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Trust UPDATE

Stillman BANK

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Protect your 401(k) money throughout your retirement

According to the Investment Company Institute's 2021 *Fact Book*, an astounding $11.1 trillion is held in tax-qualified defined contribution plans, such as 401(k) plans. That resource will play an enormous role in the retirement security of millions of Americans over the coming years. Accumulating money in a 401(k) is one thing—arrange for salary reductions to fund the plan, evaluate investment choices for the money, check on progress periodically and make adjustments as needed.

Distribution of 401(k) money is another thing entirely—one that raises a host of new and, for most people, unfamiliar issues. Care must be taken to preserve that retirement resource, typically through a rollover to an IRA. The *Fact Book* reports that IRA assets have reached some $12.2 trillion. That figure includes contributions to traditional and Roth IRAs, as well as employer-sponsored programs built on IRAs, such as SEP IRAs and SIMPLE IRAs, but the bulk of the funding has come from rollovers.

Will you be receiving a lump sum distribution of some or all of your retirement benefits when you retire? A lump sum distribution, from a 401(k) plan or another qualified retirement plan provided by your employer, can be rolled over into an IRA, preserving its special tax status well into your retirement. However, you will have many important choices to make during this process. It's not a hard or complicated process, exactly, but the consequences of your choices will last for the rest of your life, so make them carefully.

Take a direct approach

Most people will opt to roll their lump sums into an IRA in order to avoid current income taxation. There is a wrong way and a right way to handle this.

The wrong way is to accept a check for the amount of the lump sum. If you take this approach, your employer will be required to

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withhold 20% in income taxes on the distribution. You'll either have to be satisfied with an 80% rollover, or you'll have to come up with the difference from other savings sources.

The right way is to arrange a direct transfer from the qualified plan trustee to the trustee of your IRA rollover—there is no withholding requirement with this approach.

IRA investing

During the accumulation years, most people saving for retirement have a significant amount invested in the stock market. That exposure typically falls as one approaches retirement, and it may fall still further in retirement. Retirees need the steady stream of income that bonds can provide.

Still, one needs to keep in mind the probability of eroding purchasing power because of inflation that can occur over the course of a long retirement. Inflation was quite mild for many years, but now that trend has changed. Hopes for a "transitory" inflation have been dashed. Some amount of equity investing may be needed to hedge against these developments.

If you have significant savings in taxable accounts, you won't want to evaluate your investment strategy for the IRA rollover in isolation. You'll need to decide whether your stock investments belong in the IRA rollover or on the taxable side of the ledger. All the distributions from the IRA will be taxed as ordinary income, whether they are of interest, dividends, capital appreciation or return of principal. For the sake of tax efficiency, many advisors suggest focusing the IRA on providing steady income (investing primarily in good-quality bonds) and doing the stock investing outside of the IRA. This preserves the benefit of the lower tax rate on realized long-term capital gains, as well as the lower tax rate for most corporate dividends.

Planning the distributions

From age 59½ through age 72, you may withdraw as much or as little from your IRA rollover each year as you please. There's no penalty tax to worry about, but you will have to pay ordinary income tax on most withdrawals. After you reach age 72, a program of required minimum distributions must begin.

Name a surviving beneficiary

You'll want to designate a surviving beneficiary for your IRA rollover. Usually a surviving spouse is named, but another beneficiary may be appropriate, depending upon the composition of family wealth and other family circumstances. The decision can be changed at any time.

We can help

Retirement should be, fundamentally, the moment that you declare your financial independence, a declaration that lasts the rest of your life. Should there be an IRA rollover in this picture? If so, how will the assets be invested? We'll be pleased to offer you our assistance with these important financial planning issues.

We look forward to meeting with you soon to discuss your needs. ☐

Estate planning for IRAs

Before the SECURE Act of 2019, the beneficiaries of inherited IRAs were permitted to stretch the distributions and tax benefits from such accounts over their lifetimes (the "stretch IRA"). That option has now been restricted to surviving spouses and certain classes of designated beneficiaries. The general rule now is that the IRA money must be paid out over the 10 years following the owner's death.

The IRS released some 300 pages of Proposed Regulations on 2019's SECURE Act in February. With one exception, the proposals were well received by estate planners.

The exception concerns a bifurcation of the 10-year rule for beneficiary payouts. Planners generally had assumed that no distributions would be required until the end of the 10 years (though beneficiaries would be free to take distributions if desired). Instead, that approach only is available if the account owner dies before Required Minimum Distributions (RMDs) have begun at age 72. If the account owner has begun a program of RMDs, the beneficiary of the inherited account must take annual distributions, and then empty the account by the end of the tenth year.

An ambiguous SECURE exception concerned an heir who is a minor child. The law states that the 10-year rule for minors only kicks in when they reach the "age of majority." But states have different laws as to when the age of majority occurs. What's more, in some states the status of "minor" may be extended until age 26 for full-time college students.

The IRS put the ambiguity to rest. For purposes of inherited IRA distributions, the age of majority will be 21, and there are no exceptions for students. For example, if the five-year-old child of the

IRA owner inherits the account, there will be small RMDs for 16 years, and then the account will have to be distributed over the next 10 years. The IRA must be terminated when the child reaches age 31.

Note that this option is restricted to the children of the IRA owner, not the grandchildren or other relatives. Those beneficiaries must abide by the 10-year rule.

The "NUA" alternative

In most cases, when one receives a lump sum distribution from an employer's retirement plan, the best tax option is to roll the entire amount over into an IRA. That preserves the tax deferral for the retirement money for years, potentially for decades.

