Tax Planning for Retirement Savings

15 Strategies for Saving Income and Estate Taxes

by

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Preface

THIS is a book about income and estate tax planning for retirement savings. The 15 chapters represent different strategies the author has developed since the SECURE Act was passed late in 2019, in order to help advisors and clients minimize the adverse tax effects of the new law. The strategies are derived from various articles the author has published for *Estate Planning* and *Financial Advisor*, as well as three other books he has authored since February of 2020.

One of the most important tax themes recognized in this new book is the fact that, as illustrated in chapter II, except at the 37% tax bracket each of the current progressive federal income tax brackets is now reached twice as quickly by a single individual than it is by a married couple. Thus, when it comes to retirement planning for already retired couples, there is a definite "single filer penalty" that must be considered in planning for a surviving spouse.

If the interests of the couple's children are also to be considered, another important tax principle is the fact that, under the SECURE Act passed in late 2019, it is no longer possible to defer IRA and 401k fund balances over the lifetimes of the couple's children after the couple passes. Instead, the balance in the couple's IRAs and 401k plan accounts must be paid out to the children over the 10 years after the couple passes, years in which the children are likely to be in their peak income tax brackets**.**

The final focus of this book is on minimizing estate taxes on retirement savings, both at the death of the surviving spouse as well as the passing of each succeeding generation.

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I

Retirement Savings Withdrawal Planning for Retired Married Couples

ACCORDING to "Tax-savvy withdrawals in retirement," part of Fidelity's 2023 *Viewpoints* series, "[t]he good news is that in retirement, there may be more options to increase after-tax income, especially when savings span multiple account types, such as traditional retirement accounts, Roth accounts, and taxable accounts. The not-so-good news is that choosing which accounts to draw from and when can be a complicated decision. . . . There are several approaches you can take. Traditionally, tax professionals suggest withdrawing first from taxable accounts, then tax-deferred accounts, and finally Roth accounts where withdrawals are tax-free. The goal is to allow tax-deferred assets the opportunity to grow over more time."

Fidelity's *Viewpoints* then recommends a plan of withdrawing proportionally from each of a single individual's multiple account types over retirement, adding this caveat: "However, if an investor anticipates having a relatively large amount of long-term capital gains from their investments—enough to reach the 15% long-term capital gain bracket threshold—there may be a more beneficial strategy: First, use up taxable accounts, then take the remaining withdrawals proportionally." In the context of the entire article, it appears *Viewpoints* is not actually recommending the exhaustion of the taxable account itself, before applying the proportional approach, but rather only the exhaustion of the

recognized long-term capital gains inside the account during the year.

Although Fidelity's *Viewpoints* conclusions may be appropriate for many retired single individuals, the *Viewpoints* do not address the situation of a retired married couple, including a retired married couple with children. Are there any special tax factors, unique to retired married couples, which planners should consider in designing retirement savings withdrawal plans for their clients?

Tax Factors Unique to Retired Married Couples

Assume, for example, a recently retired married couple, age 64, has a $2 million IRA, a $500,000 Roth IRA, and $500,000 in other savings. They receive $60,000 annually in Social Security benefits (or approximately $51,000, after a 18% combined 12% federal and an assumed 6% state income tax rate on an 85% taxable amount), and, including Social Security, need $120,000 a year to retire on (or $10,000 a month), net of federal and state income tax. The question is, which source or sources of retirement savings should the couple draw from first, in order to satisfy their additional $69,000 after-tax retirement needs?

Under the proportional withdrawal system espoused by Fidelity's *Viewpoints*, the after-tax funds would come $13,000 from taxable accounts (for simplicity, $13,000, consisting exclusively of long-term capital gains and qualified dividends, is assumed to constitute all of the taxable income generated by the taxable accounts during the year), $13,000 from the tax-free Roth IRA, and $52,000 from the couple's taxable IRA (all of which is subject to federal and state ordinary income tax

rates at an assumed combined rate of 18% - 12% federal plus 6% state, for a net after tax amount of approximately $43,000). Bearing in mind that the couple (including the surviving spouse) will be required to begin taking required minimum distributions from their taxable IRA beginning at age 75, will the proportional withdrawal system produce optimum, long-term, after-tax results, in this situation?

The minimum annual distributions which the couple in the above example will be required to begin taking at age 75, assuming just 5% growth inside the IRA over the next 11 years, will push the couple's marginal federal income tax bracket from 12% to 22%, or higher (assuming 2023 tax brackets, adjusted for inflation). What is more, after the death of the first spouse to die, the combination of required minimum distributions and the so-called "single filer penalty" will likely cause the surviving spouse to be in the 24%, or higher, marginal federal income tax bracket, an increase of 100% or more over the couple's current federal marginal income tax bracket of 12%.

Given this phenomenon, and with the exception of taking advantage of tax-free qualified dividends and capital gains over the next 11 years, why wouldn't the couple's optimum retirement savings withdrawal planning over the next 11 years beg for satisfaction of the couple's after-tax retirement needs utilizing primarily proceeds from the couple's taxable IRA? To the extent the taxable IRA proceeds will not cause the couple's qualified dividends and long-term capital gains to be subject to tax, this step will both significantly minimize the total income taxes on the couple's taxable IRA, in the long run, and fully preserve the couple's tax-free Roth

IRA until a later date when its tax-free benefit status can be better leveraged.

The $69,000 shortfall in the couple's annual after-tax retirement needs in the above example could thus be satisfied each year first using the total of the couple's long-term capital gains and other income generated by their taxable account for the year, second with taxable IRA receipts to the extent the same does not push the couple into the 22% federal income tax bracket or cause the couple's long-term capital gains and qualified dividends to be subject to tax, and third with additional cash or other proceeds from the couple's taxable account. For example, if the couple's taxable account generated a total of $10,000 of long-term capital gains and qualified dividends during the year, the $59,000 remaining shortfall could be satisfied with $56,000 of IRA proceeds (or $46,000, net of 18% combined federal and state income taxes) and $13,000 of additional cash from the couple's taxable account.

As illustrated more in Chapter II, by paying attention to tax brackets, optimum after-tax results are achieved. Over the long run, the couple's taxable IRA is taxed at a significantly lower average federal income tax rate, income tax-free long-term capital gain and qualified dividend treatment is preserved, for at least 11 years, and the income tax-free benefits of the couple's tax-free Roth IRA are maximized by fully preserving the Roth IRA for a later day, when either the couple or the surviving spouse is likely to be in a much higher marginal federal income tax bracket.

Similar income tax benefits will ensue to the couple's children who, after their parents' passing, will be required to

withdraw their parents' taxable IRAs over 10 years, years in which they are likely to be in their peak income tax brackets. The value of their parents' taxable IRA will have been minimized, while the value of their parents' tax-free Roth IRA will have been maximized. What is more, income taxes on the taxable account the children inherit from their parents will have been eliminated as a result of it receiving a full income tax basis "step-up" at their parents passing – at least under current tax law.

It's All About Income Tax Brackets

In short, when addressing retirement savings withdrawal planning for a retired married couple, it's all about tax brackets – the couple's, the surviving spouse's, and the couple's children. Optimum retirement savings withdrawal planning must recognize that, although fact patterns are obviously going to differ, in general (i) a retired married couple is going to be in a higher income tax bracket once they are forced to take required minimum distribution, (ii) the surviving spouse is likely going to be taxed at a higher federal income tax rate than the couple was while they were both living, and (iii) the couple's children, over the 10 years after their parents' passing, on average are likely to be in higher federal income tax brackets than their parents were, while retired and still living. An optimum retirement savings withdrawal plan for retired married couples must therefore be sensitive not only to the tax bracket of the married couple today, but also to its potential tax bracket in the future, after required minimum distributions are required to begin, as well as to the likely higher future tax brackets of the surviving spouse and the couple's children.

The only exception to the above analysis would be when the couple's after-tax retirement needs are significantly more than $10,000 per month, and using exclusively taxable income and tax-exempt interest to pay retirement expenses over and above Social Security could cause the couple to pay significantly more in Medicare premiums. In this situation, using proceeds from the couple's tax-free Roth IRAs to pay a portion of the couple's retirement expenses, in order to reduce or eliminate the Medicare surcharge, could make sense. This is because Roth IRA proceeds generally do not count in the "modified adjusted gross income" computation used for purposes of determining the Medicare Parts A and D premium surcharges.[1]

[1]This issue is addressed further at page 13, including footnote 2 on that page.

II

Minimizing Income Taxes on IRA and 401k Accounts

UNDER SECURE Act 2.0, passed in late 2022, it is now possible for an individual who is not already receiving required minimum distributions from IRAs or 401k plans to defer beginning the receipt of the same until the individual attains age 73 (and in the future, age 75). The important retirement planning question for already retired couples to ask themselves is whether it makes financial sense for them to take maximum advantage of this new extended deferral period. In order to answer this question, we first must continue to explore how the federal income tax system works for a married couple filing jointly versus a surviving spouse filing as a single taxpayer.

Set forth on the following pages is a table of the 2023 federal tax brackets and rates for married couples filing jointly and for single individuals. As the table illustrates, in recent years the federal income tax system has evolved to the point where, except at the very highest tax brackets, widowed spouses reach the same federal income tax brackets at half the level of income that married couples do. Their standard deduction ($13,850) is also half the level of a married couple ($27,700). Bearing in mind that it is not at all unusual today for one spouse to survive the other by 10 years or more, in retirement planning for retired married couples the first goal should be to minimize the potential effects of this "single filer penalty."

Taxable income	Taxes owed
Married Filing Jointly	
$22,000 or less	10% of the taxable income
$22,001 to $89,450	$2,200 plus 12% of amount over $22,000
$89,451 to $190,750	$10,294 plus 22% of amount over $89,450
$190,751 to $364,200	$32,580 plus 24% of amount over $190,750
$364,201 to $462,500	$74,208 plus 32% of amount over $364,200
$462,501 to $693,750	$105,664 plus 35% of amount over $462,500
$693,751 or more	$186,601.50 plus 37% of amount over $693,750
Single Individuals	
$11,000 or less	10% of the taxable income
$11,001 to $44,725	$1,100 plus 12% of amount over $11,000
$44,726 to $95,375	$5,147 plus 22% of amount over $44,725

$95,376 to $182,100	$16,290 plus 24% of amount over $95,375
$182,101 to $231,250	$37,104 plus 32% of amount over $182,100
$231,251 to $578,125	$52,832 plus 35% of amount over $231,250
$578,126 or more	$174,238.25 plus 37% of amount over $578,125

Assume, for example, that a married couple is making $100,000 a year in retirement (including the taxable portion of their Social Security benefits). After factoring in the couple's $27,700 standard deduction (in 2023), their federal income tax liability assuming 2023 tax rates and brackets would be $9,346. If either spouse was deceased, however, the surviving spouse's federal income tax liability, on the same amount of gross income, would be $14,260, or 52.6% more than when the couple was still married.

