THE COUNTS LAW FIRM, LLC

CLIENT ALERT

The SECURE Act: Its Impact on Your Estate Plan and What to Do Next

January 31, 2020

The SECURE Act was signed into law on December 20, 2019. Among other things, it significantly changes the way that inherited retirement accounts are taxed. This significant change has been commonly referred to as "the death of the stretch IRA."

History of the "Stretch IRA"

Assets held inside of tax-deferred retirement accounts (IRA, 401(k), 403(b), etc.) have not been income taxed yet. In the past, those assets could be left to an individual beneficiary (i.e., a human being) or to a trust that qualified as a "see-through trust," and the beneficiary would then start taking required minimum distributions from the account the year after the owner's death. A beneficiary could always withdraw more than the minimum, but the required minimum distribution had to be distributed to the beneficiary each year. The distributed amount would then be included as ordinary income on the beneficiary's income tax return for that year and thus taxed. Prior to the enactment of the SECURE Act, the beneficiary's age and corresponding life expectancy could be used to calculate the required minimum distributions from the account. This is why it was called a "stretch IRA" because the distribution and taxation of the account could be stretched out over the beneficiary's life. This typically resulted in lower overall income taxes and also allowed the assets in the account to continue to grow tax-deferred: a real win-win for beneficiaries. For example, if a beneficiary was 45 years old, then the required minimum distribution was calculated using a remaining life expectancy of 38.8 years.

10-Year Rule

The SECURE Act changes all of this and now requires distribution of all retirement accounts (with a few exceptions, discussed below) within **TEN (10) years** of the owner's death. There are no longer required minimum distributions for beneficiaries. The requirement simply states that 100% of the account must be distributed (and thus taxed) by December 31st of the calendar year containing the 10th anniversary of the owner's date of death. This means that the account could be distributed in one-tenth increments each year, or all in year 10, or some other fashion as long as it is all distributed by the above date.

The new 10-year rule applies to all individual beneficiaries and also to see-through trusts, however, there are exceptions for beneficiaries who qualify as an Eligible Designated Beneficiary (an "EDB").

Eligible Designated Beneficiaries

There are five exceptions to the 10-year rule available for certain retirement account beneficiaries (EDBs):

4200 SOMERSET DRIVE
SUITE 200
PRAIRIE VILLAGE, KS 66208

TELEPHONE (816) 753.0900
FAX (816) 753.0901
COUNTSLAWKC.COM

1. Surviving Spouse – the 10-year rule does not apply at all, so you can count on the same rules applying for spouses, including the ability to elect a spousal rollover.
2. Minor Child of the Owner – a minor child of the account owner can use the old life expectancy calculation of annual required minimum distributions UNTIL the child reaches the age of majority, at which time the 10-year rule will start. Note that this applies ONLY to a minor child who is the account owner's child. It does not apply to other minor children that account owners might want to name as beneficiaries (grandchildren, nieces/nephews, etc.). PLEASE NOTE THAT WE GENERALLY DO NOT RECOMMEND THAT YOU NAME A MINOR CHILD AS A DIRECT BENEFICIARY OF YOUR RETIREMENT ACCOUNT DUE TO POSSIBLY TRIGGERING A PROBATE CONSERVATORSHIP, AMONG OTHER REASONS.
3. Disabled Beneficiary* – a disabled beneficiary can use the old life expectancy calculation of annual required minimum distributions and stretch distributions over his or her life. Upon the disabled beneficiary's death, the 10-year rule will start. PLEASE NOTE THAT WE GENERALLY DO NOT RECOMMEND THAT YOU NAME A DISABLED BENEFICIARY AS A DIRECT BENEFICIARY OF YOUR RETIREMENT ACCOUNT DUE TO POSSIBLY JEOPARDIZING THE BENEFICIARY'S ELIGIBILITY FOR PUBLIC BENEFIT PROGRAMS, SUCH AS MEDICAID AND SSI.
4. Chronically Ill Beneficiary* – a chronically ill beneficiary can use the old life expectancy calculation of annual required minimum distributions. Upon the chronically ill beneficiary's death, the 10-year rule will start. PLEASE NOTE THAT WE GENERALLY DO NOT RECOMMEND THAT YOU NAME A CHRONICALLY ILL BENEFICIARY AS A DIRECT BENEFICIARY OF YOUR RETIREMENT ACCOUNT DUE TO POSSIBLY JEOPARDIZING THE BENEFICIARY'S ELIGIBILITY FOR PUBLIC BENEFIT PROGRAMS, SUCH AS MEDICAID AND SSI.
5. Less Than 10 Years Younger Beneficiary – a beneficiary who is less than 10 years younger than the account owner can use the old life expectancy calculation of annual required minimum distributions. Upon the death of the beneficiary, the 10-year rule will start.

* "Disabled" and "Chronically Ill" are statutory definitions in the Internal Revenue Code. If you would like more information about those definitions, please contact us.

