# #41 Distribution Planning for Non-Spousal Inherited IRAs Following the SECURE Act

The stretch IRA was the ideal method for maximizing the time during which IRA assets could grow on a tax-deferred basis for non-spouse beneficiaries. Although the SECURE Act eliminated the stretch IRA for most non-spousal inherited IRAs, generally requiring that the full value of the IRA be distributed within 10 years after an IRA owner's death, several strategies are still available to increase the amount that can be accumulated for a family. These strategies include (1) naming a charitable remainder trust as the IRA beneficiary, (2) Roth IRA conversions, (3) buying life insurance, (4) multi-generational spray trusts, (5) incomplete gift non-grantor trusts and (6) IRC § 678 trusts.

## Charitable Remainder Trust as IRA Beneficiary

A charitable remainder trust (CRT) is a split interest trust that pays an amount to lead beneficiaries for a specified term with the remainder interest passing to charity. The lead beneficiaries are typically either the donor or the donor and the donor's spouse, but could also be other non-charitable beneficiaries like the donor's children. It is also possible to give a portion of the lead interest to charity, provided that there is also at least one non-charitable beneficiary.

### CRAT

A CRAT pays a fixed percentage of the trust's initial value annually or at more frequent intervals (IRC § 664(d)(1). The amount of the payout doesn't change from one year to the next.

### CRUT

A CRUT pays a fixed percentage of the trust assets recalculated annually (IRC §§ 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B)). Thus, the amount of the payments varies depending on the total return produced by the trust assets (appreciation plus income).

### Spreading out Distributions

If a CRT is named the beneficiary of a traditional IRA, there is no tax when the funds in the IRA are distributed to the trust. Tax is only payable when the beneficiaries receive distributions from the CRT. These distributions can be spread out over a term of years not to exceed 20 or for the life or lives of a named individual or individuals. The character of these payments is determined under the ordering rules of IRC § 664, first, as ordinary income, to the extent the trust has realized current or accumulated ordinary income, then as capital gains, then as other income (e.g. tax-exempt income) and finally as tax-free return of corpus.

### Comparison with Outright Distributions

If we compare the wealth accumulated for the IRA owner's heirs by using a CRT as the IRA beneficiary with the wealth accumulated for heirs with outright distributions to them over five or 10 years, we find that the results are fairly comparable even though using a CRT significantly

increases the deferral period. The reason is that IRC Sections 664(d)(1)(D) and 664(d)(2)(D) require that the present value of the charitable remainder interest must be at least 10% of the initial value of the trust assets.

Charitable Intent

If the IRA owner has charitable intent, however, and the amounts accumulated for the charity are added to the amounts accumulated by the heirs, the CRT strategy can be quite favorable.

Mortality Risk

The amount of wealth a CRT transfers to beneficiaries will depend on how long the beneficiaries live. If they die well before reaching their life expectancy, the CRT will transfer far less wealth to the beneficiaries than the other strategies. This risk might be hedged against by purchasing life insurance. On the other hand, if the beneficiaries live well beyond their life expectancy, the CRT strategy may prove to be very favorable.

CRAT vs. CRUT

Given the current low IRC Section 7520 rates, CRUTs will generally be more favorable than CRATs, although CRATs do have some advantages. The advantages of each type of CRT are summarized below.

Advantages of CRUTs

- A longer stretch-out period is possible for life CRUTs because the 5% probability of exhaustion test doesn't apply to CRUTs

- Given the low current Section 7520 rates, CRUTs can make substantially higher annual payouts to the non-charitable lead beneficiary

- Unitrust payouts provide a hedge against inflation

- CRUTs are more flexible, providing different payout options— Unlike a CRAT, a CRUT can have net income, net income with make-up or flip provisions.

Advantages of CRATs

- Some beneficiaries like the assurance of having the same payment each year regardless of investment performance. A CRAT has the same payout each year regardless of investment performance
- Ease of administration—no need for annual revaluations

With a CRAT, the charitable remainderman bears the investment risk. With a CRUT, the investment risk is split between the lead and remainder beneficiaries.

