

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

Truthing the Stretch: An Updated Guide

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

We have written multiple times in the past about inherited stretch rules. *Pensions, IRAs, and nonqualified deferred annuities (NQDAs)* can all potentially be stretched at the account owner's death. *Stretch* means that the beneficiary can delay the federal income tax consequences associated with the transfer of the account.

Stretch choices may differ based on the

- timing of the taxpayer's death,
- type of account,
- relationship of the beneficiary, and timing of the stretch election.

The financial professional will often be called on to help a client choose beneficiaries for IRAs, pensions, and annuities. One of the key factors in drafting beneficiary designations is the potential tax consequences to the beneficiary or beneficiaries of the account.

Stretching the tax result associated with an inherited IRA, pension, or NQDA is not always the right choice for the beneficiary. However, since it's often hard to predict the circumstances that will exist at the account owner's death, keeping the *option* of stretching open is usually the best help a client can get.

To make matters more complicated, stretch rules for qualified accounts were changed as part of the original SECURE Act, which became effective in 2020. SECURE Act law was further clarified last year by the IRS when it published proposed regulations at 87 FR 10504.

In this issue, we will discuss the current stretch choices available upon the death of qualified and nonqualified account owners. We have also produced reference charts in the Appendices to this article summarizing the stretch choices for various types of accounts and beneficiaries.

Understanding how certain beneficiary choices will affect stretch at the death of the taxpayer is critical to giving good advice.

Please feel free to contact me to discuss further.

Regards,
Michael W. Lagos, CFP®

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Truthing the Stretch: An Updated Guide

PENSIONS AND TRADITIONAL IRAs

The stretch options available for pension accounts and traditional IRAs are substantially identical. We will refer to stretch options as they apply to IRAs. For this discussion, pension accounts shall include qualified plans, tax-sheltered annuities (Section 403(b) plans), and eligible Section 457 governmental plans.

Required Beginning Date

The options available to a given beneficiary depend on whether the original account owner had reached the *required beginning date* (RBD) at the time of death. For most IRAs, the RBD is April 1 of the year following the calendar year in which the owner attains age 72 (73 if age 72 reached after December 31, 2022). That is the deadline for the first lifetime required minimum distribution (RMD).

For *pension accounts*, the RBD is deferred to April 1 of the year following the taxpayer's retirement if:

1. the plan is sponsored by the participant's employer, and
2. the participant is *not* a 5 percent or more owner of the employing company.

RMDs from the pension account must start by the relevant RBD.

SEP IRAs and SIMPLE IRAs are treated as IRAs, rather than pension plans, for the purpose of determining a participant's RBD.

The Tables Used to Calculate RMDs

To help explain stretch rules, we refer to the following tables used for minimum distribution calculations related to stretch.

- The Uniform Lifetime Table
- The Single Life Expectancy Table

In general, the Uniform Lifetime Table is used to calculate RMDs only during an account owner's lifetime. It may also be available for surviving spouses in certain situations. The Single Life Expectancy Table is used to calculate RMDs for beneficiaries of an inherited account. Both tables may be found in the Appendix to IRS Publication 590-B.

A Few Words about Stretch

In discussing stretch, the focus is on the *smallest* amount a beneficiary can receive. However, a beneficiary can usually opt to take bigger distributions, even after choosing to stretch, if they are needed. In most cases, bigger distributions simply mean a bigger current income tax result for the beneficiary.

In general, no pre-59 ½ penalty tax applies to inherited qualified account distributions. If a surviving spouse elects to treat an inherited qualified account or IRA as her own, the extra 10 percent tax may apply to distributions from the post-transformation account.

For qualified accounts, there is a big difference between the stretch rules that apply when the owner died prior to 2020 and accounts with post-2019 deaths.

We have done our best to compile charts with the post-SECURE stretch rules that apply to certain categories of beneficiaries of qualified accounts. Those charts may be found at Appendix 1 of this newsletter.

Spouse as Beneficiary

A surviving spouse will have choices when named the beneficiary of a pension or IRA plan. The choices differ based on whether the deceased spouse had reached the RBD at the time of death.

To be certain these options are available, the surviving spouse should be named individually as the beneficiary, rather than naming a trust as the beneficiary.

