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This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. Because the enhanced federal estate tax exemption under the Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act") gives new emphasis to income tax planning, this issue focuses on estate planning with retirement accounts. Our goal is to share our insights with wealth and philanthropy advisors, corporate fiduciaries, accountants and other advisors in a way that is accessible and actionable. We welcome feedback and additions to our mailing list (*ipb@ipbtax.com*).

TAX-EFFICIENT PLANNING FOR LARGE RETIREMENT ACCOUNTS

BY DOUGLAS ANDRE

Charitable Giving: Code section 408(d)(8) permits a person over age 70-½ to make up to $100,000 annually of charitable gifts directly from an IRA. Such gifts, called "qualified charitable distributions," are excluded from the donor's gross income, thereby reducing AGI. While the donation cannot be claimed as an itemized charitable income tax deduction, making qualified charitable distributions is generally preferable to receiving a taxable distribution and then making an offsetting charitable contribution of the cash. That is because the lower AGI associated with a qualified charitable distribution can benefit the donor in other ways (*e.g.*, a qualified charitable distribution can reduce AGI to below the threshold for the 3.8% net investment income tax). Making qualified charitable distributions is also better for individuals who don't itemize due to the larger standard deduction beginning in 2018. Qualified charitable distributions are also helpful for individuals who are subject to the 60% annual charitable deduction limitation and can be used to satisfy required minimum distributions ("RMD"). Using an IRA to make a charitable bequest also provides tax savings. A charity named as beneficiary of a traditional IRA will not be subject to income tax on account assets. In addition, the account owner's estate will receive an estate tax charitable deduction for the value of the gift.

Spouse as Primary Beneficiary: The primary tax benefit of naming a spouse as an outright beneficiary is that the surviving spouse has the right to roll over the retirement account into her own retirement plan. By rolling over the account, the surviving spouse can defer commencement of RMDs until she reaches age 70-½, especially important if the surviving spouse is considerably younger than the account holder. Once RMDs commence, the amounts required to be distributed may be less than for non-spouse beneficiaries (thereby deferring income). Finally, upon the death of the surviving spouse, she can leave the IRA to other designated beneficiaries to begin new life expectancy payout periods, thereby deferring additional taxable income.

Trusts Receiving Retirement Assets: The use of a trust to receive retirement assets should be carefully considered as missteps can accelerate income recognition. Only certain trusts will qualify for deferred/extended distributions from the retirement plan – otherwise the trust must withdraw all assets in the plan account over a five-year period, accelerating the income tax. As described elsewhere in this newsletter, properly drafted conduit trusts and accumulating trusts may be effective and appropriate given the circumstances. Trusts may be preferable where the beneficiary is a minor, is disabled or would benefit from the added creditor protections afforded by most trusts. Trusts that qualify for the estate tax marital deduction can also be used to receive retirement assets. Such trusts are essentially conduit trusts and the trust agreement must meet the requirements for both the marital deduction and the "look-through" rules associated with trusts that qualify as a "designated beneficiary." QTIP trusts may be appropriate in certain circumstances, but these may result in faster income recognition than would be the case if assets were left outright to the surviving spouse.

Additional Thoughts: We recommend that our clients review their retirement plan beneficiary designation forms periodically and after significant life events such as marriage, divorce or the birth of a child. The directions contained in the beneficiary designation form will generally be respected and will trump those in the account owner's Will, if in conflict. Under federal law, spouses are the default beneficiary for qualified retirement plans and spousal consent may be required to designate non-spouse beneficiaries.

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PRIMER ON TRADITIONAL IRA, ROTH IRA, AND ROTH 401(K) ACCOUNTS AND DISTRIBUTION RULES

BY KEN N. JEFFERSON AND BRENDA JACKSON-COOPER

Traditional IRA Account: An individual may contribute up to $6,000 to a traditional IRA for the 2019 tax year (or up to $7,000 for individuals over age 50). For those with qualifying incomes, contributions are deductible. Traditional IRA account assets grow tax-deferred and are only taxed upon withdrawal. When nondeductible contributions are made to a traditional IRA, the percentage representing the nondeductible contribution is applied to each withdrawal, and that percentage will not be taxed. Withdrawals of deductible contributions made prior to age 59-½ incur a 10% penalty in addition to ordinary income tax. An account owner who reaches age 70-½ is required to take at least the annual RMD before December 31. RMDs may be taken in monthly or quarterly installments. The RMD amount is based upon the life expectancy of the account holder. Taxpayers owning multiple IRAs have RMDs for each account. To satisfy the aggregate RMD for all the accounts, distributions may be taken from one account or a combination. Taxpayers who do not take their RMDs on a timely basis face a penalty of up to 50% of the difference in the amount withdrawn and the required withdrawal. For example, if the RMD was $7,500 and only $5,000 was distributed, a penalty of $1,250 will be due.

