THE ESTATE PLANNER

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Handle an inherited IRA with care

An inherited IRA can be a welcome financial windfall. But the rules governing required minimum distributions (RMDs) from these tax-deferred accounts are complex. IRA recipients should familiarize themselves with these rules to avoid potentially costly tax mistakes.

End of the "stretch" IRA

Until recently, IRA beneficiaries were entitled to spread distributions of inherited IRA savings over their life expectancies. These so-called "stretch IRAs" provided an advantage by enabling the IRA's funds to continue growing and compounding on a tax-deferred basis for years or even decades. However, the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 eliminated the stretch IRA for most nonspousal IRA beneficiaries. Now, beneficiaries of IRAs owned by those who died after 2019 must withdraw all funds within 10 years (with certain exceptions).

The tax impact of this change can be significant. The need to withdraw funds more quickly means IRA recipients will be taxed on those withdrawals regardless of whether they need the money. And depending on the size of the withdrawals, they may push recipients into higher tax brackets.

Failure to take an RMD when required can trigger a penalty equal to 25% of the distributable amount, potentially reduced to 10% if the recipient corrects the mistake promptly. (Note: The penalty for missed RMDs had been 50%, but it was reduced to 25% by the SECURE 2.0 Act of 2022.)

Who's subject to the 10-year rule?

Under the SECURE Act, the general rule is that inherited IRAs received by a designated beneficiary must be distributed within 10 years after the original account owner's death. However, several exceptions to the 10-year rule exist:

- The account owner's surviving spouse,
- A minor child of the account owner who hasn't reached age 21,
- A disabled or chronically ill person, or
- A person not over 10 years younger than the account owner.

Recipients who fall into these categories are still entitled to spread RMDs over their life expectancies, with special rules for surviving spouses. (See "Options for surviving spouses" on page 3.) Minor children may base annual RMDs on their life expectancies until they reach age 21, after which they must withdraw the remaining IRA balance over the following 10 years.

Special rules also apply to IRAs received by non-designated beneficiaries, such as trusts, estates and charities. These rules aren't discussed here, but your estate planning advisor can explain the pros and

cons of naming one of these entities as a beneficiary of an IRA.

How does the 10-year rule work?

The SECURE Act created some confusion over the application of the 10-year rule. It was unclear whether IRA recipients subject to the rule had to take regular annual distributions over the 10 years following the original account owner's death. Alternatively, they might have allowed the funds to continue growing and compounding, then emptied the account in year 10. The IRS provided an answer in regulations finalized late last year.

The SECURE Act of 2019 eliminated the stretch IRA for most nonspousal IRA beneficiaries.

The recipient's options depend on whether the account owner died before or after he or she was required to begin RMDs. Currently, most IRA owners must begin RMDs by April 1 of the year following the year they reach age 73. This is the so-called required beginning date (RBD). Note, however, that under the SECURE 2.0 Act, the RBD may differ depending on the year the account owner was born.

Under the final regs, if the account owner died before his or her RBD, a beneficiary subject to the 10-year rule can withdraw the funds at any time so long as the IRA is emptied within the applicable 10-year period. If the account owner dies on or after his or her RBD, the RMDs must be spread out over years one through 10.

It's complicated

The rules surrounding distributions from inherited IRAs are complex and vary depending on several factors. IRA beneficiaries should consult their advisors to ensure they comply with the rules and choose the option that best meets their needs. ▮

Options for surviving spouses

Surviving spouses named as IRA beneficiaries generally have two options (apart from taking a lump sum distribution):

Assume ownership of the IRA. Here, surviving spouses step into the shoes of the original account owners — either by naming themselves as owners or transferring the assets to their existing IRAs. Under this option, a surviving spouse can withdraw the funds at any time (subject to a 10% penalty if under age 59½) and must start required minimum distributions (RMDs) at the required beginning date (RBD).