Here are short descriptions of the spousal stretch options:

1. Continue the inherited account as if the surviving spouse beneficiary owns it, either
 - a. by having the current custodian retitle it or
 - b. by rolling over to a new surviving-spouse-owned qualified account.
2. Treat the account as inherited, taking RMDs every year
 - a. based on the surviving spouse's age using factors from the Single Life Expectancy Table (Uniform Lifetime Table for accounts inherited in 2024 or later) recalculated every year and
 - b. having no obligation to take RMDs until the year the deceased spouse would have turned 73.
3. Treat the surviving spouse in the same way as a regular nonspouse beneficiary.

Nonspouse Beneficiaries

We will refer to individual beneficiaries of a qualified account simply as nonspouse beneficiaries when they do not fall into the special EDB categories more fully described below.

If a nonspouse beneficiary inherits a qualified account from the owner prior to the RBD, the only obligation of the beneficiary is to completely liquidate the account by the end of the tenth year after the owner's death. No annual RMD is needed.

On the other hand, if a nonspouse beneficiary inherits a qualified account from the owner after the RBD, there is an annual minimum distribution requirement. The beneficiary must take any RMD for the year of death that the account owner failed to take. In addition, beginning in the year after death, the beneficiary must take annual RMDs. The annual RMDs are based on the beneficiary's life expectancy using the Single Life Expectancy Table factor to calculate the amount. The designated beneficiary's remaining life expectancy is determined by reducing that initial life expectancy by one for each calendar year that has elapsed after that first calendar year.

The account must also be completely depleted by the end of the tenth year after the owner's death.

EDB Beneficiaries

In addition to changing the old stretch rules, the SECURE Act created a new class of special beneficiaries—called eligible designated beneficiaries (EDBs)—which includes:

- Minor children of the account owner
- Disabled or chronically ill individuals
- Named individuals no more than 10 years younger than the deceased account owner

We will describe the stretch treatment the members of the new classes receive below. For the purpose of the SECURE Act, a surviving spouse is technically an eligible designated beneficiary. However, in this article we will continue to describe the stretch choices available to a surviving spouse beneficiary separately from nonspouse EDBs.

The stretch specifics vary depending on which category an EDB falls into.

1. **Minor Child of the Account Owner.** Stretch by taking RMDs based on the named beneficiary's age using a period based on the single life expectancy of the beneficiary, determined the year after death of the decedent, beginning in the year after the original account owner's death UNTIL age 21. Then liquidate the entire inherited account prior to the end of the tenth year after reaching the age of 21.
2. **Disabled or Chronically Ill.** Stretch by taking RMDs based on the named beneficiary's age (or decedent, if younger), using a period based on the single life expectancy of the beneficiary, determined the year after death of the decedent, beginning in the year after the original account owner's death UNTIL the chronic illness or disability impairment is removed. Then liquidate the entire inherited account prior to the end of the tenth year.
3. **Beneficiary No More than 10 Years Younger than Decedent.** Stretch by taking RMDs based on the named beneficiary's age (or decedent, if younger), using a period based on the single life expectancy of the beneficiary, determined the year after death of the decedent, beginning in the year after the original account owner's death.

Estate or Trust as Beneficiary

If a pre-2020 qualified account beneficiary was not a named individual, the stretch option may have been lost. If stretch was lost under pre-SECURE Act rules, the entire IRA had to be distributed—and taxed as income—within five years of the account owner's death, if the account owner had not yet reached the RBD. If the account owner was past the RBD at death, and if stretch was unavailable, the distributions had to be taken over the remaining life expectancy of the owner, determined using the age of the owner in the calendar year of his death.

Under SECURE Act rules, if an estate or trust is the beneficiary of a qualified account, the general stretch rule is:

- If the account owner died prior to the RBD, the trust or estate must liquidate the inherited account by the end of the fifth year after the owner's death. No annual RMDs are needed.
- If the account owner dies after the RBD, the trust or estate must take annual RMDs based on the account owner's life expectancy calculated from the year of death using the Single Life Expectancy Table. The estate or trust also has a 10-year account liquidation deadline.

ALTER-EGO TRUSTS OR ESTATES

Alter-ego trusts (and alter-ego estates) are under the near exclusive control of a beneficiary. Within the context of stretch, there is a special option when the beneficiary of an alter-ego trust or estate is a surviving spouse.

