Episode #08 of Intentional Wealth: What Happens When a Trust or Estate Inherits an IRA with Lanny Sodini
A Podcast from Braun-Bostich & Associates

Welcome to Intentional Wealth, a monthly podcast where, alongside notable financial professional guests, Private Wealth Advisor and Founder of Braun-Bostich & Associates, Amy Braun-Bostich, delivers useful insights and strategies that help YOU live your best financial life! Remember, when your goals are meaningful and your wealth has purpose, you can truly live with intention.

Cassandra Kirby: Good morning listeners, and welcome back to another episode of Intentional Wealth. I'm Cassandra Kirby, a private wealth advisor with Braun-Bostich & Associates, and your host for today's episode. What happens when a trust or estate inherits an IRA, especially in light of the recent passage of the secure act and proposed regulations?

My guest today is Lanny Sodini, an attorney with SutterWilliams Law here in Pittsburgh, who's been a trusted go-to legal source for many of our clients over the years. SutterWilliams is a boutique law firm, focusing on workers' compensation defense, federal black lung, and estate planning and administration, which is the firm's area of expertise that our clients have relied on for sound legal guidance.

With that brief introduction said, I welcome Lanny Sodini to Intentional Wealth to join me in discussing what happens when a trust or estate inherits an IRA. So happy you're here Lanny and thanks for joining me today.

Lanny Sodini: Thank you Cassie, it's my pleasure to hopefully provide some interesting and informative information to your listening audience.

Cassandra Kirby: Okay, so why don't we start, if you want to just give us a little bit of your professional background on yourself and the firm.

Lanny Sodini: Well, I've been a practicing attorney for a lot of years and probably for the last 20 to 25 years, mostly concentrating in the area of estate planning, estate administration, asset preservation, elder law, those areas that are mostly related to handling people's estates prior to, and after death. And I've enjoyed the work because you meet many interesting people in this field. And so, I have continued in it and hope to continue in it for a number of years to come. So that's basically my little background.

Cassandra Kirby: Thank you. That's helpful as we jump into today's topic.

So, we might as well go ahead and get started. Probably the best place to begin is to talk a little bit about the benefits and also then the potential problems that we typically see when a trust or an estate inherits an IRA. So I guess we'll start with the benefits. There's a number of them, and then we'll kind of cover the problems along the way as well.

So my understanding is one of the benefits is; It can be important for certain types of beneficiaries. So do you want to speak a little bit on that?

Lanny Sodini: Well, whether it's an IRA or just a standard trust, the problem we're dealing specifically with IRA funds when you have minors or individuals that I sometimes refer to as financially immature adults, a minor is anyone under the age of 18.

And because of the nature of individuals today, many do not become financially mature until later in life. So putting the assets into a, a trust, an IRA does somehow in some way, protect those assets from you know, a spendthrift adult individual, and also for a minor who cannot obviously receive the money directly upon the death of the parent or whoever set up the trust.

So that's one of the I think benefits of placing assets, especially an IRA into a trust. There also is a, in light of that, and can be for adults too, is that when assets are in a trust, it does provide the proper drafting of the trust creditor protection that is with the proper language and trust assets in the trust cannot be subject to claims of creditors of the beneficiaries.

And, many times when a young adult starts out in life, they incur more debt than they should. And in some instances, they may have to file early in life for bankruptcy. In which case those assets are not part of the bankrupt estate because of proper language placed into a trust that protects it from creditors.

So that's again, when you're dealing with a financially immature individual, that is a big benefit, especially as they start off in life.

Cassandra Kirby: And then do you find, in the trust, people would have so much… the beneficiaries able to access so much money at this age at another age, etc.?

Lanny Sodini: Typically, it all, obviously it's fact driven by the nature of the individual of the beneficiary, but yes, in most cases, a trust is set up in which the adult beneficiary receives a certain portion of the trust principle at various ages in life.

Typically you could start off providing a distribution at age one-third maybe at age 23, when they're out of college. If they go to college. Possibly one half of the balance at a later age, 27 and maybe the trust terminates at age 30. However, understand that with whether it be IRA money or just non-qualified funds, the trustee always has the option to pay out income and principal as the beneficiary needs it so that if they are going to college or if they are getting married, or if they are purchasing a home, the trustee in the trustee's discretion typically can make a payment of principle to supply the beneficiary with the funds for the purchase.

