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LAGOS
WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

GOT NEW QUESTIONS?

WE'VE GOT THE LATEST ANSWERS!

Michael W. Lagos, CFP®
President

Jane M. Roberts
Director of Client Services

Justin P. Boren , PHD
Chief Compliance Officer

Samuel Escobar
Financial Advisor

The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Clients are full of questions on a wide variety of topics. They often ask advisors about issues related to

- Beneficiary designations
- Stretch
- Income taxes
- Trust administration and taxation
- Charitable giving

Financial professionals often look for online resources to provide relevant information to their clients. However, the right stuff isn't always easy to find. Sometimes advisors need to turn to other resources for answers to those questions.

The attorneys at Advanced Underwriting Consultants answer questions from life and financial professionals every day. We have published some of their most-asked questions and answers in the past.

They have shared some of their more recent conversations with financial professionals, which we have transcribed and included below. The current conversations include situations involving the SECURE Act 2.0 and the proposed regulations from the original SECURE Act.

Please feel free to contact our office to discuss further.

Regards,
Michael W. Lagos, CFP®

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THE QUESTIONS AND ANSWERS

Beneficiary Designations

Question: *I have a client who has recently died owning a Section 401K account with a $350,000 balance. The account had his brother and sister as beneficiaries instead of his wife. Is there a painless way to redirect the account to the surviving spouse?*

Answer: Maybe.

If brother and sister are the primary beneficiaries and if there is no named contingent, most financial institutions' rules would make the client's estate the default contingent beneficiary.

In this case, the primary beneficiaries may be able to perform a qualified disclaimer. A qualified disclaimer would be a refusal to accept a beneficiary bequest, done in a manner which meets certain legal requirements. Those requirements are:

1. The disclaimer must be irrevocable and unqualified:
2. The disclaimer must be in writing;
3. The writing must be delivered within nine months of the date of death;
4. The disclaiming person must not have accepted the interest disclaimed or any of its benefits; and
5. The interest disclaimed must pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer.

If both primary beneficiaries in this situation disclaim, then the decedent's estate would likely be the successor beneficiary. If the decedent in this case left a will leaving all assets to the surviving spouse, the surviving spouse might ultimately end up with the money in the Section 401K account.

If the decedent left no will, then the law of intestate succession would kick in. The proper heirs would be determined by state law and the particulars of the decedent's family situation.

If a qualified disclaimer won't yield the desired family result—and assuming the named primary beneficiaries are willing to do whatever it takes to take care of the surviving spouse—the beneficiaries may decide to

- Accept the inherited account,
- Liquidate the inherited account,
- Pay taxes associated with the liquidation, and
- Gift the net proceeds to the surviving spouse.

That path is more complicated than the qualified disclaimer—if a disclaimer option is available. In any event, the parties should consult with a local attorney to help implement the optimal strategy.

Q. *My client wants to leave her life insurance death benefit in equal shares to her sister and brother. If her sister predeceases, she wants that half to be split among her sisters' children. If her brother predeceases, she wants his half to go to the surviving sister. What beneficiary language gets that done?*

A. There is no single correct way to draft a beneficiary designation that seeks that result. Here is one way we like:

> One 50 percent share to SISTER if living. If SISTER is not living, then said share to be divided equally among SISTER'S living children.
> One 50 percent share to BROTHER if living. If BROTHER is not living, then said share to SISTER if living. If SISTER is not living, then said share to be divided equally among SISTER'S living children.

We always strongly recommend that you run all but the simplest beneficiary language by the administrative decision-makers at the financial institution to make sure that they will accept and administer the client's language in the way it is intended.

Stretch

Q. *My client has a nonqualifed deferral annuity (NQDA) where the owner died a month ago and the non-spouse beneficiary has elected to stretch based on life expectancy. Does that RMD withdrawal have to be taken before the first anniversary of the date of death, or is any time before the end 2023 good enough?*

A. It's a great unanswered question. Here's what the Tax Code says about stretch rules for inherited NQDAs.

> (s) Required distributions where holder dies before entire interest is distributed
>
> In general
>
> A contract shall not be treated as an annuity contract for purposes of this title unless it provides that—
>
> (A) if any holder of such contract dies on or after the annuity starting date and before the entire interest in such contract has been distributed, the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used as of the date of his death, and
>
> (B) if any holder of such contract dies before the annuity starting date, the entire interest in such contract will be distributed within 5 years after the death of such holder.
>
> Exception for certain amounts payable over life of beneficiary
>
> If—
>
> (A) any portion of the holder's interest is payable to (or for the benefit of) a designated beneficiary,
>
> (B) such portion will be distributed (in accordance with regulations) over the life of such designated beneficiary (or over a period not extending beyond the life expectancy of such beneficiary), and
>
> (C) **such distributions begin not later than 1 year after the date of the holder's death or such later date as the Secretary may by regulations prescribe,**
>
> then for purposes of paragraph (1), the portion referred to in subparagraph (A) shall be treated as distributed on the day on which such distributions begin. (**Emphasis added.**)