The IRS has permitted a 60-day rollover of an inherited qualified account distribution into the surviving spouse's own IRA when an alter-ego trust or alter-ego estate has been the beneficiary. See PLRs 200650027 and 202227005, for example.

In situations where a trust or estate is the beneficiary and there is a question about whether the surviving spouse is eligible to make a 60-day rollover into her own IRA, the client's own tax advisors must make the final determination.

SPECIAL TRUST RULES

Special rules could apply when a trust is the beneficiary of a qualified account. Some of these rules are extremely complex.

Key Concepts

The IRS has issued regulations and letter rulings over the years on how trusts may be used in conjunction with stretch planning.

Look-Through Trusts

Beneficiaries of a trust may be treated as designated beneficiaries—and qualify for stretch treatment—if four requirements are met:

1. The trust is valid under state law.
2. The trust is irrevocable or becomes irrevocable upon the death of the grantor.
3. The beneficiaries of the trust are real people who are readily identifiable from the trust itself.
4. A list of beneficiaries or a copy of the trust is provided to the IRA by October 31 of the year following the date of the grantor's death.

These types of trusts are referred to as *look-through trusts*. The oldest beneficiary of a look-through trust is considered to be the designated beneficiary for stretch purposes. For most such trusts, the stretch rules that apply to the trustee will be the same as if the oldest beneficiary of the trust were named as a direct beneficiary, as we more fully described previously in this article. In general, that means a 10-year liquidation deadline and potential annual RMDs depending on the age of the original account owner.

Trust with Nonspouse EDB

If a look-through trust has a nonspouse EDB beneficiary, the trustee would not have the same 10-year liquidation deadline. So long as the EDB beneficiary remains a beneficiary of the trust, the trustee could continue to stretch based on the age of the oldest trust beneficiary. If and when the EDB beneficiary's impairment is removed, the 10-year liquidation deadline would apply from that point forward.

Final Thoughts

Our observations about trusts as beneficiary of qualified accounts rely on our interpretation of the IRS's proposed regulations regarding the SECURE Act, which were published last year. Those regulations may be changed in their final form, and interpretations may become more refined over time. Financial professionals should take extra care to make sure that all a client's advisors are involved in planning, and everyone involved should double-check for the most recent rules.

ROTH IRAs

The RMD rules with regard to Roth IRAs are similar to those associated with traditional IRAs. However, since Roth IRAs have no required beginning date during the lifetime of the initial account owner, all stretch choices assume the taxpayer died prior to the RBD. That means a regular nonspouse beneficiary of a Roth IRA has a 10-year liquidation deadline and no annual minimum distribution requirement.

Spousal beneficiaries, trust beneficiaries, and EDBs likewise have the same stretch choices for inherited Roths as they would for an inherited IRA where the account owner has died prior to the required beginning date. Appendix 2's chart describes the choices in more detail.

NQDAs

Beneficiaries may have some choices with regard to the timing of payments from an annuity contract and, thus, with the timing of the tax result. As a reminder, stretch rules for inherited NQDA were not changed by the SECURE Act.

Spouse as Beneficiary

A surviving spouse named as beneficiary generally has the right to continue the deferred annuity as if it is her own after the death of the spousal policyowner. The spouse can choose to defer distributions—and the income tax result associated with them—until her death.

However, as with an IRA or pension account, if a marital trust is named beneficiary—instead of the surviving spouse directly—the ability to continue the annuity on a tax-deferred basis until the spouse's death is probably lost.

If the surviving spouse beneficiary is younger than age 59 $\frac{1}{2}$, if continuation is elected, subsequent early distributions may be subject to the 10 percent penalty tax. If the surviving spouse expects to need money before reaching age 59 $\frac{1}{2}$ from the decedent's account, she may elect to be treated as a nonspouse beneficiary. Taxable distributions from an inherited NQDA account are not subject to the 10 percent penalty tax.

Nonspouse Beneficiary Stretch

Under Revenue Code Section 72(s)(2), a nonspousal beneficiary must take distributions from a nonqualified annuity

1. at least as rapidly as under the method of distribution in effect at the owner's death, or
2. completely within five years of the owner's death.

