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INVESTMENTS & WEALTH INSTITUTE®

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The Setting Every Community Up for Retirement Enhancement (SECURE) Act, passed in late 2019, was designed primarily to expand access to retirement accounts for small businesses and their employees. However, the SECURE Act also opened new opportunities for funding individual retirement accounts (IRAs) and delayed the age at which someone must begin withdrawals from their accounts from age 70.5 until age 72. But perhaps the most impactful change doesn't affect IRA owners at all—just the beneficiaries on the accounts after the owner's death. Rather than being able to stretch distributions from inherited retirement accounts during their lifetimes, most beneficiaries of IRAs whose owners died on or after January 1, 2020, are now subject to the "10-year rule," which caps the tax-deferral benefits these beneficiaries previously enjoyed and reduces the value of inheritances. More recently, the Internal Revenue Service (IRS) issued proposed final regulations that have further complicated the matter by creating a new class of beneficiaries subject to even different rules. To offset this accelerated tax, retirement account owners have several tools at their disposal. Techniques such as Roth conversions and using these accounts for charitable purposes can help mitigate the impact of these new rules. As a result, financial advisors should be talking with clients about these new rules and the best way to manage the impact on heirs.

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INTRODUCTION

As Congressional bills go, the SECURE Act never seemed to get the attention it deserved. The original version passed the House in May 2019 but then languished in Congress for months. The bill seemed destined to fall by the wayside before it was attached to a separate spending bill in late December 2019, but its details got little attention during the holidays. Many of the SECURE Act provisions became effective on January 1, 2020, around the same time the world was becoming aware of COVID-19. Focus turned to the health crisis, but also to things such as financial market volatility, the Coronavirus Aid, Relief, and Economic Security Act, the Paycheck Protection Program, and other social and economic events.

When planners did analyze the SECURE Act, many focused on a key retirement provision—the elimination of the "stretch IRA" for most IRA beneficiaries. Rather than allowing beneficiaries to take required minimum distributions (RMDs) over their lifetimes based on life expectancy, a new 10-year rule was created, requiring those beneficiaries to liquidate the account by December 31 of the year

containing the 10th anniversary of the owner's death. An exception to this rule was created for what are referred to as eligible designated beneficiaries (EDBs), which include the owner's spouse, minor children, and others, but adult children, any grandchild, and most other beneficiaries became subject to this new 10-year rule.

Further apprehension was at least partly prompted by the IRS issuing—and then changing—Publication 590-B, Distributions from IRAs, in early 2021. The original presumption by planners was that any beneficiary subject to the new 10-year rule (hereafter referred to as non-eligible designated beneficiaries or NEDBs) would have complete flexibility to withdraw as much or as little from the inherited account for the first nine years after the owner's death. In year 10, however, whatever remained in the account must be withdrawn. Instead, Publication 590-B initially instructed that beneficiaries must withdraw at least the same RMD they would have taken under the old stretch rules in years 1-9, while emptying the account by the end of year 10. The IRS quickly changed the publication, however, to go back to the

original presumption of full flexibility in years 1–9.

Then, in March 2022, the IRS issued its first set of proposed regulations for the new laws, applying essentially the same interpretation of the 10-year rule as in the original version of Publication 590-B—but with a twist focused on the owner’s required beginning date (RBD). An IRA owner’s RBD is the date by which the owner must withdraw their first RMD, which is always April 1 of the year after the year the owner turns 72. In the new proposal, only NEDBs where the owner died after their RBD are subject to RMDs in years 1–9. If the owner died before their RBD, then the NEDBs could wait to take any withdrawals until year 10 if they chose. As of publication, these regulations are still just proposed with final rules expected soon. Although it’s likely that NEDBs still would take distributions of some kind in those first nine years, this proposed regulation limits a beneficiary’s flexibility.

In the meantime, planners are focusing on what these new rules might mean for account owners and beneficiaries, and how to mitigate the impact.