Given the significant unfavorable tax position of a surviving spouse, it begs the question what proactive steps can be taken by a retired married couple to ameliorate the situation. Let's now assume a retired married couple with no other income takes a $100,000 voluntary withdrawal from a regular IRA and converts the after-tax amount, or $90,654, into a Roth IRA. Also for simplicity purposes let's assume the Roth grows by 10% the following year, or to $99,719, and that the husband dies during the year. Ignoring potential penalties for a Roth withdrawal shortly after the conversion, the wife would net $99,719 if she withdrew the entire Roth amount the following

year. Had the Roth conversion not taken place while the couple was still married, however, and the wife made a withdrawal of the $100,000 plus 10% growth, or $110,000, from the taxable IRA account the year after her husband died, her federal income taxes would be $16,475, or 76.3% more than the federal income taxes which would have been paid had the withdrawal/Roth conversion been made while the couple was still married, and the surviving spouse would net $93,525, for a net after-tax reduction of $6,194.

Again assuming the Roth conversion had not taken place while the couple was married, now further assume the wife made a withdrawal of $110,000, plus another year of 10% growth, from the taxable IRA account two years later, or $121,000. The wife's federal income tax liability would be $19,115, or now more than double what the couple would have paid in federal income taxes had the Roth conversion been made while the husband and wife were both alive, and the wife would net $101,885. Had the Roth conversion during marriage been made, the wife would have netted $109,691, for a difference of $7,806. Multiply this growing annual disparity by, say, 10 years' worth of these annual $100,000 voluntary IRA withdrawals/Roth conversions during the couple's lifetime, including after their required beginning date, while also assuming the surviving spouse lives 10 years after the first spouse to die passes, and the single filer income tax penalty for deferring withdrawals from IRAs and 401k plans for as long as possible becomes self-evident.

Illustrated another way, assume that a retired couple's annual federal gross income is $100,000, or $72,300 in taxable income after the couple's $27,700 standard deduction. This places them in the 12% marginal federal income tax bracket.

Assuming this gross income amount does not change after one of the spouses passes, the survivor will be in the 22% marginal federal income tax bracket on the survivor's $86,150 in taxable income, after the survivor's 50% lower $13,850 standard deduction.

Now assume this same couple voluntarily withdraws $17,150 from their IRAs during their joint lifetime, making their total taxable income $89,450. They would still be taxed in only the 12% marginal federal income tax bracket on this additional income. However, if the couple waited until after the first spouse died for the surviving spouse to voluntarily withdraw the same amount, the survivor's taxable income would be $103,300 (because of his or her lower standard deduction), which would place the surviving spouse in the 24% marginal federal income tax bracket for a single filer, or an increase of 100% in marginal federal income tax bracket.

Take another example where a 65-year-old retired couple's combined income (including taxable portion of Social Security and IRA withdrawals) is $200,000 per year, before their standard deduction. This will place them in the 22% marginal federal income tax bracket, and will not cause them to have to pay any Medicare Part B or D premium surcharge. A retired surviving spouse who has the same income, on the other hand, will be in the 32% marginal federal income tax bracket, and will pay an annual aggregate Part B and Part D Medicare premium surcharge of $5,500. Thus, if the value of the couple's IRAs are significant, earlier than required IRA withdrawals which do not cause the couple to have more than $200,000 in income, including the taxable portion of their Social Security and tax-exempt income, would appear to be warranted.

An analogous situation arises when both spouses die, this time as a direct consequence of the SECURE Act. Assume, for example, that the couple's gross income in retirement is the same $100,000, or $72,300 after their standard deduction. Assume also that when they both pass the couple's children are all married, and that they are all in their peak earning years, making a combined $250,000 per couple, or $222,300 after their standard deductions. The married couple's children will be in the 24% marginal income tax bracket, a 100% increase over the marginal income tax bracket of the married couple while they were both living. As a result of the SECURE Act the children will now be required to add the balance in their parents' IRAs when they both pass to their existing incomes, over the 10 years following their parents' passing, which will likely raise their marginal income tax brackets even further.

Each situation of course will need to be independently analyzed, but in general the point is made that many retired married couples can stretch their own retirement savings, and also eventually benefit their children, by paying attention to married couple versus single individual tax brackets and Medicare surcharge computations in their IRA and/or 401k plan distribution planning, both before and after their required beginning date. Only when the retired couple's income is low, and they are under age 73 (or 75, in the case of couples who will not attain age 74 until after the year 2032), in which case, and as discussed chapter IV, voluntary IRA or 401k withdrawals can cause a significant portion of the couple's Social Security receipts to be taxed when it would otherwise not be, or high, when the disparity in marginal federal income tax rates for married couples versus surviving spouses, as well as for the couple's children, is not as great, and where a

significant increase in Medicare premiums may result,[2] would it not normally make sense for a retired married couple to consider taking significant voluntarily IRA and/or 401k plan withdrawals, both before and after their required beginning date.

The withdrawn funds should then be repositioned into a tax-free Roth IRA or, as a potential option, into income tax-free life insurance. It only makes financial sense to take voluntary withdrawals in a much lower federal income tax environment and then reposition the after-tax amount into an income tax-free or low tax vehicle of some sort.

Restating the conclusions reached in this chapter, even though SECURE Act 2.0 may have changed the IRA or 401k account owner's required beginning date to age 73 (and, in the future, to age 75), waiting until these ages to begin taking voluntary withdrawals from the IRA or 401k plan will likely cause more income to be subject to income tax to the surviving spouse, later, and therefore potentially be subject to the single

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[2]Beneficiaries filing 2022 individual tax returns with modified adjusted gross income ("MAGI") of more than $103,000 and up to $129,000 must pay an additional $69.90 per month in Part B premiums and $12.90 in Part D premiums, in 2024, or less than $1,000 per year. This adjustment also applies to married beneficiaries filing 2022 joint tax returns with modified adjusted gross income of more than $206,000 and up to $258,000. Their total adjustment would be less than $2,000 per year, for the couple. This relatively minor adjustment can be much larger for higher levels of income, however.

filer penalty of as much as 100%. "Max deferring" can also cause significantly higher income taxes to the couple's children after both spouses pass, as the children will be required to include the balance of the IRA or 401k plan account in their taxable income over the following 10 years, years in which the children are likely to be in their peak income tax brackets.

III

Minimizing Capital Gains Taxes on Taxable Retirement Accounts

UNLESS the sale of significantly appreciated assets is recommended to offset otherwise nondeductible losses or for other non-tax reasons, for retired married couples, at least, liquidating significantly appreciated assets to pay retirement expenses should be low on the priority table. The reason for this is that appreciated assets held until death receive a new income tax basis in the hands of the ultimate recipient, equal to the fair market value of the assets at the death of the owner, thus eliminating or at least reducing income taxes on the "pre-death" appreciation should a surviving spouse or other beneficiary elect to later sell the assets.

There are many approaches to achieving income tax basis step-up at the passing of the first spouse to die, the choice of which depends upon all the circumstances. In community property states such as Texas, California and Wisconsin, for example, all community property owned by the husband and wife, regardless of how titled, other than so-called "income in respect of a decedent" [which is basically income an individual is entitled to receive at the time of his or her death, but which is not actually received, such as IRA proceeds, annuity income, deferred compensation, or sales proceeds], receives a new income tax basis at the death of the first spouse to die, equal to the fair market value of the property at that time. What is more, most community property

states also allow a married couple to elect to treat non-income in respect of a decedent assets which were not previously classified as community property, as community property going forward, thus qualifying any such "elected" appreciated assets for full income tax basis step-up at the death of the first spouse to die.

In other states, appreciated assets which are jointly owned by a husband and wife at the time of the first spouse's passing receive only a 50 percent income tax basis step-up at the first spouse's death, and property owned by a surviving spouse at the time of the first spouse's death receives no income tax basis step-up at that time. It is for these two reasons that married couples living in non-community property states need to plan with their advisors to achieve the maximum income tax basis step-up possible on their taxable accounts at the death of the first spouse. Included below are some planning thoughts and options designed to achieve this end.

Rather than retain all assets in joint names, the married couple could opt to transfer more of the highly-appreciated assets to the name of the spouse who is more likely to pass first. Considerations such as age, male versus female, and overall health situations are obviously relevant here. In the approximately 20 so-called "tenants by the entirety" states, where property owned jointly by a husband and wife is largely protected from lawsuits and creditors of either spouse individually, this element also needs to be considered before indiscriminately severing the protected tenants by the entirety property and transferring the appreciated assets to either

spouse.[3] Another obvious disadvantage to this plan is that the spouse who is more likely to die first may not end up doing so.

In non-community property situations, where one spouse is terminally ill, it will normally be advisable to transfer all of the appreciated assets into that spouse's name. However, Congress imposes a one-year waiting period in such situations, meaning that if one spouse transfers an interest in property to the other spouse, including the donor spouse's one-half interest in jointly-owned property, there will be no income tax basis step-up on the same if the donee spouse dies within one-year of the transfer and bequeaths the asset back to the donor spouse.

In order to overcome this "one-year rule," in situations where either spouse is terminally ill, one option may be to draft the couple's estate plan so that the terminally ill spouse's highly appreciated assets do not pass outright to the surviving spouse, but instead pass to a discretionary trust for the benefit of the surviving spouse, children and grandchildren, making it clear in the trust document that the surviving spouse is purely a discretionary beneficiary of the trust, meaning that he or she has no rights to either the income or principal of the trust, but rather is only a permissible discretionary beneficiary with no greater interest in the trust than that of the children or grandchildren. The trust instrument could also be drafted so that the surviving spouse's other assets, including IRAs, must be factored into the trustee's decision-making process in determining the need for distributions of trust income and principal to or for the benefit of the surviving spouse.

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[3]Some states, including Missouri, have solved this problem through special legislation.

To prove that the surviving spouse is not in reality the only beneficiary of the trust during his or her lifetime, it may also be recommended that the trustee actually use a portion of the trust's income or principal for the children or grandchildren. Finally, for maximum assurance that the IRS cannot argue the surviving spouse has an identifiable interest in the trust, it is best that the spouse not serve as trustee of the trust, and that the trustee's discretion be sole and absolute.

In order to address the more general situation where the spouse who is more likely to die first may not in fact pass first, another retirement planning technique in non-community property states is to divide the couple's appreciated assets roughly equally between them, so that, after the passing of the first spouse, the surviving spouse can liquidate the deceased spouse's assets, first, before liquidating his or her own assets. The portion of the surviving spouse's appreciated assets which is not liquidated by the surviving spouse during his or her lifetime will then be entitled to receive a stepped-up income tax basis in the hands of the couple's children when the surviving spouse passes. Utilizing an asset-splitting technique could thus end up approximating the favorable income tax basis step-up treatment afforded couples residing in a community property state.

