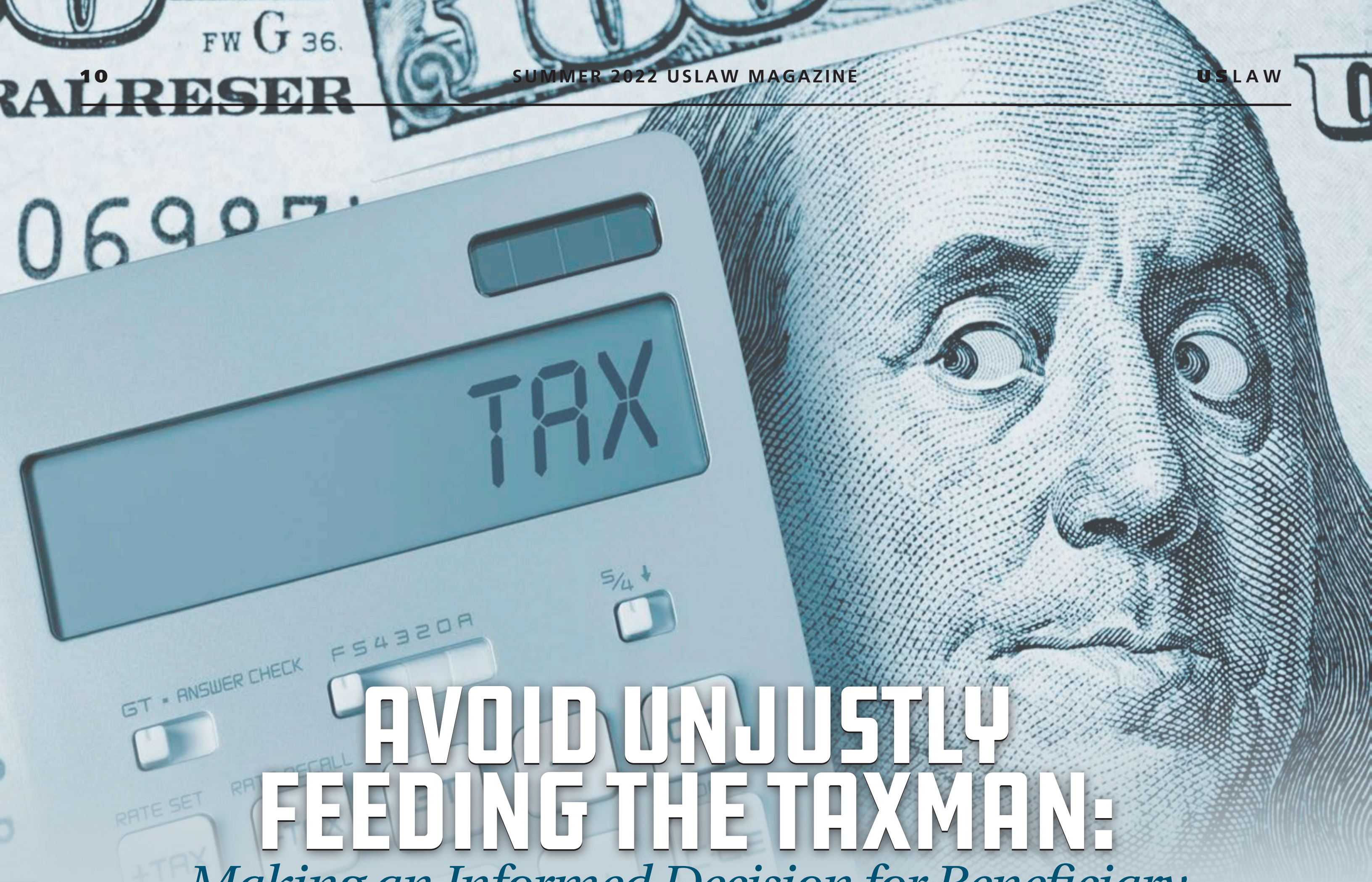

AVOID UNJUSTLY FEEDING THE TAXMAN:

Making an Informed Decision for Beneficiary Designation Under the SECURE Act

Richard R. Marsh Flaherty Sensabaugh Bonasso, PLLC

At the end of 2021, Americans held nearly 40 trillion dollars in retirement assets, a significant portion of which are held in tax-deferred accounts, such as IRAs and 401Ks. If you are holding assets in such accounts, then without proper planning, those accounts could take a larger than required hit from the taxman upon your passing. You can minimize such risk by understanding how a beneficiary designation, or lack thereof, can affect the income tax payable upon your death and acting accordingly. The choice of whom to choose as a beneficiary can be complicated, and this article intends to provide a level of understanding to permit you to start to work through the process. And perhaps more importantly, to stress the need to begin such a process.

