The Secure Act

Modification of Required Minimum Distribution Rules for Designated Beneficiaries (The "Ten-year Rule")

Presented by: Hook Law Center

Enacted December 20, 2019

- The enactment of SECURE Act in 2019 was unexpected
- The effective date of the SECURE Act is January 1, 2020
  - The SECURE Act generally does not apply to persons who die before January 1, 2020
  - However, the SECURE Act applies the 10-year rule if the original designated beneficiary dies prior to distribution of the entire account.
- The SECURE Act applies to designations of beneficiary for people dying on after December 31, 2019.

Highlights

- Increases Required Beginning Date (“RBD”) to 72
- Eliminates Age Cap for Traditional IRA contributions
- Expands eligibility for part time employees
- Increases credits for small businesses which establish retirement plans
- Expands the use of 529 Plan accounts
- Revises Kiddie Tax Rules
- Generally requires All IRAs and Qualified Plans to be distributed within 10 years of death (“Ten-Year Rule”)
    - **Expected to raise taxes on plan distributions by $16 Billion over 10 years. This increase is due to the shortened distribution period and resulting higher marginal rates.**
    - Eliminates the go-to estate plan for IRA and Qualified Plan account owners (i.e. the Stretch IRA).

Ten-Year Rule
exceptions for certain beneficiaries

- The excepted beneficiaries are called “Eligible Designated Beneficiary” (“EDB”).
- The EDB are:
  - Surviving Spouse
  - Employee’s Children under age of 18
  - Disabled persons
  - Chronically Ill persons
  - Individual not more than 10 years younger than employee

Example

- Assume a IRA account owner designates his 60 year old, unmarried child as the beneficiary of his IRA with an account balance of $500,000.
- Assume the child has $100,000 of taxable income and uses the standard deduction
- Under the pre-SECURE Act rules, the child could withdraw the funds over his life time, 25.2 years. The child would receive a Required Minimum Distribution (“RMD”) of about $19,841 ($500k/25.2) per year.
- Under the SECURE Act 10-year rule, the child would likely withdraw $100,000 per year to insure distribution within the 10-year rule.
- The SECURE Act results in a 15 year reduction in the tax deferral and an increase in the child’s marginal income tax rate of 8%.

Solutions

- Retain Income Tax Deferral
  - Designate EDB as beneficiary
  - Conduit Trust for Spouse
  - Trusts for Disabled or Chronically Ill Individuals
- Bracket Management within a Family
  - Multiple Beneficiaries
  - Multi-generational Spray Trust
- Roth Conversions
- Fulfill Charitable Goals with IRA
- Charitable Remainder Trusts
- Life Insurance

Conduit vs. Accumulation Trust

- Under the pre-SECURE rules, two types of trusts were used to obtain a Stretch IRA
  - Conduit Trust – All distributions made from the IRA to the trust must be paid to the individual life beneficiary. The life beneficiary is considered the sole beneficiary of the trust and of the IRA for RMD purposes.
    - Generally only a conduit trust for a EDB will get the life expectancy payout.
    - If the beneficiary is not an EDB, then the beneficiary will receive an outright distribution of 100% within 10 years.
  - Accumulation Trust – the trustee can accumulate IRA distributions in the trust. All beneficiaries who might ever be entitled to receive such accumulations are counted as beneficiaries for applying RMD rules.
    - With the exception of trusts for the sole benefit of a disabled or chronically ill beneficiary, an accumulation trust must take distribution of the entire IRA balance within 10 years after the employee's death.
    - The trust will be taxed on the accumulated income with a compressed rate structure (i.e. income over $13,000 is taxed at 37%)

Planning for the Surviving Spouse

- The surviving spouse is an EDB.
- If the surviving spouse is designated as the beneficiary, he or she may
  - Roll over the inherited benefits to his/her own IRA, or
  - Elect to treat the IRA as his/her own IRA
- Designate a conduit trust for the surviving spouse, which will be entitled to a life time pay out
  - The trust does not have to commence taking RMD until the end of the year in which the deceased employee would have reached age 72
  - Calculation of RMD based on spouse's life expectancy, recalculated annually
  - The 10-year rule will not apply during the spouse's life
- An accumulation trust for a surviving spouse is subject to the 10-year rule with accumulated income over $13,000 subject to a 37% rate.