If the above-described asset-splitting techniques are not utilized, and significantly appreciated assets are retained in joint names by a couple living in a non-community property state, as each jointly-owned appreciated asset is sold by the surviving spouse, there will be taxable gain on one-half of the appreciation.

An ancillary benefit of these asset-splitting techniques arises if federal and/or state estate taxes at the surviving spouse's death are a potential issue. "Two-share planning" while the couple is still married will provide the best opportunity to reduce or eliminate the estate tax liability, regardless of whether the surviving spouse should remarry after the first spouse to die's death. Although the general rule for federal estate tax purposes is that titling assets in joint names and designating the surviving spouse as outright beneficiary of any IRA or 401k benefits may entitle the couple to a combined two estate tax exemptions, this "portability" benefit may not apply if the surviving spouse were to remarry. It may also not exist for state estate tax purposes, in states which still impose an estate tax. Finally, the "portability" rule does not apply to any appreciation in the first spouse's to die assets occurring after his or her passing and prior to the surviving spouse's passing, and it does not apply for federal generation-skipping transfer tax purposes.

Under the recommended "two-share" approach, at the death of the first spouse to die all or a portion of the assets allocated to his or her separate share will normally be held in a federal and state estate tax-exempt trust for the benefit of the surviving spouse (and, if desired, for the couple's descendants). Planning in this fashion assures two full federal and state estate tax exemptions for the family (i.e., even if the surviving spouse should remarry), and, unlike the "portability" plan, any appreciation in the value of the first spouse to die's assets which occurs after his or her passing is also removed from the surviving spouse's taxable estate.

IV

Maximizing After-Tax Social Security Benefits

THE debate here is not only about whether it is nominally better to begin taking Social Security benefits at normal retirement age versus age 70, or whether one spouse should take his or her Social Security at normal retirement age while the other should wait until age 70. If income tax consequences and the solvency of the Social Security system are ignored, and one assumes the spouses live to their projected life expectancies, the numbers will generally argue in favor of the spouse with the larger Social Security account waiting until age 70 to begin receiving his or her benefits, with the spouse having the smaller Social Security account taking Social Security benefits at "full retirement age."

Based on the above-discussed principles, however, we know that the analysis is not always this simple, at least in the situation of retired married couples. Pushing the start of Social Security benefits off until age 70, so that there will be a larger projected aggregate payout to the couple over time, also means that, on a projected basis, a greater portion of the couple's Social Security benefits will be payable after the first spouse dies, and will therefore be subject to the single filer penalty in the hands of the surviving spouse.

Bunching more Social Security benefits into the years after both spouses attain age 70 can also increase the tax bracket of the couple, including the surviving spouse. Deferring

Social Security benefits likewise eliminates the ability of the couple to invest the otherwise larger pre-age 70 payments into an investment which will grow with better tax characteristics, i.e., capital gain and dividend tax rates, and with the potential for income tax basis step-up at the death of the first spouse to die.

Finally, solvency issues with Social Security unfortunately cannot be ignored today. In years past Congress has chosen to change the way Social Security payments grow with inflation, and it has increasingly subjected Social Security payments to income tax. It only stands to reason that, in the not-too-distant future, additional changes to Social Security payments will be made which will not likely be to a couple's advantage. The old proverb, "a bird in hand is worth two in the bush," may be appropriate here.

Maximizing a retired couple's after-tax Social Security benefits also requires recognition of the couple's other sources of income, including both taxable and tax-deferred accounts, especially prior to the new age 73 (and eventually age 75) required beginning date for receiving IRA and 401k plan receipts. This is because, at very low levels of outside income (whether taxable or not), a couple's Social Security benefits start becoming taxable, with up to 85% of the receipts potentially being included in the couple's taxable income.

There are several different fact patterns which can come into play here, assuming the couple has accumulated a significant IRA balance. In the simplest of situations, a retired married couple, age 62, elects to take a much smaller amount of Social Security, early. In this situation in all likelihood the couple will need more funds to live off of, so utilizing other

sources of income will most likely come out of necessity, as opposed to by design. Further, the tax on 85% of a much lower Social Security benefit amount will likely have less than a significant impact, in the long run.

In the next situation we have a 66-year-old retired couple electing to take full Social Security at this point. The couple has little or no other outside income (other than the potential to take voluntary IRA withdrawals), and is able to live off of its Social Security. Under these facts it would at first blush appear to make sense for the couple to defer taking distributions from their IRAs until age 73. By doing so the couple will not only lock in the best situation possible with respect to the Social Security benefits they are receiving, earlier rather than later, but perhaps more importantly they will also avoid income taxes on seven years' worth of Social Security benefits.

The above-described Social Security benefit planning will mean more IRA benefits could end up being paid to the surviving spouse, however, subject to the single filer penalty previously discussed at some length. This higher potential income tax on the larger annual IRA receipts in the long-term will therefore need to be balanced against the zero or low-income tax on the total Social Security benefits in the short-term. It should also be remembered that, once the couple attains age 73 (or 75), when required minimum distributions will be forced upon them and their Social Security will become taxable regardless, they can then begin a plan of taking larger than required withdrawals from their IRAs prior to the passing of the first spouse to die, and still benefit (albeit to a lesser extent) under the analysis included earlier in chapters I and II.

What about the situation of a 66-year old couple that does have significant annual income other than IRA receipts, including nontaxable income -- enough to cause the maximum 85% of the couple Social Security receipts to be included in its taxable income each year? Would this couple benefit by taking voluntary early IRA withdrawals before age 73 (or75)? The answer should be yes, based upon our previous analysis. The only caveats to this answer are that, at higher levels of annual income (i,e., over $200,000 per year), the couple's Medicare premiums may be higher, in the short run,[4] and at even higher levels of annual income (i.e., over $400,000), the couple's hoped for income tax benefits may be marginalized.[5]

Lastly, what about the situation of a couple age 73, who is now obligated to begin receiving required minimum distributions from its IRAs? Should this couple consider taking additional voluntary withdrawals from their IRAs, and not worry about its effect on the taxability of their Social Security benefits? Subject to the caveats described in the immediately preceding paragraph, the answer again should be yes, based upon the analysis already included in this chapter.

It can be argued that the single filer penalty imposed on the surviving spouse will be offset by the fact that the surviving spouse's Social Security income may be a third or more less than what it was while his or her spouse was alive, and so the

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[4]See footnote 2 at page 13. Note, however, that the consequent lower levels of future income will cause the couple's Medicare premiums, especially those of the surviving spouse. to be lower.

[5]See the discussion at page 28.

surviving spouse's income tax will be reduced by the tax on 85% of this reduction. Although a true statement, this is not because of some special tax treatment for a surviving spouse, but rather because the surviving spouse is receiving less income. The reduction in Social Security benefits to the surviving spouse only adds to the negative impact of the single filer penalty the surviving spouse is forced to incur on his or her other taxable income, in other words, and is therefore another reason for working hard to minimize the single filer penalty, not the opposite.

The same principle applies if the couple has elected a joint and survivor pension benefit, which pays the surviving spouse only 50% of the joint benefit. The reduction in the pension benefits payable to the surviving spouse is just another reason to minimize the single filer penalty on the surviving spouse's other taxable income.

V

SECURE Act 2.0's Increase in the RMD Beginning Date: Gold Mine, or Tax Trap?

THE first SECURE Act extended the beginning date for taking RMDs from the year after the account owner attains age 70-1/2 to the year after the account owner attains age 72. Just three years later "SECURE Act 2.0" extended this age to 73, with a further provision which extends it again, to age 75, beginning in 2033. The question for financial advisors is whether these new "extensions" are a gold mine for their clients, or a tax trap, for married couples, at least.

The most important principle to consider here is the manner in which, as already described, Congress taxes married couples versus the manner in which it taxes single individuals. Except for the 37% bracket, the federal marginal income tax brackets for single individuals are reached at levels of income which are half as high as the levels for married individuals filing jointly, and the federal standard deduction for single individuals is half as high as that of married individuals filing jointly.

Assume, for example, 2023 tax brackets and standard deductions, and that these levels do not change in the future. Assume also that, under pre-SECURE Act 1.0 law, the RMD for the couple who attains age 70-1/2 this year would have been $89,450 (which equates to a combined IRA for the couple

of a little over $2 million). Assume also that the couple is retired, and has other taxable interest income during the year of $27,700, or exactly equal to the standard deduction for a married couple filing jointly. Under this not at all unusual scenario, the federal income tax liability to the couple, had they voluntarily withdrawn the $89,450 this year, would be $10,294, ignoring, at this point, taxable Social Security benefits received by the couple. Now assume the couple elects not to withdraw the $89,450 during 2023, and instead this same amount is withdrawn by the surviving spouse in a year after the first spouse passes. The surviving spouse's federal income tax liability, on the same $89,450 amount, would be $18,192, or almost 77% more than what the tax liability would have been had the couple not taken advantage of the new extension rules, again ignoring, at this point, taxable Social Security benefits received by the couple. Now multiply this almost $8,000 difference in federal tax liability by up to three years, beginning this year (or up to five years, beginning in 2033).

The point is that, for many couples, the surviving spouse will be subject to federal income taxes on IRA distributions at a rate which is higher than he or she would have been subject to while his or her spouse was still alive. Given the fact that some spouses survive their partner by 10 years or more, and the fact that RMD percentages increase as one gets older, the total difference in income tax liability can be considerable, before state income taxes are even considered. What is more, as a result of "SECURE Act 1.0," the couple's children are also likely to be taxed at a higher income tax rate on what is left in their parents' IRA when they both pass, because the children are likely to be in their peak earning years at that point, as a result of the new law's general 10-year maximum payout period applicable after the couple passes.

Finally, if IRA withdrawals are taken earlier rather than later by a married couple, the amount which the after-tax withdrawals appreciate to during the husband and wife's lifetimes will receive a potential "stepped-up income tax basis" as each spouse passes, thus completely eliminating all income tax on the appreciation. This is an important income tax benefit which does not apply to IRA receipts after the death of the account owner, and is one which Congress may have had in mind when it extended the beginning date for RMDs - not once, but two or three times now. Alternatively, because RMDs are not required until age 73, earlier than required withdrawn IRA amounts may be fully rolled into a nontaxable Roth IRA.

Even for a single individual (including a widow or widower), if one simply argues that the increased deferral will allow the IRA to grow more, i.e., because it has not been taxed yet inside of the IRA, it must be remembered that the counter arguments are that the increased growth may end up being taxed in a higher income tax bracket (either to the single person or to his or her family), and that the undistributed IRA amount will not receive any step-up in income tax basis when the single person passes.

Note also that the "tax bracket strategies" outlined above can be enhanced by taking withdrawals even earlier than the previous age 70-1/2 required beginning date, as long as the couple is retired at that point and not in a significant income tax bracket. The thought to remember here is that taking ever-increasing RMD amounts later in life will not only potentially increase the couple's federal income tax bracket, but will cause the "single filer penalty," discussed above, to come into play in the hands of the widow or widower spouse.