Open an inherited IRA and name himself or herself as beneficiary. Under this option, the surviving spouse takes RMDs over his or her life expectancy, beginning on the *later* of 1) the year the original account owner would have reached his or her RBD, or 2) the end of the year following the year of the account owner's death. Alternatively, if the account owner died before his or her RBD, the surviving spouse can choose the 10-year rule and withdraw the funds by the end of the 10-year period.

The right option depends on the surviving spouse's circumstances and financial needs. For example, assuming ownership allows the surviving spouse to continue contributing to the IRA and defer distributions until RMDs are required. Contributions to inherited IRAs aren't permitted, and distributions may be required sooner than an assumed IRA. If the surviving spouse needs the money right away and is under age 59½, an inherited IRA may be preferable, because distributions from an assumed IRA would be subject to penalties.

Intrafamily loans vs. trust loans

Two methods for providing financial help to a loved one

If a relative needs financial help, you can offer an intrafamily loan. However, if it's not executed correctly, such a loan can carry substantial negative tax consequences. Also, an intrafamily loan may be impossible if you lack liquid assets.

If the family member needing financial assistance is also the beneficiary of one of your trusts, he or she may have the option to borrow money from the trust. Let's take a closer look at intrafamily loans and trust loans.

Intrafamily loans

An intrafamily loan can be a great way to help out your children or other family members financially while also transferring significant amounts of wealth free of gift and estate taxes. Why not simply make an outright gift? A gift may be the better option, so long as your unused exemption is enough to cover it and you don't need the funds or the interest income. However, a loan can be an attractive alternative if transfer taxes are an issue or if you're not prepared to part with the money just yet.

> *The trustee has a fiduciary duty to manage the trust in a prudent and impartial manner.*

Generally, to pass muster with the IRS, the interest rate on an intrafamily loan must be at least the applicable federal rate (AFR) for the month the loan is made. Otherwise, the IRS may view the loan as a disguised distribution, which can result in a variety of unpleasant tax complications.

The loan should also be documented by a promissory note and otherwise treated as an arm's-length transaction. If the borrower places the funds in investments that enjoy returns that are higher than the interest rate on the loan, then the excess appreciation is, in effect, a tax-free gift.

Trust loans

It may be possible for a trust beneficiary to obtain a loan from your trust. You might wonder why a beneficiary would borrow from the trust rather than take a distribution. There are several situations in which a loan may be necessary or desirable, including:

- The trust's terms place conditions on distributions that aren't currently satisfied,
- The borrower seeks an amount that exceeds limits on distributions imposed by the trust (an income-only trust, for example),
- The trust has multiple beneficiaries, and the borrower seeks an amount that would be unfair to other beneficiaries if taken as a distribution, or
- A loan is preferable for tax-planning purposes.

Before taking action, check whether trust loans are permissible. Many trust instruments explicitly authorize loans. But even if the trust is silent, the law in many states permits loans unless the trust expressly prohibits them.

The trustee has the final say

There's a critical difference between intrafamily loans and trust loans: The trustee has a fiduciary duty to manage the trust in a prudent and impartial manner. If you lend money to family members from your assets, you can generally structure the transaction as you see fit. However, a trustee considering a loan request must act in the best interests of the trust and all of its beneficiaries. So, for example, a trustee who approves a loan to a current beneficiary who's

a bad credit risk is likely breaching his or her fiduciary duty to the remainder beneficiaries.

To fulfill this duty, the trustee must treat the loan as an investment of trust assets. That means the interest rate should be reasonable compared to other potential investments (the AFR probably isn't sufficient), and the trustee should consider steps to ensure collection, such as assessing the borrower's ability to repay and securing the loan with adequate collateral.

Of course, if the terms of a trust loan are comparable to those available from a bank, the trustee should question why the beneficiary isn't simply obtaining a bank loan. Suppose the answer is that the beneficiary isn't creditworthy. In that case, the trustee should act in the trust's best interests by rejecting the loan request, increasing the interest rate or demanding additional collateral.