IMPACT OF THE 10-YEAR RULE

In short, the new 10-year rule will mean beneficiaries will have to liquidate inherited IRAs much sooner than anticipated, often meaning larger distributions on an annual basis. These larger distributions may then be subject to a larger tax cost by moving the beneficiary into a higher marginal bracket. The larger tax cost, combined with less time for the assets to grow tax-deferred inside the traditional IRA, ultimately means less wealth will be transferred by the account owner to beneficiaries. That probably seems intuitive to most planners, but the magnitude of the lost wealth over time may be surprising.

To illustrate this, consider the following scenario: A decedent leaves a \$1-million IRA to a 55-year-old child, who is an NEDB. This NEDB child already pays the 37-percent top federal tax rate, plus state tax of 5 percent, for a total tax of 42 percent. Under the old stretch rules, the beneficiary would have withdrawn RMDs of about \$442,000 over the first 10 years (assuming 7-percent growth in the IRA). Those RMDs, after being taxed, are reinvested in a taxable account (assumed to earn 5.5 percent after taxes). In 10 years, that investment

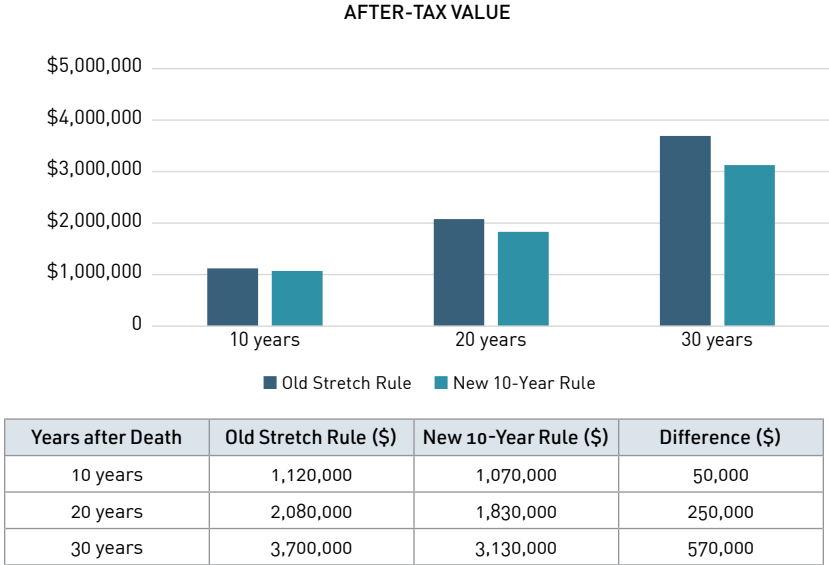
account is worth around \$320,000. Meanwhile, almost \$1.4 million remains in the IRA. Projecting a 42-percent tax on that balance means the IRA is worth about \$800,000 after taxes in 10 years, for a combined value to the beneficiary of \$1.12 million.

Contrast that to the new 10-year rule. Assume the NEDB, hoping to spread the tax cost over the 10 years, withdraws one-tenth of the IRA in year 1, then one-ninth in year 2, one-eighth in year 3, and so forth. After 10 years, nearly \$1.5 million has been withdrawn from the IRA, leaving the account empty. That \$1.5 million, after being taxed, is reinvested earning the same 5.5-percent after-tax return. That account is worth about \$1.07 million in year 10, a loss of roughly \$50,000 in value from the old stretch scenario (see figure 1). That’s not a huge difference in projected after-tax value, but over time that difference becomes more significant.

After 20 years, the old stretch scenario would leave the beneficiary with about \$2.08 million total after-tax. Under the 10-year rule, with the IRA liquidated and the earnings fully taxed annually, the beneficiary would have about \$1.83 million, or \$250,000 less than in the old stretch scenario. After 30 years, the balances are about \$3.7 million and \$3.13 million, respectively, a difference of nearly \$570,000.

