging/pre-74 capital gains is a one-time election

Net Unrealized Appreciation

- Distribution of company stock from employer plans is eligible for favorable tax treatment
- Net unrealized appreciation (NUA) = fair market value of stock minus plan trustee's basis in the stock
  - NUA is taxed as a long-term capital gain only in a taxable disposition of the distributed stock
    - No step-up in basis at death so treated as IRD
    - Transfer of stock to a CRT allows for tax-free diversification and deferral of capital gains taxes
  - Basis of NUA stock is taxed as ordinary income in the year of distribution from the plan

NUA Election vs. IRA Rollover

NUA Election Favored

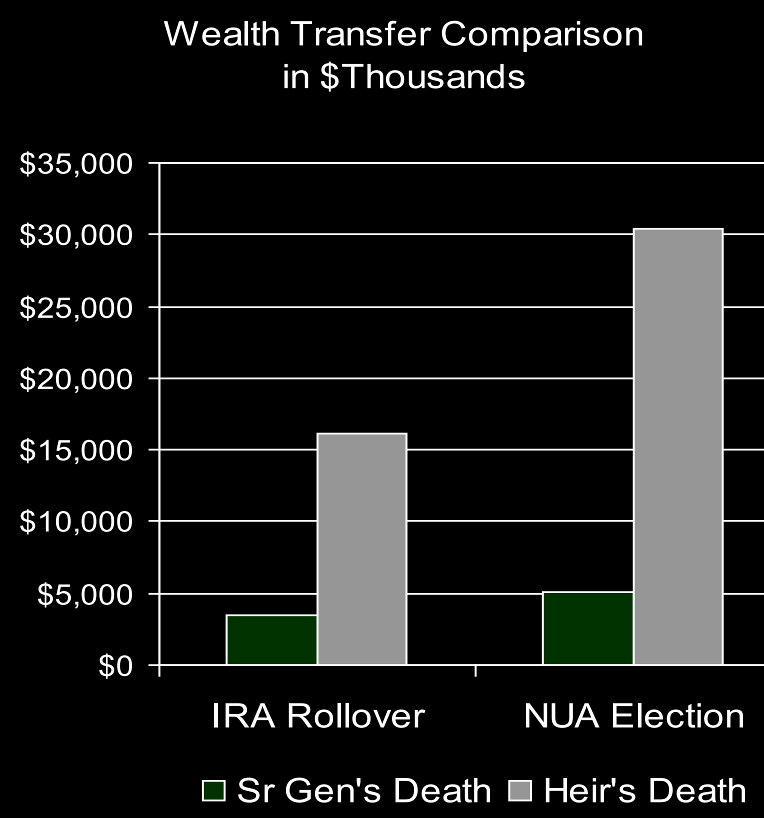
- Higher NUA: basis ratio
- Shorter post-distribution deferral period for IRA
- Higher marginal tax rate
- Special lump-sum distribution treatment
- Longer post-distribution holding period for stock
- If funding a CRT with company stock is desired

IRA Rollover Favored

- Lower NUA: basis ratio
- Longer post-distribution deferral period for IRA
- Lower marginal tax rate
- Desire to diversify
- Pre-age 55 lump-sum distribution

LSD with NUA Example

- $1,000,000 qualified plan
- $750,000 employer stock
- $600,000 NUA
- P retires at age 60
- DB age 35
- Life expectancies age 90
- Highest tax brackets
- 40% federal estate tax rate
- 8% employer stock growth rate
- Employer stock held until P's death; then fully liquidated
- 2%/6% income & growth on other investments
- Annual RMDs/10-year rule applies



Required Minimum Distributions

- Final regulations (effective 2003) simplified the complex RMD rules, but planning remains essential
  - Use of a Uniform Lifetime Table is mandated
  - P's death supersedes the RBD as the date on which certain planning decisions are irrevocable for postmortem distribution purposes
- Failure to make RMDs results in a 25% excise tax
  - Reduced to 10% with a timely correction and return filing
  - Pre-SECURE 2.0 Act the excise tax was 50%
- SECURE Act modified some of the key postmortem distribution rules