Income taxes on Social Security benefits also play a role in the analysis. For example, assume the couple in the above example waits until age 70 to begin withdrawing Social Security benefits, and that these benefits then work out to be $40,000 per year. Because the couple is receiving $27,700 in non-IRA taxable interest each year, they have $47,700 in so-called "provisional income," after including one-half of their Social Security benefits. Without explaining all of the technicalities of taxable Social Security income, this factor would reduce the tax advantage in the above example (i.e., of taking early withdrawals) by as much as 50%. If the couple were receiving $40,500 or more in non-IRA taxable interest, however, they would have already maxed out on the includability of their Social Security benefits in taxable income, so they would not be adversely affected by taking IRA distributions early.

As alluded to previously in this book, at higher levels of annual retirement income the above-discussed tax advantages of taking earlier than required IRA withdrawals can become marginalized. This is because taking earlier than necessary withdrawals can result in a significant increase in Medicare premiums at married couple income levels of over $206,000 per year (in 2022), for the year 2024.[6] Also, and as illustrated at pages 8-9, the difference in tax brackets of a married couple versus a surviving spouse narrows at income levels (before reduction for the standard deduction) of approximately twice this amount, or $414,000, estimated for the year 2024.

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[6]See the discussion at page 13, including footnote 2, for more background on this point.

Finally, in lower income situations and tax years where the couple may qualify for tax-free long-term capital gain and/or qualified dividend treatment on a significant amount, the couple may want to place a cap on the amount of their early IRA withdrawals, in order to preserve this significant short-term tax benefit. [See the discussion in chapter I.]

VI

Use of Roth IRAs and Life Insurance after the SECURE Act

AS already illustrated, from a pre- and post-death income tax planning perspective, the SECURE Act is all about tax brackets. If left unaddressed the result of the new law will likely be that the account owners' children will be forced to pay income tax on the account owners' IRA balances at death over a maximum of 10 years—years in which the children are likely to already be in their peak tax brackets, e.g., ages 55 to 65. The general recommendation for IRA and 401K account owners, once they retire (i.e., and are now in a low tax bracket), is for them to begin to "milk out" their IRA balances rather than (i) wait until age 73 (or 75) to begin withdrawing their balances, and (ii) after attaining age 73 (or 75), only withdraw the minimum required amounts each year—amounts which are typically very small until the account owners attain approximately age 85, when the tables are reversed.

Under the "retirement amortization plan," or "RAP," a retired married couple with no other taxable income other than Social Security can minimize overall tax brackets for themselves and their children if they, in effect, "amortize" the IRAs over their lifetimes plus 10 years (i.e., the children's maximum deferral period). Take, for example, a recently retired couple ages 62 for the husband and 59 for the wife, who estimate their joint life expectancy to be 30 years. They then add 10 years onto this (for the distribution period of their

children, under the SECURE Act), and attempt to amortize their IRAs equally over an approximate 40-year period.

Assume the couple's combined IRAs are worth $1,300,000. If the couple amortized this amount over 40 years, at a 5% interest rate, their annual withdrawals, as well as the total annual withdrawals of their children, would be approximately $75,000, which would keep the couple in the 12% federal marginal income tax bracket (under current law), assuming their other income, including the taxable portion of their Social Security, is $42,000 (or $45,000, if the couple were over age 65), and, more importantly, would minimize the federal marginal income tax brackets of their children. Exceptions to these general conclusions would occur if the couple's qualified dividends and long-term capital gains could be taxed at 0%, or if the their taxable Social Security benefits and other income turns out to be significantly higher. [See chapter I.]

The next question becomes how to invest the $75,000 annual withdrawal. Prior to age 73 (or 75), the couple could roll this entire annual amount into a Roth IRA. After attaining age 73 (or 75), however, only the portion of the IRA withdrawal that exceeds the couple's required minimum distributions for the year can be converted into a Roth IRA.

For purposes of this analysis, we will assume the couple can roll the entire annual amount into a Roth IRA over their remaining 30-year combined life expectancy and/or invest it in assets which will produce no annual income, only appreciation, e.g., a non-dividend paying equity portfolio and/or tax-exempt bonds. After 30 years, compounded at a 5% rate of return, the $75,000 annual contributions would grow to $5,232,059. If

either the husband or wife lives five years beyond their anticipated life expectancy, i.e., until age 97 for the husband and/or 94 for the wife, the $75,000 annual contributions would grow to approximately $7 million, again, all tax-free.

The couple's option would be to invest the $75,000 annual amount in income tax-free second-to-die life insurance, or one life insurance policy that does not pay out until both spouses die, and is therefore considerably less expensive than a policy on either spouse's life alone. Assuming the couple is in preferred health, the guaranteed income tax-free death benefit would be approximately $7 million.

The differences between the "Roth IRA investment plan" and the "second-to-die life insurance" investment plan are the following:

1. The Roth IRA investment plan is not guaranteed to produce the above-outlined tax-free results, which may be relevant to the couple in an unstable stock market.

2. Second-to-die life insurance can be guaranteed, and obviously produces an income tax-free windfall for the children if the parents should die before the expiration of the 35 years. This windfall can then be utilized by the children to help pay the increased income taxes on the larger IRA receipts as a result of their parents dying early. This represents an advantage of the second-to-die life insurance plan over the Roth IRA plan, i.e., in the event the couple should pass earlier than anticipated.

3. Unlike a Roth IRA, the cash value of the second-to-die policy will be small or non-existent if the goal is

to maximize the income tax-free death benefit to the children, so clients who feel they may need to access a significant portion of the policy's cash surrender value during their lifetime will generally want to utilize a second-to-die life insurance policy with a smaller death benefit amount and a larger lifetime cash surrender value.

4. If the couple outlives the longer 35-year joint life expectancy referred to above, the Roth IRA approach would normally have then been preferable, in hindsight, assuming the 5% lifetime rate of return is achieved.

The couple could choose to hedge their bets and invest some of the $75,000 annual amount in a Roth IRA and some of it in second-to-die life insurance. The key point is that, either way, what the retired couple has accomplished by this plan is to minimize the effects of the potentially very high income tax brackets of their children (because likely the IRA balance will need to be paid out during the children's peak earnings years) by "milking out" the couple's IRA balances during their retirement years and over their joint lifetime, at low tax rates, and transferring the withdrawn funds into a tax-free vehicle producing a reasonable rate of return.

If the death benefit of the life insurance is sufficient to cause federal or state estate taxes on the same, the couple will want to utilize an irrevocable life insurance trust to be the owner and beneficiary of the policy, in order to remove the policy's proceeds from the surviving spouse's taxable estate. Through the use of permissible loans, the irrevocable trust can be drafted in a fashion which will allow the couple to access the cash surrender value of the policy during their lifetime, without causing estate tax inclusion of the policy proceeds.

Potential Limitations on the RAP

The RAP could apply equally to an unmarried retired account owner, of course utilizing a single-life policy rather than a survivorship policy. A relevant factor in deciding whether to employ the RAP for an unmarried individual, however, is a single individual's tax brackets and standard deduction versus the tax brackets and standard deduction of any married children of the account owner. If filing as a single taxpayer causes the account owner to pay higher income taxes on the IRA or 401k distributions than his or her married children would pay, this of course should affect the amortization amount during the single account owner's lifetime.

Finally, note that the RAP generally does not apply to account owners who are living off of their IRAs or 401ks or who plan to live off the same when they are retired. It likewise may not fully apply to account owners who are or will be receiving other pension plan distributions or income sufficient to cause them to be in a significant income tax bracket, since the goal of the RAP is to minimize overall income tax brackets for the account owners and the account owners' children. Higher income situations will also bring into play the Medicare premium surcharges described at footnote 2 on page 13. Additional IRA withdrawals could cause the surcharges to be even higher.

VII

Dueling Approaches to Roth Conversions after the SECURE Act

FOR years financial and tax advisors have counseled their clients to make Roth conversions when deemed expedient, but typically not to the extent the same pushes the client into a higher federal income tax bracket. After the SECURE Act, does this strategy always still make tax sense?

Take, for example, this scenario: A couple, both age 65 and recently retired, have accumulated a combined taxable IRA of $2 million. They are expecting no other significant sources of retirement income, other than Social Security having a taxable portion assumed to be equal to their standard deduction amount. The couple estimates their current combined life expectancy at 20 years.

Especially given the likelihood of higher individual income tax rates beginning in the year 2026, if not earlier, common tax planning advice for this couple may be to withdraw taxable IRA funds earlier and to a greater extent than is required by the tax law, and then roll this amount (likely after tax, in this fact situation) either into a nontaxable Roth IRA, to the extent the amount withdrawn exceeds the required minimum distribution ("RMD") amount for the year, or into some other form of no-tax (e.g., life insurance or municipal bonds) or low-tax investments.

The question remains, however, what amount is the optimum annual amount to withdraw from the taxable IRA? There are two basic alternative approaches - the so-called "tax table approach," where the focus is on not causing the couple to be pushed into a higher current income tax bracket, and the so-called "amortization table approach," which ignores current income tax brackets and instead focuses on lowering the total income tax liability of the couple and their children, after the couple's death.

Under the "tax table approach," the couple may choose to voluntarily withdraw $89,450 per year (or about 4.5% of the initial IRA value) for the first 10 years, because this will keep them in the 12% federal income tax bracket, and out of the 22% bracket (applying 2023 tax brackets). After that (i.e., age 75), the couple will be forced to take the potentially larger RMDs.

The federal income tax on the withdrawals during the first 10 years (again assuming the taxable portion of the couple's Social Security equals their standard deduction amount) would be $10,294 per year, or approximately $103,000 over the 10-year period, assuming tax rates do not change and the couple is able to file jointly the entire period. Assuming a 5 percent gross growth rate (or 0.5% after the annual 4.5% distributions), the couple's taxable IRAs would be worth approximately $2,100,000 million after year 10. Again assuming a 5 percent gross growth rate, the total tax on the RMDs from year 10 through year 20 would be approximately $137,000, for a total tax on the IRA withdrawals under the tax table approach of approximately $240,000 during the couple's estimated 20-year life expectancy.

Under the "amortization table approach," the couple would instead add their 20-year estimated life expectancy to the 10-year maximum period over which the couple's children must withdraw the balance of the taxable IRAs after the couple's death, and "amortize" their taxable IRAs over 30 years. Assuming a 5 percent growth rate, equal annual withdrawals would be $128,837. The federal income tax on this larger amount would be $18,959 per year, or approximately $379,000 over the couple's estimated 20-year life expectancy, again assuming tax rates do not change and the couple is able to file jointly the entire period. The couple thus pays $139,000 ($379,000 - $240,000) more in income taxes under the amortization table approach than under the tax table approach.