That’s a meaningful impact for a top-bracket taxpayer. But the impact could be more significant for an NEDB who would have remained in a lower tax bracket under the old stretch rules, but who becomes subject to a higher tax cost due to the larger distributions. For example, assume a beneficiary would have paid a 24-percent tax on the old stretch RMDs, plus another 5-percent state tax, for a total tax of 29 percent. In that case, because of the lower tax cost, the after-tax value of the IRA and savings account would be roughly \$1.37 million after

Figure 1 **IMPACT OF THE 10-YEAR RULE—BENEFICIARY ALWAYS IN A 42% TAX BRACKET**

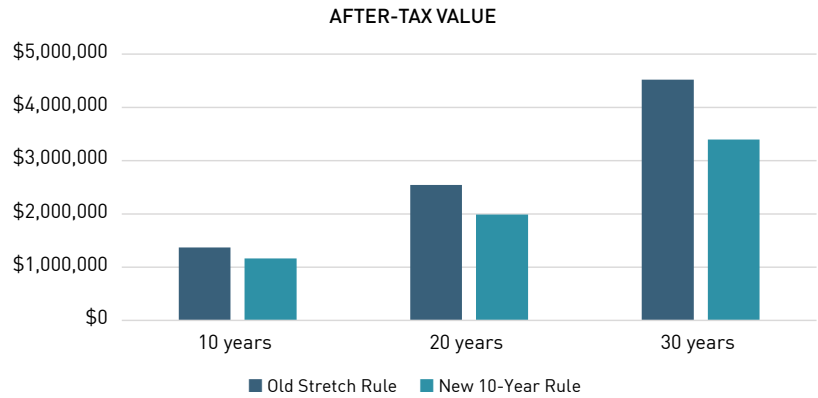


10 years (see figure 2). By having to liquidate the IRA over those first 10 years, using the same one-tenth, one-ninth, etc., approach as before, the larger distributions are now mostly taxed at a 32-percent federal rate, plus the 5-percent state tax, for a total of 37 percent. In that case, after 10 years the value to the beneficiary is just \$1.16 million, a reduction of more than \$200,000.

Looking out even further into the future, the difference grows. After 20 years, being forced to liquidate the IRA under the 10-year rule leaves the NEDB with more than \$550,000 less than under the old stretch rules. After 30 years, the lost value is more than \$1.1 million compared to the old stretch rules.

Figure 2

IMPACT OF THE 10-YEAR RULE—BENEFICIARY MOVES FROM 29% TO 37% TAX BRACKET



Years after Death	Old Stretch Rule (\$)	New 10-Year Rule (\$)	Difference (\$)
10 years	1,370,000	1,160,000	200,000
20 years	2,550,000	2,000,000	550,000
30 years	4,500,000	3,400,000	1,100,000

A CONUNDRUM FOR OWNERS

This loss in value creates a conundrum for the IRA owner. The new 10-year rule won't change how owners access savings over their lifetimes, and spouses are exempt from these accelerated withdrawals. The loss in value is exclusively an issue for the beneficiary. Most strategies to mitigate this impact, however, can be implemented only by the owner before death. Some owners may not be willing to disrupt any of their existing plans to help beneficiaries in this situation; perhaps they'll think that the beneficiaries already are getting a large inheritance and taxes are just something they must deal with. Regardless of the reasons, not all IRA owners will be concerned about this loss of value.

From the beneficiary's standpoint, once the owner dies, little can be done about the accelerated distributions. The beneficiary's only real choice is to be strategic in how the withdrawals are taken from the inherited IRA. The proposed regulations may force an RMD from the IRA, but the beneficiary still would control how to withdraw the remaining balance over that 10-year window. Maybe the beneficiary limits withdrawals to just the RMD for a few years, until retirement perhaps, when

other income likely will fall—then take larger withdrawals without fear of triggering a larger marginal tax rate.

Given the choice of their savings going to heirs or to taxes, however, most IRA owners likely will choose the heirs. And although the loss in value can't be completely made up through planning strategies, an owner can do things to at least improve the situation. Some are easier than others, and all have complications and risks, but advisors should be prepared to discuss these strategies with clients.