The IRS offers favorable distribution and taxation rules if the beneficiary is an individual. If the named beneficiary annuitizes the annuity over his lifetime within a year of the owner's death, he'll be considered in compliance with the distribution rules. This annuitization has some income tax appeal, as it allows the beneficiary to stretch the income tax result over his lifetime. Further, if annuitized, each annuity payment will be partly a recovery of basis and partly a taxable distribution.

In PLR 200313016, the IRS approved of three non-annuitization methods for a nonspouse beneficiary to satisfy the requirements of Section 72(s)(2):

- Amortization calculation method
- Annuitization calculation method
- RMD calculation method

Each of these calculation methods is similar to those approved for use for so-called Section 72(t) distributions.

The RMD method approved by the PLR produces the lowest initial payout to the beneficiary. The nonspouse beneficiary, within a year of the taxpayer's death, must begin taking distributions using the factor from the Single Life Expectancy Table and the account balance from December 31 of the prior year.

While the IRS did not specify in the PLR, manual distributions taken from an inherited NQDA are likely to be taxed under normal LIFO annuity taxation rules.

Not every insurance carrier allows beneficiaries to elect inherited NQDA stretch. If the existing carrier doesn't allow RMD distributions, one might be tempted to change via Section 1035 exchange to a carrier that does allow RMD distributions. While the Service has permitted the 1035 exchange of an inherited NQDA from one carrier to another in a private letter ruling, not every annuity company allows for such an exchange—so agents should check with sending and receiving companies first.

Trust as Beneficiary of NQDA

A NQDA policyowner may want annuity funds directed to a testamentary trust, for example, for the benefit of his children in the event of his death. Based on current rules, it appears that directing nonqualified annuity proceeds to a trust will require that the annuity be completely distributed—and taxed—within five years of the policyowner's death.

No direct published authority recognizes look-through trust stretch treatment with an inherited NQDA account. However, some insurance companies have taken the position that inherited trust stretch should be allowed. Check with the carrier and the client's tax advisors to decide on a client's options.

TWICE-INHERITED ACCOUNTS

As if inherited account stretch rules were not complicated enough, sometimes a beneficiary will pass away before having completely liquidated the inherited qualified account or nonqualified annuity. Clients will often ask their financial professionals about any special RMD rules in those cases.

Fortunately, the analysis is straightforward. The successor beneficiary of an inherited account simply continues the stretch the original beneficiary started. If, for example, an EDB was taking lifetime distributions, the successor continues those distributions as if the EDB was still alive.

The only additional requirement imposed on the successor beneficiary is that the deadline to completely liquidate after the death of the original beneficiary is the end of the tenth year after the first beneficiary's death.

CONCLUSION

The rules regarding beneficiary stretch options are complex, and it's easy for even experienced professionals to get confused. However, here are some general observations for naming beneficiaries of pensions, IRAs, and NQDAs:

- A named surviving spouse beneficiary of the account will have the most options for deferring taxes at the account owner's death.
- If naming the spouse is not desired or possible, an individual nonspouse beneficiary will generally have a 10-year liquidation deadline for an inherited qualified account. Lifetime stretch is still available for an inherited NQDA.
- If the account owner has a prospective EDB beneficiary in mind, naming the EDB directly or as one of the beneficiaries of a named look-through trust may provide certain stretch flexibility for a qualified account.
- Trusts named as beneficiaries of inherited NQDAs may be stuck with five-year liquidation after the owner's death.

A financial professional who gives his client's beneficiaries plenty of choices regarding taxation of distributions will maximize the chances of continuing to be the family's trusted advisor.

Appendix 1 – Part 1

Qualified Account, IRA, or Roth IRA Stretch

Note: If the account owner died after the required beginning date but before taking the RMD for the year of death, it is the beneficiary's responsibility to take that RMD.