Under the amortization table approach, the amount remaining in the taxable IRAs at the couple's projected death in 20 years will be approximately $1 million, while under the tax table approach the amount remaining in the taxable IRAs in 20 years will be approximately $2.1 million.

Now we need to compute the approximate annual withdrawal amount to the children after the couple's death, under each of the two approaches, assuming equal annual withdrawals over 10 years and a 5 percent growth rate. Under the 30-year amortization table approach, these annual withdrawals (on the approximately $1 million starting base) would be $127,279. Under the tax table approach, these annual withdrawals (on the approximately $2.1 million starting base) would be $280,013.

Now assume the couple has one child, and that this child's annual taxable income, excluding the equal IRA

payments, but factoring in the child's standard deduction and itemized deductions, is $150,000. The child's total annual taxable income during the 10-year payout period would be $277,279 under the amortization table approach and $430,013 under the tax table approach.

Assuming 2023 tax tables and that the child's tax status is married filing jointly (and ignoring for this purpose any potential tax on Social Security payments), the child's annual tax liability would be $53,347 under the amortization table approach (or $533,470 total, over 10 years) and $95,268 under the tax table approach (or $$952,680 total, over 10 years), a difference of $419,000 over 10 years. This amount must then be compared to the $139,000 lower lifetime tax amount of the tax table approach versus the amortization table approach, for a net tax savings in favor of the amortization table approach over the tax table approach, over the entire 30 years, of $280,000. This tax savings could be even larger if the child was in a higher income tax bracket.

It can be argued that, while this tax savings in favor of the tax amortization table approach is substantial, it does not reflect the time value of the loss use of the $139,000 additional tax payments during the lifetime of the couple. However, this potential loss in the time value of money must be balanced against the potential that one of the two spouses will die some years before the other, so by not withdrawing the additional amount earlier, when the couple's tax bracket was as little as half the tax bracket of the widow or widower, these two competing factors can be viewed as essentially cancelling each other out. [See the discussion in chapter V.] Also remember tax rates could rise in the future, so withdrawing a larger amount earlier may also be beneficial from this perspective.

At higher levels of retirement income, the above-outlined tax advantages of the amortization table approach to withdrawing IRAs over the tax table approach can become marginalized. As already described, this is because taking earlier than necessary IRA withdrawals can result in a significant increase in Medicare premiums at levels of annual retirement income which exceed $206,000 (reportable in 2022, for 2024 tax years) for married couples.[7] Also, and as illustrated at pages 8-9, the difference in tax brackets of a married couple versus a surviving spouse begins to narrow at levels of income over $400,000, as, obviously, does the potential difference in tax brackets between the couple and their children.

The numbers can obviously be run a variety of ways, and of course there are countless different client fact patterns. The purpose of this chapter is merely to illustrate that traditional Roth conversions strategies need to be challenged in light of the SECURE Act, to ensure that families are not foregoing a significant potential family income tax savings by not exploring all of the Roth conversions approaches available to them.

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[7] See the discussion at page 13, including footnote 2, for more background on this point.

VIII

Tax Leveraging Retirement Savings for Long-Term Care Needs

IT will be an unusual circumstance when a married couple will be in a position to convert all of their regular IRAs and/or 401k accounts to Roth IRAs or to tax-free life insurance during their joint lifetime. There will thus be a portion of these accounts which will remain. This is the portion which can be best utilized if long term custodial care costs for the couple or the surviving spouse should arise. Subject to the annual 7.5% floor for the deduction for medical expenses, either spouse's long term custodial care costs can be paid using taxable IRA and/or 401k plan proceeds. In the case of costs incurred by a surviving spouse, this will also help mitigate the single filer penalty by reducing the surviving spouse's taxable income.

For the reasons outlined in chapter III, taxable IRAs and 401k accounts should usually be utilized by the couple, at least while they are married, before generating unnecessary capital gains taxes on taxable investments, taxable gains which would have been wiped out by the step-up in income tax basis at the owner's passing. This same general principle should also apply after the first spouse dies, provided the surviving spouse is in a lower income tax bracket then his or her children are likely to be, or if the surviving spouse will use the proceeds of these accounts to pay tax deductible long-term care expenses. If only appreciated taxable investments remain in the surviving

spouse's estate, however, these investments can be liquidated by the surviving spouse, largely income tax free, if the proceeds are used to pay tax deductible long-term care expenses.

Because potential tax-deductible long-term care costs are speculative, however, the planning outlined in this chapter should certainly not be a married couple's sole plan for minimizing income taxes on their IRAs and 401k plan accounts. Nevertheless, this planning may end up being a convenient way to "soak up" some of the balance of the couple's regular IRAs and 401k accounts which they were not able to convert to Roth IRAs or other lower taxed accounts during their lifetime.

IX

Planning Opportunities When Beneficiaries are in Dissimilar Tax Brackets

THERE are a number of alternatives the client can consider in order to mitigate the adverse effects of the SECURE Act after his or her death, and in particular the rule which requires generally that non-spouse beneficiaries withdraw the balance in the owner's IRA or 401k account over 10 years after his or her death. One such alternative, when the account owner's beneficiaries are in dissimilar tax brackets, is to pay all or a larger portion of the account owner's IRA or 401k benefits to the lower income tax bracket beneficiaries. The theory and goal here is that, if we must live with the adverse effects of the SECURE Act, we can at least minimize this adverse impact by planning for the disposition of the IRA or 401k owner's accounts in a "tax-wise" manner.

To illustrate the significant potential income tax savings associated with this tax-wise IRA planning technique using sample numbers, assume that an individual has two children, A (in a 20% combined federal and state marginal income tax bracket) and B (in a 40% combined federal and state marginal income tax bracket), and an estate consisting of a $1 million IRA and $1.5 million in cash, investments, real estate and life insurance proceeds. Instead of leaving the IRA equally to A and B, the individual might decide instead to leave the $1 million IRA all to child A, with $1 million worth of cash, investments, real estate and life insurance held outside of the IRA to child B. Assuming the children's marginal income tax

brackets remain the same after the account owner's passing, this single step will lower the aggregate federal and state income tax liability on the $1 million IRA from $300,000 to $200,000, or by one-third. Stated another way, the family's income taxes would be 50% higher if they did not utilize the tax-wise IRA planning technique in this situation.

Ancillary Benefits and Drafting

The plan also ensures that each child receives the same approximate amount, after taxes. It accomplishes this by including compensating adjustments in the owner's estate planning documents for the facts that (i) IRA proceeds are made payable to the owner's beneficiaries in unequal percentages, and (ii) the owner's beneficiaries who receive the IRA proceeds will eventually need to pay federal and state income taxes on the same. This necessitates a careful review of the account owner's financial situation to ensure that there is a sufficient amount of "non-IRA" assets to make the compensating adjustments.

The September, 2023 issue of *Estate Planning* includes a sample trust form attorneys can utilize to not only make the compensating adjustments in the account owner's estate planning documents, but also to determine whether the account owner possesses sufficient non-IRA assets to ensure the adjustments. The form operates under the assumption that the typical IRA beneficiary after the SECURE Act will elect to spread the IRA payments equally over the 10 years after the account owner's death, in order to lower the beneficiary's aggregate income taxes.

Drafting and Ancillary Benefits in Action

In order to illustrate the operation of the trust form included in the *Estate Planning* article, assume that the account owner has three children, A, who is in the 20% marginal federal and state income tax bracket, B, who is in the 30% marginal tax bracket, and C, who is approximately in the 40% marginal tax bracket. Assume also that owner has a $1 million IRA account and approximately $1 million of other assets, including a home, taxable savings, and life insurance. Seeing that child A is in a much lower income tax bracket than child C, while child B is in the middle, and recognizing that the owner has only $1 million worth of non-IRA assets in which to make the compensating adjustments called for above, the account owner elects to pay 70% of the IRA to child A, 30% to child B, and 0% to child C. Applying the article's included formula, of the account owner's $1 million in non-IRA assets, child A will receive $30,000, child B will receive $380,000, and child C will receive $590,000, or a total of $1 million.

While it appears in the above example that children A and B are each receiving less than child C, when the addition of the after-tax value of the IRA to each such child's share is factored back into the equation, each child receives an equal amount of $590,000. The total income tax to the children will be $230,000, as compared to the 30% more $300,000 amount if the IRA was allowed to pass equally to the three children. If the value of the account owner's IRA turns out to be twice the $1 million amount, the dollar amount of the income tax savings would be approximately double, and similarly if the IRA is even larger. This income tax savings is all accomplished automatically under the trust form, based upon the marginal

income tax brackets of the children at the time of the account owner's death.

As alluded to above, the *Estate Planning* article's included sample form also has as a goal treating each of the account owner's children equally, after-tax. Had the account owner instead elected to distribute the $1 million IRA equally to his three children, obviously child C would end up receiving much less than child A, after-tax, because child C is in twice the marginal income tax bracket of child A. Unless there is some other underlying factor which causes the account owner to want to treat his children in a dissimilar fashion, when asked most account owners state that they desire that their children receive equal inheritance amounts from their estate, after taxes. If an account owner does desire to treat his children in a dissimilar manner, then the above formula clause will need to be modified in order to dovetail with the account owner's specific intent.

It should be noted, again, that the account owner needs to have sufficient non-IRA assets in order to make the compensating adjustments describe above. Thus, if it is determined that there are insufficient non-IRA assets for a 70%-30%-0% split of the IRA, the account owner might instead opt for a 50%-40%-10% split. Although the income tax savings may not be 30% with this more compressed split, or as great as the 50% figure in the initial example set out above, it will still be substantial.

Additional Trust Drafting and Ongoing Monitoring Needed

The above discussion assumes that, when IRA, etc. proceeds are made payable to a trust for the beneficiary rather than to the beneficiary outright, the trust is specially drafted utilizing Section 678 of the Internal Revenue Code, which section causes the trust beneficiary, rather than the trust itself, to be taxed on the IRA proceeds. If the trust is not drafted in this manner, then it will not be possible to take advantage of the trust beneficiaries' dissimilar income tax brackets and still preserve the underlying purposes of the trust, since all trusts are taxed based on the same highly compressed federal income tax brackets. For the attorneys, the advanced planning and forms in this area are all included in my August and October, 2022 *Estate Planning* articles.

The children's or other beneficiaries' optimum percentage interests in the "IRA portion" of the account owner's estate will obviously be subject to change over time, including for reasons such as their future relative income tax situations, anticipated retirement ages, future tax laws, etc. This analysis will become part of the account owner's regular periodic updates of his or her estate plan. Given the significant tax saving possibilities involved, and the fact that periodic estate planning update meetings are always highly recommended in any event, these extra sessions with the estate planning attorney present a minor inconvenience, at worst.