Cassandra Kirby: Yeah, I think we have, you know, a few clients where this would be helpful for them. And also for disabled beneficiaries to, a trust would be good.

Lanny Sodini: Well, you bring up disabled beneficiaries, I think the issue there is a trust, whether again, funded with IRA money or non-qualified monies is a good way to establish what is referred to as a special needs trust.

That is when an individual is receiving some sort of financial assistance from the government, whether it be a SSI or other types of benefits, such as medical benefits, if the individual receives those monies outright, then those benefits from the government will stop. So a special needs trust is designed to supplement the needs of the beneficiary, not to supplant the aid that the government is providing to the individual, but rather to supplement it.

For example, I have a case now, in which we're talking about maybe taking the special needs child, adult child that is, on a vacation or to the hockey game, hopefully the playoffs, that's one of the advantages of a trust situation.

We get into some problems when we deal with IRAs, which I assume we'll get into in a little bit, but that is a very important matter to consider when either a parent has a special needs child or grandparent who is establishing money maybe for their grandchildren, and if they have a special needs grandchild. So, that is one of the main benefits of using a trust in that situation.

Cassandra Kirby: Okay. And then another benefit I think, and this may not be one of the top benefits just because it probably doesn't impact that many people but, would be the shelter some of your assets that are inside of an IRA from passing on to a surviving spouse's estate.

Lanny Sodini: Well that, yeah, one of the biggest problems in estate planning is when you have a blended family. That is, two adult individuals that are in their second marriage, and they have children from previous relationships or a marriage. They're typically both depending upon the wealth of each individual, they want the wealth they bring into the marriage to mostly pass for the benefit of their children.

But at the same time, they want to be able to provide for their second spouse. Or their current spouse that is. And, by placing the assets into trust IRA assets, a non-qualified asset, you're able to preserve the fact that upon the death of the surviving spouse, the assets placed into the trust will continue on for the benefit of the children of the first spouse to die. So, that provides a mechanism to preserve assets by placing assets into a trust.

Cassandra Kirby: And then I think there's also, by using a trust, you kind of have the ability to control like successive beneficiaries?

Lanny Sodini: Very good point, Cassie, yes. You have the option to continue on in case the beneficiary who receives the money in case that beneficiary dies.

Let's go back to the example where you have a trust set up for one of your children and it doesn't terminate until the age of 30. Let's say, well, you can provide if that child dies before the trust terminates where the monies in the trust are to be distributed and whether or not

they will stay in a trust. It could go to that child's children, if that child has children or may have children, or it could go to your other children or to your siblings or whomever you want. So you can control until the trust finally terminates, you can control where the money passes if the beneficiary dies before the termination date of the original trust that was established,

Cassandra Kirby: I think that covers most of the benefits of naming a trust as beneficiary.

And so now we maybe want to touch on some of the problems or the issues. So let's start with what happens if you have your estate named as beneficiary of an IRA? What are some of the issues with that?

Lanny Sodini: The real problem with, and this is where it does take some professional guidance to create trust so that you do not destroy whatever benefits there could be by naming a trust as a beneficiary of an IRA.

If you name your estate, the beneficiary, or if you fail to name beneficiaries, ultimately it will default to your estate. The problem there is, in that particular case, the IRA must be liquidated within five years after the death of the IRA owner and, in today's world, IRAs make up a significant portion of one's wealth and to liquidate an IRA within five years creates a number of problems for the beneficiary and also for the estate.

The beneficiary is going to have to report maybe substantial income in the next five years. And you have to keep the estate open for five years in order to spread out the distribution. And that creates an administrative cost either through attorney's fees or accounting fees CPAs, because the trust has to file an income tax return.

And so therefore naming an estate is probably the last option for anybody that has an IRA, you should always try to name beneficiaries. So, avoiding the estate as a beneficiary is an important thing to do. What you have to do is, especially with regard to an IRA, in the trust is that you have to have named beneficiaries.

It has to be referred to as a see-through trust. And a see-through trust is one that is, there's four elements to a see-through trust, actually three plus one follow-up is that it must be valid under state law, and two, it must be irrevocable. And three, you must have identifiable beneficiaries.

So that, for example, you cannot name a charity as a beneficiary of an IRA with other individuals, because that is not, a charity is not an identifiable beneficiary. And nor can you name your estate because the estate is not an identifiable beneficiary. So those are three elements that must be complied with in order for an IRA to be considered in a see-through trust. And the reason you want a see-through trust is so that you could spread out the distributions from the IRA to the beneficiary.

