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Eye on Washington

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SECURE Act Signals End of “Stretch IRA” Planning in Many Respects

In spite of an increasingly acrimonious environment in Washington (recently culminating with articles of impeachment against President Trump), the political parties were able to find agreement in that last refuge of comity: an end-of-year consolidated appropriations spending package. Included in this bill is legislation that makes significant changes to the rules governing the inheritance of qualified retirement plans and individual retirement accounts (IRAs). Titled “Setting Every Community Up for Retirement Enhancement,” the SECURE Act was signed into law on December 20, 2019, but is generally effective beginning in 2020.

Changes to RMDs for Beneficiaries of Qualified Plans and IRAs

The most significant change under the law for individuals is the end of “stretch IRA” planning for many beneficiaries inheriting plans. Under a stretch IRA approach, the beneficiary of a qualified retirement plan or IRA limits distributions from such accounts to the required minimum distributions (RMDs) based on their own age. This permits a beneficiary to maximize the tax deferral available to such plans—the younger the beneficiary, the greater the potential benefit.

Under the new rules, however, all individual beneficiaries (and certain trusts) other than specific exception beneficiaries are required to fully distribute inherited accounts within a 10-year period.

Key Points to Consider

- The beneficiary is not required to take any annual distributions upon inheriting—so long as the entire account is distributed at the end of year 10, the distribution rules will be satisfied.
- The 10-year rule applies generally to defined contribution plans [401(k)s and the like] and IRAs—annuity options under defined benefit plans (and defined contributions plans that contain annuity investments) and individual retirement annuities are generally not impacted.

- The distribution rules for plans passing to ***non-designated beneficiaries*** (e.g., estates, charities, non-qualifying trusts, etc.) continue to apply [5 years where the participant died before the required beginning date (RBD), or based on the participant's life expectancy if the participant died after such date].
- The new distribution rules apply to beneficiaries of **Roth IRAs** as well as **traditional IRAs**.

Exception Beneficiaries

Five exception beneficiaries are exempt from the 10-year rule and may continue to take distributions based on their age:

- Spousal beneficiaries (who may also continue to roll over plans into their own name);
- Minor children (but not grandchildren or other minor relatives);
- Disabled or chronically ill individuals (and certain trusts for their benefit); and
- Beneficiaries who are no more than 10 years younger than the original owner/participant.

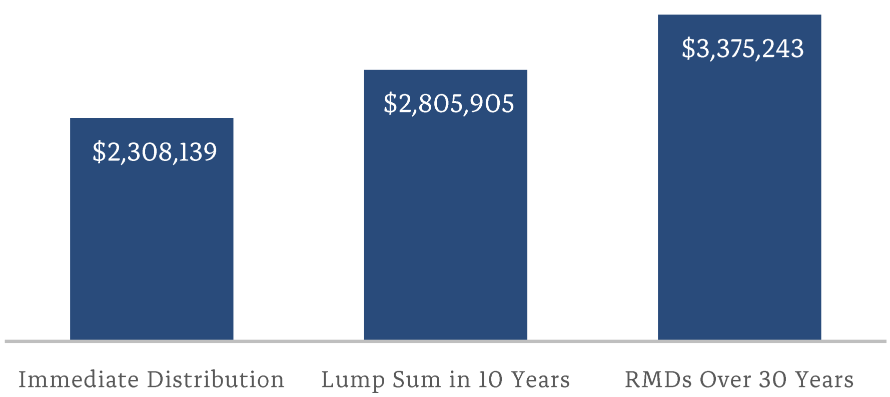
Once the exception no longer applies (e.g., death of spousal beneficiary, minor child reaches age of majority, disabled individual ceases to be disabled), the 10-year rule applies to the subsequent or existing beneficiary.

Effective Date

The new rules apply to accounts inherited in 2020 and beyond—for individuals who inherit an account from a 2019 decedent (or inherited in prior years), the old RMD rules continue to apply. Note, however, that it appears that the legislation requires a 10-year distribution period for any successor beneficiaries of such accounts, assuming the current beneficiary dies in 2020 or later. In other words, the grandfathering of the old RMD rules only applies to current beneficiaries of accounts—the 10-year rule will apply to any successor beneficiaries. For spousal beneficiaries of accounts owned by individuals who died late in 2019, it may be worthwhile to consider a qualified disclaimer of such account (generally within 9 months of death). Assuming such disclaimer could pass the account to significantly younger family members, longer tax deferral may be available under prior RMD rules.