X

Postmortem Tax Planning for IRA and 401k Distributions after the SECURE Act

THE SECURE Act has changed the way certain beneficiaries will need to think about receiving their IRA and 401k proceeds. Previously these beneficiaries had their whole lives to remove those proceeds. Now they have to do it 10 years, and these more concentrated distributions from IRAs and 401ks could throw them into higher tax brackets. The new law means that IRA and 401k beneficiaries and their advisors will need to be on the alert after the IRA or 401K participant/owner passes. The individual's estate planning file—especially his or her home or safekeeping file—needs to be carefully flagged with a bold notation for the beneficiaries to seek the advice of a competent tax advisor before they make any decisions about the withdrawal of funds from IRAs and qualified plans after the participant/owner's passing.

Let's assume, for example, that the participant/owner dies when his or her three children range in age from 55 to 63. Under this common scenario, how should the children be advised if they would like to minimize the otherwise harsh effects of the SECURE Act?

The key factor, as always, will be income tax brackets. Assume, for example, that the 63-year-old child is two years from retirement. It's very likely, then, that it will be wise for this child to defer taking any distributions (except to the extent

the law requires the child take minimum distributions because his parent was already beyond his required beginning date at the time of his death) for the two years while the child is still drawing a salary, and when extra income from an IRA can pump up the child's income tax bracket. After retirement, the now 65-year-old child would take one-eighth of the IRA balance as a distribution each year.

Now let's take the 55-year-old child. Assume that the child is "about 10 years" from retirement. It's very likely then, that it will make sense for the child to the spread the IRA proceeds equally over the entire 10-year period, in order to lower his or her overall tax bracket. This approach may also cause a lesser amount of the child's future Social Security payments to be taxed and the child's future Medicare premiums to be lower.

If a child has children of his own who may be in their early working years (and not subject to the so-called "Kiddie Tax"), it may make sense for the child to disclaim all or a portion of the IRA proceeds so that they will then be spread among more taxpayers—taxpayers who are likely to be in lower income tax brackets than the child who would otherwise receive the proceeds.

If a "minor" child or trust for a minor child is a direct beneficiary of an IRA or 401k, it may make sense for the child or trust to take distributions more rapidly than the law requires, because of the child's lower income tax bracket at the time versus what it may be in the future, subject to the potential application of the Kiddie Tax if either or both of the child's parents is/are then living.

The postmortem planning strategies eventually become apparent: With the advent of the new accelerated post-death distribution rules for IRAs and other qualified plan benefits in the hands of most non-surviving spouse beneficiaries, all options for withdrawing the proceeds should be considered if the non-surviving spouse beneficiaries wish to minimize their total income tax liability on the distributions.

XI

Paying IRAs and 401Ks to Trusts; Examining Ed Slott's New Stretch IRA

ED Slott's 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, from this point on the article succumbs to several overgeneralizations regarding estate planning with IRAs, and the use of trusts. In the first place, life insurance is not the new stretch IRA. As already illustrated in this book, life insurance has always played an important role in tax and estate planning for IRAs, but it is not the "new stretch IRA." Individuals should not be mislead 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, as discussed already in this book, it is definitely recommended that retired individuals consider annually "milking out" a portion of their IRAs, at lower income tax rates, 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" in this fashion, without first carefully examining the after-tax math associated with each individual plan.

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 this passage from the article to see if it is 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 prior to retirement, 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? Again, 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.

Mr. Slott states 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.

Mr. Slott then concludes 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. As discussed in detail in my August and October, 2022 *Estate Planning* articles, the beneficiary of a trust, including a grandchild, 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.

Mr. Slott's 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, Mr. Slott's February, 2020 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.

The statements made in Mr. 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."

The statement, "Any funds retained in the trust though would be taxed at high trust tax rates," again is an overgeneralization about how trusts are taxed for federal income tax purposes. As discussed in my August and October, 2022 *Estate Planning* articles, 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.

This "power of withdrawal approach" will also help avoid proposals like the 2021 Build Back Better Act's 5% and 8% surtaxes on trust taxable income levels in excess of $200,000 and $500,000, which levels of income will be more likely achieved as a consequence of the SECURE Act's post-death 10-year payout rule.

Accumulating IRA and qualified plan distributions inside of a trust may become even more important with the larger federal estate tax exemption scheduled to sunset at the end of 2025, if not earlier. Paying a portion of IRA and qualified plan distributions to a bypass trust may be an important way to not

only maximize the estate tax exemptions available to a married couple, but also to maximize the couple's generation-skipping transfer tax exemptions, in order to minimize estate taxes on the IRA proceeds for future generations.

As discussed in the following chapter, it may actually also make income tax sense to accelerate some of the IRA and qualified plan receipts by paying the same to a bypass trust for the surviving spouse. Paying a portion of the IRA and qualified plan receipts to a bypass trust over a 10-year period may reduce the overall income taxes of the surviving spouse and children, by reducing the RMDs the surviving spouse will need to take later in life from the "outright portion" of the IRA or qualified plan interest, as well as the amount which the children will need to withdraw over the 10 years after the surviving spouse's death.

XII

Estate Planning for Married Couples' IRAs and 401ks

THE scheduled 50 percent reduction in the size of the federal estate tax exemption in the year 2026 has caused a renewed interest in estate planning for IRA and 401k accounts owned by married couples. For married couples owning significant IRA and 401k accounts, the question is whether the couple should now consider paying all or a portion of the same to a so-called "bypass" trust for the benefit of the surviving spouse, in order to remove the designated portion of the IRA or 401k proceeds from the surviving spouse's taxable estate, as well as to achieve certain other non-tax objectives.

Limitations of the Spousal Portability Election

In 2013 Congress permanently passed into law what is known as the portability election for assets passing outright to a surviving spouse at the first spouse to die's death. Portability allows a surviving spouse to use the unused federal estate tax exemption of the deceased spouse, thus claiming two estate tax exemptions. Given the obvious beneficial aspects of this now 10-year old law, why is there any longer a need for a married couple to consider utilizing a bypass trust in their estate planning?

There are actually at least five such reasons:

1. The portability election will not remove appreciation in the value of the "ported" assets from the surviving spouse's taxable estate, whereas a bypass trust will remove all appreciation;

2. The portability election will not apply (at least as to the first spouse to die's estate tax unused exemption) if the surviving spouse remarries and the new spouse predeceases him or her, whereas remarriage of the surviving spouse is irrelevant in the case of assets transferred to a bypass trust;

3. The portability election will not apply for federal generation-skipping transfer tax purposes, meaning that the amount which could have passed to an estate and generation skipping transfer tax-exempt bypass trust, including all appreciation in the value of the same, will now potentially be subject to federal transfer tax in the children's estates;

4. Utilizing the portability election will cause the "ported" assets to be subject to potential lawsuits against the surviving spouse as well as to the potential claims of a new spouse, whereas lawsuits and claims against a surviving spouse will be avoided if a bypass trust is utilized; and

5. Utilizing the portability election will result in the first spouse to die losing the ability to control where the "ported" assets pass at the surviving spouse's death, control which could have been retained had a bypass trust been used, instead.

The Traditional Bypass Trust as an Alternative

In light of the above-described limitations of the spousal portability election when compared to so-called "bypass trust

planning," whereby married couples divide their assets in some fashion so that, at the death of the first spouse to die, all or a portion of his or her separate assets pass to an estate tax-exempt trust for the survivor, bypass trust planning is obviously still in play after 2013. The question is: are bypass trusts an appropriate receptacle for IRA and 401k plan proceeds given that, after the SECURE Act, these trusts are generally subject to a 10-year maximum payout rule, whereas the outright payment of IRA and 401k plan proceeds to a surviving spouse is entitled to spousal rollover treatment, and therefore greater income tax deferral? Further, bypass trusts are generally subject to the highest federal income tax rate at levels of gross income of as low as only $14,450 (for 2023 tax years), include an exemption of only $100, and do not qualify for income tax basis step-up at the surviving spouse's death.

It is a simple matter to dispatch with the last issues mentioned. Judicious use of Internal Revenue Code Section 678 in the drafting of the bypass trust will generally eliminate the relevance of high trust income tax rates, as well as the minimal exemption, because the trust is not even taxed to the extent the surviving spouse is taxed instead, under Section 678. What is more, utilizing Section 678 of the Internal Revenue Code will cause the estate tax exempt bypass trust to be unreduced by the annual income taxes which are payable by the surviving spouse, thereby further buttressing its importance in estate planning for married couples. [For more information on these subjects, see the discussion in my August and October, 2022 *Estate Planning* articles.]

Finally, a so-called "conditional general testamentary power of appointment" can be included in the terms of the bypass trust, which inclusion can oftentimes result in income

tax basis step-up for all or a portion of the appreciated assets in the trust at the surviving spouse's death. [See the discussion in Chapter XIII.]

As far as the loss of greater income tax deferral when IRA or 401k plan proceeds are paid to a bypass trust versus outright to the surviving spouse, the question becomes whether having the surviving spouse maximize income tax deferral on the IRA or 401k proceeds always makes economic sense after the SECURE Act, given the demise of so-called "stretch IRA" treatment to the children at the surviving spouse's passing. Observing that the children will likely be in their highest income tax brackets when the surviving spouse passes, and will now need to add the IRA or 401k plan proceeds to their peak taxable incomes over a maximum period of 10 years, it could actually turn out to be that, by intentionally choosing not to maximize income tax deferral of the IRA and 401k plan proceeds after the death of the first spouse-to-die and before the surviving spouse's death, overall income taxes to the family will be reduced.

The "after-tax math" will obviously be different in each estate planning situation. The estate planner will need to be cognizant of (i) the likely size of the IRA or 401k plan account at the first spouse-to-die's death as well as at the surviving spouse's passing, (ii) the likely tax situation of the surviving spouse, (iii) the likely tax situations of the couple's children after the surviving spouse's death, and (iv) the number of children who will be dividing the IRA or 401k plan proceeds at the surviving spouse's death, and therefore the amount of IRA or 401k plan proceeds each child will receive, to be taxed to each of them over 10 years.

The age of the surviving spouse will also be a relevant factor. For example, if the surviving spouse will already be at least age 73 (or 75, beginning in 2033), the income tax deferral benefits from a spousal rollover will not be as significant as they would have been if the surviving spouse was, say, age 55.

It may also make overall sense in a given situation to pay a portion of the IRA or 401k plan proceeds to the bypass trust, and a portion to the surviving spouse outright. Assuming the IRA or 401k plan administrator makes it available, use of a beneficiary designation which will allow for a full or partial disclaimer by a surviving spouse, in favor of a bypass trust, would also be an excellent estate planning tool here, due to the flexibility the technique affords.

XIII

IRS Offers Favorable Post-Death Income Tax Strategy For IRA And 401k Accounts

A common estate planning strategy, which can save federal and state death taxes, protect assets from the rights of a divorced spouse, and insulate assets from lawsuits, is to pay IRA and/or 401k accounts to a trust for the lifetime benefit of the account owner's spouse and/or children. With special drafting, it is also possible to have the income of the trust taxed at the spouse's or children's usually lower federal income tax rates, rather than at the typically much higher federal income tax rates imposed on trusts. Up until the Internal Revenue Service issued its proposed regulations in late February, 2022, however, it was uncertain whether it was possible to draft a trust so that, in addition, income taxes are saved at the death of the spouse or children, when the trust assets pass to the next generation of beneficiaries.

