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Navigating The New Estate Planning Realities

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Commentators appear to be almost uniform in proclaiming the demise of so-called stretch IRAs and other defined contribution plan benefits, including 401(k)s, after the Further Consolidated Appropriations Act of 2020 (FCAA) was signed in December. Before 2020, designated beneficiaries could put off receiving benefits from IRAs and other defined contribution plans and stretch them out over their lifetimes. The new rule, however, says the benefits have to be paid out and done in 10 years.

For example, with certain exceptions (including those for a surviving spouses) a designated beneficiary having a 30-year life expectancy who previously could have delayed receiving IRA or plan benefits over 30 years must now fully withdraw the benefits within 10 years of the plan participant's or IRA owner's death. There is no set schedule for distributing the funds during those 10 years, as long as they are all withdrawn by the end.

The Nature Of The Problem

Under the new law, not only must all of the tax on IRAs and plans benefits be paid much earlier than it was before, but the rate will likely be much higher too, since that income will be bundled into recipients' peak earning years.

Let's take an example of how the new law changes things. Let's say we have an IRA owner who dies and leaves a $1 million IRA. The designated beneficiary is 60 years old and expected to live another 25 years. We assume the IRA's income/growth rate is 5%. We're also assuming there's a 20% combined income tax rate on the income generated by withdrawn funds invested outside of the IRA.

Under the old law, if the beneficiary took only the required minimum distributions over his or her 25-year life expectancy, the after-tax value of the IRA distributions when the designated beneficiary was age 85 would be $2,204,122. (We're assuming there's a 30% combined federal and state tax rate since most of the income would not be in the beneficiary's peak earning years.)

Now let's look at what happens under the new law. If we assume that the beneficiary will take equal payments over 10 years, these payments would be $82,731 (based on a standard amortization table at 5% and a 35% combined federal and state income tax rate). Once removed from the taxable accounts, after 25 years the payments would grow to $1,854,391.

Now let's assume the designated beneficiary waits until the end of year 10 to take the IRA balance. Here we assume there's a 40% combined federal and state tax rate on the lump sum. The after-tax amount after 25 years would be $1,760,242, or approximately 5% less than the strategy of spreading the IRA distributions equally over 10 years.

The $2,204,122 result under the old law is about 19% more than the best scenario under the new law, since it spreads out payments even further at an even lower income tax rate.

Planning Alternatives

There are a number of alternatives the client can consider in order to dampen the new law's tax effects. The major alternatives will be briefly explored and tested here:

1. Taking larger IRA distributions during the clients' lifetimes. The theory here is to withdraw significant additional penalty-free amounts from IRAs, etc., during the account holder's lifetime, so they will hopefully be taxed at a lower income rate than they

would be otherwise, with the net after-tax funds then reinvested either in a Roth IRA or in other assets that will receive a stepped-up income tax basis when the owner dies.

Does this plan make sense? Let's assume the combined federal and state income tax rate for the IRA owner or designated beneficiary on early withdrawals (by the account owner) and withdrawals under the new 10-year withdrawal rule (by the designated beneficiary) is 35%, but that there's only a 20% combined federal and state tax rate on the investments purchased with the after-tax withdrawals. (Remember, the tax rate on capital gains could be as little as 0% if beneficiaries hold the investments until they die.) The numbers can be run a variety of different ways. But in general, in most situations, it won't make sense mathematically to pay income taxes early—at significantly higher rates than you would have paid maximizing the income tax deferral available during your lifetime.

In some scenarios, the strategy can actually reduce the after-tax amount ultimately available to the client and family. The clients are accelerating the income tax payable during their lifetimes, at a significantly higher income tax rate, and not taking advantage of the new law's full 10-year income tax deferral after they die. If the account owner has not retired, the negatives associated with accelerating taxable IRA withdrawals could be compounded by this strategy.