However, there is an important exception to this conventional wisdom. If the lump sum includes employer securities, there is an alternative tax strategy to look at. The distribution of employer securities from an employee stock ownership plan or a 401(k) plan will have two components for tax purposes. First, there is the value of the shares when they were acquired by the retirement plan. Then there's the growth in the value of the stock while it was held by the qualified plan, which is called *net unrealized appreciation* (NUA).

Choices

In the year that the lump sum is received, the cost of the employer securities will be taxable at ordinary income rates. The NUA will not be taxed until the shares are sold, and then it will be taxed at long-term capital gain rates. This is true even if the shares are sold in the same year as they are received.

Example 1. At retirement Oscar received 2,000 shares of Old Employer stock, valued at $100 per share. The average cost basis of the shares was $25. Accordingly, Oscar will have $50,000 of ordinary income, and $150,000 of NUA.

Alternatively, Oscar could arrange to roll the employer securities into an IRA. Then he would pay no tax in the year of the distribution, and all his money would be growing to build a larger capital base for retirement. The trouble with that approach is that the NUA advantage is lost, as all the distributions from the IRA will be taxed as ordinary income.

If Oscar were to sell all the shares and realize the $150,000 gain, he would owe $30,000 in long-term capital gain taxes if he is in the top bracket of 20%. (Note that the 3.8% surtax that applies to investment income of top taxpayers does *not* apply to distributions, such as Oscar's, from qualified plans.) That's roughly half of the tax he would pay when his IRA sold the shares and distributed the proceeds to him, assuming he's still in the top tax bracket during retirement.

Having your cake and eating it, too

There is a middle ground to consider. In Private Letter Ruling 8538062, the IRS held that a partial rollover of employer shares to an IRA could eliminate income taxation in the year of the lump sum, and the remaining shares could still enjoy NUA treatment.

Example 2. Oscar rolls 500 shares of Old Employer stock into an IRA, with a value of $50,000. According to the ruling, the rollover eliminates the $50,000 ordinary income that otherwise would be taxed. The remaining shares may be held in a taxable portfolio, and all of the NUA is attributable to them, so they have a cost basis of zero.

What happens when Oscar sells those shares in five years? Let's assume that they have grown in value to $175,000. If Oscar is in the top tax bracket, and if capital gains tax rates have not been changed again by Congress, $150,000 of the gain will be taxed at 20%, and the remaining $25,000 will be taxed at 23.8%. Any growth in value after the distribution of the shares is not considered to be received from a qualified plan, and so is subject to the surtax.

One more twist

If Oscar has philanthropy as one of his estate planning goals, he might consider funding a charitable remainder trust with the employer securities received in the lump sum distribution. A charitable income tax deduction will be computed on the full fair market value of the shares. The charitable trust can sell the shares with no tax consequences. This can provide valuable portfolio diversification at no tax cost. Oscar may reserve a lifetime income for himself from the trust, and a portion of it may be taxed at long-term capital gain rates.

See your tax advisors

If your retirement nest egg will include employer securities from a qualified retirement plan, you will have a number of important decisions to make—decisions that will affect your retirement security for the rest of your life. See your tax advisors to learn more about your choices and work through the numbers. ☐

Reports to trust beneficiaries

Most trusts require that the trustee communicate certain information about the trust to the beneficiaries. However, certain trusts, sometimes called "silent trusts," may expressly prohibit communication to beneficiaries of the trust, for example, while the trust creator or the creator's spouse is alive. The goal of withholding information from beneficiaries usually has to do with avoiding any diminution of ambition in the beneficiaries, so they don't start to think that their life's goal is simply to survive until their trust fund becomes available.

Apart from what the trust provides for, state law may have mandates for reporting to beneficiaries that may be overridden by express terms of the trust. For example, state law might require reports be given to beneficiaries unless expressly prohibited in the trust document. Another aspect of this is that many trustees strongly prefer to report regularly to beneficiaries. Some state laws limit the rights of beneficiaries to assert claims against trustees if beneficiaries receive certain types of reports. Some institutional trustees will not accept a trust appointment that restricts their ability to report (absent perhaps extenuating circumstances, such as a mental health issue affecting the beneficiary) because of the impact on their liability exposure.

Apart from the legalities, there can be important personal impact on the beneficiaries. In some instances, for example, a beneficiary struggling with an addiction issue could be severely harmed by learning about new trust benefits. A more common situation is that a planned, phased introduction to the beneficiaries of the existence of a trust that benefits them, then perhaps some of the benefits under the trust, and over time increasing information as to the financial status of the trust, may be the ideal way to acclimate and educate a beneficiary as to the purpose and benefits of an inheritance in trust. All of these factors should be evaluated and addressed, not only when the trust is created, but also as circumstances evolve.

The plan for reporting, as illustrated above, should not only be evaluated at inception based on the document and applicable law, but should be revisited based on changes in trust assets, needs and maturity of beneficiaries, and other relevant factors. As beneficiaries grow, it may even be reasonable to include them to some degree in an annual trust meeting. The key point is that best addressing reporting to beneficiaries requires knowledge of the trust terms, trust assets, and personal characteristics of the beneficiaries over time.

Sound trust administration is a vital step to increasing the likelihood of any estate, asset protection, or trust plan accomplishing its intended goals. Reporting to beneficiaries is an issue that should not be taken for granted. ☐

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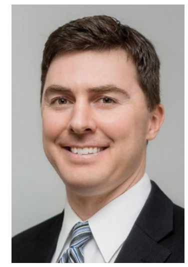

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