Cassandra Kirby: Okay, so this raises a couple of questions from me. So can you briefly explain to our listeners the difference between an irrevocable versus a revokable trust?

Lanny Sodini: Well, it's a good question. Because some people think that you can change… once you establish an irrevocable trust, you cannot change it. Now, understand that this trust becomes irrevocable typically at your death, not during your lifetime. You can't establish an irrevocable trust during your lifetime. But when you make an IRA the beneficiary of a trust, typically it's in a Testamentary trust under your Will, which becomes irrevocable at your death. So it cannot be changed.

A lot of people establish revocable trust during their lifetime. That is not the same thing and since it's revocable, the IRA is still your IRA. In fact, there's positions that you cannot transfer an IRA into a revocable trust because you're creating a new owner of that trust and you would generate an income tax consequence.

So it's an irrevocable trust and can't be changed once you die. That's it. The beneficiaries are set. The distribution scheme is set at that. One of the problems of establishing the IRA into the trust or any trust matter is selecting the trustees. I'm sure you've dealt with people that are trustees of trust that you invest assets on their behalf.

And that becomes a problem because who do you appoint as the trustee of the trust? This is somebody that's going to manage this money for a potential significant period of time until that adult child reaches the age of 30. And so therefore you, in selecting the trustee, creates a problem… who do you pick?

And, if that trustee doesn't survive and live, or is unable to manage the trust until that trust is terminated, who should be a successor trustee? Should you appoint a successor trustee, should you appoint co-trustees? So there's a level of checks and balances. A trustee can walk away with the money, albeit against the law and ended up in jail, but that's not what you want. So that becomes a real problem, especially if you don't have an extended family that you can rely upon to be trustees, siblings, or adult cousins for your children, and forth.

Cassandra Kirby: So I have another question on the see-through trust. So let's say you have an IRA, you name a trust as beneficiary, and it qualifies as a see-through trust, but you have money that's passing to identifiable beneficiaries, but also to charitable beneficiaries. How do you structure that? Do you need to have two separate IRA accounts or what should you be aware of?

Lanny Sodini: Okay, very good. That's exactly what you have to do Cassie. If you want to give a portion of your IRA money to a charity, then you should separate the IRAs into two different separate trusts and which one the charity is named as the beneficiary of the one trust and identifiable beneficiaries are named of the second IRA account.

Excuse me, you should try to establish two IRA accounts so that you have the estate as the beneficiary of one IRA account and the individuals as beneficiaries of the second IRA account.

Cassandra Kirby: Okay, but not two trusts, the same trust. What accomplish, you would just need to separate the accounts.

Lanny Sodini: Well, you know, the trust for the distribution to the charity will be outright, it won't be in trust, it'll go out right at death. And so therefore you will name, you'll have two accounts, account A will name, you know, the American Red Cross as a beneficiary. When you die, the American Red Cross will get that money. The second IRA account will name the individuals as beneficiaries, and then they will, that money will be held in a trust.

Cassandra Kirby: Got it. And while we're on the topic of charitable beneficiaries, should we talk about why it's good to name a charity as the beneficiary of an IRA? Some of the reasons you might do that.

Lanny Sodini: Yes, there are important tax reasons why. Let's assume that you have IRA accounts and non-qualified accounts and cash in the bank, in the house and so forth of that nature that are all going to be sold.

If you're charitably inclined, I would always recommend that you name a charity, a beneficiary of the IRA account or establish two accounts and name a charity, depending upon the amount you want to give to the charity. The reason being is that the charity receives that money from the IRA tax free, both inheritance tax, Pennsylvania inheritance tax free and income tax free.

A beneficiary, an individual beneficiary would receive the IRA money and have to pay Pennsylvania inheritance tax, and then as that IRA is liquidated, we'll have to pay income tax. I use the example; if you're going to leave someone a hundred thousand dollars and you have 200,000, you want to leave a hundred thousand to charity, leave the IRA that's worth a hundred thousand to the charity and leave a hundred thousand cash or securities to the individual. That way that's not double taxed to the individual inheritance tax and income tax.

Cassandra Kirby: Yeah, we try to do that whenever possible.

Lanny Sodini: Absolutely. The problem is somewhat compounded now, because you mentioned in light of the secure act with regard to an IRA, into a trust at death, with regard to the secure act, which became effective last year.