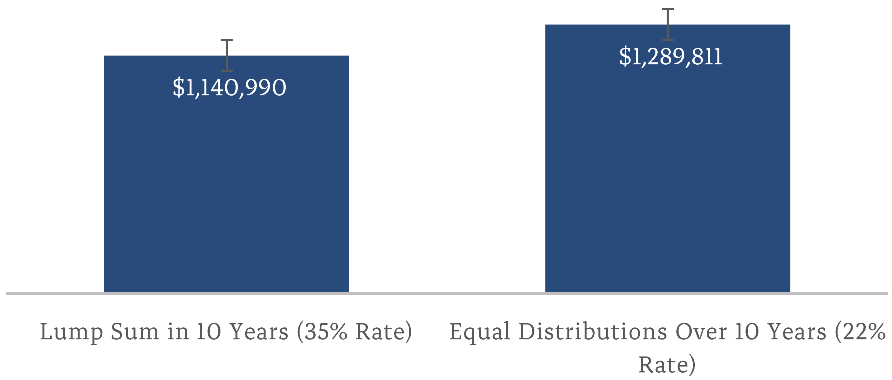
Impact of Loss of Deferral

While most beneficiaries of IRAs have the option of taking out as much of the account as desired, "stretch" distribution planning would generally result in a significant benefit to such beneficiary. For example, the total net after-tax balance of a $1 million IRA inherited by a 40-year-old beneficiary would be significantly higher if an RMD schedule were followed. Assuming a 6% pre-tax earnings rate and 30% income tax rate on earnings and distributions, the total net after-tax balance in 30 years would contrast as follows:



Post-SECURE Distributions: Gradual vs. Lump Sum

Of course, while it may be intuitive to maximize deferral in the account for the full 10 years, a sizable distribution in a single year may subject the bulk of the distribution to a higher marginal income tax rate. For example, assuming a beneficiary can take equal distributions of a $1 million IRA (earning 6% annually pre-tax) over a 10-year period at a 22% federal bracket, versus a complete distribution in year 10 subject to a 35% rate, the total net after-tax balance in year 10 would be as follows:



Note that IRA distributions also increase the beneficiary's adjusted gross income (AGI). Exceeding certain AGI thresholds can impact a beneficiary's eligibility for the Internal Revenue Code Section 199A qualified business income tax deduction, or subject investment income to the 3.8% net investment income tax (NIIT).

Ultimately, the significance of this change and impact on beneficiaries will depend on several factors, including the size of the inherited accounts, a beneficiary's marginal tax bracket, and the extent to which affirmative planning steps may have been taken to ensure that tax deferral would be optimized (generally by designating a qualifying trust as the beneficiary).

Conduit vs. Accumulation Trusts

To ensure that plan distributions for beneficiaries are limited to RMDs, many individuals may have created trusts under their estate planning documents and designated such trusts as beneficiary of their retirement accounts. The trustee can therefore exercise control over how much is distributed from the plans to the trust beneficiary. To avoid a 5-year accelerated distribution rule, however, the trust must qualify as a "designated beneficiary." One option to achieve this is to direct the trustee to distribute all IRA distributions outright from the trust to the beneficiary—the so called "conduit trust" approach. Under a 10-year distribution rule, however, conduit trusts will require the entirety of the IRA to be distributed outright to the trust beneficiary. As a result, the IRA assets will no longer enjoy the non-tax benefits of trust planning, including protection from creditors, divorcing spouses, and mismanagement or overspending.

The chart at right contrasts potential distributions from a trust assuming a $1 million IRA, 6% pre-tax earnings, and RMDs under prior law for a 40-year-old trust beneficiary. After the SECURE Act, gradually increasing annual distributions of between $20K-$40K would become one large lump sum distribution of nearly $1.7M.

