INSIGHT ON ESTATE PLANNING

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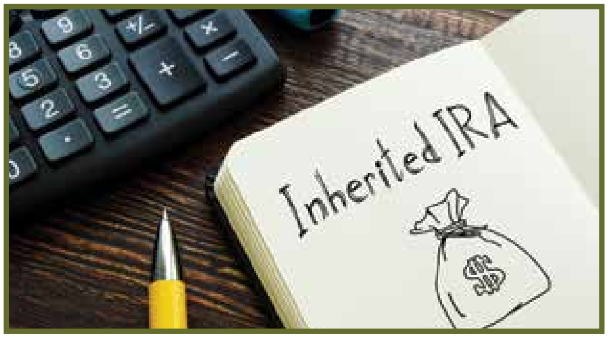
The IRS delays RMDs for inherited IRAs

The IRS has for the third consecutive year offered relief to taxpayers covered by the "10-year rule" for required minimum distributions (RMDs) from inherited IRAs or other defined contribution plans. Let's look at how this may affect your retirement and estate plans.



Rules for RMDs

Once you reach a specified age — known as the required beginning date (RBD) — you must begin taking RMDs from your IRA on an annual basis. Comparable rules apply to qualified plans such as 401(k) accounts.

Previously, the RBD was generally April 1 of the year following the year you reach age 70½. The Setting Every Community Up for Retirement Enhancement (SECURE) Act extended the age to 72, beginning in 2020. SECURE 2.0, a follow-up to the initial SECURE Act, increased the age to 73, beginning in 2023.

The amount of your RMDs is based on the account balances on December 31 of the prior year and IRS-approved life expectancy tables. Absent special waivers from the IRS, you must take RMDs in each succeeding year. RMDs are taxed at ordinary income rates currently topping out at 37%.

Rules for inherited IRAs

Before the SECURE Act, all beneficiaries of inherited IRAs were allowed to stretch the RMDs on the accounts over their entire life expectancies. For younger heirs, this meant they could take smaller distributions for decades, deferring taxes while the accounts grew. They also had the option to pass the IRAs on to later generations, which deferred the taxes even longer.

Note that the SECURE Act rules don't apply to stretch IRAs created before 2020. These IRAs are "grandfathered" by the law and can continue to operate under the prior rules.

To avoid this extended tax deferral, the SECURE Act imposed limitations on which heirs can stretch IRAs. Specifically, for IRA owners or defined contribution plan participants who died in 2020 or later, only "eligible designated beneficiaries" may stretch payments over their life expectancies. The following heirs are eligible designated beneficiaries:

- Surviving spouses,
- Children younger than the "age of majority,"
- Individuals with disabilities,
- Chronically ill individuals, and
- Individuals who are no more than 10 years younger than the account owner.

All other heirs (designated beneficiaries) must take the entire balance of the account within 10 years of the death, regardless of whether the deceased died before, on or after the RBD for RMDs.

What's the penalty?

It's important to note that you must continue to take required minimum distributions (RMDs) from your IRA and/or qualified plans if you've reached your required beginning date. Don't make the mistake of ignoring or forgetting about this responsibility.

Failing to take timely RMDs from inherited IRAs or other defined contribution plans can result in unwanted tax consequences. The penalty, however, isn't as severe as it was before the latest tax law changes.

In the not-so-distant past, the penalty was equal to a staggering 50% of the amount due (or any shortfall, if lesser). But the SECURE 2.0 law cut the penalty in half, to 25%. Furthermore, the penalty is reduced to 10% if the error is corrected in a timely fashion.

Of course, you still must pay the regular tax on RMDs. Don't add insult to injury by incurring a penalty.

Proposed regs added to confusion

The IRS issued proposed regulations in February 2022 that came with an unwelcome surprise for many affected heirs. Under the proposed regs, beneficiaries of IRAs where the account owner had attained their RBD must take their taxable RMDs in years one through nine after death (based on their life expectancies). They must then receive the balance in the 10th year. In other words, they aren't permitted to wait until the end of 10 years to take a lump-sum distribution. This annual RMD requirement gives beneficiaries much less tax planning flexibility and could push them into higher tax brackets during those years.

This caught many beneficiaries, as well as their professional tax advisors, by surprise. It also led to greater uncertainty in estate planning. In particular, it wasn't clear if RMDs must be spread over the applicable 10-year period.