Planning for Minor Children

- A Minor Child is a EDB, entitled to a payout of an IRA based on the child's life expectancy – only until he/she reaches majority (age 18), at which point benefits must be paid in full within 10 years.
- A conduit trust for a minor child is entitled to the same treatment.
- The EDB exception for minor children applies only to the children of the deceased employee, not to grandchildren.
- How does the exception work if there is a conduit trust for multiple minors? The answer is unknown.
- An accumulation trust for a minor child is subject to the 10-year rule with accumulated income over $13,000 subject to a 37% rate.
- Realistically in most cases parents of minor children will prefer the use of an Accumulation trust to avoid giving a very young child control and will focus on how to pay the taxes (buy life insurance) rather than on deferral of taxes.

Planning for Disabled and Chronically Ill

- A disabled beneficiary is an EDB. An individual is considered disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment.
- A chronically ill beneficiary is an EDB. An individual is considered chronically ill if he requires assistance with at least 2 activities of daily living.
- An Accumulation Trust for a disabled or chronically ill individual can get a life time expectancy pay out.

Planning for Less-Than-10-years-younger Beneficiary

- An individual (who is not a surviving spouse, minor child, disabled or chronically ill individual) who is not more than 10 years younger than the employee is an EDB.
- You may obtain a life expectancy payout by
  - designating the less than 10 years younger beneficiary as the beneficiary
  - Designating a conduit trust for a less than 10 years younger beneficiary as the beneficiary

What Happens on the Death of the EDB?

- Upon the EDB's death, the remaining IRA account must be distributed within 10 years after the death of the EDB.

Bracket Management within a Family

- Consider designating multiple beneficiaries to obtain lower marginal income tax rates.
- Consider designating a multi-generation discretionary trust which will permit the trustees to distribute taxable income to multiple family members to obtain lower marginal rates.
  - Although the trust would be subject to the 10-year rule, income distributed by the trustee would be taxable at the marginal rates of the beneficiaries.
  - Consider Kiddie Tax when distributing to minor grandchildren.

Roth Conversions

- Most of the concerns discussed here pertain to traditional retirement plans and IRAs, where taxes are going to be substantially accelerated (and therefore probably also be in higher brackets) than under previous law.
- With a Roth IRA, acceleration does not increase taxes, since the distributions are tax-free—the acceleration just means loss of future tax-free growth.
- Thus, one response to SECURE will presumably be increased Roth conversions during life by IRA owners, especially if the IRA owner is in a lower tax bracket than he expects his beneficiary to be (often correctly if the beneficiary is a trust).

Fulfill Charitable Intent Using the IRA

- If the client wishes to make a testamentary charitable gift(s), consider fulfilling this intent by designating a tax exempt charity(s) as a beneficiary of the IRA.
- Since the charity is a tax exempt organization, it may accept the IRA benefits free of any income tax.

Charitable Remainder Trust (CRT)

- CRTs may have more appeal now for a client who has charitable intent and a desire to leave a lifetime income stream to the beneficiary rather than a 10-year payout taxed at high rates.
- Traditional retirement benefits can be paid income tax-free into the CRT, which then pays a lifetime stream of fixed dollar or fixed percentage payouts (taxable) to the human beneficiary.
- The annuity percentage must be at least 5% and not more than 50%.
- Returning to our example, if a CRT is the designated beneficiary, it could provide that the 60 year old beneficiary could receive a 5% annuity payout ($25k) for the greater of his life or 20 years. The beneficiary would annually report the annuity payment as taxable income. At the end of the term, the trust would distribute the remaining balance to Charity.

Life Insurance

- If life insurance can be purchased on the IRA account owners life, then consider creating an irrevocable life insurance trust (ILIT) to purchase the life insurance.
- The amount of the insurance will be the projected income tax that will be paid on the IRA benefits at the owner's death (or the amount of the increased income tax due to the 10-year rule).
- The IRA account owner will make withdrawals during his lifetime from the IRA and gift the withdrawals to the ILIT to be used to pay the insurance premium.
- If the IRA owner is married, consider:
  - Designating the spouse as primary beneficiary and the ILIT as contingent beneficiary
  - Purchasing survivorship insurance to reduce premium payments.

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