This copy is for your personal, non-commercial use only. Reproductions and distribution of this news story are strictly prohibited.

- View reprint options • Order a reprint article now • Print

Examining Ed Slott's Proposed Stretch IRA Alternative

FEBRUARY 11, 2020 • **JAMES G. BLASE**

Ed Slott's recent articles in response to the SECURE Act, while well-intended, contain too many overgeneralizations regarding estate planning. Let's take his February 6, 2020 online article in *Financial Planning*, for example: "Why Life Insurance Is The New Stretch IRA."

The article's initial premise is certainly correct: "Clients [with the largest IRA balances] are naturally concerned about post-death control. They built large IRAs and want to make sure that these funds are not misused, lost or squandered by beneficiaries due to mismanagement, lawsuits, divorce, bankruptcy or by falling prey to financial scams or predators." Unfortunately, it is from this point on that the article reverts to making several overgeneralizations regarding estate planning with IRAs, and the use of trusts.

In the first place, life insurance is not the new stretch IRA. Life insurance has always played an important role in tax and estate planning for IRAs, but it is not the "new stretch IRA." We should not be misleading clients into thinking it is.

The article suggests: "In order to keep your client's IRA estate plan intact, the IRA portion will probably have to be replaced with either a Roth IRA (via lifetime Roth conversions) or with life insurance, which offers better leverage and flexibility since it won't be subject to any post-death Secure Act limitations." "Replaced?" So the goal is to completely replace (i.e., with life insurance or Roth IRAs) the IRA portion of the estates of clients "with the largest IRA balances?"

Although it is definitely recommended that clients consider annually "milking out" *a portion* of the IRA at lower income tax rates (e.g., after the client has retired) and rolling the after-tax proceeds into life insurance and/or, in the case of the portion of the withdrawal over the required minimum distribution for the year, a Roth IRA, the advisor must be very careful before embarking on a program to completely replace "the largest IRA balances" among our clients in this fashion, without first carefully examining the after-tax math associated with each individual plan.

The article also suggests cashing out IRAs, paying income taxes, now, at potentially significant income tax rates, and then using the after-tax proceeds to purchase life insurance for grandchildren. Remember that these same grandchildren are likely to be in lower income tax brackets than their grandparents at the time of the liquidation of the taxable IRAs. If we are going to use the after-tax IRA proceeds to purchase tax-free life insurance (which, again, can be an effective tax-saving strategy), then why do we need to leave the life insurance proceeds to grandchildren, when we were only using them for their longer life expectancies (which now have become moot), in the first place?

If we are primarily using grandchildren for the income tax leverage that they bring to the table, why don't the same grandchildren bring income tax leverage for IRAs after the SECURE Act? Remember, these grandchildren are likely to be in lower income tax brackets than the IRA owners doing the liquidating of the largest IRA balances, and, more importantly, are likely to be more numerous than one IRA owner, thus spreading the taxable IRA proceeds over more taxpayers.

The article continues:

"Under the old stretch IRA rules, if the trust qualified as a see-through trust, RMDs could be based on the age of the oldest grandchild, say, a 19-year-old. RMDs would be paid to the trust and from the trust right through to the individual grandchildren over 64 years (the life expectancy for a 19-year-old), leaving the bulk of the inherited IRA funds protected in trust for decades…"

"But no more. Under the Secure Act, if this plan stays as is, *all* of the funds will be released to the grandchildren and taxed by the end of the 10th year after death—contrary to the client's intention. Even if a discretionary (accumulation) trust was used to keep more funds protected, the entire inherited IRA balance would still have to be paid out to the trust by the end of the 10 years—and be taxed at trust rates for any funds retained in the trust for continued protection."

Let's unpack these two paragraphs to see if they are accurate.

In the first place, subject to the potential application of the so-called "Kiddie Tax," why would it be a bad idea to pay IRA benefits to a trust for a grandchild in his or her early working years? Aren't these the years when the grandchild will likely be in his or her lowest income tax brackets? Are we sure it makes sense for an IRA owner to withdraw funds now, at a likely higher income tax rate than the grandchildren will be in, only to pay these higher income taxes on the IRA proceeds many years before it would otherwise be necessary? It might be wise to run the after-tax math on this idea, first, and in so doing factor in the number of grandchildren (i.e., separate taxpayers) involved, versus the lone IRA owner-taxpayer.

