Legacy Planning for IRAs

From [Ed Slott's IRA Advisor](#) (April 2024)
Written with Joseph A. Clark, CFP®
Financial Enhancement Group Trust Services | Lafayette, IN

IRAs are designed as an accumulation tool to supplement the owner's retirement income, similar to employer-sponsored retirement plans such as 401(k)s. Once the owner separates from the workforce and the paychecks stop, Social Security, IRAs and other retirement accounts help to provide the cash flow necessary to maintain a consistent standard of living. The percentage of income a person saves in various types of retirement accounts should be focused purely on replacing earnings and maintaining his or her lifestyle in retirement. Rarely is our date of death predetermined, so many IRA owners will meet their demise with remaining assets. *Now what happens?*

Because it is common for IRAs to outlast their owners, retaining funds running into five or six or even seven figures, IRAs should be addressed in a legacy plan. Setting the stage for favorable distribution of IRA dollars can leave cherished memories as well as liquidity to a surviving spouse, descendants, loved ones, and favored causes.

Changing Times

Things will change in family dynamics, tax code provisions and economic needs. As a result, efficient legacy planning for IRAs demands ongoing review. Account owners and advisors must deal with complex distribution requirements and beneficiary requirements. The tax code is anything but a static vacuum, so changes are more likely than stability.

For example, recent legislation changed the beginning date for required minimum distributions (RMDs) from age 701/2 to 72 and now to age 73. In 2033, the RMD age will increase to 75, so anyone now 64 or younger will have two more years to develop a tax-efficient IRA distribution strategy.

Legislation also has changed to allow for IRA contributions for individuals remaining in the workforce later in life. Changes will continue so quality planning requires a plan that works today, addresses possible changes in the future and has a bent towards flexibility rather than rigidity.

Change requires new planning questions that should be addressed. *Do these delays mean more time for tax-deferred buildup inside IRAs? Or, will postponing RMDs inevitably lead to more annual RMDs, perhaps taxed at steep rates if government financial stress becomes acute?* A potential change in legacy planning might call for cautious pre-RMD

---

distributions to fill up currently modest tax brackets, using the withdrawn dollars for family gifts, supplemental life insurance premiums, or future untaxed distributions without RMDs after Roth IRA conversions.

The key takeaway is that there are choices; depending on the owner's circumstances and intended objectives, the strategies for accumulation in tax-deferred accounts are anything but straightforward.

Heirs Are Not Equal

Retirement account dollars are not equal — *neither are beneficiaries.* There are meaningful differences between IRAs and employer plans. Taxation on a distributed dollar from a tax-deferred savings vehicle and a Roth account is very different. The same holds true for beneficiaries: the needs of one beneficiary are not the same as the needs of another.

Recent tax code changes have impacted beneficiary distribution options. As before, surviving spouses can roll over inherited IRAs and use life-expectancy-based RMDs to stretch taxable IRA distributions for many years or even decades. Stretch IRAs may also be available to certain eligible designated beneficiaries (EDBs), including individuals deemed to be disabled or chronically ill.

However, now, many next-gen beneficiaries must follow a 10-year requirement, depleting an IRA they receive within a decade. Therefore, IRA owners and their advisors may have to consider how old a prospective beneficiary is currently, and how old he or she will be in 10 years. *What is the anticipated tax rate and income need?* A savvy legacy plan's goal will include helping beneficiaries who are excluded from stretch IRAs, not hinder them.

One case I worked on recently, involving an owner with three children (one of whom was deceased) and seven grandchildren, required five different legacy distribution strategies:

- Child 1: She had a rocky marriage, suggesting marital planning considerations.
- Child 2: He was independently wealthy and philanthropically motivated.
- Children of child 3: The surviving children of the deceased child had a 20-year age span, so tax code regulations pointed to three different strategies.

Assets will transfer to the next generation under then-current tax rules so the age and economic condition of each beneficiary will suggest varying legacy strategies, including the use of trusts.

Putting Trust in Trusts

One way to respond to such an evolving environment is to name a trust as IRA beneficiary, rather than designating individuals. The selected individuals can then be the beneficiaries of these "IRA trusts," ultimately receiving IRA distributions. IRA trusts provide the maneuverability to address the highest needs of the beneficiaries at the time of the owner's demise. Flexibility is constrained upon the owner's demise so distribution strategies for the beneficiaries must be addressed beforehand.

Why name a trust as IRA beneficiary? Because they are flexible enough to provide results desirable in specific situations. A sizable IRA may have more protection from creditors, from unfavorable divorce settlements, or from spendthrift descendants if it passes to a trust at the owner's death. In the case of a second marriage, a trust can provide a widow(er) with IRA distributions yet maintain substantial funds for an eventual payout if there are children from a previous marriage or relationship. If loved ones have special needs, keeping the IRA money away from individual ownership may help to maintain government aid. There may be tax advantages as well.