In response, only six months after the proposed regs were published, the IRS waived enforcement against taxpayers subject to the 10-year rule who:

- Missed 2021 and 2022 RMDs if the plan participant died in 2020 on or after the RBD, or
- Missed 2022 RMDs if the participant died in 2021 on or after the RBD.

The waiver guidance indicated that the IRS would issue final regs that would apply no earlier than 2023. But the IRS later extended the waiver relief to excuse 2023 missed RMDs if the participant died in 2020, 2021 or 2022 on or after the RBD.

In Notice 2024-35, the IRS has again extended the relief, this time for RMDs in 2024 from an IRA or defined contribution plan when the deceased passed away during the years 2020 through 2023 on or after the RBD. If certain requirements are met, beneficiaries won't be assessed a penalty on missed RMDs, and plans won't be disqualified based solely on such missed RMDs.

Final regs on the horizon

As of the writing of this article, the IRS has yet to issue final regs for the rule that will apply for the purposes of determining RMDs from inherited IRAs or qualified plans in 2025. In the meantime, consult with your estate planning advisor for the latest information and to learn more on how the proposed regs may affect your retirement and estate plans. •

Have grandkids?

Opening 529 plan accounts can benefit them and your estate plan

The cycle continues: Your adult children — one of the first generations to benefit from Section 529 plans — are saving for their kids' college educations through 529 accounts of their own. Did you know that parents aren't the only ones who can establish 529 plan accounts? As a grandparent, you can follow the same path. In fact, recent enhancements may encourage you to include 529 plans in your estate plan.

Types of plans

There are two types of 529 plans: prepaid tuition plans and college savings plans. A prepaid tuition plan is designed to keep pace with rising tuition costs. Essentially, you buy shares at a current price that can be used to pay for tuition in the future. This plan is attractive because there's no risk of loss of principal and the investment may be guaranteed by the state.

With a college savings plan, you can't lock in future tuition expenses as you can with a prepaid tuition plan. But it has a bigger potential upside because you may be able to generate a better return.

Typically, the plan will offer an asset allocation strategy based on your grandchild's age. For example, it may provide aggressive investments in the early years and then switch to more conservative investments. Most college savings plans also offer a wide range of risk-based asset allocation portfolios managed by professionals.

Each state sets its own limits on contribution amounts to its college savings plan. But most limits are generous and reach well into six figures. Check the rules for the states you're considering.

Depending on your situation, you might set up accounts for several grandchildren. After one grandchild graduates, you can roll over any remaining funds into the account of a younger grandchild. Similarly, you may transfer funds if a grandchild decides not to go to college or drops out.

Tax implications

529 plans offer tax benefits on both the federal and state levels. First, the amounts you contribute to the account can continue to grow tax-free. There are no potential tax consequences until amounts are withdrawn.

Second, no tax is imposed on withdrawals used to pay for qualified higher education expenses. Typically, these include tuition, fees, books, supplies and equipment, plus room and board for students who are enrolled at least half-time. Distributions for other reasons, however, are taxable.

Third, many states offer tax breaks for contributions, including deductions or matching grants, subject to certain restrictions.

What about gift tax? Contributions to a 529 plan may be sheltered by the annual gift tax exclusion. For 2024, the exclusion is $18,000 per recipient ($36,000 for joint gifts by a married couple). Any excess is sheltered by the federal gift and estate tax exemption ($13.61 million in 2024).

Unique opportunity: The tax law allows you to give up to five years of contributions to a 529 plan at one time that's sheltered by the annual gift tax exclusion. For instance, you and your spouse can contribute a total of up to $180,000 per recipient in 2024 — all of it exempt from gift tax.

Recent enhancements

The favorable tax rules for 529 plans have been further enhanced by recent developments. Prior to the Tax Cuts and Jobs Act (TCJA), the tax exclusion for qualified expenses was strictly limited to colleges and graduate schools. Under the TCJA, this tax break is extended to the first $10,000 of tuition at an elementary or secondary public, private or religious school.

Also, the SECURE Act allows you to use up to $10,000 in a 529 plan to repay the beneficiary's student loans, plus another $10,000 to repay student loans held by the beneficiary's siblings. It also allows 529 funds to be used to pay for apprenticeships (for example, classroom instruction at a community college).

Finally, a change in the way that financial aid is calculated on the Free Application for Federal Student Aid (FAFSA) form may help grandchildren. Gifts from grandparents to 529 accounts no longer affect the allowable aid.