So if we read the Code by itself, it seems like the deadline is the first anniversary of the annuity owner's death. If the insurance company doesn't honor that deadline, then the contract is not a deferred annuity.

Having said that, inherited NQDAs borrow much of their stretch processes from the rules on inherited IRAs. Inherited IRAs may begin stretch distributions for nonspouse beneficiaries who are eligible by the end of the year after the account owner's death.

Based on our own limited experience, the carriers are divided on how they interpret the one-year requirement. Some strictly interpret the rule, while others feel there is little risk in allowing the NQDA beneficiary's RMD to begin by the end of the year after death.

We suppose that means it's safest to assume the one-year rule should be interpreted strictly but that the risk of waiting until the end of the year after death for the first RMD is small.

Q. *I have two clients, husband and wife, who are the beneficiaries of their daughter's 401K account. The daughter was 55 years old when she passed away in 2021. The parents have done nothing with the account since then. What year would the two beneficiaries, who turn ages 88 and 85 this year, need to start taking RMDS from this account?*

A. The stretch rules for the parent-beneficiaries are governed by the first version of the SECURE Act, which became effective for qualified accounts inherited in 2020 or later. If the parents leave the 401K account intact where it is, it has become an inherited 401K account. The money in the account may be direct-transferred to an inherited IRA.

Whether the account stays an inherited 401K or is transferred to an inherited IRA, the same stretch rules will apply.

The daughter passed away before reaching her required beginning date. The parents, since they are older than the account owner, have two stretch options:

1. Completely liquidate the inherited qualified account by the end of the tenth year after their daughter's death or
2. Take distributions based on the beneficiary's life expectancy beginning in the year after their daughter's death (2022).

Annual RMDs for this account would be calculated using the single life expectancy table factor for the older beneficiary using the birthday in 2022, the year after death. We would use the older beneficiary's age because the account was not separated into two portions by the end of the year after the original owner's death. Based on the facts, the table factor would be for an 87 year old—7.1 years.

In this situation, since the RMD factor is less than ten, the beneficiaries' best option may be the first one—complete liquidation by the end of the tenth year after their daughter's death. The surviving parents would have no annual RMD obligation—just the duty to liquidate the inherited account by the end of 2031.

Trust Administration and Taxation

Q. *A couple has a revocable living trust that owns an NQDA on the wife, who recently passed. The husband (not the trust) is the named beneficiary, and he wants to do a spousal continuation with this annuity. Is there any obstacle to the carrier allowing a spousal continuation?*

A. This is another question for which there is no solid answer.

If the wife had owned the NQDA directly, with husband as the beneficiary, the tax code is clear that the husband—as surviving spouse—can elect to continue the annuity as his own.

Here, the trust owned the NQDA—not the wife. The IRS has never said when we have trust-owner, wife-annuitant, and husband beneficiary if spousal continuation is possible. Logic says probably yes, if it's the wife's revocable trust, but there's no authority to reference. The husband is at the mercy of the carrier's interpretation.

This ambiguity is one of the reasons we almost always try to talk agents out of having a trust own an NQDA. By the way, we do not think it's a good idea for a trust-owned annuity to name an individual the beneficiary of the contract. The reason is because there is a significant danger that the trustee will be cheating one or more of the trust's beneficiaries by naming an individual the annuity beneficiary rather than the trust itself.

Q. *I manage a trust account and would like to know at what rate long-term and short-term capital gains are taxed when inside an irrevocable trust.*

A. In general, there are three alternate ways income will be taxed when a trust produces an income taxable result:

1. The grantor will pay income tax at the grantor's rates.
2. The trust itself will pay the income tax at its rates.
3. One or more of the beneficiaries will pay income tax at their rates.

Most revocable trusts—and some irrevocable ones—are taxed the first way. So if the grantor is alive, everything that happens in the trust tax-wise will be treated as if she sold the assets herself. So trust transactions will be taxed at the grantor's personal rates, and she would be liable to pay the taxes.