ROTH CONVERSIONS

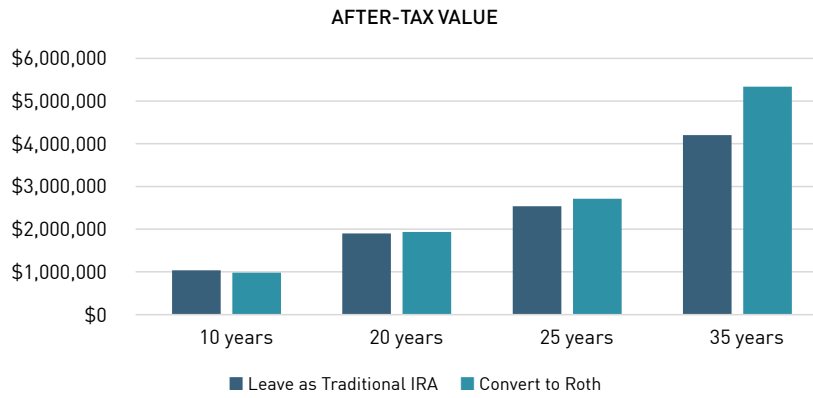
When the 10-year rule became law, Roth conversions were one of the first strategies promoted by planners, and, at first glance, they make sense. If IRA owners are concerned about the accelerated taxes heirs are going to pay by inheriting a traditional IRA, maybe owners should move the assets into an account that will grow tax-free for the rest of its existence. Neither the owner nor spouse is required to take withdrawals from a Roth, so there could be many years of tax-free growth. In addition, although the Roth is still subject to the

10-year rule for an NEDB, those beneficiaries can let the funds continue growing for the first nine years they own the account, and then take a full distribution in year 10. Because Roth IRAs aren't subject to RMDs during the owner's lifetime, there is technically never an RBD, so the proposed regulations requiring annual RMDs won't apply.

A Roth conversion can be very effective in this situation, but it often takes time for that benefit to become obvious. Take an example of a 65-year-old IRA owner who is considering a \$500,000 Roth conversion. Assume the owner lives to age 90, at which point an NEDB inherits the account. If the owner chose to not convert, the owner would take the RMDs from the traditional IRA each year, pay the tax cost, and reinvest the net amount in a savings account. If the owner converts, the conversion taxes would be paid from non-IRA assets, and the Roth may remain untouched for the rest of the owner's life. Upon the owner's death, the NEDB inherits either the traditional or Roth IRA (along with the taxable account used for reinvesting). For the traditional IRA, the beneficiary takes pro rata distributions over 10 years; for the

Figure 3

**ROTH CONVERSION—29% TAX BRACKET FOR OWNER;
42% TAX BRACKET FOR BENEFICIARY**



After-tax Value in:	Leave as Traditional IRA (\$)	Convert to Roth (\$)	Roth Advantage (\$)
10 years	1,040,000	984,000	(56,000)
20 years	1,900,000	1,934,000	34,000
25 years	2,525,000	2,700,000	175,000
35 years	4,200,000	5,300,000	1,100,000

Upon the owner’s death at age 90, the balance would then go to the NEDB child, who is a top-bracket taxpayer (37-percent federal + 5-percent state = 42-percent total). Tax adjusting the value of the traditional IRA to provide an equal comparison, our analysis shows it takes about 18 years for the Roth conversion scenario to provide the same value as the no-conversion scenario. During this time, the owner may be questioning the strategy, wondering if it was worth the upfront tax cost to convert. However, by the time of the owner’s death at age 90, the Roth scenario has a \$175,000 advantage over the no-conversion scenario (see figure 3).

It’s at this point that the two scenarios diverge, as the beneficiary begins taking annual distributions from the traditional IRA but leaves the Roth IRA untouched until year 10. In year 10, when both accounts are fully liquidated, the Roth scenario provides \$5.3 million in value to the heir, whereas the traditional IRA scenario provides \$4.2 million, an advantage of \$1.1 million.

