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Incorporating Retirement Assets Into Your Estate Plan

by Christopher J. Kamath

The Setting Every Community Up for Retirement Act (also known as the Secure Act) became law on December 20, 2019, and went into effect in 2020. More recently, Congress enacted the SECURE 2.0 Act, with some of the provisions having already taken effect as of January 1, 2023. The SECURE Act and SECURE 2.0 Act (the "Acts") made mostly favorable changes to retirement plans such as IRAs, 401(k)s, and 529 Education Saving Plans. These laws were intended to improve access to tax-advantage retirement accounts and prevent older Americans from outliving their retirement funds. Even if most of your wealth doesn't come from employer sponsored or individual retirement accounts, you should understand how the changes potentially affect the funds you contributed to these accounts. A comprehensive estate plan should maximize the tax-deferred benefits of these accounts while supporting your overall legacy goals.

QUALIFIED RETIREMENT PLANS

Retirement plans are divided into two broad categories of plans: defined benefit plans and defined contribution plans. This article focuses on defined contribution plans, such as 401(k) plans and 403(b) plans, and traditional individual retirement accounts ("IRAs"). Defined contribution plans are funded by the employee/participant with contributions taken directly from the employee's paychecks. Sometimes an employer will match a portion of the employee's contributions. Defined contribution plans do not guarantee a specific amount of benefit; the ultimate payout depends on the underlying performance of the plan's investments.

The greatest advantage of these plans over other investments is their preferential tax treatment. The money contributed by a participant to a qualified retirement plan or IRA is generally not subject to income tax when it is earned. This deferral of income tax allows both your money and Uncle Sam's money to grow through investment. However, distributions

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from the retirement account will ultimately be subject to income tax in the year they are received by the owner or beneficiary of the account.[1]

For 2023, employees can contribute up to $22,500 per year to a 401(k) plan. In contrast, the total contributions you make each year to all of your traditional IRAs and Roth IRAs can't be more than $6,500 ($7,500 if you're age 50 or older). Prior to the SECURE Act, you couldn't make contributions to an IRAs after you turned 70 ½ years old. The SECURE Act removed this age restriction and now you can contribute to these IRAs as long as you have compensation, which generally means earned income from wages or self-employment. If your plan allows it, individual participants who are 50 years of age or older can make "catch up" contributions above the normal statutory limits for both qualified retirement plans and IRAs. These changes reflect the reality that people are living longer and working later in the life.

REQUIRED MINIMUM DISTRIBUTIONS (RMDS)

Tax deferred savings plans like 401(k)s and IRAs were created to incentivize saving for retirement, they were never intended to be vehicles to transfer wealth from one generation to the next. In order to prevent this practice, Congress enacted a series of rules known as the Required Minimum Distribution ("RMD") rules to ensure that such funds are used for their intended purposes. Under the old rules, you had to start withdrawing a minimum amount of money from your retirement account each year after attaining age 70 ½. The SECURE 2.0 Act raised the RMD age to 73 beginning on January 1, 2023, and will increase this age to 75 beginning on January 1, 2033. RMDs rules are highly complex and the amount and timing of RMDs will vary depending on the account balance, when the participant passes away, and who is listed as the beneficiary on the account, among other things.

PARTIAL ELIMINATION OF STRETCH IRAS

Prior to 2020, most beneficiaries who inherited tax-deferred retirement accounts could stretch distributions over their life or life expectancy. This allowed the contributed funds to continue investment and growth on tax-deferred savings over a longer period. The Acts radically changed RMD rules (and not necessarily for the better). Except for certain Eligible Designated Beneficiaries, funds must be distributed to a beneficiary within five or ten years of the plan participant's death.

Your beneficiary's RMD will depend on whether the beneficiary is an Eligible Designated Beneficiary ("EDB"), Designated Beneficiary ("DB"), or a Non-Designated Beneficiary ("Non-DB"). EBDs can generally elect to stretch out distributions over their life expectancy and include your surviving spouse, disabled or chronically ill child, and individuals not more than 10 years younger than plan participant.

A Designated Beneficiary is any individual designated as a beneficiary by the plan participant. In other words, an actual person that will pass away some day. A DB must receive full distribution of the retirement account within 10 years of the plan participant's death. In general, no distributions are required until the tenth year of the RMD period; however, annual distributions may be required if the plan participant died after his or her RMD period commenced.