**Roth IRA Conversions**

A Roth IRA is generally subject to the same rules that apply to a traditional IRA except that contributions to the IRA aren't deductible and qualified distributions are tax-free.[183] A "qualified distribution" is a distribution that occurs after a five-year holding period and is made on or after the day the beneficiary reaches age 59½, after the owner dies, after the owner becomes disabled or is a qualified special purpose distribution.[184]

The conversion of a traditional IRA to a Roth IRA is treated as a distribution in which the taxpayer recognizes taxable income. When an IRA conversion is done during life, the timing of the distributions is important. The conversion can be done in steps to prevent income from going into a higher tax bracket. However, this staged conversion strategy isn't available for converting an inherited non-spousal IRA after the death of the owner. If the conversion is to be done in steps, it must be done during the IRA owner's life.

An important advantage of a Roth IRA is that there are no required minimum distributions (RMDs).[185] This enables the entire value of the IRA to grow tax-free until the beneficiary's death, facilitating accumulation of wealth for the family. If the beneficiary doesn't need distributions, the Roth IRA could be viewed more as a wealth transfer tool than as a retirement income vehicle.

Pre-SECURE Act Roth Conversion Decision

There is a tradeoff between paying current tax on the amount transferred and avoiding tax on later distributions from the account. In deciding whether to do a Roth IRA conversion, taxpayers must analyze this tradeoff. The analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion and the taxpayer's expected marginal income tax rate when distributions are received.

We could draw the following general conclusions about the Roth conversion decision:

- If the tax rate is lower at the time of conversion than at the time distributions are received, a Roth conversion will be favorable.

- If the tax rate is higher at the time of conversion than at the time distributions are received, a Roth conversion will be unfavorable.

- If the tax rate is the same at the time of conversion and the time distributions are received, a Roth conversion will be neutral.

There are other factors that might favor a Roth conversion, however. If the conversion tax can be paid with outside funds instead of funds from the IRA, the conversion tax can be offset by favorable tax attributes like NOL carryovers, unused charitable deductions, AMT carryovers, or current year ordinary losses, or the beneficiary expects to have a taxable estate, a Roth conversion will generally

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[183] IRC §408A(c)(3).
[184] IRC §408A(d)(1).
[185] IRC §408A(d)(2).

be favorable even if the tax rate on the conversion is moderately higher than the tax rate when distributions are made.

## Different Comparison after the SECURE Act

Note that the Roth conversion decision is different in the context of an inherited IRA following the SECURE Act. The tax rate at the time of the conversion is still important, but the assets can only stay in the IRA for a maximum of 10 years after the IRA owner dies. Instead of comparing a Roth conversion with leaving the money in a traditional IRA where it would continue to grow at a pre-tax rate of return in either case, we would be comparing it with other alternatives—distribution to a taxable account, CRT, to an out-of-state trust, to a multi-generational spray trust or to a Section 678 spray trust. Another possibility would be investing the IRA assets or distributions in life insurance.

## Roth IRA Conversion vs. Other Strategies

It appears that unless a very substantial increase in ordinary income tax rates is expected, a Roth conversion would ordinarily be superior to transferring traditional IRA funds to a taxable account. If the beneficiary can pay the conversion tax with outside assets instead of assets from the traditional IRA, the economics of the conversion are even more favorable. In effect, the beneficiary can pack more value into the Roth IRA. There would be a shift of assets from a taxable account to the tax-free Roth IRA.

A Roth conversion also has important advantages over other potential strategies. Investing traditional IRA assets in life insurance would provide continued tax-free growth, but returns inside the policy would typically be lower than returns inside the Roth IRA. Moreover, there is less mortality risk with the Roth IRA. If the beneficiary lived well beyond life expectancy, life insurance would prove to be a less desirable investment. On the other hand, if the beneficiary died early, investing IRA funds in life insurance would prove to be the best strategy for passing wealth on to heirs.

An advantage of a Roth conversion over a transfer to a CRT is that there is no need to transfer 10% of the value to charity. The full value can go to heirs.

Transferring assets to a multi-generational spray trust would enable the family to spread out distributions, but the assets wouldn't grow tax-free like they would in the Roth IRA. On the other hand, if the beneficiary has a taxable estate, the estate planning advantages of a multi-generational trust might outweigh the income tax benefit of the Roth IRA.