Uniform Lifetime Table

- Used to determine RMDs in most cases
- Exception where spouse is sole beneficiary and is more than 10 years younger
  - Actual recalculated joint life expectancy of participant/spouse is used annually
  - Different table for determining RMD factors
- Incorporates current mortality assumptions and thus allows for longer distribution periods
- Final regulations (November 2020) extend the lifetime distribution period via updated mortality tables

Death before the RBD

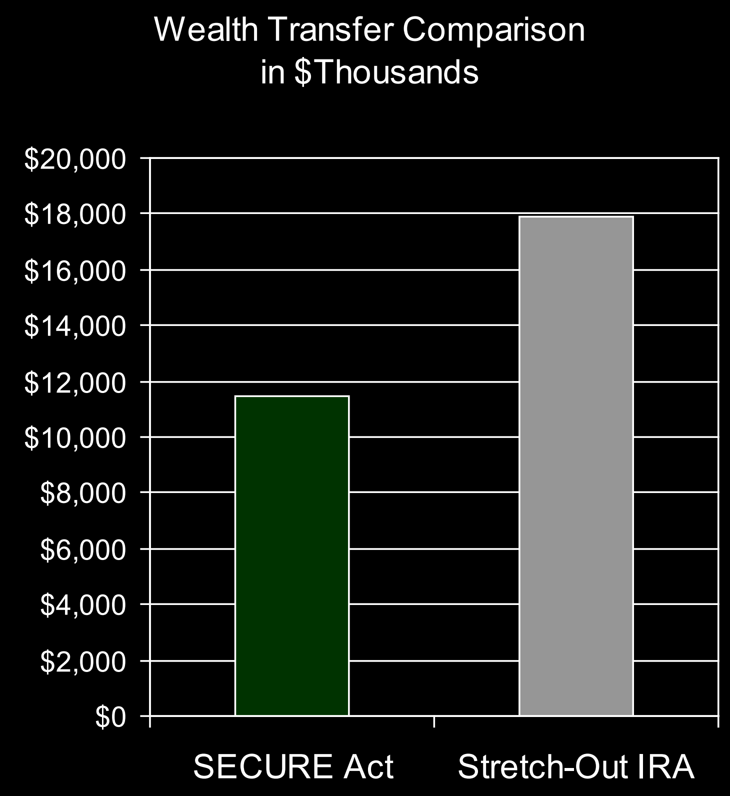
- If no DB, total distribution required by 12/31 in the 5th anniversary year of P’s death
- Spouse DB (if no spousal rollover executed)
  - RMD factor based on surviving spouse’s life expectancy (recalculated until spouse’s death)
  - Must begin by later of 12/31 in the year following P’s death or when P would have reached the RBD age
- Nonspouse EDB can distribute over EDB’s fixed life expectancy, starting by 12/31 of year after P’s death
- Non-EDB must distribute in full by 10th year following year of P’s death (new rule per the SECURE Act)

Death after the RBD

- If no DB, distributions are based on P’s life expectancy at death, reduced by 1 each year
- If spouse DB, distributions are based on spouse’s life expectancy (recalculated until death)
- If nonspouse EDB, distributions are based on EDB’s life expectancy in year following P’s death, reduced by 1 each year; 10-year rule election may also apply
- If non-EDB, RMDs in yrs 1-9; distribute 100% in yr 10
- With multiple beneficiaries, DB with the shortest life expectancy is used to determine distribution schedule

SECURE Act Example

- $1,000,000 IRA
- P dies in the current year
- DB age 35 does not qualify as EDB
- DB life expectancy age 90
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth
- NB: In the SECURE Act scenario the DB does not receive a distribution until year 10, at which time the IRA is distributed in full



Spouse Beneficiary

- Naming P's spouse as DB provides flexibility as spouse can accept or disclaim plan/IRA
- Spouse can execute a postmortem IRA rollover and elect to treat the account as own
  - Spouse names one or more DBs/EDBs
  - Spouse can delay RMDs until his/her own RBD
  - Spouse can also receive postmortem RMDs as a beneficiary rather than electing to own the account
- Creating multiple rollover accounts increases pre-59½ distribution planning flexibility (substantially equal periodic payments or SEPPs)

