NEW SECURE ACT AFFECTS ESTATE PLANNING FOR RETIREMENT PLANS

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Tax, Private Clients, Trusts and Estates Alert

Effective January 1, 2020, a new federal law dramatically changes the landscape for estate planning with retirement accounts. The Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act") implements new rules regarding payout of retirement accounts to a deceased participant's beneficiaries.

Under prior law, most designated beneficiaries of an inherited retirement account were generally permitted to take required minimum distributions from the account over the life expectancy of the beneficiary. By allowing the beneficiary to "stretch" withdrawals out over his or her lifetime, the beneficiary could indefinitely continue the benefit of allowing the account to earn investment returns on a tax-deferred basis. In most cases, the SECURE Act now eliminates the ability to "stretch" these withdrawals from inherited retirement accounts over a beneficiary's lifetime. Instead, the account must be distributed in full within 10 years after a plan participant's death. Going forward, the SECURE Act will limit the potential use of the lifetime stretch rules, still with some modification, to five classes of beneficiaries: (1) the participant's surviving spouse; (2) minor children of the participant; (3) disabled beneficiaries; (4) chronically ill individuals; and (5) beneficiaries less than 10 years younger than the plan participant.

The SECURE Act changes how many current beneficiary designations may be implemented as well as the impact the designations may have on tax liability. Thus, some plan participants will lose some control over their planning options, and most beneficiaries will pay income tax on an accelerated basis and at higher rates.

Everyone with a retirement account is encouraged to review current beneficiary designations and estate planning documents, particularly plans involving trusts as retirement plan beneficiaries. Thoughtful estate planning strategies implemented now can help mitigate some of the impact of the SECURE Act.

NAMING A SPOUSE AS BENEFICIARY

Under the SECURE Act, a spouse named as an outright beneficiary still may: (1) stretch the required distributions over the spouse's lifetime; and (2) roll over inherited benefits into the spouse's own IRA. Similarly, where a trust benefiting a spouse is named as beneficiary of a retirement plan, so long as the trust terms require that all required distributions of a plan be distributed to the spouse, then the required distributions still may be stretched over the spouse's lifetime.

If a trust for the benefit of a spouse is the named beneficiary of a retirement account, plan participants should review the terms of the trust. In particular, if the retirement account pays to a trust in which the spouse is only entitled to receive annual distributions of income (and not the greater of the income or the required distribution), the retirement account will be subject to the 10-year payout rule — thereby accelerating the income tax payments on the required distributions.

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NAMING CHILDREN AS BENEFICIARIES

With some limited exceptions, the majority of designations naming children as beneficiaries of retirement accounts will now result in the accelerated 10-year payout of benefits.

Adult children and trusts for adult children now will be subject to the new 10-year payout rule. Where minor children or trusts for minor children of the plan participant are named as beneficiaries, the 10-year payout clock will begin to run when the minor child reaches the age of majority. Other minors, such as grandchildren, are not considered eligible designated beneficiaries and are immediately subject to the 10-year payout rule.

NAMING A TRUST AS A BENEFICIARY

Prior to adoption of the SECURE Act, "conduit trusts" were often used in conjunction with the lifetime stretch rules for distributing retirement accounts to beneficiaries. A conduit trust is one in which all required distributions from a retirement account received by a trust are distributed at least annually to the trust beneficiary, with income associated with the required distributions then being taxed to the beneficiary at his or her individual income tax rate. Using this trust structure historically has minimized the income tax impact on required distributions.

With the new 10-year payout rule under the SECURE Act, conduit trusts could cause punitive income tax consequences. Beneficiaries will now have to realize a significant amount of income over a shorter period of time since all plan benefits must be distributed outright to beneficiaries within the 10-year term, likely resulting in higher income tax rates. Further, trusts with conduit provisions no longer provide the long-term control or protection of retirement benefits and their proceeds for beneficiaries that many plan participants previously expected.

Plan participants may consider naming an accumulation trust as the beneficiary of a retirement account, instead of a conduit trust, if they wish to avoid the retirement account being distributed in full to a beneficiary within the 10-year term. An accumulation trust allows the required distributions to collect inside a trust, with the trustee maintaining discretion regarding distributions to trust beneficiaries. The retirement account, however, would be required to distribute to the trust in full under the new 10-year payout rule, resulting in accelerated income tax payments at higher tax rates charged to trusts (though actual distributions to a beneficiary will still carry out income).

Terms of trusts in existing estate plans should be carefully reviewed in conjunction with the new SECURE Act terms to ensure that a plan participant's intentions are still met.

IMPACT ON ROTH IRAS

Roth Individual Retirement Accounts ("IRAs") are also subject to the accelerated 10-year payout rule under the SECURE Act. However, since distributions from Roth IRAs are not subject to income tax, the accelerated income tax liability is not a concern.

Where IRA owners have a lower income tax bracket than the intended beneficiary of an IRA, IRA owners may want to consider a Roth conversion during life. As such, the IRA owner would pay income tax at his or her income tax rate, with distributions passing income-tax free to the named beneficiary.

CALCULATING THE 10-YEAR TERM

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All amounts to be distributed under the new 10-year payout rule must be distributed in full by December 31 of the year that contains the tenth anniversary of the date of death of the retirement plan participant. No distributions are required to be made until the end of the 10-year period, although distributions may be made before then.

IMPACT ON PRE-2020 DEATHS

Although the SECURE Act applies in full to all plan participants dying on or after January 1, 2020, the SECURE Act also may affect plans for some decedents dying prior to January 1. For decedents who died in 2019, disclaimer of retirement accounts to contingent beneficiaries should be considered to possibly lock-in lifetime stretch payments for the contingent beneficiaries. Further, for plans in which the participant died prior to January 1, 2020, the 10-year payout rule will apply in most cases upon the death of the originally named beneficiary. Upon any death, analysis of the SECURE Act's impact on retirement accounts should be considered.

OTHER IMPACTS OF THE SECURE ACT

The SECURE Act has several impacts on the payout of retirement benefits other than the highlights mentioned above. The SECURE Act has new requirements and impacts on beneficiaries or trusts for beneficiaries who are: (1) disabled; (2) chronically ill; or (3) less than 10 years younger than the plan participant. With some exceptions, the SECURE Act allows lifetime stretch payouts to beneficiaries falling into these categories. Careful planning must be done to ensure the longer payout period will apply.

WHAT TO DO NOW?

With the implementation of this new legislation, all retirement plan participants should carefully review their current retirement plan beneficiary designations in conjunction with a review of their estate planning documents. We invite you to contact any member of our private clients, trusts and estates team to discuss your estate plan and beneficiary designations and to review whether any updates may be prudent.

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