The advantage of transferring the IRA assets to an irrevocable non-grantor (ING) trust would be that distributions to beneficiaries could be spread out and state income tax could be avoided. The Roth IRA could not only avoid state income tax, but also federal income tax.

Whether a Roth conversion will be more favorable than one of these other alternatives will depend on the facts of the case. A detailed quantitative analysis is necessary to determine whether it provides an overall economic benefit for a specific taxpayer. This sensitivity of the economic result to the facts of the case highlights the need for tools to analyze the best strategy for a client's specific situation.

## Life Insurance

Beneficiaries who don't need to consume the required minimum distributions they receive from their inherited IRAs during the 10-year SECURE Act period may be able to increase the amounts that can be accumulated by heirs by using some or all of the distributions to buy life insurance. The proceeds of the policy would be paid income tax-free to the beneficiary's heirs or to a trust for their benefit.

Buying life insurance with the distributions would have no effect on the traditional IRA. The same amount could stay in the IRA, the required minimum distributions would be the same and the same amount would still pass to a taxable account, CRT, etc. at the end of the 10-year period.

An investment in life insurance has two advantages over a taxable investment. First, assuming that the contract meets the definition of life insurance, there is no tax on the build-up of the policy's cash surrender value.[186] Moreover, there is generally no income tax payable when the insured dies.[187] Thus, as a general rule, the insurance proceeds are never subject to income tax.[188]

On the other hand, a taxable investment will generally produce a higher pre-tax return because the insurance company has to make a profit, pay commissions and cover overhead. Thus, whether investing distributions in life insurance will be a favorable strategy depends on whether its tax advantages outweigh the lower pre-tax return. Since buying life insurance is a bet-to-die strategy, this will depend in large part on how long the insured lives. Whether the life insurance strategy will be favorable will depend on the facts of the case—

- The after-tax rate of return on a taxable investment;
- How long the insured will live; and
- The effective rate of return on the life insurance policy

Depending on how these variables play out, the life insurance strategy could either be very favorable or very unfavorable. For example, if the life insurance policy provided a

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[186] IRC §§7702(g); 72.

[187] IRC § 101(a)(1). There is an important exception for transfers for value. If there has been a transfer of the policy for valuable consideration, the amount excluded from income can't exceed an amount equal to the sum of actual value of such consideration and the premiums and other amounts subsequently paid by the transferee (IRC § 101(a)(2)).

[188] This is generally true even if amounts are withdrawn from the policy. The only time a cash withdrawal is taxed is if the amount withdrawn exceeds your basis, i.e. how much premiums you have paid into your policy.

favorable return and the IRA owner lived only a short time after buying the policy, the family would receive an economic windfall. On the other hand, if the IRA owner could invest the RMDs to produce an after-tax return substantially higher than the rate of return for the life insurance policy and lived well beyond life expectancy, the life insurance strategy would turn out to be highly unfavorable. The rate of return for the insurance policy given various life spans could be determined. The rate of return on the taxable reinvestment  account and how long the IRA owner would live couldn't be determined precisely, but reasonable estimates would ordinarily be possible.

Timing of the Life Insurance Purchase

If tax rates stay the same throughout the 10-year period, it probably wouldn't make sense to take a distribution from the IRA at the beginning of the period and use the money to buy life insurance. Although the funds would grow tax-free in the life insurance policy, they would also grow tax-free if left in the traditional IRA and perhaps produce a better return. If tax rates were expected to be higher at the end of the 10-year period than at the beginning, the benefit of the lower rate would have to be weighed against the lower expected return. It might also be a good idea to stage the life insurance purchases to manage tax rates, depending on the facts of the case..

Estate and Gift Tax Considerations

Investing in life insurance would have an important advantage for taxpayers with taxable estates. The value of the taxable account will be included in the IRA owner's gross estate when he dies, but the life insurance generally won't be included unless the owner had incidents of ownership in the policy.[189] Thus, the life insurance scenario is both income tax and estate tax-free. Given the current high applicable exclusion amounts, however, there would be estate tax consequences for only a small percentage of taxpayers.

Joint and Survivor Life Insurance

Investing in a joint and survivor life insurance policy might be better than investing in a single life policy. The benefit of a second-to-die policy is the lower "mortality drag" which results in a higher return on investment (ROI) on the insurance design.

