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Estate Planning Under the SECURE Act

The SECURE Act considerably reduces the ability of most beneficiaries to stretch the required minimum distributions from inherited retirement accounts. With this significant change, it is imperative for financial advisors and retirement account owners to thoughtfully consider their options when naming beneficiaries.

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LOSS OF THE STRETCH ON INHERITED RETIREMENT ACCOUNTS

One of the most widely discussed changes brought about by the SECURE Act is the loss of the Required Minimum Distribution (RMD) stretch for most non-spousal beneficiaries. Prior to the Act, any individual named as a beneficiary on a decedent's retirement account could stretch the RMDs from their inherited IRA over the course of their lifetime. This reduced income tax bunching and allowed for continued tax-deferred growth. This benefit was magnified when the beneficiaries were very young. The SECURE Act eliminates the stretch, except in cases of certain "Eligible Designated Beneficiaries." Instead, most beneficiaries must fully withdraw the balance, and thus recognize the income, within 10 years. This change makes retirement accounts less appealing wealth transfer vehicles.

10-YEAR RULE

For the most part, the new rules apply only to retirement accounts of owners dying after December 31, 2019. The 10-year payout period means that the balance of the account must be withdrawn by the beneficiary by the end of the 10th year starting the year after the owner's death. No distributions are required in any year leading up to the 10th and final year.

CATEGORIES OF BENEFICIARIES UNDER THE SECURE ACT

There are now three categories of beneficiaries.

- **Non-Designated Beneficiary** (estate, charity, non-qualified trust, etc.)**:** The rules for Non-Designated Beneficiaries did not change with the passing of the SECURE Act. The 5-year rule still applies to beneficiaries of retirement accounts where the owner died prior to their required beginning date (RBD). If the IRA Owner passes away after their RBD, the beneficiaries must take distributions based on the IRA Owner's life expectancy.
- **Designated Beneficiary:** A Designated Beneficiary must withdraw the balance of the account according to the 10-year rule.
- **Eligible Designated Beneficiary:** Eligible Designated Beneficiaries are still able to stretch required distributions over their life expectancy, with modifications in certain situations.
    - The following individuals are considered eligible designated beneficiaries and may elect to stretch their inherited IRA within applicable limits, each determined as of the date of the decedent/owner's death:

- **Spouses**: A spouse may continue to elect to roll a deceased spouse's IRA into their own, or they may elect to receive an inherited IRA to be distributed over the course of their life expectancy.
- **Minor children**: A minor child of the retirement account owner may stretch the account until they reach the age of majority (determined by the state of the child's residency). Once they reach the age of majority, life expectancy distributions stop and the 10-year rule kicks in. For example, if the age of majority is 21 in the child's state of residence, he or she will have until the end of the year in which they turn 31 to deplete the account. This exception only applies to a minor child of the account owner, not to a grandchild or other beneficiary. If the child dies before reaching the age of majority, the 10-year clock starts upon his or her death.
- **Disabled Persons**: Certain individuals with disabilities, as defined under I.R.C. 72(m)(7), may use the life expectancy payout option. The 10-year rule must be used once the disabled beneficiary passes away.
- **Chronically ill persons**: Certain individuals with chronic illness, as specifically defined under I.R.C. 7702B(c)(2), may use the life expectancy payout option. The 10-year rule must be used once the chronically ill person passes away.
- **Persons Close in Age**: A person who is not more than 10 years younger than the account owner may stretch over their own lifetime. Perhaps the idea here was two-fold. First, naming an individual close in age is not part of the targeted tax-deferral behavior, as the individual will be in much the same position as the decedent/owner. Secondly, this eliminates the possibility that the 10-year period would make it more advantageous for an individual with less than a 10-year life expectancy.

These significant changes highlight the fact that beneficiary designations are never one-size-fits all. It is important for an account owner to weigh his or her priorities, identify who an account owner's desired beneficiaries are, and then determine the owner's goals for those beneficiaries.

LIFETIME OPPORTUNITIES: ROTH CONVERSIONS AND LIFE INSURANCE

Some retirement account owners might consider increasing the death benefit on their life insurance policies to help mitigate the tax liability for beneficiaries. In one such strategy, an IRA owner could take IRA withdrawals during their lifetime and use the after-tax proceeds of those distributions to pay for the life insurance premiums.