Before doing any significant Roth conversion in order to minimize income taxes to the designated beneficiaries, the planner must be mindful of the various potential negative aspects of the Roth conversion:

a. There is likely going to be a significantly higher income tax rate payable by the owner under a Roth conversion than there would be by taking minimum required minimum distributions during the owner's lifetime. There is also the time value of the taxes saved by not converting.

b. The taxable growth in the after-tax RMDs can be controlled, and in any event the growth will receive a stepped-up income tax basis at the death of the account owner. This eliminates all income taxes on this growth up until the time of the account owner's death.

c. Only 10 years of tax-free Roth deferral after the account owner's death are permitted under the new law. This undermines the post-death tax benefits available to Roth IRAs under the old law.

d. The IRA owner may need to use the IRA funds themselves to pay the conversion tax, and therefore be converting much less than the entirety of the IRA distribution.

Another early withdrawal option that may produce significant income tax saving benefits would be to apply an "amortization approach" to the withdrawals. Under this plan, beginning when the account owner is retired, the owner can determine his or her (or joint, if married) approximate life expectancy, and then take withdrawals over this period plus 10 years.

For example, if a married couple are both age 72 and retired and feel their joint life expectancy is approximately 15 years, they could withdraw from their account assuming there will be a 25-year amortization table and a 5% interest rate, and that the designated beneficiaries could make any annual withdrawals the couple did not take during their lifetime.

The only modification to this plan would be for the designated beneficiaries to defer withdrawing all or some of the balance until after they retire but within the 10-year window, if this step will lower their overall taxes.

The major difference between the amortization approach during the couple's lifetime and a plan of just taking required minimum distributions is that the withdrawals will be slightly greater in the earlier years and slightly less in the later years, which in turn will hopefully create a smoothing out of taxable income at lower tax brackets. The goals of this plan are to reduce the income tax rate at which the withdrawals will be taxed to the couple each year by avoiding a large bunching of income during their working years or in the event they outlive their life expectancy, and to reduce the income tax rate designated beneficiaries will experience when they receive the payments during what are likely to be their peak earning years. During the account owner's lifetime, the annual distributions that exceed his or her RMD amount can be rolled into a Roth IRA, if desired.

2. Paying all or part of the IRA portion of the estate to lower-income-tax-bracket beneficiaries. The theory here is that, if we have to live with the new tax law, we can at least minimize its effects by planning our estates in a tax-sensitive manner. Assume, for example, that a client has four children, two of them in high-income tax brackets and two who aren't. Why not consider leaving the IRA portion of the client's estate to the children in lower brackets, and the assets with a stepped-up basis to the others? Of course, a drafting adjustment should be made for the fact that the lower-tax-bracket children will be receiving taxable income, whereas the others won't be.

This plan can be taken a step further if the client is interested in leaving a portion of his or her estate to grandchildren or great grandchildren, who may be in even lower income tax brackets than the children (that amount is subject, of course, to the Kiddie Tax). True, it’s no longer possible to defer IRA income tax over the lives of these later generations. But that does not mean it isn’t helpful to distribute to grandchildren or great grandchildren (a group that’s usually larger than the second generation, requiring income to be spread over more taxpayers). It’s still a beneficial income tax planning technique because of the lower overall income taxes that often result.

Finally, a client will want to first make any charitable gift out of the IRA portion of the estate.

3. Withdrawing additional IRA funds early and using the after-tax amount to purchase income-tax-free life or long-term-care insurance. This option is intended to combine the first two options, but rather than withdrawing all or most of the IRA funds early, the technique merely “freezes” the current value of the IRA since the client withdraws only the account growth or the required minimum distribution, whichever is greater, hopefully without increasing the account owner’s income tax bracket. All or a portion of the after-tax withdrawals are then reinvested in income-tax-free life insurance, including so-called second-to-die life insurance that pays only at the death of both spouses and is therefore cheaper than an individual policy insuring only one spouse.

The life insurance can then be left to the beneficiaries in the higher income tax brackets, while the rest of the IRA goes to those in the lower tax brackets, including, if desired, grandchildren and great grandchildren (again, of course with any adjustments desired to account for the disparate income tax treatment of the beneficiaries and with due regard for the Kiddie Tax).