<u>Tax Rates</u>

In addition to a huge loss of tax deferral years for most of our clients, the SECURE Act also triggers another problem for the large number of our clients who have named their revocable trust as the primary or contingent beneficiary of their retirement accounts. This problem relates to the tax rates applicable to individuals vs. trusts. As you may know, there are various

income tax rates that apply to individuals based upon their total income for a tax year. For example, a single individual with taxable income between $9,701 and $39,475 in 2019 was in the 12% tax bracket. A married couple (filing jointly) with taxable income between $78,951 and $168,400 in 2019 was in the 22% tax bracket. Trusts, on the other hand, accelerate to the highest tax bracket (37%) with only $12,750 of taxable income.

When income earned by a trust is distributed to a beneficiary, the income gets taxed at the beneficiary's rate, not the trust's. A lot of our clients' trusts for their children provide for distribution of income and principal as needed for the child's health, education, maintenance, and support. Under trust accounting rules, distributions first carry out the trust's income to the beneficiary. Thus, if the trust received a $20,000 required minimum distribution from an IRA in a given year, then the first $20,000 distributed to the child during that year would carry out the income to the child. This was beneficial because typically (but not always) children are in lower tax brackets than trusts. However, if 1/10 or more of a retirement account is distributed to a trust in a given year, rather than 1/38, for example, then the income to the trust may easily exceed what the child needs from the trust for the child's health, education, maintenance, and support. This means that income will be trapped inside the trust and taxed at the trust's higher rate.

Trusts

In the past, there have been two types of trusts that are commonly used in planning with retirement assets in order to achieve the "stretch" of a life expectancy payout. These types of trusts that qualify for stretch IRA treatment (typically using the oldest trust beneficiary's age to calculate the life expectancy payout) are called "see-through trusts."

Conduit trusts are a type of see-through trust where any distributions from retirement accounts are automatically distributed out to the beneficiary. With a conduit trust, no retirement account distributions can be accumulated inside the trust. Thus, the trust just acts as a conduit for the retirement account distribution to pass through, and all retirement account distributions are taxed on the beneficiary's income tax return.

Accumulation trusts are another type of see-through trust where distributions from retirement accounts can be accumulated inside the trust and do not have to be distributed to the beneficiary. Most of our clients have accumulation trusts because of the flexibility and protection they provide. Trustees typically have the discretion to distribute the retirement account distributions if the beneficiary needs the income for the beneficiary's health, education, maintenance, and support. But if the retirement account distributions are not needed for these purposes, then they can be accumulated inside the trust, which may offer creditor and divorce protection.

Under the new rules, accumulation trusts will be subject to the 10-year rule (with a potential exception for disabled beneficiaries). On the other hand, conduit trusts where the beneficiary is one of the five Eligible Designated Beneficiaries described above, will qualify for the life expectancy calculation using the beneficiary's age. (For minors, the life expectancy calculation ends when the child reaches the age of majority.) Thus, if your beneficiaries fall within one or more of the five EDB categories, then we may be able to achieve a longer stretch than the 10-year rule.

However, if your beneficiaries are adult children who otherwise do not fall into one of the five EDB categories, then unfortunately you are stuck with the 10-year rule, whether the assets are left to your beneficiaries directly or via a see-through trust.

Weighing Tax Savings vs. the Benefits of Trusts

Because many of our clients will be subject to the 10-year rule for their beneficiaries, they will need to decide whether or not they want to continue leaving retirement assets to them through their trusts. Leaving the assets through your trust provides potential creditor and divorce protection benefits that many of our clients value for their children and other beneficiaries. However, without updated distribution provisions and careful Trusteeship that includes thoughtful income tax planning, having retirement assets pass through a trust may result in a much larger tax bill because of the trust's higher rate.

Clients with beneficiaries falling within one of the EDB categories (minor child, disabled beneficiary, etc.) may want to explore whether the life expectancy calculation is a viable option for them under the new rules, and what revisions to their plan may be necessary in order to achieve it.

Charitably inclined clients may want to consider leaving retirement accounts to a charitable remainder trust which can essentially eliminate the income tax on the retirement account while providing a lifetime stream of payments to beneficiaries.

Bottom Line

If you have your trust named as the primary or contingent beneficiary of your retirement accounts, you need to do something. This could include amending your trust or removing your trust as a beneficiary of your retirement accounts (and, for example, naming adult children instead). In addition, many of our clients with accumulation trusts have provisions in their trusts regarding the identity of contingent beneficiaries that they may not otherwise want but that were included solely to qualify the trust as a see-through trust. Clients may want to review and amend those contingent beneficiary provisions since they are no longer needed under the new rules.

Unfortunately, there is no one-size-fits-all solution for all clients. There are many factors to consider in making these decisions, and we strongly encourage you to contact us to discuss your individual situation, how the SECURE Act impacts your plan, and ultimately what solutions make the most sense for you and your family.

4200 SOMERSET DRIVE
SUITE 200
PRAIRIE VILLAGE, KS 66208

TELEPHONE (816) 753.0900
FAX (816) 753.0901
COUNTSLAWKC.COM