The latest federal regulation for retirement accounts is the SECURE Act. The SECURE Act was passed to provide mechanisms that would encourage Americans to participate in retirement savings accounts. A more cynical view is that the Act, in part, was intended to cut down on inherited wealth and ensure that the IRS was getting its cut of Americans' retirement savings. But, of course, that is something that the individual taxpayer wants to prevent, as lawfully permitted.

TAX-DEFERRED RETIREMENT ACCOUNTS GROW TAX-FREE UNTIL THE WITHDRAWAL OF MONEY, AND SUCH WITHDRAWALS CAN ONLY BE POSTPONED FOR A CERTAIN TIME PERIOD.

Although it is a fundamental aspect of retirement accounts, reviewing how 401Ks and IRAs are taxed helps explain why the SECURE Act can hasten payment to the government. With that in mind, most 401Ks and IRAs are tax-deferred, meaning that pre-tax income is put into a 401K or IRA investment account. The income invested in such an account then grows tax-free. When you withdraw funds from the account, such withdrawn funds are reported as ordinary income to the IRS and taxed based on your income tax bracket. The general logic is that when you start withdrawing from the retirement account, your ordinary income will be lower than when you invested it. Due to your lower income, you are in a lower tax bracket and, ultimately, have lower taxes.

An important issue is when you have to start removing funds as the IRS does not want this money to accumulate tax-free indefinitely. Therefore, you must take a required minimum distribution from the account by April 1 of the year after you turn 72 years of age and by December 31 of each subsequent year. The distribution amount is based upon the account balance at the end of the previous year divided by your life expectancy (as outlined in IRS tables).

YOUR RETIREMENT PLAN MUST BE INCLUDED FOR IN YOUR ESTATE PLAN.

Of course, if the account is not depleted by the time you pass, it must go to another person or entity. Retirement plan management then falls into the realm of estate planning. Unfortunately, this can be problematic because the retirement plan is often overlooked even though it is a valuable asset.

When dealing with a retirement plan and estate planning, you need to take a more "three-dimensional view" than you would with most other assets due to the income tax component. Most of your assets will pass to your heirs with no tax or even positive tax consequences. Real property, life insurance, bank accounts, and similar assets all pass to your heirs tax-free unless you are in a state that has estate or inheritance tax or your estate is worth more than the federal estate tax exemption. Therefore, in most instances, you can focus on who is to receive the asset.

The same tax treatment does not apply to retirement accounts: the IRS will most definitely be coming for its share. Due to this income tax component, you must consider whom to leave the retirement account and how such a choice affects the ultimate amount received by the beneficiary.

Prior to the SECURE Act, you could minimize the income tax implications of a retirement account. This was done in much the same manner as the required minimum distribution: you "stretched" the distribution over many years, often decades. This could occur because the IRS would allow a beneficiary to stretch the distributions over such beneficiary's lifetime expectancies. Based on regulations, it could be challenging to understand which lifetime expectancy to use, but the underlying premise was still true: the distribution schedule could occur over many years.

THE SECURE ACT SIMPLIFIES BUT OFTEN SHORTENS YOUR BENEFICIARIES' TIME TO WITHDRAW THE RETIREMENT FUNDS.

The SECURE Act simplified the determination of which life expectancy to apply but took away the option for many beneficiaries to stretch the distributions. This has hastened the payment of the government's cut of retirement accounts. Many individuals who previously could stretch out such distributions now find the timeframe condensed. For that reason, extra consideration must be given to who is named as a beneficiary.

Beneficiaries fall into one of three categories, and such categories determine the time window to withdraw funds. A beneficiary can be an "eligible designated beneficiary," a "designated beneficiary," or a "non-designated beneficiary." A designated beneficiary must withdraw all funds within 10 years after the account holder's death. A non-designated beneficiary only has five years after the account holder's death to make such withdrawal.[1] And finally, the eligible designated beneficiary has the most favorable withdrawal timeframe, and such timeframe will differ depending on who the beneficiary is.