Satisfactory Structuring

Determining the type of IRA trust to be used can be a challenge. I have found that worst-case scenarios may occur when attorneys name grantor trusts as the IRA beneficiary without understanding the issues involved. That is like walking on a ledge for no reason. The custodian of the funds maintains the right to interpret the trust and often will err in favor of its potential legal liability rather than the trust creator's intended wishes.

A grantor trust is always a "living trust": one established while the trust creator (the "grantor") is alive. The grantor controls and directs the trust income and assets while owing any resulting tax. Often, a grantor trust will be a *revocable* trust, meaning that the arrangement can be undone if the IRA owner decides to go in another direction.

Leaving an IRA to a revocable grantor trust can create problems. Often, this trust holds assets from transfers during the IRA owner's lifetime. If an IRA owner names his or her revocable grantor trust as the IRA beneficiary, effectively mixing the IRA with these assets at death, this can lead to trouble. Unless the trust comports with all the specific rules pertaining to IRAs, there could be very negative tax consequences.
There is no reason to take such a major risk that leaving an IRA to a revocable grantor trust can present. Instead, naming a standalone IRA trust as beneficiary reduces the chance that it will run afoul of IRS rules.

Going Separate Ways

Instead of a grantor trust, separate IRA trusts should be used. For example, at hypothetical Adam's death, his IRA might divide evenly so that 25% goes to a trust where Bob is the beneficiary; 25% goes to a trust for Carol; 25% goes to a trust for Dan; and 25% goes to a trust for Earl. Or, Adam's IRA might go to a single trust at his death, and that trust might split into 4 sub-trusts for Bob and Carol and Dan and Earl. Each separate trust could have focused provisions such as a spendthrift clause for Bob's trust, special asset protection language for Carol's trust because of her state's law, and a possible lifetime stretch of RMDs for Dan, who is disabled.

A similar approach can be used on a master trust that will divide into separate sub-trusts for multiple beneficiaries. Separate trusts or sub-trusts also work well for IRA owners who have charitable gifts in mind as part of their legacy plan. In addition to one per human beneficiary, a separate trust could hold assets to be donated. If IRA owners hold after-tax assets in non-retirement accounts, IRAs should fund any and all charitable intentions.

When a properly structured IRA trust passes pre-tax assets to a recognized charity after inheriting the account, neither the trust nor the charity will owe income tax. Meanwhile, other assets can be retained by the IRA owner and bequeathed to loved ones. Under current law, appreciated assets get a basis step up, reducing or eliminating income tax on unrealized capital gains.

The bottom line is that IRAs and other retirement plans should be included in legacy planning. By collaborating and communicating with their asset managers, attorneys, CPAs, and other professionals, IRA owners can create holistic plans that leave fond recollections as well as wealth behind. IRA trusts may turn out to play a key role in creating happier endings.

Advisor Action Plan

- Include IRAs and other retirement accounts in estate planning meetings.
- Discover whether specific clients have circumstances that call for using trusts as IRA beneficiaries. Talk to the beneficiaries about their wishes and tax circumstances, if possible.
- For clients who would benefit, suggest they meet with attorneys, tax professionals, and other planners to determine how IRA trusts should be structured and who will be the trust beneficiaries.

- Advocate the use of separate trusts or sub-trusts versus grantor trusts for IRA beneficiaries.
- In addition to helping clients in this area, focus on your own legacy planning.
- If indicated, set up IRA trusts to meet foreseen needs.
- Inform heirs of your legacy plans, especially the role they will play in any IRA trusts.

Credentials

Joseph A. Clark, Certified Financial Planner (CFP®), and a Charter Member of Ed Slott's Master Elite IRA Advisor Group℠ is an accomplished author and educator with vast media experience.

Joe is a *USA Today* bestselling author known for his ability to distill complex concepts into easily understandable language. Moreover, his experience as a professor at Purdue University showcases his dedication to educating others.

Joe was a talk radio host for over 25 years, and it shows. He has also made countless appearances on CNBC, Fox Business News, and other reputable networks. His expertise and ability to articulate complex concepts make him an engaging guest on any platform.

Realizing that families needed help completing their financial journey, Joe founded Financial Enhancement Trust Services after working in the financial services industry for over 35 years. His mission is to help families complete the financial journey they set out to create many years ago.

Joe can be reached at (877) 514-6863 or TrustTeam@FEGtrust.com.