Other than certain what we call qualified beneficiaries, the secure act now provides that a non-qualified beneficiary must liquidate the IRA within 10 years of the IRA owner's death. That creates a real problem because the individual not only could be as they mature and become adults, enter into a job and have an income tax bracket, but the IRA, when it's liquidated, is going to be taxable as income. So the question becomes. How much do you pay off or pay to the beneficiary from the IRA account. There's no minimum amount that must be paid, although I'm going to correct that in a second if the new regulations are adopted, but it must be liquidated within 10 years.

So let's assume that with regard to let's first, go back and define who are qualified beneficiaries in which this 10 year liquidation rule does not apply. That would be a spouse, a minor, anyone under the age for federal purposes under the age of 21, although a state may

have a minor no longer be a minor at age 18, someone who has a disability in that particular case.

So that let's assume you have someone named as a beneficiary who is a non-qualified beneficiary. That means the account has to be liquidated when they become age, if they, if they're minors, when they reach the age of 31 years of age, because you have to start the liquidation at age 21, but it has to be fully liquidated at age 31.

Well, at age 31 and 30, they could be making a substantial income. And now they're going to also receive IRA income. And unfortunately there's not much you can do. Now in addition, the proposed regulations, which most likely will be adopted is changing the rules with regard to an IRA in which the IRA owner was receiving Required Minimum Distributions (RMDs). That's somebody that's now over the age of 72. That individual, the beneficiary, must not only liquidate that IRA account within 10 years, although there doesn't have to be any minimum distribution during those 10 years, it could be at the end of the 10 years, but that the required minimum distributions must continue for the 10 years that that individual is receiving the distributions from the IRA based upon whatever the required minimum distributions were for the IRA account holder.

So they are going to receive minimum distributions for 10 years and in addition, the IRA must be liquidated within 10 years.

Cassandra Kirby: And before this was before the secure act was passed, if you inherited money from a parent that had already been taking their required distributions, you could then spread that out over your own lifetime.

Lanny Sodini: That's exactly right, and unfortunately that's changed. That creates a big problem because, again, you're talking about substantial funds in an IRA account that have to be liquidated. It becomes a burden upon the trustee as to when do you start liquidating for the 10 years?

How much do I give this 21-year-old individual? Because I don't want to give it all to him or her at age 31. So it's a burden upon the trustee, a significant burden upon the trustee, the other option, and this determines whether or not the trust that you set up is referred to as an accumulation or a conduit trust.

A conduit trust means you have to pay out the income as it's received, as the distributions must be made every year to the beneficiary versus if it's an accumulation trust, you don't have to pay it to the beneficiary, but you could throw it back into a trust, which is then going to hold that money for a longer period of time.

The problem with an accumulation trust in which you keep the distribution in the trust is that trusts are in a compacted tax bracket. So that rather than the individual paying the income tax on the distribution from the IRA, the trust pays the distribution. For example, in 2021, if a

trust received more than $13,050 in income or dividends, taxable income, which IRA is income, it would be in the 37% tax bracket.

So if you accumulate income, instead of distributing it to the beneficiary over the 10 years, then most of that money is going to end up going to the government in taxes.

Cassandra Kirby: Yeah, that's huge. That rate.

Lanny Sodini: It's a very big rate. So my thoughts to people is that an IRA, if possible, should always, at least for people that you have concerns about financially immature people, miners, people with disabilities, and all the reasons we talked about establishing a trust.

You have to select a trustee who is going to have some knowledge of money management and also rely upon hopefully the financial advisor that the account IRA account holder was using because a lot of issues are involved in terms of income tax issues, inheritance tax issues… is th beneficiary and mature enough to receive this money. Should I wait till age 31? Should I PR provide distributions over a 10-year period making them equal distributions? Is the beneficiary going to be unemployed next year? If so, maybe I should then make the distributions at that time.

Cassandra Kirby: Lots to consider.

Lanny Sodini: Yeah, a lot to consider.

Cassandra Kirby: Okay. So I just want to recap: So, if the beneficiary is the estate or a trust, then the draw down period is five years. If it's an individual, it's 10 years.

Lanny Sodini: If the beneficiary of the trust is an individual it's 10 years and let's say qualified beneficiary, spouse, disabled child, or a disabled person, or someone under the age of 21.

Cassandra Kirby: Okay. And then before we started to say if the deceased had already been collecting their IRA distributions, is there a different rule if the deceased had not yet been age 72.