The two paragraphs then suggest that, under the SECURE Act, all of the funds of the trust will be released to the grandchildren and taxed by the end of the 10th year after death. This is an incorrect statement. The SECURE Act does not require that the funds be released to the grandchildren by the end of the 10th year after death, or indeed at any point. The client may choose to release the funds to the grandchildren by this point, but the SECURE Act itself does not require this.

Finally, these two paragraphs conclude that if a discretionary (accumulation) trust was used to keep more funds protected, the funds would "be taxed at trust rates for any funds retained in the trust for continued protection." This overgeneralization about the trust income tax laws is not true. The beneficiary can be given a power of withdrawal over the IRA proceeds payable to the trust and the proceeds will be taxed at the individual's income tax rates, and not at the trust's income tax rates, regardless of whether the beneficiary actually withdraws the proceeds from the trust.

The article continues: "Due to the life insurance leverage, the payout after death can far exceed the $1 million balance in the IRA, of course depending on the client's age and health." This is a true statement, if it is referring to the "after tax" payout. But this has always been the case when life insurance proceeds are compared to IRA proceeds; there is nothing new about the SECURE Act which leads us to this conclusion regarding the potential income tax benefits of life insurance.

Finally, the article suggests: "Life insurance trusts can be more versatile for multi-generational planning as well, keeping the funds protected for decades if desired." Again, this is an overgeneralization of state law and the federal income tax laws. Under most state laws and the federal income tax law trusts receiving IRA proceeds can be protected for generations, just as life insurance trusts can be.

Ed Slott's articles are based on a misconception of the federal income tax laws applicable to trusts as well as the asset protection laws applicable in most states. Take this assertion Mr. Slott makes in his article appearing in the January 7, 2020 online edition of *Financial Planning*, "New Tax Law Obliterates IRA Trust Planning":

"With a discretionary trust, when more post-death control is desired, the annual RMDs are paid out from the inherited IRA to the trust, but then the trustee has discretion over whether to distribute those funds to the trust beneficiaries or retain them in the trust. This provides the trustee with greater post-death control of what gets paid to the trust beneficiaries, as compared to the conduit trust, which pays out all annual RMDs to the trust beneficiaries. *Any funds retained in the trust though would be taxed at high trust tax rates.*" (Emphasis added.)

The statement, "Any funds retained in the trust though would be taxed at high trust tax rates," is an overgeneralization about how trusts are taxed for federal income tax purposes. Properly drafted trusts will grant the beneficiary a power of withdrawal over the trust income, subject to a suspension power in the trustee in the event the beneficiary is abusing the withdrawal power or in the event of a creditor attack against the trust. Drafted in this manner, the trust does not even pay income taxes. All of the trust income is taxed to the beneficiary, at the beneficiary's income tax rates. Furthermore, the trust income that is not withdrawn during the year accumulates inside the trust, and in most states remains protected for the beneficiary, which, as mentioned at the outset of this article, was Mr. Slott's initial and correct premise for writing his articles (For further discussion in this area, see Mr. Blase's February, 2020 article published in the *NAEPC Journal of Estate & Tax Planning)*.

No doubt life insurance is an important tool in the client's estate planning team's arsenal of tools intended to counteract the punitive effects of the SECURE Act, but it is not the new stretch IRA. Equally important are the various other tools the client's estate planning team can utilize to help minimize the income tax liability on the IRA proceeds themselves. Some of these techniques have been described above; others have been outlined by the author elsewhere.

James G. Blase is principal of Blase & Associates LLC. He has authored over 50 peer review articles in the estate and tax planning area and teaches a course in Income Taxation of Trusts and Estates in the Villanova University Charles Widger School of Law Graduate Tax Program.

This copy is for your personal, non-commercial use only. Reproductions and distribution of this news story are strictly prohibited.

- **View reprint options** • **Order a reprint article now** • **Print**