Year	Lump Sum Value	RMD Distributions
1	$1,000,000	**$23,419.20**
2	$1,060,000	**$24,824.36**
3	$1,123,600	**$26,313.82**
4	$1,191,016	**$27,822.56**
5	$1,262,477	**$29,491.92**
6	$1,338,226	**$31,178.95**
7	$1,418,519	**$32,960.36**
8	$1,503,630	**$34,937.98**
9	$1,593,848	**$36,928.75**
10	**$1,689,479**	**$39,030.02**

As a result, “accumulation” trusts may increase in favor. Such trusts permit the trustee to accumulate IRA distributions inside the trust for the eventual benefit of the beneficiary. Such trust must still qualify as a designated beneficiary, which generally requires that all beneficiaries of the trust be identifiable individuals. Careful drafting will be required as well to ensure that certain traps (e.g., a charitable entity as a remainder beneficiary) are avoided. One notable disadvantage of accumulation trusts is the fact that trust income tax rates are steeply graduated. As a result, IRA distributions that are retained by the trust may be subject to a higher income tax rate than if distributed to the individual beneficiary (where income is generally taxed at his or her own tax rate).

For conduit trusts that can no longer be amended (e.g., due to the death of the grantor), a trust reformation under state law may be an option to prevent an acceleration of trust distributions. Reformations may be available in situations where changes in the law act to defeat the original objectives of the grantor in establishing such trust. Reformations are subject to varying state rules and can require judicial approval, or might otherwise be effected by agreement of all parties to the trust.

Trusts for the Benefit of Exception Beneficiaries

Trusts that are established for the benefit of spouses, minor children and disabled or chronically ill individuals may still permit distributions to be taken based on the age of the specified exception beneficiary, assuming such trusts are designed as conduit trusts for such individual. This may pose a considerable problem for trusts for minor children, as 1) RMDs must generally be distributed outright to a custodian or custodial account; and 2) the 10-year rule applies once the child reaches the age of majority.

Updates in the SECURE legislation, however, accounted for concerns elicited by planners in the special needs arena. Special needs trusts (SNTs) are commonly employed for the benefit of disabled family members to prevent an inheritance from disqualifying such individual from public benefit programs. Since such trusts are by definition accumulation trusts (distributions are generally made on behalf of such individual to supplement benefits provided under public programs), early versions of the bill would have eliminated the exception beneficiary benefit for disabled beneficiaries of special needs trusts. The finalized legislation provides that such trusts will qualify for the exception so long as all current trust beneficiaries qualify as chronically ill or disabled (under Internal Revenue Code §7702B(c)(2) and §72(m)(7) respectively). Therefore, individuals who have engaged in such planning should review their documents to ensure compliance. For example, some planners in the special needs area frequently include other family members as potential beneficiaries of an SNT as a potential escape hatch if the trust is otherwise perceived as disqualifying for assistance programs.

Planning Considerations for Owners of Large Accounts

Consider Lifetime Roth Conversions

Due to the myriad tax and planning considerations that come into play with an inability to stretch distributions over a beneficiary’s life expectancy, Roth conversions of traditional IRAs and defined contribution plans (where available) will likely take on an increased focus. While non-exception beneficiaries of Roth accounts will still be required to distribute the accounts over a 10-year period, such distributions are not subject to income taxation—eliminating concerns about increases in marginal tax rates and AGI threshold considerations, while making accumulation trust planning much more palatable for long-term wealth preservation.

To be effective, Roth conversions within the same marginal income tax bracket at a minimum should be considered (while avoiding an increased marginal rate). As the following tax tables show (based on 2020 federal income rate brackets), an account owner may have considerable room within the applicable tax bracket to take advantage of such “strategic” conversions. Additionally, the payment of taxes for such conversion should generally be satisfied with non-qualified assets where possible (to maximize the tax-free accumulation of Roth IRA assets).

Taxable income		Flat amount	+ %	Of amount over
Single Taxpayer Rates				
$ 0 to	$ 9,875	$ 0	10%	$ 0
9,876 to	40,125	987.50	12%	9,875
40,126 to	85,525	4,617.50	22%	40,125
85,526 to	163,300	14,605.50	24%	85,525
163,301 to	207,350	33,271.50	32%	163,300
207,351 to	518,400	47,367.50	35%	207,350
518,401 to	+	156,235.00	37%	518,400
Married Filing Jointly Rates				
$ 0 to	$ 19,750	$ 0	10%	$ 0
19,751 to	80,250	1,975.00	12%	19,750
80,251 to	171,050	9,235.00	22%	80,250
171,051 to	326,600	29,211.00	24%	171,050
326,601 to	414,700	66,543.00	32%	326,600
414,701 to	622,050	94,735.00	35%	414,700
622,051 to	+	167,307.50	37%	622,050

Note that a Roth conversion cannot be effected by a beneficiary of a plan; however, a spousal beneficiary could consider a conversion after rolling such plan into his or her name. To satisfy the tax liability on such a conversion, life insurance may be appropriate to consider as well.