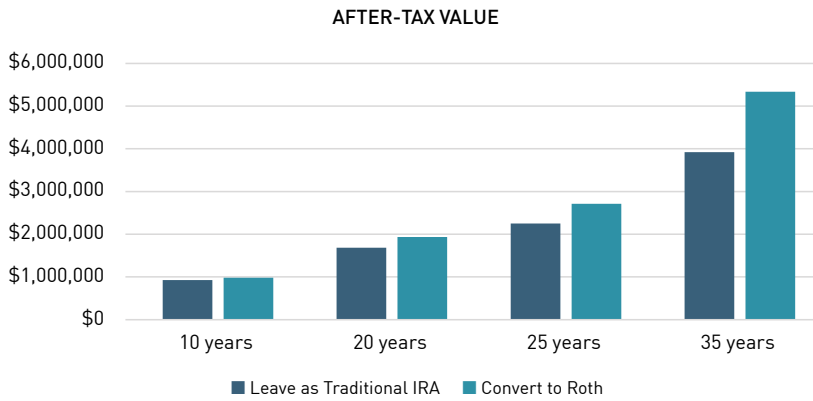
If the parent is in the same high tax bracket as the NEDB child (42 percent every year), the difference becomes more significant (see figure 4). The result of the Roth conversion scenario stays the same—the added tax cost upon conversion is paid with outside funds, leaving the same \$5.3 million in the Roth. The no-conversion scenario, however, provides just \$3.9 million of wealth. The advantage of the Roth to the NEDB child increases to \$1.4 million.

Even in the case where both owner and beneficiary are in the 29-percent combined tax bracket (other than the parent’s 40-percent tax in the year of the conversion), as shown in figure 5, the advantage to the Roth after 35 years is about \$900,000 (\$5.3 million versus \$4.4 million).

The Roth clearly provides an advantage, but often not a meaningful one for several years, and for older IRA owners there’s less chance they’ll live to see

Figure 4

**ROTH CONVERSION—42% TAX BRACKET FOR OWNER
AND BENEFICIARY**



After-tax Value in:	Leave as Traditional IRA (\$)	Convert to Roth (\$)	Roth Advantage (\$)
10 years	928,000	984,000	56,000
20 years	1,690,000	1,930,000	240,000
25 years	2,250,000	2,700,000	450,000
35 years	3,900,000	5,300,000	1,400,000

inherited Roth, the beneficiary leaves it untouched until year 10, at which point it’s fully distributed. All distributions from either IRA would be reinvested in the taxable account, which earns a 5.5-percent after-tax return. While in the IRAs, the funds would each earn a 7-percent pre-tax return.

When evaluating the conversion decision, we’ll focus on different tax scenarios. Assume the IRA owner is in a 24-percent federal and 5-percent state tax bracket (29-percent total) during a typical tax year but would jump to a blended 35-percent federal tax cost in the year of conversion (40-percent total).

that difference. The scenario where the Roth conversion is least likely to provide a benefit, even over a longer time frame, is when the parents spend more than a nominal amount from the accounts during their lifetimes. By spending down the Roth IRA without giving it time to grow tax-free, the accelerated tax cost of the conversion can result in a net negative impact on the beneficiary.

LEAVE THE IRA TO A CHARITABLE REMAINDER TRUST

The other solution commonly discussed by planners in the wake of the SECURE Act is to leave the IRA to a charitable remainder trust (CRT). There is a lot to like about this approach because a CRT allows the owner to create a legacy planning tool that also leaves an income stream for a beneficiary.

Upon the owner's death, the IRA is liquidated, but because the account is transferred to a CRT, there is no immediate tax cost. Instead, the assets continue to grow tax-deferred, and only the distributions to the income beneficiary are taxable. The CRT provides that annual income as either a fixed amount (an annuity trust, or CRAT) or a percentage of the trust value (a unitrust, or CRUT), and this income to the beneficiary closely replicates the RMD stream under the old stretch IRA rules.