The next question is what type of beneficiary falls into each category? The eligible designated beneficiary encompasses individuals the government believed were reasonable to receive the stretch benefit. Examples include the account owner's spouse or minor child, a disabled or chronically ill person, or a person who is older or less than 10 years younger than the account owner. Designated beneficiaries include all other individuals as well as see-through trusts. See-through trusts are ones in which all countable beneficiaries are individuals. A non-designated beneficiary encompasses all other beneficiaries, most notably the account owner's estate.

IN CHOOSING YOUR BENEFICIARY, CONSIDER THE LENGTH OF TIME THE BENEFICIARY HAS TO MAKE THE WITHDRAWALS AND HOW TO MINIMIZE TAX IMPLICATIONS FOR THE BENEFICIARY.

The next step is applying the rules and deciding whom you should leave the retirement account. The best starting point for that decision is determining who you want to receive your assets. In many instances, that decision dictates whether the tax consequences are largely irrelevant because you do not have any tradeoffs to consider. For example, many people choose to leave their entire estate to their spouse without considering any children or others. If this is the case, then consideration of the tax implications is largely moot. Luckily, the surviving spouse receives the most favorable tax treatment because they can roll over the retirement account into their account, take the required minimum distributions according to their life expectancy, or some combination of both.

The real considerations begin when you have a choice of multiple beneficiaries. Common situations include allocating between a second spouse and your children, between your children and charity, or between your children when one may have special needs. As a starting point, you should consider leaving the retirement assets to the person who can extend the withdrawal period the longest. Then, you can make up the difference to the other beneficiaries with assets that are not subject to income tax. However, there are other considerations at play. As between your second spouse and your children, will the children ultimately receive any portion if you name the second spouse as the beneficiary? For the charity scenario, although the charity will have a shorter period to withdraw the money (5 years vs. 10 years), the charity can do so tax-free (and all at once if it desires). Therefore, leaving the retirement account to the charity and other assets to the children may make more sense. Finally, suppose the beneficiary is a special needs beneficiary. In that case, that beneficiary can stretch the withdrawals over their life expectancy, making such beneficiary (through an appropriate special needs trust) the best recipient of the retirement account. When choosing between multiple beneficiaries, the income tax consequences should be a priority in determining how to allocate the retirement account.

Another common issue is how to provide for minor children. For most assets, the choice is easy, set up a trust and have the trust manage the funds for the children until they are young (or older) adults. However, such a decision is more complicated with a retirement account. If the account is left directly to the minor child, then the child has the remainder of their minority plus 10 years to withdraw the entire amount. But, of course, that places control solely in the child's hands unless a trust receives the retirement account. The trust will likely only have 10 years to withdraw the funds in that event. Moreover, any money not distributed will be taxed nearly at the usury rates for trusts. The account owner is thus faced with a dilemma: do I leave the funds outright to the child or protect them and suffer tax consequences? This can lead further down the proverbial rabbit hole and make the account owner consider whether the owner should withdraw more funds, take the tax hit now, and protect the assets in a trust. These are the kinds of issues that an owner must consider on behalf of the beneficiaries.

These scenarios are a part of the situations encountered when planning to distribute a retirement asset. Estate planning with retirement assets, both before the SECURE Act and after, has many factors to consider. The ultimate goal behind this article was not necessarily to teach the rules of such planning but rather to stress the importance of assessing and trying to work through beneficiary designations on retirement accounts. If such accounts are overlooked, the owner may inadvertently cause substantial losses due to income tax that could have otherwise been minimized.

Richard Marsh is an attorney with Flaherty Sensabaugh Bonasso PLLC in Clarksburg, West Virginia. His practice focuses on trust and estate planning, administration and litigation; real property; general business representation; and bankruptcy and creditor representation. He may be reached at 304.624.5687 or rmarsh@flahertylegal.com.

[1] Though, adding to the oddity of the tax code, if the account holder was over the age of 72, the non-designated beneficiary can still stretch the minimum distributions and do so over the account holder's life expectancy had the holder not died. This creates a situation where the non-designated beneficiary has longer to withdraw the funds than the designated beneficiary.