Life Insurance Hedge

The 10-year rule, creates new actuarial risk of early death. Under prior law, qualified accounts could be drawn-down over decades after death capturing deferral and virtually assuring bracket arbitrage. However, a 10-year distribution requirement will unfairly tax those who die when their savings peaks around retirement age or shortly thereafter. Life insurance could offset this risk that family wealth will be lost to tax.

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[189] IRC § 2042.

Multigenerational Spray Trusts

Prior to the SECURE Act, IRA owners often named trusts as beneficiaries of their IRAs. Two kinds of trusts were used, a conduit trust and an accumulation trust. Conduit trusts no longer provide favorable results following enactment of the SECURE Act because all assets received from the IRA have to be distributed within 10 years. Naming accumulation trusts structured as multigenerational spray trusts might still be a good strategy, though.

Accumulation Trust

With an accumulation trust, the trustee must take required minimum distributions (RMDs) each year, but has discretion to decide how much, if any, to pay to the beneficiaries and how much to keep in the trust. If the funds are retained, they will be taxed to the trust at trust tax rates. If they are distributed, the trust will generally get a DNI deduction and the amounts will be taxed to the beneficiaries at their personal tax rates.

Assuming that the trust qualifies as a designated beneficiary, the IRA funds must all be distributed to the trust within 10 years after the IRA owner dies. If the trust doesn't qualify as a designated beneficiary, the IRA must be paid out within five years (if the IRA owner died before reaching his required beginning date) or over the participant's "ghost" life expectancy (if the owner died after reaching her RBD). The ghost life expectancy RMD is calculated using the life expectancy factor for the decedent's age at death.

A trust is treated as a designated beneficiary if four requirements are satisfied:

1. The trust is valid under state law, or would be but for the fact that there is no corpus;[190]
2. The trust is irrevocable or will by its terms become irrevocable upon the death of the employee;[191]
3. The beneficiaries of the trust can be identified from the trust instrument;[192] and
4. Proper documentation has been provided to the plan administrator.[193]

Both the Five-Year rule and the "Ghost" Life Expectancy rule appear to have survived the Secure ACT for non-designated beneficiaries. Note that the ghost life expectancy rule may be more favorable for IRA owners in the 71-82 year-old age range than the 10-year rule because they have a life expectancy of greater than 10 years.

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[190] Reg. § 1.401(a)(9)-4, Q&A 5(b)(1).
[191] Reg. § 1.401(a)(9)-4, Q&A 5(b)(2).
[192] Reg. § 1.401(a)(9)-4, Q&A 5(b)(3).
[193] Reg. § 1.401(a)(9)-4(b)(4).

Naming an Accumulation Trust as the IRA Beneficiary Following the SECURE Act

Although accumulation trusts increase costs and add complexity, they also create important non-tax advantages for a family. They limit beneficiary access to funds, protect assets from creditors, provide professional management of trust assets and may enable the trustee to manage tax brackets. They may also provide divorce protection and dead-hand control and facilitate estate planning and planning for special needs beneficiaries.

If an accumulation trust is the beneficiary, all the IRA funds would have to be paid to the trust by the end of the 10-year period, but the trustee wouldn't have to pay out all the funds to the trust beneficiaries. As a result, trust funds could remain in the trust after the end of the 10-year period and accumulate on a tax-deferred basis for the trust beneficiaries. The problem with retaining the IRA funds in the trust, however, is that they will generally be taxed at a much higher rate than amounts that are distributed to beneficiaries. For 2023, all trust income above $14,450 is taxed at the top rate of 37%. By contrast, married taxpayers filing jointly aren't subject to the 37% rate until income exceeds $693,750.