Heirs as Beneficiary

- If spousal ownership via rollover would imperil heirs' chances of receiving plan/IRA benefits
- If P died before 2020, postmortem IRA distributions can be stretched out over DB's fixed life expectancy
- Post-2019 deaths (per SECURE Act)
  - EDBs can follow the old life expectancy stretch-out rules
  - Non-EDBs must fully distribute by 10th year after P's death
- Employer plan may require lump-sum or other payout
- Postmortem IRA rollovers are permitted only if trustee-to-trustee transfers

Trust as Beneficiary[1]

- Provides greater testamentary control and asset protection than outright bequests
- If the following requirements are met, trust beneficiaries can be treated as DBs (i.e., trust is considered a see-through trust)
  - Valid under state law but for lack of corpus
  - Beneficiaries of trust are identifiable
  - Is irrevocable or becomes irrevocable at P’s death
  - Certain trust information must be furnished to plan administrator, trustee, custodian, etc. by 10/31 in the year following P’s death

Trust as Beneficiary[2]

- Separate share rule states that plan benefits payable to a multi-beneficiary trust must use the shortest life expectancy period, even if the trust is split into separate shares
  - Solution 1: Plan or account is split into separate shares via the beneficiary designation
  - Solution 2: Subtrusts are directly named as beneficiaries
  - Solution 3: Separate trusts are named beneficiaries
- Potential trap for the unwary, requiring coordination of plan/IRA beneficiary designations with trust provisions

Trust as Beneficiary[3]

- Per SECURE Act a see-through trust can see through to EDBs who are totally disabled or chronically ill individuals
  - More favorable postmortem stretch-out distribution treatment is available (i.e., life expectancy rule applies, unless the 10-year rule election is available and made)
- Per SECURE Act a see-through trust can see through to EDBs who are P's minor children
  - No RMDs, unless P dies on or after reaching the RBD
  - 10-year rule applies once the child reaches majority (21) or 10 years after child's death if sooner

QTIP Trust as Beneficiary

- Rules governing both RMDs and qualified spousal interests for estate tax purposes apply
- Advantages
  - Participant maintains testamentary control
  - Estate-tax deferral via unlimited marital deduction
- Disadvantages
  - Potential sacrifice of income-tax deferral relative to spousal IRA rollover
  - Complexity involving the interaction of federal tax laws with local property laws and fiduciary accounting rules

Bypass Trust as Beneficiary

- Qualified plans and traditional IRAs are not ideal assets for funding bypass trusts
  - Income tax burden reduces value of the bequest
  - Per SECURE Act postmortem distribution period is limited to 10 years, unless see-through trust DBs qualify as EDBs
  - Trust can be named as contingent beneficiary, which inherits plan in the event of spousal disclaimer
- Roth IRA is ideal funding vehicle since qualified distributions are tax-free
- Pecuniary funding of trust accelerates income tax

Generation-Skipping Transfers

Benefits

- Bypasses estate taxes at second generation level
- Per SECURE Act postmortem distribution period has been reduced
  - 10-year max tax deferral
  - Tax-free with Roth IRAs
- Creates or adds to a significant legacy for children’s heirs