However, the CRT is not a perfect solution. First off, creating and administering a CRT can be complicated, requiring an attorney to draft the trust and an accountant to prepare the trust's tax return. More importantly, though, the income beneficiary of the trust only has access to the annual income stream. The principal is reserved for charity and never can be accessed by that income beneficiary. Although this can be a great outcome for the charity, it doesn't meet the objective of replacing the beneficiary's lost wealth because of the new 10-year rule.

Take a case where an IRA owner dies with a \$500,000 traditional IRA, which is left to an NEDB. Using the same

Figure 5

ROTH CONVERSION—29% TAX BRACKET FOR OWNER AND BENEFICIARY

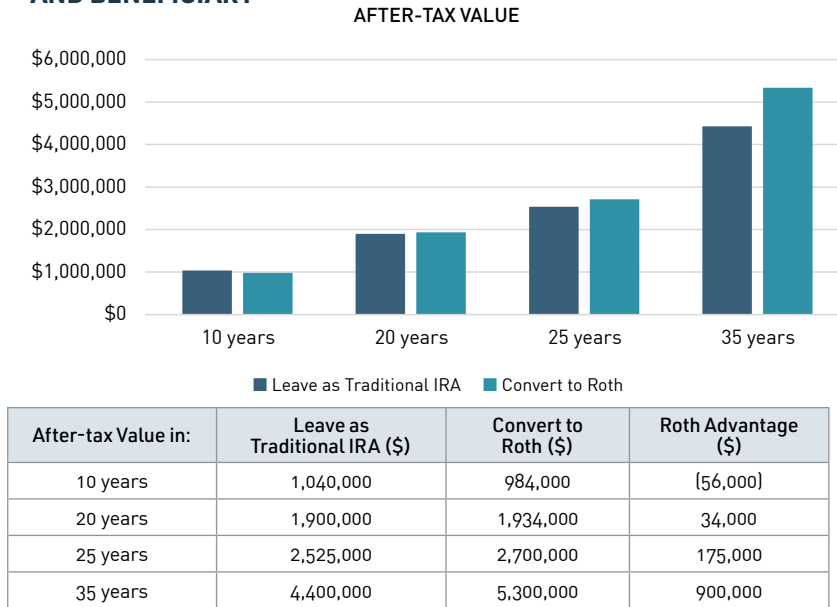
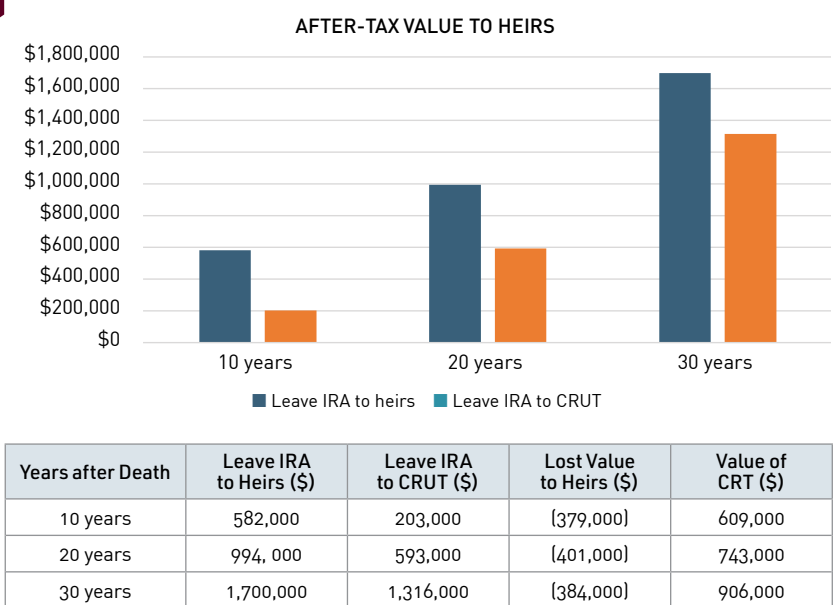


Figure 6

5% CHARITABLE REMAINDER TRUST SCENARIO



assumptions as earlier about investment returns, pro rata withdrawals over the 10 years, a combined 42-percent tax rate, and saving all the after-tax withdrawals, the beneficiary would have an after-tax value of roughly \$582,000 after 10 years, \$994,000 after 20 years, and \$1.7 million after 30 years (see figure 6).