Prior to the issuance of the proposed regulations in early 2022, sometimes referred to as the "SECURE Act proposed regulations," it was commonly thought that, in order to achieve maximum income tax deferral when IRAs or 401k accounts are made payable to an "accumulation trust," or a trust which authorizes accumulation of the IRA and/or 401k plan receipts for the above-mentioned estate tax savings, divorce protection, and lawsuit protection reasons, there had to be a trade-off. The persons or trusts that took the balance of the trust assets when the spouse or child died would be required to receive a "carryover" federal income tax basis in the IRA or 401k

proceeds which were reinvested in other assets, equal to the historical cost basis of the assets, rather than a "stepped-up" income tax basis equal to the fair market value of the trust assets at the time of the spouse's or child's death. As a consequence, when the trust assets were later sold after the death of the spouse or child, there could be significant income taxes to pay.

Assuming this aspect of the proposed regulations is finalized in its current form, the IRS will now allow maximum income tax deferral for the IRA or 401k accounts which are made payable to the accumulation trust (which maximum deferral period could be either for the lifetime of the trust beneficiary or for up to 10 years, depending on the purpose and structure of the trust), and will simultaneously permit the income tax basis of all or part of the trust assets which were purchased with the IRA or 401k proceeds to be adjusted to the fair market value of the assets at the spouse's or child's death. The technical reason for this is that the IRS has announced in its proposed regulations that a technique estate planning attorneys utilize to create this result (sometimes referred to as a conditional testamentary general power of appointment) will not affect the maximum income tax deferral period on IRA and 401k accounts made payable to an accumulation trust.

In higher net worth situations, the income tax basis adjustment at the spouse's or child's death may be limited, but, if the trust instrument is properly structured, in most situations the income tax basis adjustment will be significant, if not full. Also significant is the fact that, in so-called "multi-generation trust" situations, this same federal income tax basis adjustment at each generation can continue for hundreds of years, if not forever, as discussed in the immediately succeeding chapter.

XIV

Multi-Generation Trust Planning under the SECURE Act Proposed Regulations

THE purpose of this chapter is to examine how well perpetual or multi-generation trusts fit with the SECURE Act Proposed Regulations issued in early 2022, and to explore various drafting opportunities in light of the release of the same.

A Typical Multi-Generation Trust Example

In an effort to examine how well a typical multi-generation trust operates under the Proposed Regulations, let's examine a typical multi generation trust we use in estate planning. (For purposes of this chapter we will only use examples which do not involve an "eligible designated beneficiary trust" under the SECURE Act.) Normally if the clients have two or more children, a separate trust is established for each child and the child's own descendants, with the remainder as each child passes held in separate trusts for the child's own children and their respective descendants, etc. If a child and all of his descendants should die out, the remaining trust assets pour over into the trusts for the benefit of the clients' other children and their descendants, etc. If all of the client's descendants should die out, the remaining assets of the "survivor" trust then typically pass to one or more other individual beneficiaries and/or to charity (the "contingent taker"). Lastly, each child or remote descendant will typically have been given a combination of limited and/or general

testamentary powers of appointment over the assets remaining in his trust at the time of his death.

As illustrated in my August, 2023 *Estate Planning* article, this typical perpetual or multi-generation fact pattern fits very well with the SECURE Act proposed regulations, having primarily in mind the goal of achieving the maximum available 10 years in deferral for the post-death required payout of the clients' remaining IRA and/or 401k accounts. Although the below discussion is somewhat technical, it is nevertheless important if the goals of multi-generation trust drafting (e.g., the minimization of estate taxes and the avoidance of potential claims of creditors and a divorced spouse) are to be achieved, without causing the trust beneficiaries undue income taxes.

Multi-Generation Trust Drafting

Charity as Contingent Taker. What does this all mean for multi-generation trust drafting? One would think that, in most circumstances, ensuring that charity is designated as the contingent taker in the case of a multi-generation trust would probably be low on the priority table of most clients establishing these types of trusts, i.e., because of the low probability the contingent gift will ever become effective. If the client nevertheless wants to ensure that charity would take under the contingent gift clause, but also wants to defer income tax on his IRAs, etc. for as long as possible, and with the greatest flexibility possible regarding how much of the IRAs, etc. must be withdrawn each year, the client would have the following options, depending upon whether he is already beyond his required beginning date, and depending upon whether the drafting attorney agrees with my August, 2023

Estate Planning article analysis concluding that the charity's contingent interest should be disregarded in determining the designated beneficiary of the trust, and therefore 10-year deferral automatically applies:

1. Assuming the client is already beyond his required beginning date, and the drafting attorney does not agree with my analysis, the client and attorney may simply allow the trusts to be treated as disqualified (i.e., because charity is not a permissible beneficiary), and allow the IRAs, etc. to be paid out over the client's remaining life expectancy. As long as the client is age 82 or younger, this period will be 10 years or longer. If the client is over than age 82, however, this option may prove to be undesirable. Life expectancy drops to five years at age 92, for example.

2. If the client is already beyond his required beginning date and chooses not to proceed under option 1, his two options would be to either (a) rely on the analysis outlined in my August, 2023 *Estate Planning* article as to why 10-year deferral applies, with annual payments during the 10-year term based on the oldest, not disregarded, designated beneficiary of the trust's life expectancy, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to charity, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.

3. If the client has not reached his required beginning date his two options would be to either (a) rely on my analysis as to why 10-year deferral applies, with no annual payments required during the 10-year term, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from

the client's other assets, not allowing the "IRA trust" to pass to charity, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.

4. A final option which is available under the Proposed Regulations, but arguably not prior to the issuance of the same, is to provide in the client's trust document that, in the case of any trust beneficiary who at the time is the last descendant of the client then standing, it is the client's desire that said beneficiary designate X Charity as appointee under a testamentary power of appointment in the beneficiary, at least to the extent a surviving spouse of the beneficiary or any other desirable appointee is not designated. Because permissible appointees are disregarded for trust designated beneficiary purposes under the Proposed Regulations, this option may provide a potential solution if the drafting attorney does not agree with my analysis regarding why the charity's contingent interest should be disregarded.

Individuals as Contingent Takers. If the contingent gift is to an individual or individuals, rather than to charity, and the client desires the longest deferral period possible, and with the greatest flexibility possible regarding how much of the IRAs, etc. must be withdrawn each year, he would have the following options, again depending upon whether he is already beyond his required beginning date, and upon whether the drafting attorney agrees with my August, 2023 *Estate Planning* article analysis regarding why the individuals' contingent interests should be disregarded in determining the designated beneficiary of the trust:

1. Assuming the client is already beyond his required beginning date, and the drafting attorney does not agree with

my August, 2023 *Estate Planning* analysis disregarding individual contingent takers from the trust designated beneficiary determination, the client and attorney may simply allow the trust to be treated as disqualified (e.g., by not complying with the Proposed Regulations' post-death "documentation requirements"), and allow the IRAs, etc. be paid out over the client's remaining life expectancy. As long as the client is age 82 or younger, the period will be 10 years or longer. If the client is over than age 82, however, this option may prove to be undesirable. Life expectancy drops to five years at age 92.

2. If the client is already beyond his required beginning date and chooses not to proceed under option 1, his two options would be to either (a) rely on my analysis as to why 10-year deferral applies, with annual payments during the 10-year term based on the oldest designated beneficiary of the trust's life expectancy, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to any heir older than his oldest child, and with a potential adjustment in the "non-IRA trust" for the elimination of the older heirs' shares of the IRA trust.

3. If the client has not reached his required beginning date his two options would be to either (a) rely on my August, 2023 *Estate Planning* analysis as to why 10-year deferral applies, with no annual payments required during the 10-year term, or (b) draft the trust instrument so that IRAs, etc. are held in a separate trust from the client's other assets, not allowing the "IRA trust" to pass to any heir older than his oldest child, and with a potential adjustment in the "non-IRA trust" for the elimination of the charity's share of the IRA trust.

4. A final option if the drafting attorney does not agree my August, 2023 *Estate Planning* analysis would be to treat the individual contingent taker heirs as counting for designated beneficiary purposes, but limit the ages of the individual contingent takers to a specified age. For example, the client could limit the category of heir-at-law takers under the contingent gift to individuals no older than the client's oldest niece or nephew living at the time of his death, assuming the client has a niece or nephew then living. As long as the client's oldest niece or nephew is no older than age 82, annual payments during the 10-year deferral period should be no more than 1/10th per year, if the client was beyond his required beginning date, and zero, otherwise.

If the client only has one child, but also has at least one grandchild at the time of his death, results similar to those outlined above can be achieved provided the grandchildren are not current beneficiaries of the trust for the child's benefit during the child's lifetime, i.e., they are only secondary beneficiaries of the trust who have no current interest in the trust during the child's lifetime. Assuming my August, 2023 *Estate Planning* analysis is correct, under the Proposed Regulations the 10-year deferral rule should apply.

If the client has only one child, but no other descendants at the time of his death, the contingent takers after the death of the child are not going to be treated as remote, and therefore will be considered in determining the designated beneficiaries of the trust. It will therefore be impossible to achieve 10-year deferral if charity is the contingent taker, unless the two-share approach outlined above is employed. If the contingent takers are individuals, the age of oldest such individual (if older than the client's child) will be used for denominator purposes if the

client dies after his required beginning date, which brings into consideration the above-outlined strategy of potentially limiting the age of the contingent takers.

Other Trust Drafting Recommendations

The planning outlined in this chapter thus far will turn out to be of very little consequence if it is not coupled with a strategy for taxing the income of the trust at the individual beneficiaries' tax rates, rather than at the compressed federal income tax brackets of the trust. Because distributing out the IRA, etc. income to the trust beneficiaries will of course defeat the purpose of multi-generation trust planning, Section 678 of the Internal Revenue Code must be utilized if the planning outlined in this article is to have any real benefit. The general techniques for utilizing Section 678 are outlined by me in the August and October, 2022 issues of *Estate Planning*, including specifically as they apply after the issuance of the Proposed Regulations.

Finally, because the existence of potential appointees under a power of appointment are considered not to be a tax deferral problem under the Proposed Regulations, if the trust is properly drafted income tax basis step-up at the beneficiary's death can now be achieved for all or a portion of the reinvested IRA, etc. proceeds payable to the trust after the account owner's death, through the employment of a general testamentary power of appointment. Previously it was necessary to establish two shares for each beneficiary in order to accomplish this objective, an "IRA share" and a "non-IRA share," and it was generally impossible to achieve income tax basis step-up for the IRA share. Furthermore, the clients can now include their descendants' surviving spouses as

permissible appointees by their descendants, without having to concern themselves with the potential ages of the spouses. [See chapter XIII.]