Charitable Planning Options—Qualified Charitable Distributions

Charitable planning for qualified plans and IRAs has become increasingly popular in recent years due to the ability to avoid income (and possibly estate) taxes on account balances. As a result of the SECURE Act, it is likely that charitable arrangements will be even more attractive.

One option will be for owners of large accounts to deplete them over time with charitable bequests, while providing alternative estate assets to heirs. Of course, plan owners cannot simply transfer balances to charity—taxable distributions must first be taken, followed by charitable gifts that are subject to a donor's AGI deduction limitations. A qualified charitable distribution (QCD), however, is one option available to account owners who have reached age 70½ to effectively obtain a full deduction for up to $100,000 of gifts from IRAs annually. *Note that the new RMD starting age of 72 (as described below) does not impact the eligible age for the QCD.* So long as the transfer is effected on a trustee to trustee basis to a public charity (private foundations and donor advised funds do not qualify), the gift:

- Avoids inclusion in the donor's income (preventing an increase in AGI that may trigger adverse phaseouts or other taxes);
- Counts towards the RMD for the given year; and
- Ensures that the entire transfer is effectively deducted.

Note as well that beneficiaries of an IRA also can effect a qualified charitable distribution, so long as they are over age 70½.

Outright Charitable Beneficiary

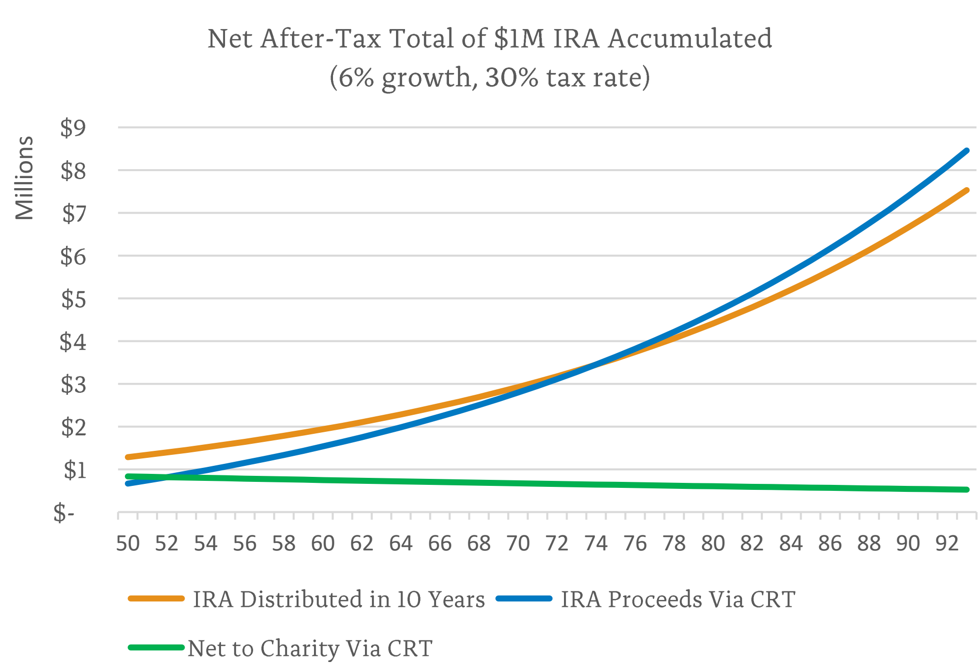
Of course, any plan balances left to beneficiaries are ultimately distributed and subject to income taxation at the beneficiary's own income tax rate. For non-exception beneficiaries (i.e., adult children, grandchildren of any age, etc.), income taxation will now be accelerated over or at the end of the required 10-year period. For account owners with sizable estates that may be subject to federal and/or state estate taxes, the effective tax impact on IRAs is significantly higher. While federal estate taxes attributable to plans are deductible for federal income tax purposes, plans subject to estate taxes remain subject to income taxes as well. As a result, total effective taxes can easily exceed 60% or more on estate taxable retirement accounts. Naming a charitable beneficiary (including a foundation or donor advised fund) for such account can eliminate estate and income taxes, preserving the entire balance for a charitable legacy. The drawback is that accumulated funds are no longer available for the benefit of family members. Other estate assets, or life insurance established outside of the taxable estate, can frequently serve as a wealth replacement mechanism. Where life insurance is utilized, it may make sense to use excess IRA distributions as a funding source, depending on the overall impact on one's income taxes.