A Non-DB is simply a beneficiary who does not otherwise qualify as a EDB or DB, such as your estate, non-qualified trusts, charitable organizations, etc. If the plan participant dies before the commencement of his or her RMDs, the Non-DB must receive all benefits within five years of the participant's death. If the participant passes away after RMDs have commenced, the Non-DB may continue receiving RMDs over the life expectancy of the participant as if the participant had not died. Non-DBs will receive income distributions over a shorter period of time and likely have to pay higher income taxes.

Despite the consequences described above, it may still make sense to designate a trust as a beneficiary on your retirement accounts. Good planning must consider your legacy goals and the needs and limitations of your beneficiaries. Protecting assets from creditor's claims is always an important consideration. And sometimes beneficiaries cannot receive direct control over an asset because of disability, immaturity, or drug use concerns.

Certain qualified trusts known as "see-through" trusts can be treated as an EDB or DB. By carefully drafting the terms of the trust, the IRS will look through the trust and treat the trust beneficiaries as having been designated direct beneficiaries on the retirement account. A detailed discussion of these types of trusts is beyond the scope of this article. All things being equal, it is better to list individual persons as beneficiaries on qualified retirement accounts and IRAs.

CONCLUSION

Retirement benefits are an important consideration in any estate plan. A proper estate plan should consider the type of plan holding the assets, the required minimum distributions under the plan, beneficiary designations, and your legacy goals. And if you haven't participated in a qualified retirement plan or IRA, it might be time to reconsider—it is never too late to start saving for retirement.

This article is intended to provide a general overview of estate planning for retirement assets. There are many exceptions to the rules described above and new regulations are being proposed all the time. Consequently, it is important periodically review your retirement accounts with the plan administrator and your estate planning attorney to ensure the current plan is consistent with your long-term goals. ■

[1] *Roth IRAs and Roth 401(k) accounts are funded with post-tax earnings and may be withdrawn without incurring income tax.*

Estate Freezing and Gifting

ESTATE PLANNING IN THE SHADOW OF THE TCJA SUNSET

by Alexander H. Asawa & Andrew A. Willaert

Under the current federal tax code, the lifetime gift and estate tax exemption for an individual is $12,920,000 and $25,840,000 for a married couple. However, unless legislative action is taken to extend these exemptions, decedents who pass away after January 1, 2026, will have effectively half of the previous exemption amount estimated to be around $6,800,000 for individuals and around $14,000,000 for married couples. This is known colloquially as the TCJA (Tax Cuts and Jobs Act) Sunset. However, it is possible to utilize the existing gift tax exemption in anticipation of the TCJA Sunset through the technique of "Estate Freezing".

Estate Freezing utilizes a transfer in which the value of assets for gift and estate tax purposes is set at the time of the transfer, allowing any subsequent appreciation in value to be passed to beneficiaries without creating additional gift or estate tax liability. For example, an individual transferring an asset to certain types of trusts "freezes" the value of that asset at the fair market value at the time of transfer and is then applied against the individual's lifetime gift and estate tax exemption. This general idea can take various forms which can be chosen based on the individual's preferences and objectives.

There are many different types of trusts that can be utilized in Estate Freezing with various different benefits. The most prevalent type of trust for this purpose is a grantor trust because, with a grantor trust, the grantor pays the income tax on the trust earnings, allowing the trust assets to appreciate tax free and providing essentially a tax-free gift to the trust beneficiaries by paying the income tax liability of the trust. A grantor retained annuity trust (GRAT) is an irrevocable trust in favor of the grantor's beneficiaries that also provides for the grantor to receive annuity payments from the trust. A grantor retained unitrust (GRUT) is similar to a GRAT, except that the annual payment is recalculated based on a percentage of the value of the assets owned by the trust rather than a fixed annuity. GRATs and GRUTs are in effect for a limited term, during which time the grantor retains control of the assets and enjoys the income stream provided. After the time specified, the assets are transferred to the beneficiaries. One downside of GRATs and GRUTs is that if the grantor dies before the end of the specified term, the trust assets are counted in the grantors' taxable estate.