A Great Fit

Unlike the situation which existed previously when the client's interest in an IRA or 401k plan was made payable to a perpetual or multi-generation trust, the Proposed Regulations now specifically allow for the ready removal of contingent takers and other remote interests (including charity) from consideration in determining the designated beneficiary of the client's interest in the IRA or 401k plan account, and therefore allow for full 10-year deferral. Furthermore, by specifically authorizing the use of powers of appointment without causing a designated beneficiary problem, the Proposed Regulations allow the client to permit the beneficiary to appoint trust assets to, say, charity or a surviving spouse (regardless of age), without disturbing full 10-year deferral. The beneficial clarification regarding the use of powers of appointment also enables the drafting attorney to strategically and simply utilize general testamentary powers of appointment to minimize capital gain taxes at each succeeding generation, including gains on the reinvested proceeds of IRAs or 401k plan accounts made payable to the trust. All told, the Proposed Regulations appear to be a great fit for multi-generation trust planning.

XV

The IRA/Charitable Remainder Trust

ALL not-for-profit planned giving officers are familiar with the significant income tax advantages available when donors contribute all or a portion of their taxable IRAs to charity when they pass. The only difficult selling point to the donors is that, although this technique will turn an otherwise fully taxable IRA into a completely tax-free asset, and therefore net the charity and the donors' family, as a group, more after-tax resources, the donors' family itself receives no financial benefit when charity is named as beneficiary of the donors' IRA. Wouldn't it be great if, instead, the donors could leave all or portion of their IRAs to charity, without costing their family a penny, and potentially even put their family in a better place, financially, than they would have been, otherwise? Today that goal may actually be achievable, as a direct consequence of the SECURE Acts of 2019 and 2022, as well as the IRS' 5.4% Section 7520 interest rate for the month of October, 2023, a rate which is a full five percentage points higher than in was in November, 2020, and still rising. Let's explain.

Impact of the SECURE Acts and Higher Interest Rates

The significant adverse income tax aspects of the SECURE Act are that it not only shortens the period over which the clients' children may defer income taxes on the donors' IRA and/or 401k plan accounts after the clients' death, from the children's lifetimes to 10 years, but, in most

situations, it also requires withdrawal of the IRA proceeds by the clients' children over the 10 years when they are likely to be earning their peak incomes, i.e., ages 55-65, and are therefore in their highest income tax brackets.

Especially because "SECURE Act 2.0," passed in late 2022, will eventually change the required beginning date for the children to withdraw their own IRA and/or 401k plan benefits to age 75, it would have been far better, from the children's perspectives, had Congress allowed them to take at least half of the IRA receipts from their parents during these "recently retired years," i.e., ages 65-75. As a consequence of higher IRS-assumed interest rates, and by inserting a charitable remainder annuity trust into the picture, this is exactly what the family may now accomplish.

Here we are not talking about the new, one-time $50,000 maximum charitable remainder trust an IRA owner can fund during his or her lifetime with an IRA, but rather about a "charitable remainder annuity trust" for a term of 20 years, which the donors fund with all or a portion of their IRA and/or 401k plan benefits after they both pass. Teamed with the fact that an 80-year-old married couple, including the surviving spouse, may now use a 20-year life expectancy for purposes of computing their annual required minimum distributions from their IRAs and/or 401k plan accounts, spreading the residual balance of the IRA and/or 401k balances over an additional 20 years will have the obvious effect of lowering the tax brackets to all parties concerned.

In the case of the clients' children, this will oftentimes allow at least half of their parents' IRA and/or 401k balance at the time of their death to be paid to the children after they retire

but before they must begin to withdraw their own IRA and/or 401k accounts, at age 75, and therefore in years when the children are likely to be in a lower than normal federal income tax bracket, especially as compared to the tax brackets which applied during their peak earning years.

A Typical Example

Take, for example, a child of the clients, age 55, who, along with his or her spouse, make $300,000 in total salary income and have $20,000 of other income. They are thus in the 24% marginal federal income tax bracket (assuming 2023 tax brackets) and an assumed 6% marginal state income tax bracket, or 30%, total, when the child's parents pass. The child and child's spouse plan to retire when the child attains age 65. At that point they anticipate approximately $100,000 in total income, including the taxable portion of their Social Security, but excluding benefits from their own IRAs, which they anticipate deferring until age 75. When they attain age 75, the child and the child's spouse anticipate another $100,000 in annual income from their own IRAs.

Now assume the parents designate the child as beneficiary of a $1 million IRA, and that the child opts to spread the required distributions from the IRA evenly over the 10 years after the parents pass, in order to level the child's tax brackets over the 10 year-period, and to avoid a bunching of income in any one or more years. Assuming a 5.4% growth rate inside of the IRA (or the IRS' Section 7520 rate for the month of October, 2023), this would equate to annual withdrawals from the IRA of approximately $129,600 over the 10-year period, ages 55-65, which withdrawals will likely be taxed during the child's peak tax bracket years. What is more,

no portion of the IRA receipts will be entitled to the benefit of lower federal "capital gains" tax rates or to tax-exempt income treatment.

As an alternative to this "direct IRA beneficiary" plan, assume that the clients designate a 20-year tax-exempt charitable remainder annuity trust for their child as beneficiary of their $1 million IRA, and structure the trust so that charity will receive, actuarially, the required minimum 10% of the initial trust assets, which, again assuming a 5.4% compound growth and Section 7520 interest rate, works out to $289,000 for charity in 20 years. The clients' child will receive an annual annuity of $74,600 per year, for 20 years. Compare this number to the above-mentioned $129,600 figure the clients' child would receive each year, for 10 years, as direct beneficiary of the IRA, and remember that the additional annual amount under the direct IRA beneficiary plan, or $55,000, will be received during years when the child is likely to be in his or her highest income tax brackets.

By contrast, during the three and one-half years 11 through 13-1/2 under the "IRA/charitable remainder trust" alternative, or years when the child in the above example is likely to be retired but not yet required to take benefits under his or her own IRA and/or 401k plan account at age 75, the $74,600 annuity payments will be taxed as ordinary income, but likely at much lower income tax rates than the payments during years 1-10, when the child was still working. Furthermore, and if structured properly, during the six and one-half years 13-1/2 through 20, also years in which the child is likely to be retired but not yet required to take benefits under his own IRA or 401k plan account at age 75, the annuity payments to the child could enjoy the benefits of the lower

capital gains income tax rates and, to the extent the trust invests in tax-exempt securities, may not even be subject to federal income tax.

A Zero-Cost Planned Gift

From the above example we already know that charity will receive an estimated $289,000 (assuming a growth rate equal to the October, 2023 Section 7520 rate) on a $1 million initial value charitable remainder annuity trust when the trust terminates after 20 years, but how do the clients' child and child's spouse, if any, fare? The answer depends, in part, on how old the child in the above example is when his or her parents pass. If he or she is age 55 and, along with his or her spouse, is likely enjoying his or her peak earning years, he or she would likely fare somewhat better than he or she would have, had the IRA/charitable remainder annuity trust not been utilized. This is because the child would have been taxed, on all of the IRA income, at a higher income tax rate, for an assumed 10 years still working. If, on the other hand, the child is age 65 and, along with his or her spouse, is retired when the child's parents pass, he or she would likely fare slightly worse than he or she would have, had the IRA/charitable remainder trust not been utilized. This is because the IRA/charitable remainder trust alternative would not be benefitting the child by partially avoiding the higher income tax rates while the child is in his or her peak earning years. If the child is somewhere in between, say age 60, the child would likely be in "breakeven" territory, i.e., neither profiting nor losing as a consequence of the IRA/charitable remainder trust plan.

Despite the fact that the child basically receives the same after-tax amount under either form of IRA disposition,

the charity would receive an estimated $289,000 at the end of year 20, under the IRA/charitable remainder annuity trust alternative (assuming a 5.4% income tax-free compound growth rate), while it obviously would have received $0 under the direct IRA beneficiary plan. How can this possibly be?

There are at least six reasons. First, approximately 50% less money is paid out during the first 10 years after the account owner's death under the IRA/charitable remainder trust plan, years in which the child beneficiary is likely to be in his or her peak income tax brackets. Second, by spreading the income from the IRA over 20 years as opposed to only 10, the income from the IRA/charitable remainder trust is likely to be taxed to the child beneficiary in lower marginal income tax brackets, generally. Third, the funds which were not paid out of the charitable remainder trust during the first 10 years after the parents pass have the ability to grow and compound, unreduced by federal and state income taxes, inside the tax-exempt IRA/charitable remainder trust, thus increasing the annual annuity amount payable to the child beneficiary. Fourth, the federal income tax rate to the child beneficiary on the last six and one-half years' worth of annuity payments (or the years after the initial $1 million deposit has been distributed to the child beneficiary) from the IRA/charitable remainder trust, or 32.5% of the overall payments, can be as low as 0%. Fifth, because the IRA/charitable remainder trust is income tax-exempt, the $100,000 (or 10%) portion of the initial value of the trust corpus compounds, income tax-free, inside of the trust, before it eventually passes to charity, unreduced by income or estate taxes. Finally, because the IRS' Section 7520 rate has risen a full five percentage points from its low of 0.4% in November of 2020, the permissible annual annuity payable

to the child under the IRA/charitable remainder trust, pursuant to the IRS' tables, has similarly risen.

Each donor's individual financial and family situation, as well as the IRS' Section 7520 rate at the time, will determine the ultimate tax benefits to be derived from the IRA/charitable remainder trust alternative, and the client should therefore consult with his or her tax advisor before proceeding with the plan. Given today's higher Section 7520 rates, however, the average family will suffer little, if at all, financially by choosing the IRA/charitable remainder trust alternative, over the direct IRA beneficiary plan, as the recipient of all or a portion of the client's taxable IRA, while the charity will obviously receive a substantial benefit in 20 years. Clients who have been fortunate enough to have accumulated significant taxable IRA and/or 401k plan accounts will therefore want to consider the IRA/charitable remainder trust as part of their overall estate plan.

About the Author

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Mr. Blase is a 1981 graduate of Notre Dame Law School, where he served as Managing Editor on *the Notre Dame Law Review*, and a 1982 graduate of the New York University Law School Graduate Program in Taxation, where he served as Graduate Editor on the *Tax Law Review*. He also owns a Certified Public Accountant certificate from the State of Missouri.

The author of over 80 articles for various tax and estate planning professional publications, Mr. Blase is also the author of four other tax and estate planning books: *Optimum Estate Planning: Explanation and Sample Forms*; *6-7-8: Estate Planning with Section 678 of the Internal Revenue Code*; *Estate Planning for the SECURE Act: Strategies for Minimizing Taxes on IRAs and 401Ks*; and *Retirement Planning for Already Retired Couples: Strategies for Stretching Your Retirements Savings*.