Roth IRA Accounts: A Roth IRA has contribution limits similar to a traditional IRA (and another article in this newsletter discusses conversion from a traditional IRA to a Roth account). Distributions to a Roth IRA account owner prior to age 59-½ and from an account that is less than five years old may be subject to both taxes and a 10% penalty on earnings**.** While distributions to the account owner after age 59-½ generally are not taxed, earnings will be subject to taxes if assets are withdrawn within five years of creating the account or converting from a traditional IRA. No RMDs are required during an original owner's lifetime and a spousal beneficiary who rolls the account over into his own or a new Roth IRA is not subject to RMDs either. A non-spouse beneficiary, however, must take RMDs. Distributions may either begin no later than December 31 of the year following the year of the account owner's death and continue over her life expectancy, or she may delay distributions until December 31 of the fifth year after the year of the account holder's death, at which time all assets must be distributed.

Roth 401(k) Accounts: A Roth 401(k) permits an annual contribution of up to $19,000, with a $6,000 catch-up contribution for account owners age 50 or older. There is no income limit imposed on an otherwise eligible employee participant in an employer-sponsored plan. Like Roth IRAs, withdrawals are not generally taxed, and the Roth 401(k) also grows tax-free. Unlike a Roth IRA, however, a Roth 401(k) is subject to RMDs after age 70-½, based on traditional IRA rules. To avoid the Roth 401(k) RMDs, an account owner could roll the account over into a Roth IRA following departure from his employer.

Strategies for Distributions: Owners of traditional IRA or Roth 401(k) accounts without current income needs may maximize tax-deferred or tax-free growth by delaying distributions until RMDs are mandated at age 70-½. The account owner may then enjoy enhanced tax savings due to a lower income tax bracket or relocation to a state with no income tax or exemptions for retirement account distributions (such as Florida, Kentucky or Colorado). His beneficiaries may inherit a larger account and depending on the account owner's and the beneficiaries' domiciles at time of death, potentially free from state estate and income tax. A Roth IRA account owner who delays distributions indefinitely will preserve tax-free growth into subsequent generations by leaving the account to younger beneficiaries.

Impact of the 2017 Tax Act: Under prior law, a taxpayer who made a nondeductible contribution to an IRA, and then later liquidated all of her IRAs, could recognize a loss when the amounts distributed were less than the remaining unrecovered basis in the IRAs. This loss would have been claimed as a miscellaneous itemized deduction subject to the 2% floor on AGI. Because the 2017 Tax Act has suspended miscellaneous itemized deductions, after December 31, 2017 and before January 1, 2026, account owners who liquidate their Roth or traditional IRAs have no means to use unrecovered basis to offset the increase to their adjusted gross income.

ROTH IRA CONVERSIONS AFTER THE TAX CUTS AND JOBS ACT OF 2017

BY KASEY A. PLACE

The 2017 Tax Act lowered the top marginal income tax rate for individuals from 39.6% to 37%, potentially reducing the overall tax liability of a Roth IRA conversion. At the same time, the 2017 Tax Act eliminated the ability to "undo" the transaction by recharacterizing converted assets. As a result, although Roth conversions may be more attractive now than ever, clients must approach them with caution as the stakes are higher.

Background: A Roth IRA is a special type of retirement savings vehicle. Contributions to a Roth are not deductible, but the account assets grow tax-free and, unlike a traditional IRA, are generally not taxed on withdrawal. Moreover, a Roth IRA is not subject to RMDs during the original owner's lifetime, meaning the assets can grow for a longer period of time within the account.

While there are income limits restricting who can contribute to a Roth IRA, anyone can convert their traditional IRA to a Roth. The conversion is essentially a taxable rollover of retirement funds to a Roth account. The owner will have to pay income tax at ordinary rates on the pre-tax amounts converted, but, if the conversion is done properly, should not owe an early withdrawal penalty, even if he or she has not yet attained age 59 1/2. Note that, to avoid penalties, the taxes cannot be paid from the converted funds.

Benefits of a Roth Conversion: The general rule is that it is better to defer income taxes, not accelerate them. A Roth conversion turns that conventional wisdom on its head. By converting a traditional IRA to a Roth, the owner pays income tax now at ordinary rates in return for tax-free growth and tax-free withdrawals. In particular, this may be beneficial to owners who expect to be in a higher income tax bracket after retirement, either because they will have more income at that time or because tax rates will have increased.

For high net worth clients, Roth conversions may be appealing for estate planning reasons as well. If the client will not need the IRA assets in retirement, the elimination of RMDs allows the account to grow tax-free for a longer period of time, thereby increasing the amount that will pass to the owner's beneficiary(ies) at death. Further, for clients who will be subject to estate tax at death, the assets used to pay the income tax liability on a Roth conversion will reduce their taxable estate. They are essentially pre-paying the income taxes on behalf of their beneficiaries without having to pay gift tax, dip into their exemption amount, or use their annual exclusion.