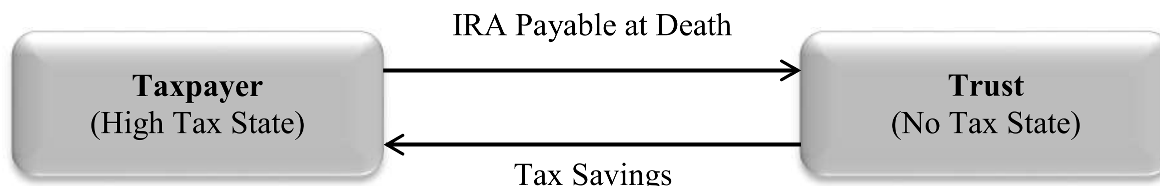
An accumulation trust should be structured as a spray trust. A "spray" trust names a broad group of family members as beneficiaries and sprays distributions across the group according to the instructions provided by the grantor to the trustee. In this way, the family has the flexibility to vary the amount of IRD recognized across the trust and the trust beneficiaries in order to minimize income tax obligations. Thus, a spray trust could be used to combine the tax benefits of low tax rates with the non-tax advantages of an accumulation trust..

Dynasty Trust

For very wealthy taxpayers with wealthy children and very large IRAs, transferring the IRA to a dynasty trust might be considered for its estate planning advantages. Dynasty trusts are explained at Opportunity #21 above

**Incomplete Gift Non-Grantor (ING) Trusts**

The benefits of using a multigenerational accumulation trust as a beneficiary of an IRA can be enhanced by making the trust an incomplete non-grantor (ING) trust in a state that doesn't tax trust income. The leading states for creating these trusts are Delaware, Nevada and Wyoming. In Delaware they are called DING Trusts, in Nevada, NING Trusts, and in Wyoming WING Trusts. They can also be created in several other states.



IRA distributions received by the trust will be taxed to the trust beneficiaries to the extent they are distributed and to the trust to the extent they are retained. In most cases, the trustee will try to distribute most or all the amounts received from the IRA because the beneficiaries will typically be in lower tax brackets than the trust. If the beneficiaries are in the 37% tax bracket, don't need current distributions and live in a high tax state, however, accumulating the IRA distributions in the trust might save significant amounts of tax.

> ***Example.*** T dies owning a large IRA and names an ING trust as the beneficiary. Assume that the trust receives $300,000 per year from the IRA. The beneficiary lives in a high tax state and has a combined federal and state tax bracket of 45%. Because the trust isn't subject to state tax it pays 37% on the trust income. This saves $24,000 per year in state tax (.08 x $300,000). If we assume that the tax savings can be invested at 6%, they will grow to $316,339 after 10 years and $882,854 after 20 years.

Mechanics of the Strategy

To accomplish the desired results, the transaction must be carefully structured to meet all of the following requirements:

(1) The trust must be created in a state that (a) does not tax trust income, (b) allows domestic asset protection trusts (DAPTs) and (c) allows the grantor to retain inter vivos and testamentary special powers of appointment.

(2) The income from the trust must not be taxable by the grantor's home state.

(3) The trust cannot be structured as a grantor trust.

(4) The trust must allow discretionary distributions to the settlor without making the trust a grantor trust; and

(5) Transfers to the trust must be incomplete gifts for federal gift tax purposes without making the trust a grantor trust.[194]

Location of Trust

The ING trust must be set up in a state that (1) doesn't tax trust income, (2) has a domestic asset protection trust (DAPT) statute, and (3) allows the settlor to retain a lifetime and testamentary non-

[194] A detailed analysis on NING trusts is beyond the scope of this booklet. For further information see Steven J. Oshins, "NING Trusts Provide Tax and Asset Protection Benefits," CCH Estate Planning Review - The Journal (Aug. 20, 2013); Steven J. Oshins and Brian J. Simmons, "Save State Income Taxes using a Nevada Incomplete Gift Non-Grantor Trust," The Trust Advisor (Dec. 2013); Robert S. Keebler, *Using Incomplete Gift Nongrantor (ING) Trusts to Reduce State Income Tax,* Taxes, July 2015.

general power of appointment. Nevada has perhaps become the most popular state for ING trusts. Other states that work include Alaska, Delaware, Ohio, South Dakota and Wyoming.[195]

Trust Not Taxable in Grantor's Home State

Locating the trust in one of the states listed above does not necessarily mean that the trust income won't be taxed by the grantor's home state. For example, some states treat a trust as a resident trust if the grantor was a resident of the state when the trust became irrevocable or if the trust has in-state beneficiaries even if the trust is administered in one of the states listed above

The Trust Can't be a Grantor Trust

If the trust is a grantor trust, all income will be reported on the grantor's Form 1040 and be subject to tax in the grantor's home state.