Others may wish to create a lower overall tax effect with Roth Conversions. Especially if the account owner is retired or otherwise in a lower tax bracket than the anticipated beneficiary, he or she may wish to take advantage of the current lower income tax rates and recognize the income by converting a portion of his or her Traditional IRA account to a Roth IRA. This may avoid the later bunching of income to be reported by a beneficiary who may be in their highest income earning years at the time. The effect is a potentially lower overall tax liability, with a larger net gift to beneficiaries. While a Roth Conversion can certainly help with income tax planning, the same required minimum distribution rules will apply upon the Roth IRA Owner's death. However there is one exception, a Spousal rollover does not would not require the Spouse to take distributions during their lifetime.

ESTATE PLANNING WITH TRUSTS

A common estate planning tool for owners of substantial estates has been to establish long-term trusts for their descendants and name the trust as the beneficiary of retirement accounts. Under the old rules, if established as a "look-through trust," the trust and beneficiary could enjoy the income tax benefits of stretching the RMDs over the trust beneficiary's life expectancy, while controlling and protecting much of the account principal.

Sources: Setting Every Community Up for Retirement Enhancement Act of 2019; I.R.C. 401(a)(9); Tres. Reg. 1.401(a)(9)-4; Robert S. Keebler "The End Is Near for Stretch IRAs" and various other titles; LISI Employee Benefits and Retirement Planning Newsletter #713 (December 26, 2019) at http://www.leimbergservices.com, Copyright 2019 Leimberg Information Services, Inc. (LISI).

Perhaps the most common tool was to incorporate "conduit provisions," which require the trust to distribute all retirement account distributions (*i.e.,* RMDs plus any additional amounts withdrawn in a given year) to the trust beneficiary. Because the distributions must be paid directly to the beneficiary, they are reported at individual tax rates rather than the compressed trust income tax rates. Overall, this design was the best of both worlds for many account owners as it allowed for the stretch over the trust beneficiary's lifetime, continued tax deferral on the growth of the account, and protected assets from creditors for the beneficiary.

Although it appears that conduit trusts may continue to qualify as look-through trusts, because the stretch for most has been eliminated, the best result for most conduit trust beneficiaries is that the retirement assets will be subject to the 10-year payout rule, meaning the assets will ultimately end up in the beneficiaries' hands outright within ten years since conduit trusts require all distributions be paid directly to the beneficiary. Essentially the upside of including conduit provisions will be to stretch the RMDs an additional 5 years (from the 5-year general rule to the 10-year look through) and providing asset protection over the retirement assets while they are held in trust during that 10 year period.

If the primary goal of a long-term trust is to provide spendthrift and creditor protection for the beneficiaries, a conduit trust now looks much less favorable since the beneficiaries are required to receive the balance of the funds outright within 10-years, meaning an important trust asset will be quickly depleted and all protection that the trust would have otherwise provided will be lost. Where the primary goal is to protect the principal from, or for, the beneficiary, the client may elect to forego the 5 extra years of deferral and remove the conduit provisions from their trust, thus allowing the account proceeds to remain protected in the trust, through an accumulation Trust. While the accumulation trust may provide greater asset protection and control of the assets, the retained income distributed from the IRA to the Trust will be subject to income taxes at the Trust tax rates,

CONDUIT TRUSTS FOR ELIGIBLE DESIGNATED BENEFICIARIES

In some cases, the inclusion of conduit provisions can still be effective if the individual beneficiary of the trust is also an Eligible Designated Beneficiary. For example, if the spouse is a beneficiary of a conduit marital trust, since the spouse may continue to use his or her life-expectancy, so may the trust. This may also be effective in the case of minor children. It is important to note, however, that in the case of a spouse, the 10-year clock will start for the remainder beneficiaries at the spouse's death; for a minor beneficiary, it will start upon reaching the age of majority. To effectively use this tool, it is imperative that the trust created for that specific Eligible Designated Beneficiary be named on the applicable beneficiary designation form (for example: the Descendant's Separate Trust f/b/o Jane Smith c/u the Revocable Trust of John H. Smith"). If the descendant's Revocable Trust itself is named as the beneficiary (e.g. "The Revocable Trust of John H. Smith"), it is possible that the stretch will be lost even if a portion of the IRA ends up on a conduit trust for the beneficiary Because of the specific rules identifying the "Beneficiary."

ACCUMULATION TRUSTS DO NOT PROTECT STRETCH FOR MOST ELIGIBLE DESIGNATED BENEFICIARIES

Another trust structure that has traditionally allowed for the look-through is an accumulation trust. The accumulation trust does not require the mandatory distribution of all account withdrawals to the trust beneficiaries. Although accumulation trusts may continue to work under some circumstances to achieve the 10-year pay-out period, it does not appear that they will achieve a life-expectancy stretch for most Eligible Designated Beneficiaries. This is because the Eligible Designated Beneficiary (for example a spouse) will generally not be considered the only potential beneficiary for purposes of determining look-through status. The only case in which the IRS may allow the stretch with an accumulation trust is in the case of Eligible Designated Beneficiaries who are considered disabled and or/chronically ill.