Compare that to a CRUT that pays the beneficiary 5 percent of the trust value

every year, taxed at the same 42-percent combined tax rate, with the after-tax payment reinvested. After 10 years, the income beneficiary would have just \$203,000, or \$379,000 less than by inheriting the full IRA. The CRUT falls further behind the inherited IRA every year, before eventually reversing course after 23 years. Still, after 30 years the CRUT lags the inherited IRA scenario by \$384,000.

On the other hand, after those 30 years, roughly \$906,000 is sitting in the CRUT, waiting to be paid to a charitable beneficiary. The IRA beneficiary may receive a lower net inheritance, but the difference is going to charity rather than to taxes.

One way to offset this difference is to design the CRUT with a 10-percent payout to the income beneficiary. Doing

so will leave that beneficiary with \$1.56 million after 30 years, a difference of just \$135,000. Of course, giving more to the beneficiary leaves less for the charity, because the CRUT value after 30 years would be just \$200,000 (see figure 7).

Combining a CRT with an IRA can be a terrific planning tool for those looking to create a charitable legacy and still

provide an income stream for a beneficiary. However, on its own, it won't mitigate the impact of the new 10-year rule. In fact, it will usually lead to an even smaller bequest for that beneficiary.

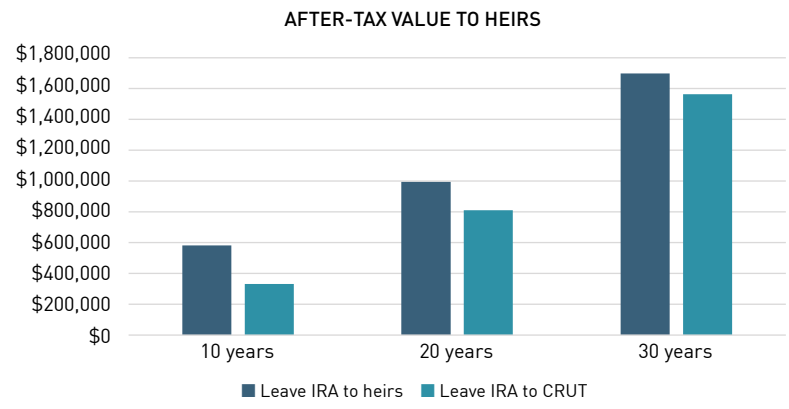
OTHER STRATEGIES TO CONSIDER

Although Roth conversions and CRTs are the most common suggestions in these scenarios, they are far from the only ones (see table 1). For example, maybe an IRA owner isn't comfortable with the tax cost of a Roth conversion, especially knowing that making any withdrawals from the account can reduce or even eliminate the benefit of the strategy. Yet maybe the owner has a lower tax bracket relative to the heir and wants to take advantage of that situation. In this case, maybe the owner uses the tax-deferred IRA for living expenses rather than spending assets from a taxable account. Doing so can preserve the taxable assets for a step-up in basis at the owner's death, essentially providing a tax-free inheritance. Convincing the owner to trigger a tax liability by using IRA dollars may be challenging, but this is where the advisor can use

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Figure 7

10% CHARITABLE REMAINDER TRUST SCENARIO



Years after Death	Leave IRA to Heirs (\$)	Leave IRA to CRUT (\$)	Lost Value to Heirs (\$)	Value of CRT (\$)
10 years	582,000	331,000	(251,000)	369,000
20 years	994,000	810,000	(184,000)	272,000
30 years	1,695,000	1,560,000	(135,000)	200,000