Discretionary Distributions to the Settlor

Grantors typically don't want to give up the possibility of receiving trust income. Thus, the trustee must be given the power to make discretionary distributions to the settlor without causing the trust to be a grantor trust. If the trust is structured as a domestic asset protection trust (DAPT), however, allowing discretionary distributions does not make the trust a grantor trust

Incomplete Gift

Historically, most taxpayers who transferred assets to a state income tax saving trust didn't want the transfer to be subject to the gift tax. Thus, they needed to retain enough control over the transferred assets to avoid making a completed gift subject to the federal gift tax and without creating grantor trust status. This was accomplished by (1) giving the settlor both an inter vivos and a testamentary special power of appointment over the trust assets, and (2) requiring the consent of a distribution committee for any distributions to the settlor. The testamentary special power of appointment made the transfer to the trust an incomplete gift and the consent requirement allowed the trust to avoid grantor trust status.

Following recent increases in the applicable exclusion amount, settlors wish to avoid making a taxable gift for a different reason. Assuming that they are among the 1/10 of 1% of decedents who don't have a taxable estate, they want the transferred assets to be included in their gross estate when they die so their heirs can get a stepped-up basis.[196]

## Section 678 Trust

Naming an accumulation trust as the beneficiary of a traditional IRA provides important non-tax benefits for a family. Trusts can protect assets from creditors, and provide professional management of trust assets, divorce protection and dead hand control of the assets. They may also facilitate estate planning.

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[195] Tennessee and a few other states may also qualify.

[196] IRC § 1014.

To get these advantages, however, the assets must stay in the trust instead of being distributed to the trust beneficiaries. Unfortunately, any amounts retained in the trusts would ordinarily be taxed at the high trust tax rates. For 2024, all trust income above $15,200 is taxed at the top individual income tax rate of 37%. By contrast, if the RMDs are distributed to the trust beneficiaries, they will be taxed at the beneficiaries' individual tax rates, which might be substantially lower than 37%.

If the individual beneficiaries don't all the money from IRA distributions, it is possible to obtain the benefits of a trust without the high trust tax rates. Under IRC Section 678, a person other than the trust's grantor is treated as the owner of a trust if that person is given a power to withdraw trust assets without the consent of any other person. If a trust beneficiary is treated as the owner of a trust under Section 678, all items of income, deductions, and credits against tax of the trust would be reported on the beneficiary's Form 1040 instead of on the trust's tax return.

If the trust named as the IRA beneficiary was a Section 678 trust, the trustee could retain the RMDS, but they would be taxed at the beneficiaries' rates, say 24%, instead of the trust's 37% tax rate. The family of the IRA owner would get the best of both worlds, the advantages of leaving the assets in the trust listed above, with the lower tax rates of the individual beneficiaries.

Note, however, that the beneficiaries of the trust would be paying tax on income they wouldn't receive, perhaps causing a cash flow problem. To address this potential difficulty, the trust could distribute enough trust income to the beneficiaries to pay the tax on the trust income and leave the rest in the trust.

> Example. F dies and transfers $2,500,000 to an accumulation trust, $1,000,000 of which is a traditional IRA. The beneficiary of the trust is F's daughter (D), who is treated as the owner of the trust under Section 678. The trust takes a $100,000 distribution from the IRA and has $25,000 of other income. Because D is treated as owning the trust, she reports the $125,000 of income on her form 1040. Assume that D is in the 24% marginal tax bracket and that the tax payable by her on the trust income is $30,000 (.24 x $125,000). The trust distributes $30,000 to D to pay the tax liability for the trust income and retains the remaining $95,000. If the $100,000 IRA distribution had been made directly to D, the tax payable would have been $37,000 instead of $24,000

There is one caveat for beneficiaries who expect to have a taxable estate. The beneficiary's right to take assets from the trust would be treated as a power of appointment and leaving assets in the trust would be treated as a lapse of the power of appointment resulting in a taxable gift from the beneficiary to the other trust beneficiaries. This rule only applies, however, to the extent the lapse exceeds the greater of $5,000 or 5% of the trust's value at the time of the lapse. In the example above, this amount would be the greater of $5,000 or $125,000 (.05 x $2,500,000).

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