Drawbacks

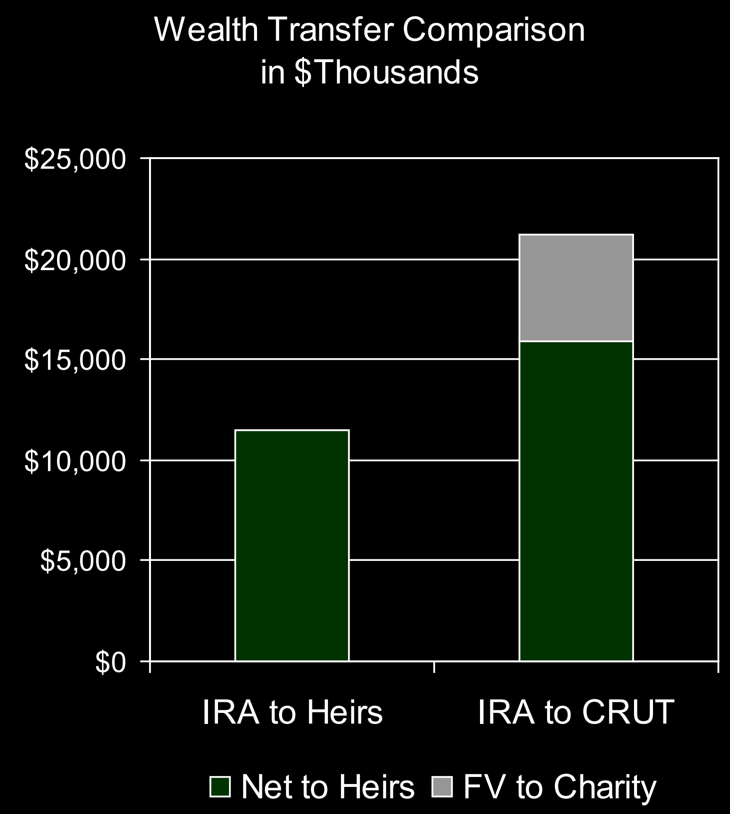
- Income taxes reduce value of transfer
- Estate taxes if QRP/IRA bequest exceeds applicable exclusion amount
- Additional planning complexity

Funding Charitable Bequests

- Qualified plans and traditional IRAs are ideal assets for funding charitable bequests
  - Charities are tax-exempt so IRD not a problem
  - Assets entitled to step-up in basis can pass to family
- Charities do not qualify as DBs, so should be cashed out by 9/30 in year following P's death to avoid acceleration of postmortem RMDs
- Bequests to CRTs can serve as a substitute for RMDs for P's heirs while benefiting charity

IRA-to-CRUT Example

- $1,000,000 IRA
- P dies in the current year
- DB age 35 does not qualify as EDB
- DB life expectancy age 90
- Highest tax brackets
- 40% federal estate tax rate
- 5% CRUT payout
- 2% income
- 6% growth
- 2.0% 7520 rate
- NB: In the IRA-to-Heirs scenario the DB does not receive a distribution until year 10, at which time the IRA is distributed in full



Charitable IRA Rollover

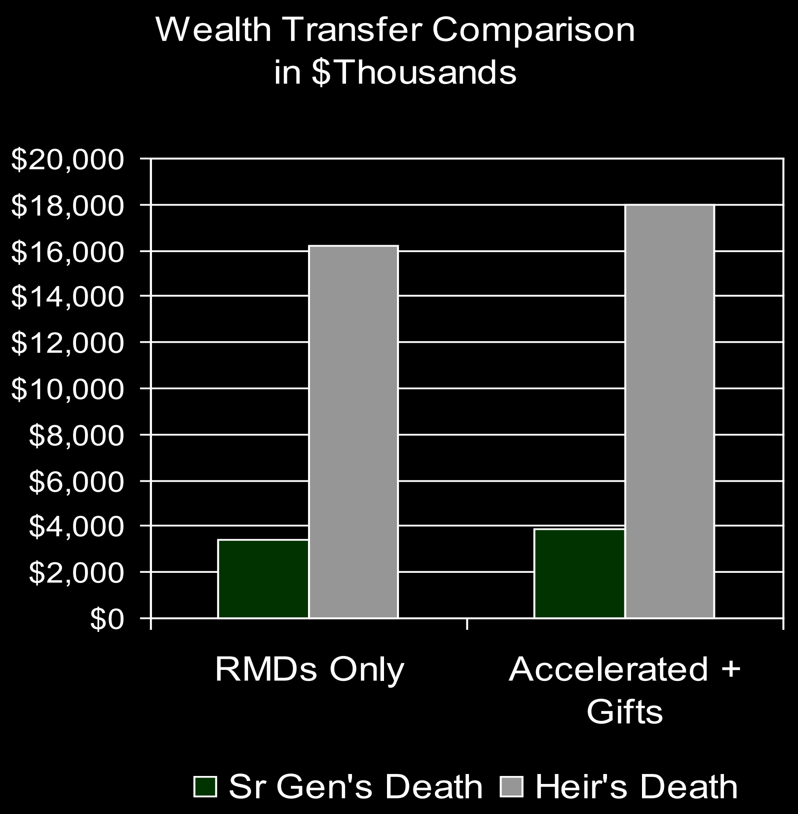
- Individuals 70½ or older can make lifetime transfers directly from IRAs to qualified charities
  - Known as QCDs
  - Up to $100K (indexed starting in 2024) can be transferred per year per individual
  - Donor advised funds, supporting organizations do not qualify
- Transfer is income tax-neutral
  - Excludable from gross income
  - Nondeductible (i.e., not treated as an itemized deduction)
- QCDs are applied against RMD requirements