	Spouse	Nonspouse	Nonspouse EDB	Estate or Non-Look-Through Trust	Look-Through Trust
IRA owner dies on or after required beginning date (does not apply to Roth IRAs)	Spouse may treat as his or her own. Or Distribute over spouse's life using Single Life Expectancy Table (Uniform Lifetime table for deaths in 2024 or later) with age recalculated each year. Or Treat as non-spouse beneficiary.	Make annual RMDs beginning with the year after death using Single Life Expectancy Table. Use younger of beneficiary or owner's age in year of death to get initial calculation factor. Use oldest age of multiple nonspouse beneficiaries. Reduce beginning life expectancy by one for each subsequent year. Have the account completely liquidated by the end of the tenth year after death.	Make annual RMDs beginning with the year after death using Single Life Expectancy Table. Use younger of beneficiary or owner's age in year of death to get initial calculation factor. Use oldest age of multiple nonspouse EDBs. Reduce beginning life expectancy by one for each subsequent year. Have the account completely liquidated by the later of the end of the tenth year after death or the tenth year after removal of impairment.	Make annual RMDs beginning with the year after death using Single Life Expectancy Table. Reduce beginning life expectancy by one for each subsequent year. Have the account completely liquidated by the end of the tenth year after death. If there is an EDB of the trust, have the account liquidated by the later of the end of the tenth year after death or the tenth year after removal of impairment.	Make annual RMDs beginning the year after death using Single Life Expectancy Table. Use younger of oldest trust beneficiary or owner's age at death for initial calculation factor from Single Life Expectancy Table. Reduce beginning life expectancy by one for each subsequent year. Have the account completely liquidated by the end of the tenth year after death.

Appendix 1 – Part 2 Qualified Account, IRA, or Roth IRA Stretch					
	Spouse	Nonspouse	Nonspouse EDB	Estate or Non-Look-Through Trust	Look-Through Trust
IRA owner dies before required beginning date (applies to all Roth IRAs)	Spouse may treat as his or her own. Or Distribute over spouse's life using Single Life Expectancy Table (Uniform Lifetime table for deaths in 2024 or later) with age recalculated each year; if this option is chosen, distributions begin in the year the deceased owner would have turned 73. Or Liquidate by the end of the tenth year after death.	Have the account completely liquidated by the end of the tenth year after death.	Make annual RMDs beginning with the year after death using Single Life Expectancy Table. Use younger of beneficiary or owner's age at death to get initial calculation factor. Use oldest age of non-spouse EDBs. Reduce beginning life expectancy by one for each subsequent year. Have the account liquidated by the later of the end of the tenth year after death or the tenth year after removal of impairment. Or Have the account completely liquidated by the end of the tenth year after death.	Have the account completely liquidated by the end of the fifth year after death.	Have the account completely liquidated by the end of the tenth year after death if no trust beneficiary is an EDB. Or If one or more trust beneficiaries are EDBs, the trustee may instead use oldest trust beneficiary's age and Single Life Expectancy Table to get initial calculation factor for an annual RMD. Reduce beginning life expectancy by one for each subsequent year. Have the account completely liquidated by the later of the end of the tenth year after death or the tenth year after removal of impairment.

Appendix 2
Inherited NQDA Stretch

Spouse	Nonspouse	Nonspouse EDB	Estate or Non-Look-Through Trust	Look-Through Trust
Spouse may treat as his or her own. Or Distribute over beneficiary's life beginning with the year after death using the beginning factor from the Single Life Expectancy Table for the beneficiary's birthday age in that year. Or Liquidate by the end of the fifth year after death.	Distribute over beneficiary's life beginning with the year after death using the beginning factor from the Single Life Expectancy Table for the beneficiary's birthday age in that year. Or Liquidate by the end of the fifth year after death.	Distribute over beneficiary's life beginning with the year after death using the beginning factor from the Single Life Expectancy Table for the beneficiary's birthday age in that year. Or Liquidate by the end of the fifth year after death.	Have the account completely liquidated by the end of the fifth year after death.	Have the account completely liquidated by the end of the fifth year after death. (Some experts are of the opinion that look-through trust stretch is possible based on the age of the oldest trust beneficiary. Check with the client's own tax advisors and the administering annuity carrier for options.)

Appendix 3
Twice-Inherited Accounts

NQDAs	Qualified Accounts
The successor beneficiary must finish the stretch option begun by the first beneficiary.	The successor beneficiary must finish the stretch option begun by the first beneficiary, with the additional requirement that the account must be completely liquidated no later than the end of the tenth year after the original beneficiary's death.



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Building Protecting and Perpetuating Family Wealth

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