After the grantor's death, the trust itself may pay income taxes, or the beneficiaries may be liable for the income tax results. That will depend in part on the words in the trust and also in part on the decisions the next trustee will make after grantor's death.

The federal government taxes short-term capital gains (from assets held 12 months or less) and nonqualified dividends as ordinary income. Qualified dividends and capital gains on assets held for more than 12 months are taxed at the long-term capital gains rate.

For trusts in 2023 there are three long-term capital gains brackets:

0%:	$0 – $3,000
15%:	$3,001 – $14,649
20%:	$14,650 and higher

If the trust is paying capital gains tax, then the 3.8 percent Affordable Care Act surtax also potentially applies. For many trusts, the surtax starts at $11,650 of capital gains.

It is not always clear who will be liable for the income taxes associated with trust transactions, so the trustee should check with a tax professional for a reliable answer.

Income Taxes

Q. *My client has received a Form 1099-R from the financial institution that contains incorrect information. What should I do to help?*

A. Form 1099-R is designed to be the payer's best guess regarding the correct tax treatment of a distribution as it affects the recipient. In most cases, the payer's guess will be recorded as a fact on the recipient's income tax return. That is especially true when the payer has complete information on all facts relevant to a taxpayer's transaction.

Sometimes a payer will incorrectly report details on Form 1099-R even when it has all the details. For example, if a taxpayer took a distribution from an IRA account of $10,000, and the payer mistakenly reports on Form 1099-R that the gross distribution was $12,000, the 1099-R might need to be amended by the payer.

However, when the payer does not have all the information relevant to the taxpayer's situation, the payer's guess about tax results on Form 1099-R may not match up with the actual correct tax result. When that happens, it will be up to the taxpayer and the tax professional to reconcile the difference between what is reported on Form 1099-R and tax reality on the recipient's federal income tax return.

It's also possible that the financial institution has correctly reported information on Form 1099-R but the client has a mistaken impression about what it should say. For example, the IRS tells the company processing a qualified charitable distribution (QCD) to report the transfer as a normal, taxable distribution on Form 1099-R.

Section 1035 Exchanges

Q. *I have a client who is performing a partial Section 1035 exchange now and plans to do another Section 1035 exchange within the next six months. Would this cause an issue?*

A. We can't say for sure.

The most recent thing the IRS has published on this topic is Notice 2011-38, a copy of which can be found here:

https://www.irs.gov/pub/irs-drop/rp-11-38.pdf

This 2011 Notice says that when you do a partial exchange of an annuity, if you take money out of either contract within 180 days, the IRS has the option to say that the distribution is taxable boot or that the exchange failed.

Is a subsequent 1035 exchange within 180 days a distribution the IRS would say is taxable? We don't know for sure because the 2011 Notice didn't say. The IRS has not said anything in the interim that says one way or the other.

That's why the safest thing to do is to wait on the second exchange until 180 days have passed after the first.

Charitable Giving

Q. *How do I structure an annuity in connection with my client's charitable remainder annuity trust?*

A. Charitable remainder trusts are a tax code-approved way to make sophisticated gifts to charity while generally allowing the donor to retain an income stream. The implementation of a CRT begins with a trust document drawn up by an attorney. The client-donor decides on the parameters about how the CRT will divide the income and remainder interests between donor and charity.

CRTs come in two main flavors:

- A charitable remainder unitrust (CRUT), which recalculates the income stream every year based on the value of the trust's assets

- A charitable remainder annuity trust (CRAT) which generally pays a fixed income stream to the donor every year

Some get misled by the name *charitable remainder annuity trust*. They believe a commercial deferred annuity is somehow an integral part of the CRAT. That is not the case. The "annuity" in CRAT refers to the style of the payout rather than a deferred annuity.

The trustee of a CRAT generally invests in assets that can help support the income stream needed for the donor, while also maximizing the chances the charitable remainder beneficiary will also eventually be rewarded. While there is nothing in CRT regulations preventing the trustee from investing in a deferred annuity, often more promising returns—consistent with the CRT objectives—are offered by taxable stock and bond funds.

CONCLUSION

Life insurance professionals' and financial advisors' clients ask questions on a wide range of topics. The questions answered in this newsletter may help readers expand their expertise and affirm what they already know.

LAGOS WEALTH ADVISORS

BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

1320 VALLEY VISTA, SUITE 202
DIAMOND BAR, CA 91765
Phone: 866-444-4964, Fax: 714-940-0889

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LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.