Acceleration vs. Deferral

- Maximizing tax-deferred compounding by minimizing distributions is generally advisable
- Accelerating distributions may be more beneficial in limited circumstances
  - Funding a lifetime gifting program with distributions where other sources are unavailable
  - Funding a “non-propertied” spouse’s unified credit
- If retirement plan assets are needed to fund living expenses, create multiple accounts, especially for pre-59½ distributions

Accelerated Distributions Example

- $1,000,000 IRA
- Account owner age 60
- DB age 35 does not qualify as EDB
- Life expectancies age 90
- Discretionary distributions between now and the RBD (age 73)
- Annual exclusion gifts
- 2 donees
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth
- NB: PM RMDs in years 1-9; 100% distribution in 10th year



Role of Life Insurance

- Provides estate liquidity
  - Large qualified plan/IRA balances create significant tax exposure
  - Insurance may be necessary to preserve the tax-deferred status of these plans following P's death
- Lifetime gifts with after-tax plan distributions
  - Reduce P's taxable estate
  - Assets in irrevocable trust can fund insurance premiums
- Can combine an IRA-to-CRUT bequest with an ILIT (aka wealth replacement trust)

Roth IRAs

- Contributions are nondeductible
  - Post 70½ contributions are allowed
  - Subject to phase-out at specified AGI levels
- Qualified distributions are not subject to federal income taxes or penalties
  - Age 59½, death, disability or first home purchase
  - Must meet 5-year holding period requirements
- No lifetime RMDs
- Postmortem distribution period limited to 10 years
- Powerful wealth transfer planning vehicle

Roth IRA Conversions

- Taxpayers at all income levels are eligible
  - Income related to conversion is excluded
  - AGI < $100K requirement does not apply after 2009
- For best long-term results the taxes associated with the conversion should be paid with non-IRA funds
- CAUTION: RMDs cannot be converted
- Recharacterizations (i.e., unwinding) of Roth IRA conversions are no longer permitted
- In many ways a Roth IRA conversion is like a grantor trust, another powerful tax planning vehicle

Pros & Cons of Conversion

Benefits

- Income-tax burden on IRA is frozen
- Conversion income may be offset with unused tax carryovers (e.g., NOLs)
- No lifetime RMDs
- Tax-free growth
- Tax-free distributions
- Ideal funding vehicle for credit shelter bypass trusts

Drawbacks

- Income taxes are accelerated
- Using IRA funds to pay taxes reduces benefits
- State creditor protection statutes may leave Roth IRA vulnerable
- Uncertainty surrounding future tax laws

Roth IRA Conversion Example

- $1,000,000 traditional IRA
- Account owner age 60
- DB age 35 does not qualify as EDB
- Life expectancies age 90
- 100% conversion in 2022
- Taxes paid with non-IRA cash
- Highest tax brackets
- 40% federal estate tax rate
- 2% income
- 6% growth
- NB: In No-Conversion scenario DB receives RMDs during PM years 1-9 plus a 100% distribution in year 10; in Roth scenario 100% year 10 only

Summary

- Rules governing distributions from qualified plans and IRAs are increasingly complex
- SECURE Act introduces new traps and opportunities, so careful planning and sound advice is paramount
- Customized IRAs and contingent beneficiary designations can provide maximum flexibility
- Do not overlook the estate planning advantages of using trust beneficiaries, disclaimers, and Roth IRAs
- Ensure adequate estate liquidity to preserve the tax-favored status of retirement plans