For example, assume that Dorothy, an unmarried 55-year-old Florida resident, has $1 million in a traditional IRA and $370,000 in a checking account. With a net worth of over $15 million, Dorothy expects to be subject to estate tax at death and does not expect to need the IRA proceeds in retirement. Accordingly, she could convert the IRA to a Roth this year and use the cash in her checking account to pay the taxes. This will reduce her taxable estate and push value down to her beneficiary (in this case, her 25-year-old son, Michael), without having to pay gift tax on the transfer. Dorothy can let the assets accumulate tax-free until her death, at which time Michael can convert the account to an inherited Roth IRA and withdraw the assets over time free of income tax. The tax savings will be even more pronounced if, at the time of withdrawal, Michael is subject to higher tax rates than Dorothy was at the time of conversion. This may be the case, for example, if he resides in a high-tax state such as California, Hawaii or Oregon.

Impact of the 2017 Tax Act: Prior to 2018, a recharacterization could be particularly useful if, for example, it turned out the conversion pushed the owner into a higher tax bracket, caused the phase-out of certain deductions, or if the assets declined in value after the conversion.

The 2017 Tax Act's elimination of recharacterizations for post-2017 conversions means clients who are interested in converting a traditional IRA to a Roth should speak with their advisors and carefully consider all of the potential tax and non-tax consequences.

PLANNING BY NON-SPOUSE BENEFICIARIES FOR INHERITED RETIREMENT ACCOUNTS

BY LINDA KOTIS

Overview: An individual who is unmarried or married with children from a prior marriage likely will name a non-spouse as a beneficiary of her retirement account. Deciding whether to leave a share of the account outright or in trust is typically based on the account's value, as well as the beneficiary's age and capacity to handle inherited wealth. Other factors to consider are that the non-spouse beneficiary will pay income tax on an inherited traditional IRA, unlike an inherited Roth IRA, and post-death RMD rules apply to all inherited accounts. Complex rules governing retirement plans necessitate professional guidance to maximize opportunities.

Minor Child as Beneficiary: Naming a younger beneficiary allows payments of retirement benefits over a longer life expectancy which has the effect of deferring income tax. For a minor child, this works best when the IRA passes to a trust for the child's benefit. Though a custodian under a Uniform Transfers to Minors Act (UTMA) account may be named to hold retirement assets for a child, the custodian must pay the account balance to such child at age 18 or 21 (depending upon state law). Some jurisdictions, however, may permit the UTMA account balance to be transferred to a qualified minor's trust without a court order.

Tips on Taxes: Because estate tax applies to transfers to children, using estate tax exemption to shelter the bequest of a traditional IRA subject to income tax is tax-inefficient. IRA distributions to young beneficiaries may also be subject to the "kiddie tax" affecting certain children with unearned income. The 2017 Tax Act modified the kiddie tax to apply the ordinary and capital gains rates of estates and trusts. Now the top 37% rate applies to certain children with income starting at $12,500 (contrast this with the top rate at over $500,000 for adult individuals). These tax issues may be reasons to name a child as beneficiary of a Roth IRA instead.

Trust as Beneficiary: The advantages of naming a properly drafted trust as the beneficiary of a traditional IRA include (i) extending payments over longer periods and (ii) empowering a trusted third party to control discretionary distributions. There are two types of trusts suitable to hold IRAs. A conduit trust requires all RMDs to be distributed to or for the benefit of the income beneficiary. Additional distributions may be made. A conduit trust does not allow accumulation inside the trust, which may be contrary to the account owner's wishes. An accumulation trust authorizes the trustee to hold the RMD as principal of the trust. The trust pays income tax on the accumulated RMDs at its higher tax rates, which may be an undesirable result.

Traps to Avoid: Naming the retirement account owner's estate as beneficiary will foreclose the stretch-out of distributions. Whether the owner dies before or after RMDs begin, the estate will most likely receive larger distributions and bear a greater income tax burden sooner than if the owner had named a "designated beneficiary." Also, a general reference to the primary beneficiary "as stated in wills" does not qualify a testamentary trust as having designated beneficiaries. The IRS refused to accept such beneficiary designation language as naming eight trust beneficiaries under a decedent's will as designated beneficiaries of an IRA. This was despite the fact that a state court issued a ruling to the contrary.

IPB IN THE NEWS ...

- *TCJA Alert: Unexpected Effect of Section 4960 Excise Tax* (February 2019)
- *"Maintaining Treaty Benefits: Time to File?"* by Doug Andre and Heléna Klumpp (January 29, 2019)
- *"Reset of the District of Columbia's Estate Tax Exemption,"* co-author, Linda Kotis (LISI) (January 9, 2019)
- Carter Hood, IPB Partner, Selected by *Washingtonian Magazine* as one of DC's Best Lawyers (January 4, 2019)

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