Table 1

PLANNING AROUND NEW RULES FOR INHERITED RETIREMENT ACCOUNTS—COMPARISON OF PLANNING STRATEGIES

Planning Strategy	Advantages	Disadvantages
Roth conversion	<ul style="list-style-type: none"> Taxed at owner's (presumably) lower tax rate Reduces owner's future RMDs Growth in the Roth is tax-free 	<ul style="list-style-type: none"> Too large a conversion could result in an overall larger tax cost Opportunity cost on the funds used to pay the conversion tax Roth is still subject to the 10-year rule
Leave IRA to Charitable Remainder Trust	<ul style="list-style-type: none"> Preserves tax-deferral of the IRA Replicates the regular income stream from RMDs Trustee maintains control over the principal Creates a lifetime legacy planning vehicle 	<ul style="list-style-type: none"> Requires attorney to create the CRT, CPA to prepare the tax return, trustee to administer Income beneficiaries and their heirs have no access to the principal
Spend down IRA during life	<ul style="list-style-type: none"> Taxed at owner's (presumably) lower tax rate Reduces owner's future RMDs Leaves taxable assets unused, which benefit from basis step-up at owner's death 	<ul style="list-style-type: none"> Large withdrawals could result in an overall larger tax cost Opportunity cost on the funds used to pay the tax on extra withdrawals Lost tax-deferred growth in the IRA
Strategic beneficiary designations	<ul style="list-style-type: none"> Less total value lost to income tax Heirs can receive a larger after-tax inheritance 	<ul style="list-style-type: none"> Difficult to determine initial split of assets Splits may need to be updated periodically due to changes in values, tax law, or beneficiary's situation Must explain why pre-tax inheritances are no longer equal
Irrevocable life insurance trust (ILIT)	<ul style="list-style-type: none"> Insurance premiums can be leveraged into a larger benefit Death benefit of insurance is tax-free Using an ILIT allows IRA owner to maintain control of assets 	<ul style="list-style-type: none"> IRA owner may not be insurable, or cost may be prohibitive Costs associated with creating ILIT Potential gift-tax concerns

PLANNING AROUND NEW RULES ...

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projections to show the long-term advantage.

Another idea that won't impact the owner today, but could be beneficial to heirs, is to be more strategic with beneficiary designations. Typically, an individual with multiple children will leave an equal amount of each account type to each child. However, those children may be in very different tax situations, and inheriting part of a traditional IRA may mean a much different inheritance for each child. Instead of simply dividing all assets equally, consider leaving tax-deferred assets such as traditional IRAs or employer plans to children in lower tax brackets, and leaving a Roth IRA, life insurance death benefits, or assets with a stepped-up basis to those in higher tax brackets. This can be tricky to implement because account values, tax rules, and the heirs' situations change over time, but it can be much easier to implement than many of the other strategies.

Maybe the easiest strategy to understand, but not always the easiest to implement, would be using life insurance to replace the value lost to income taxes. By having the death benefit paid to an irrevocable life insurance trust (ILIT), the owner can remove the death benefit from their taxable estate and still maintain control over the money after death. In addition, the death benefit is income-tax-free, making it significantly more attractive to an heir than a retirement account. The trick is identifying this opportunity before the IRA owner is too old or in declining health, in order to purchase a policy at a reasonable cost. This may work well for someone in their 50s or even 60s, but it might be cost-prohibitive once they reach their 70s.

CONCLUSION

The SECURE Act's 10-year rule will have a negative impact on the net amount passed to most heirs by forcing distributions from plans earlier than under previous laws. The extent of the

impact, or the actions that IRA owners are willing to take to mitigate that impact, will vary by situation. Advisors will be tasked with illustrating this impact to clients, laying out the options for addressing it, and then assisting in implementing the desired solutions. If advisors hope to work with the heirs, these efforts may be a key factor in an heir's decision. This could end up being a pivotal planning opportunity for advisors, one they shouldn't take lightly. ●

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