Give to future generations

Given the high costs of a college education, as well as many private elementary and secondary schools, it's important to plan for these expenses. Opening 529 plans for your grandchildren can be a powerful, tax-efficient tool you can use to save for their education expenses. And the estate planning benefits are a plus. Consult with your estate planning advisor to learn how 529 plan accounts may affect your plan. •

Is your estate plan ready for future estate tax law changes?

The year 2017, when the Tax Cuts and Jobs Act was signed into law, seems like a long time ago. As you may be aware, many of the tax provisions of that law are set to expire in a relatively short amount of time — on January 1, 2026.

For estate planning, it's important to realize that the federal gift and estate tax exemption is scheduled to drop to an inflation-adjusted amount of only $5 million. (Based on current estimates, the amount is expected to adjust to approximately $6.08 million). Still, that's a far cry from today's amount of $13.61 million.

While there's a chance that Congress will step in with new tax law legislation before 2026, there's no guarantee. Thus, you need to consider strategies that take advantage of the current exemption amount while retaining flexibility to access your wealth should a need arise.

Draft a SLAT

If you're married, a spousal lifetime access trust (SLAT) can be an effective tool for removing wealth from your estate while retaining access to it. A SLAT is an irrevocable trust, established for the benefit of your children or other heirs, which permits the trustee to make distributions to your spouse if needed, indirectly benefiting you as well.

So long as you don't serve as trustee, the assets will be excluded from your estate and, if the trust is designed properly, from your spouse's estate as well. For this technique to work, you must fund the trust with your separate property, not marital or community property. However, there's a caveat.

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Beware the "reciprocal trust doctrine"

Keep in mind that if your spouse dies, you'll lose the safety net provided by a SLAT. To reduce that risk, many couples create two SLATs and name each other as beneficiaries. Couples who establish such trusts for each other must plan carefully to avoid running afoul of the "reciprocal trust doctrine."

Under the doctrine, the IRS may argue that the two trusts are interrelated and leave the spouses in essentially the same economic position they would've been in had they named themselves as life beneficiary of their own trusts. If that's the case, the arrangement may be unwound and the tax benefits erased.

To avoid this outcome, the trusts' terms should be varied so that they're not substantially identical. For example, you might appoint different trustees, establish the trusts in different states, fund the trusts at different times, designate different beneficiaries, or provide for different withdrawal rights or powers of appointment.

Take advantage of the gift tax exemption

A domestic asset protection trust (DAPT) is another tool that allows you to remove wealth from your estate, taking advantage of the current gift tax exemption, while preserving indirect access to your assets in the future. A DAPT is an irrevocable trust established in a state with a DAPT law, which protects trust assets from creditors even though you're a beneficiary of the trust. An independent trustee has the power to make discretionary distributions to you should a need arise.

DAPTs aren't risk-free, however. Their ability to shield assets from creditors hasn't been fully tested in the courts, particularly for trusts established in a state with a DAPT law by a resident of a non-DAPT state.

Uncertainty reigns

Having so much uncertainty regarding estate tax laws can be unnerving. Plus, the outcome of the national elections in November may have a major effect on any new tax legislation in 2025. Your advisor can keep you apprised of new tax laws that can affect your estate plan. •

ESTATE PLANNING PITFALL

You're guilty of procrastination

There are many hurdles to overcome in estate planning. They can include potential estate taxes, complex tax laws and a lengthy probate process, among other things. But the biggest obstacle is often self-imposed: procrastination.

There are numerous reasons for putting off estate planning. You're busy with other aspects of your life and you don't expect to die anytime soon. Or you think that you don't have enough in the way of assets to make estate planning a necessity. Furthermore, no one likes to think about his or her own mortality. So, it's just easier to postpone the whole thing.

But here's some practical advice: Motivate yourself. Not having an estate plan in place, especially the basics of a will and health care directives, can have dire tax consequences in the event of an unexpected demise.

Without a will, your assets will be divided according to state law, regardless of your wishes. This can cause family disputes and lead to legal actions. It can also result in tax liabilities that could have been easily avoided.

A living will can spell out instructions for end-of-life decisions. A power of attorney can appoint someone to handle your affairs if you're incapacitated. A living trust can be used to transfer assets without going through probate. These are just a few relatively simple documents that can comprise an estate plan.

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