Another option is an intentionally defective grantor trust (IDGT). An IDGT is an irrevocable trust structured to retain some characteristics of a grantor trust, specifically that the grantor pays income tax on the trust assets, but the trust is considered irrevocable at the time of the grantor's death so the assets in the IDGT will not be counted in the grantor's taxable estate, removing the term risk present in GRAT/GRUTs. However, IDGTs are considered more aggressive than GRAT/GRUTs and while the IRS has established the validity of GRAT/GRUTs, it has shown far more willingness to challenge IDGTs. There are additional potential tax benefits to utilizing the types of trusts described above and an experienced estate planner is recommended to walk you through these benefits on an individualized basis. It is also worth noting that estate freezing may be achieved without the creation of a specialized tax conscious trust; however, for estates above the exemption threshold there may be little reason not to take advantage of additional tax benefits.

Given the potential for the TCJA Sunset to occur, Estate Freezing is even more relevant. The IRS has given guidance that it will not retroactively impose gift and estate taxes to gifts made between 2018 and 2025. In practice, this means that gifts made prior to the TCJA Sunset will enjoy the doubled lifetime gift and estate tax exemption without risk of a clawback from the IRS. From an estate planning perspective, this strongly incentivizes those with potential estates that would exceed the post TCJA Sunset exemptions before January 1, 2026 by freezing the value of the transferred asset and apply that frozen value to the current lifetime gift and estate tax exemptions ($12,920,000 for an individual and $25,840,000 for a married couple).

However, it is worth noting that there is no guarantee that Congress will allow the TCJA to sunset and any estate planner should consider their options with and without the TCJA Sunset. Additionally, while estate freezing has the benefit of setting the value of an appreciable asset, it may also bar beneficiaries from taking a stepped-up basis in the asset which could result in capital gains tax liability for the beneficiary. Ultimately there is no one-size-fits-all method to estate planning and each estate plan should be based on the individual's objectives, asset mix, and personal circumstances. Luckily, there are many capable and experienced estate planners available to guide you through the process and achieve the best result for you and your beneficiaries. ■

Dealing with Divorce and Taxes

by Andrew M. Tatge

Divorce and taxes—two topics most people don't wish to think about. However, tax issues have a substantial impact on divorce and the lives of those involved. Here are a few key divorce tax takeaways that are sometimes forgotten:

1. **Update Your Withholdings.** People typically file a new form W-4 with an employer to change withholdings after their divorce is final to update your new tax status. Talk to your accountant about your specific needs and circumstances before doing so though.

2. **The Spousal Maintenance Tax Loophole is Closed—Probably Forever.** In the good old days, parties could use spousal maintenance as a way to "increase the pie" and have Uncle Sam pay for part of it. Spousal maintenance was taxable to the recipient and tax-deductible to the payor. This meant that the higher earning spouse could typically transfer funds to the lower earning spouse, thereby decreasing the overall tax paid. Sometimes, property settlements were disguised as spousal maintenance in order to provide further tax benefits. No more. For divorces after January 1, 2019, spousal maintenance is no longer taxable to the recipient and the payor pays the income tax. You can imagine how payors feel about this particular change in the law.

3. **Deal With Dependency Exemptions.** Generally speaking, a parent who has 50% or more of the parenting time gets to claim the child tax dependency exemption. However, state law can modify that, and many divorcing parties stipulate an equal division of tax dependency exemptions. If the parties can't agree, courts must apply several factors and make specific findings on who will claim a dependent child after the divorce is final.

4. **Divorce Property Division is Generally Not a Taxable Event.** Some people, and even accountants, misunderstand the rule. Generally speaking, there is no recognized gain or loss on property transfers between spouses or former spouses if the transfer is because of a divorce. There is no specific timeframe on when the actual transfer has to occur. Therefore, a divorce that says Spouse A will pay Spouse B two million dollars over 20 years will allow the parties to do so without it being a taxable event even though the final payment will occur decades in the future. Assets divided go to the recipient spouse with the asset's built-in tax attributes. So, a spouse awarded land with significant capital gains attached will pay all of those capital gains when the property is sold. That means if sale is imminent and necessary, it is a good idea to simply sell the property together and share the tax obligations if a sale is necessary or imminent.

5. **Filing Status Changes.** Many people also forget that when parties divorce, they are considered single in the year they divorce. Even if you divorce on December 30, you are considered single for that entire tax year. However, if you have qualifying children, you may be able to claim head of household status and there are factors the IRS looks to for that. With multiple children, it is possible for both parents to claim head of household if each has a child for one day more than half the year, which is sometimes written into a divorce agreement.

Tax considerations can play an important role in a divorce, including timing and other issues. Although not sexy, resolving these issues the right way can greatly impact you tax-wise. ■

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