Another option is to use the after-tax withdrawn funds to purchase long-term-care insurance (including a hybrid life/long-term-care insurance policy) in order to protect the portion of the IRA that has not been withdrawn and potentially create an income tax deduction for premiums paid on a traditional long-term-care insurance policy (including a so-called “partnership program” traditional long-term-care insurance policy).

4. Paying IRA benefits to an income-tax-exempt charitable remainder trust. This alternative technique involves designating an income-tax-exempt charitable remainder trust as the beneficiary of the IRA proceeds. Assume, for example, that a $100 IRA is made payable to a charitable remainder unitrust that pays the owner’s three children (ages 60, 58 and 56)—or pays the survivors or survivors of them—7.5% of the value of the trust corpus (determined annually) each year, until the last of the three children dies. Assume this takes 30 years, and that the trust grows at the same 7.5% annual rate throughout the 30 years. Under this plan, the owner’s children will receive a total of $7.5 a year (or $5 after an assumed 33.3% combined federal and state ordinary income tax rate), which when then compounded outside of the trust, at a rate of 6% after a 20% capital gains tax rate, will equal almost $400 in 30 years. The charity will receive the $100 principal at the end of the 30 years, and the trust meets the requirements of a qualified charitable remainder unitrust.

This sounds good, but compare this alternative to the one of doing no planning under the new tax law. The $100 IRA would grow to $206 10 years after the owner’s death. If we assume that there’s a 40% tax rate on this amount compressed during the children’s peak earning years, this would net them $124 10 years after the owner’s death. Next assume this amount grows at a 7.5% rate (or 6% net of an assumed 20% capital gains tax rate) for the next 20 years. Just as they would in the charitable trust alternative, the children would net almost $400. The difference is that charity does not receive $100 under this no-planning scenario. Perhaps more significantly, however, under the no-planning alternative the entirety of the IRA funds is available to the children, at all times, whereas under the charitable remainder trust alternative the principal of the trust may not be accessed until paid out to the children according to the designated schedule.

Paying IRA Funds To Trusts After The FCAA

After the death of the account owner, does it still make sense under the new law to pay funds from IRAs or other vehicles into trusts to protect the money for the beneficiary? (Traditionally, that's been done for protection against lawsuits, divorce and estate taxes, etc.) Many will argue it doesn't make sense anymore because of the high income tax rates on trusts.

Recall, however, that you can handle those higher rates by judiciously using Section 678 of the Internal Revenue Code in the drafting of the trust. This allows the income of the trust to be taxed at the beneficiary's income tax rates, not the trust's rates. Note that this refers to the so-called "accumulation trust" approach to planning for payments from IRAs and other vehicles to trusts on a "stretch" basis. It will not work in the case of a so-called "conduit trust," because conduit trusts mandate that all IRA and plan distributions be paid to the designated beneficiary of the trust upon receipt. Note also that existing "accumulation trusts" may need to be modified in light of the new law in order to ensure the 10-year deferral period for payments to a "designated beneficiary" is achieved over the 50% shorter five-year default period. The key language for the drafting attorney to focus on is found in the Code of Federal Regulations Section 1.401(a)(9)-4, A-1:

"A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it possible to identify the class member with the shortest life expectancy."

For example, if the trust includes a testamentary power of appointment to the surviving spouse of the beneficiary, with no age limit on the beneficiary's surviving spouse, the trust will not qualify as a designated beneficiary because it is impossible to identify the class member with the shortest life expectancy.

Some Final Thoughts

Among all these strategies, the ones that work best in a given situation will depend on all the facts and circumstances. What's important to note here is that they can be combined, if desired, to produce maximum benefits. For example, the amortization approach can be combined with the plan of leaving the remaining IRA-type assets to the lower-income-tax-bracket members of the family. It can also be combined with the life insurance and long-term-care insurance options.

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