Consider your options

The decision to make an intrafamily loan or a trust loan can be complicated. For the former, you must consider the current AFR and whether you have liquid assets. For the latter, you must determine whether your trust allows loans. Before taking action, talk to your estate planning advisor. He or she can determine the best option based on your circumstances.

Is it time to update your will? Consider a codicil

Creating a will is a foundational step in your estate plan. But life rarely stays the same after it's drafted. Whether you've gotten married (or divorced), welcomed a new family member or acquired significant property, it may be time to revisit your will and make any necessary revisions.

One option for making minor updates is a codicil, a simple legal amendment to your will. However, it's essential to understand when this tool is useful and when you might be better served to begin from scratch and draft a new will.

The pros

In a nutshell, a codicil is a legal document that modifies an existing will without replacing it entirely. It's typically used to make relatively minor changes, such as naming a new executor, adjusting a gift to a beneficiary or correcting a clerical error. Indeed, codicils can be a cost-effective and convenient solution for these revisions because they

preserve the original will and avoid the need to draft a new one.

However, even minor updates require care. To be legally valid, a codicil must be signed and witnessed just like a will. It should also clearly reference the original will to avoid confusion.

The cons

Despite its usefulness, a codicil has limitations. Over time, multiple codicils can make an estate plan harder to interpret. This is especially true if the changes are scattered across documents written years apart. This can create inconsistencies and confusion for your heirs and your executor. In probate, courts must review each codicil alongside the original will, increasing the likelihood of misinterpretation or challenge.

Additionally, the laws governing wills and estates may have changed since your original will was created. A codicil might not fully account for new legal developments or significant shifts in your financial or personal situation. When changes become too extensive or complex, it may be safer to draft a new will instead.

When a new will makes sense

In many cases, drafting a new will is the better course of action. For example, if you've gone through a significant life event, such as getting married, divorced, or becoming a parent, or if you've acquired substantial new assets, a comprehensive update may be necessary. Similarly, if you've moved to a different state, your will may need to reflect your new state's legal requirements.

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Creating a new will allows you to revoke all previous versions and ensure that your current wishes are accurately reflected in a cohesive document. It can

also simplify the probate process by eliminating the need to reconcile multiple versions and amendments.

Turn to the professionals

Estate planning decisions can have long-term consequences for your family. Even a seemingly minor mistake can lead to delays, extra costs or disputes. Your estate planning advisor can help you understand the tax and financial implications of your choices, while working in tandem with an estate planning attorney to ensure that your will is drafted correctly and updated. ▮

ESTATE PLANNING RED FLAG

You've sent your child to college without an estate plan

As you create a checklist of things your college-aged student will need for the upcoming school year, an estate plan is a critical and often overlooked item. Even though your child is likely to have few assets in his or her name, a basic estate plan is necessary should the unthinkable happen.

Here are four estate planning documents your son or daughter should have before heading off to college:

1. Health care power of attorney. Also known as a health care proxy or durable medical power of attorney, this document appoints another person — usually a parent — to make health care decisions on your child's behalf if he or she can't do so. Typically, the document also provides guidance on your child's preferences for using or withholding life-sustaining medical procedures. Children age 18 or older are usually treated as adults, so without a health care power of attorney, you'll have no say in your child's medical treatment should he or she become incapacitated.

2. HIPAA release. An important complement to a health care power of attorney, this document ensures that health care providers are authorized to share confidential information about your child's medical condition with you.

3. Financial power of attorney. This document appoints another person — usually a parent — to make financial decisions, pay bills and conduct other financial transactions on your child's behalf. The document specifies the conditions under which the representative is authorized to act. For example, if your child is out of the country, or, in the case of a "durable financial power of attorney," if your child becomes incapacitated.

4. Will. Even if your child has only a small amount of money or other assets (including personal possessions with only sentimental value), it's a good idea to prepare a basic will to ensure he or she has a say over their disposition.

Contact your estate planning attorney for help in drafting these important documents.

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