PLANNING FOR SPOUSES

Sources: Setting Every Community Up for Retirement Enhancement Act of 2019; I.R.C. 401(a)(9); Tres. Reg. 1.401(a)(9)-4; Robert S. Keebler "The End Is Near for Stretch IRAs" and various other titles; LISI Employee Benefits and Retirement Planning Newsletter #713 (December 26, 2019) at http://www.leimbergservices.com, Copyright 2019 Leimberg Information Services, Inc. (LISI).

For the most part, participants and their spouses may continue to use the same planning tools for one another. A spouse can continue to roll a deceased spouse's account into his or her own IRA, and, alternatively, can continue to delay RMDs until the deceased spouse would have reached age 72, even if left to a conduit marital trust. One difference is that at the death of the surviving spouse, the 10-year payout period will commence.

PLANNING FOR NON-DESIGNATED BENEFICIARIES

The rules above only apply to "Designated Beneficiaries." A broader group than "Eligible Designated Beneficiaries," Designated Beneficiaries encompasses any individual beneficiary designated by the participant, including trusts that qualify as look-through trusts (discussed above). The distribution rules are unchanged as to those accounts with Non-Designated Beneficiaries which include: (1) an estate, (2) a charity, (3) a trust that doesn't qualify as a look-through, or (4) where no beneficiary is designated.

For Non-Designated Beneficiaries, the distribution period depends on whether the participant died prior to or after April 1st of the year after reaching age 72. If the retirement account owner died on or before April 1st of the year after reaching age 72, the account is subject to the 5-year payout rule. If the retirement account owner died after April 1st of the year after reaching age 72, the beneficiary may continue taking the distributions on the deceased retirement account owner's remaining life expectancy. With the elimination of the stretch, there may be some rare cases where it makes sense for a participant over age 72 to name his estate or a trust which is designed not to achieve look-through status. This is because the non-designated beneficiary status may allow for a stretch longer than 10 years if the retirement account owner died after April 1st after reaching age 72 but before age 81. Again, there are other potentially unfavorable consequences to either. For example, if an estate is named, the assets will be subject to probate. These options should only be executed after careful consideration and discussion with the participant's legal and/or tax advisor.

CHARITABLE REMAINDER TRUSTS

One option to simulate an IRA stretch is to create a Charitable Remainder Trust (CRT) as the IRA beneficiary. A CRT is designed to pay an income stream in the form of a unitrust or annuity payment to the designated recipient (in this case the account owner's beneficiaries) for a specified term of years or their lifetime. At the end of the designated term, the trust balance is distributed to charity. The trust itself does not recognize the income from liquidating the account. However, the trustee keeps track of the income that would have otherwise been created (*i.e.* ordinary income in the amount of the proceeds) and the beneficiary will pay income tax each year to the extent distributions are made. The result is income tax deferral for the beneficiaries, but the trade-off for this deferral is that the remainder, if not depleted, will pass to charity rather than other family members.

For example, an individual creates a Charitable Remainder Unitrust (CRUT) for his child and names the CRUT as the beneficiary of his $1 million IRA. The CRUT must make a 5% unitrust payment to the beneficiary annually. The CRUT will record the $1 million of ordinary income, but it will only be reported by the beneficiary to the extent of his annual distributions. In year 1, the beneficiary would receive approximately $50,000 (or 5% of the trust value at the valuation date) and report the full amount as ordinary income. In contrast, if the account owner named the beneficiary individually, the individual's best stretch would be to report approximately $100,000 per year for 10 years.

CONCLUSION

Regardless of your goals, the significant changes brought forth under the Secure Act make it imperative that you and your advisors review the beneficiary designations on all of your accounts to identify issues and plan for the desired result.

Sources: Setting Every Community Up for Retirement Enhancement Act of 2019; I.R.C. 401(a)(9); Tres. Reg. 1.401(a)(9)-4; Robert S. Keebler "The End Is Near for Stretch IRAs" and various other titles; LISI Employee Benefits and Retirement Planning Newsletter #713 (December 26, 2019) at http://www.leimbergservices.com, Copyright 2019 Leimberg Information Services, Inc. (LISI).