Charitable Remainder Trust as Beneficiary

Traditional stretch IRA planning also can be facilitated by naming a charitable remainder trust (CRT) as the beneficiary of an IRA. A CRT is a tax-exempt trust that can provide distributions to a designated family member for their lifetime (or a specified term of up to 20 years), with the balance passing to charity at the end of such period. By naming a CRT as the beneficiary of an IRA, the proceeds are distributed free of income tax to the trust and grow tax-free inside such trust. Distributions to the non-charitable lifetime beneficiary are generally subject to income tax (as they would normally be if such individual were the beneficiary of the IRA), but a synthetic stretch of IRA distributions can be effected based on the distribution terms of the trust. With an "annuity" trust (CRAT), a fixed percentage of trust assets based on the initial IRA value are distributed annually. With a "unitrust" (CRUT), a fixed percentage of trust assets re-valued annually is distributed.

Due to the actuarial rules that govern CRTs, CRUTs are likely to be the most viable option in most cases. Due to the ability to obtain long-term tax deferred growth on IRA assets via the CRT, total net after-tax assets accumulated by the beneficiary may ultimately be higher, while a considerable charitable legacy can be provided.

For example, assume a 40-year-old inherits a $1 million IRA through a lifetime CRUT (paying 7.072% annually), with assets growing at 6% annually and subject to a 30% income tax rate. The graph below illustrates total net after-tax accumulated distributions and assets passing to charity (at the beneficiary's death) contrasted with a 10-year accelerated distribution.



Note potential drawbacks of naming a CRT as beneficiary of an IRA:

- Due to the aforementioned actuarial guidelines applicable to CRTs coupled with the currently low interest rate environment, CRTs may not be effective with younger beneficiaries. For example, assuming the current 7520 rate of 2.00%, a CRUT established for the lifetime of an individual younger than age 27 may not satisfy the required 10% present value remainder test applicable to CRTs.
- Because CRT assets pass to the designated charitable recipient upon the death of the non-charitable beneficiary, a portion of IRA assets are not available for the ultimate benefit of the family. For this reason, it may make sense to consider establishing life insurance on the lifetime beneficiary as a wealth replacement tool.

Other Notable Aspects of SECURE Act

Beyond the elimination of the stretch IRA planning option for many beneficiaries, the SECURE Act contains other provisions that may be more well received, including:

- The age to begin taking RMDs from IRAs has increased from 70½ to 72. Therefore, individuals who turn 70½ in 2020 will now have an additional year (or possibly two) to defer taking distributions from their retirement accounts. For example, an individual turning 70½ on December 30, 2020, would previously have to take their first RMD by April 1, 2021. Since such individual will not reach age 72 until 2022, their first RMD will not be required until April 1, 2023. **Note that for those who turned 70½ in 2019, RMD rules remain the same.** (Note as well that the IRS has submitted proposed revisions to the Uniform Lifetime Table for RMD purposes that may be adopted in 2020, or possibly beyond).
- Individuals may now continue to contribute to their IRAs beyond reaching age 70½. Note that the annual limit on qualified charitable distributions will be reduced by the amount of deductible IRA contributions made after such point.
- 529 plans may now additionally be used to pay for certain costs associated with registered apprenticeship programs, as well as for qualified education loan repayments.
- Small employers will be eligible for tax credits of up to $5,000 in startup costs for establishing new qualified retirement plans.
- Safe harbor rules have been added to ERISA to give fiduciaries more latitude to purchase annuities on behalf of account owners to offer options for guaranteed sources of retirement income.

Conclusion

The SECURE Act has introduced a very significant change to how beneficiaries of qualified retirement plans and IRAs ultimately inherit such accounts. As always, it is crucial for owners of such accounts to consult with their professional advisors and review current beneficiary designations, governing estate planning documents, desired family and philanthropic distribution schemes, and potential tax ramifications. In many cases, changes to the current structure may be necessary, and additional strategies may offer the ability to significantly increase tax efficiency while simultaneously satisfying one's planning objectives.

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