Lanny Sodini: That is correct. Then the beneficiary of the IRA does not have to receive any required minimum distribution.

And I'm glad you raised that point because if it's a Roth IRA, then Roth IRAs do not have required minimum distributions so therefore the Roth IRA goes into the trust. Then all that is required is that it be liquidated within 10 years. So, yes, but most of the time, not most of the time, I can't say that… when people that have IRAs and they pass it on to their children, most likely they are already receiving their required minimum distributions.

Although I believe the there's also pending now where they're going to increase the age at which minimum distributions will be required. But again, that's a current law, that just came out. And understand the required minimum distribution over the 10 years is regulations that have been proposed by the IRS but have not yet been adopted. So, considered by many that it will be adopted,

Cassandra Kirby: But they do have, under the current law, they do have to draw it down within 10 years. Okay. So we'll wait and see what develops there. And I guess the whole, the goal with that was just to speed up the receipt of that tax revenue.

Lanny Sodini: Well, yes, if you recall, you may be too young Cassie, but way back, a beneficiary couldn't take the distribution over their life expectancy. It was a five-year distribution rule. They changed it a number of years ago, where they then provided that the beneficiary could liquidate the IRA account over their life expectancy. That that was a significant gift to the taxpayer and the government just maybe decided it was too big of a gift and brought it back a little bit and said, now, instead of five years, we'll give you 10 years and must be liquidated.

Cassandra Kirby: What if it's a 401k? And I think we had talked about this. Cause you touched on if it was a traditional IRA or Roth IRA, what if it's money that was left in a retirement plan? Like a 401k or a 403b?

Lanny Sodini: That's going to be governed under the regulations and rules of the 401k and the 403b rules and regulations.

And so therefore whatever they require in terms of, in most cases, I think they permit the person, although not always to roll it over into an IRA, in which case, then you're governed under the IRA regulations. But yes, that could be a problem depending upon the regulations of the 401k or the 403b account, the trustee on that.

Cassandra Kirby: So, okay. Let's just do a quick recap. So we touched on some of the benefits of having your estate or a trust listed as a beneficiary of an IRA, and we said that a trust could be a good option for a minor beneficiary or somebody that's disabled or someone that you don't necessarily trust with large sums of money all at once.

We also said it might be good for a second marriage or a blended family situation. It offers creditor protection, which is important. And then the ability to control contingent or successive beneficiaries beyond the primary beneficiary.

Lanny Sodini: That was absolutely correct. I think that that sums up those benefits.

Cassandra Kirby: Okay. And then some of the issues like last resort would be naming your state as the beneficiary of an IRA because it just brings up quite a few problems, including potentially higher rates, the estate being open for multiple years and then ongoing costs of filing tax returns for the estate.

There's a number of problems with naming your estate as the beneficiary of an IRA, but also in doing that, you can, your distribution options are more limited and you also kind of run into some of those concerns with the new rules, the new proposed regulations.

Lanny Sodini: And I think one of the biggest problems to is when you put it into a trust is selecting the trustees. I think that becomes a real problem, especially if you're you know, do not have an extended family that you can trust holding on to this money for an extended period of time.

Cassandra Kirby: And then when possible, if you have charitable intentions, you should use your IRA as a way to pass money to charities.

Lanny Sodini: Absolutely. If you leave an IRA to a beneficiary and depending upon how the will is written, the beneficiary may be responsible or the instead of the estate to pay the inheritance tax on that money. So they have to withdraw money from the IRA to pay the inheritance tax and the money they withdraw to pay to pay the inheritance tax is now subject to income tax. And that creates a double edge problem.

Cassandra Kirby: And then we really just want to stay tuned, I guess, to the Secure Act and any of these proposed regulations that are on the table and just be mindful of how your estate is set up and how the new roles could impact your kids or other beneficiaries.

Lanny Sodini: Exactly. And it's changing every day. It's a lot to keep up on. It's very difficult.

Cassandra Kirby: Okay. Any other comments?

Lanny Sodini: Cassie, I think you covered it in terms of what what's the important parts of, of this. And hopefully I've provided some information for people. I think they have to, if they're concerned, they should really talk to their financial advisor about this issue and then if a trust is a viable option, they should retain counsel that deals with a state planning and a state administration.

Cassandra Kirby: Perfect. Thank you so much for your time. This has been really helpful. I think our listeners will take a lot away from this episode, so really appreciate it.

Lanny Sodini: I thank you for the opportunity, and thank you Cassie!