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SPECIAL REPORT: How the SECURE Act Will Limit Stretch IRAs and Retirement Planning

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While offering certain incentives to enhance retirement savings, proposed legislation known as the SECURE Act[1] (the "Act") would severely limit the use of stretch IRAs and cause many individuals to amend their estate planning documents and retirement planning generally. The proposals are winding their way through Congress now and have substantial bipartisan support on both sides of the aisle. This Special Report summarizes the proposed legislation, reviews the current IRA and stretch IRA rules and how the SECURE Act will impact those rules, and offers some planning suggestions to mitigate the loss of stretch IRA benefits.

Upside of the SECURE Act.

On the positive side, the Act permits individuals to defer required minimum distributions and make tax deductible contributions until age 72. In addition, individuals with 529 plans would be able to withdraw up to $10,000 to pay down student loans, which will help reduce the student loan epidemic nationwide. Another upside is that the bill allows new parents to withdraw up to $5,000 without being penalized from their IRAs or 401k plans to help defray birth and adoption expenses. Also, employers would be permitted to offer annuities as an investment option in their employer-sponsored 401(k) plans and would receive a $500 tax credit for automatically enrolling new employees and up to a $5,000 credit for

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[1]H.R. 1994, known as the "Setting Every Community Up for Retirement Enhancement Act", was overwhelmingly passed (by a vote of 417-3) by the House of Representatives on May 23, 2019. The Senate is currently considering passage of its own bill, S. 972, the Retirement Enhancement and Savings Act ("RESA"). If the Senate passes its bill and House and Senate reconcile any differences in joint committee, the reconciled bill is expected to become law effective in 2020 if signed by the President. The hold-up in the Senate apparently relates to the deletion of a provision in the House bill (which was in the Senate bill) that would have permitted 529 plans to be used for home schooling and for other administrative reasons.

plan startup costs. The bill would increase the cap on automatically raising payroll contributions from 10 to 15 percent of an employee's gross paycheck.

Enactment of these incentives would come at significant cost for many taxpayers, and the price tag may far outweigh the Act's benefits. To pay for the incentives, the Act will raise over $15.7 billion over the next decade by requiring IRAs and other qualified retirement plans to be liquidated within 10 years following the death of the plan participant. The Senate's version of the bill is slightly different than the House version. It would allow a lifetime stretch on the first $450,000 of aggregated IRAs but would require the rest to be distributed in five years. Significant exceptions to the mandatory distribution rule are discussed below, but either version signals the death knell for stretch IRAs.

Background on IRAs Generally and Stretch IRAs in Particular.

IRA's are potent tax deferral vehicles that allow participants to build significant retirement savings generally without paying tax until the funds are withdrawn from the plan. Roth IRA's are popular alternatives that can be funded with post-tax earnings, but permit tax-free withdrawals as long as certain requirements are met and are not subject to the lifetime required minimum distribution ("RMD") rules that apply to traditional IRA's. Roth IRA's are subject to the RMD rules following the death of an owner-participant.

In the case of traditional IRAs, the RMD is the minimum amount that an individual must withdraw annually based upon IRS rules and life expectancy tables. If an individual inherits an IRA, the rules become more complicated depending on who inherits, the age of the person from whom the IRA was inherited, and the relationship of the person inheriting the IRA to the IRA owner-participant. Here are some of the more common scenarios relating to inherited and stretch IRAs and how RMD's are determined.

Spouse inherits an IRA from a spouse younger than 70-1/2 and makes the IRA his or her own (i.e., rolls over the IRA). The surviving spouse must follow the same rules as the deceased IRA owner. This means the surviving spouse must take his/her RMD by April 1 of the year following the calendar year in which he/she reaches age 70-1/2.[2] In every subsequent year, the surviving spouse must withdraw his/her RMD by December 31 using the Uniform Lifetime Table published by the IRS. If the spouse inherits a Roth IRA, he/she generally does not pay tax on the distributions, but earnings on the contributions generally will be taxable if withdrawn before age 59-1/2 or the 5-year holding period for the Roth IRA has not been met. Here, the surviving spouse can name his/her own designated beneficiaries.

Spouse inherits an IRA from a spouse at least 70-1/2 and makes the IRA his or her own (i.e., rolls over the IRA). For a traditional IRA, the surviving spouse must take the RMD for the year of the account holder's death (if the account holder has not already done so) and every year thereafter. The amount of the RMD in this case also is determined using the Uniform Lifetime Table. For a Roth IRA, the same rules apply as noted above for an account holder spouse who is under age 70-1/2. The year-of-death RMD will be calculated using the deceased spouse's age and life expectancy. If surviving spouse misses the

[2] A surviving spouse may begin taking withdrawals after reaching age 59-1/2 without penalty; withdrawals before that age would be subject to a 10% excise tax. If the spouse needs access to IRA assets before age 59-1/2, he/she could keep the assets in the deceased spouse's plan and remain as a beneficiary under the plan. In that event, the spouse could take distributions before age 59-1/2 without penalty, and when he/she reaches age 59-1/2, roll over the assets into his/her own IRA account.

December 31 deadline, he/she may be subject to an IRS penalty equal to 50% of the amount not withdrawn. For deaths that occur late in the year, the surviving spouse can file IRS Form 5329 with a letter of explanation requesting a waiver of the penalty if he/she misses the deadline.

Spouse inherits an IRA from a deceased spouse and treats himself/herself as the beneficiary (and not as the account holder). In this case, the surviving spouse creates an "inherited IRA", into which the assets of the decedent spouse's original IRA are transferred and the surviving spouse is treated as the beneficiary of the account.[3] Distributions would be spread over the surviving spouse's life expectancy using the IRS' Single Life Expectancy Table (as compared to a rollover that is treated as the surviving spouse's own account, which uses the Uniform Life Table) and must begin no later than December 31 of the year in which the deceased spouse would have reached age 70-1/2. In a traditional IRA, RMD's are taxed to the extent the distributions exceed the income tax basis of the assets in the account.[4] This rule also applies to non-spouses who inherit IRAs. Here, when the surviving spouse remains the beneficiary of his/her spouse's IRA, the payout period after the surviving spouse's death continues based on the original account owner's life expectancy.

The decision of whether to treat the IRA as the surviving spouse's own versus as a beneficiary depends on the ages of the spouses at the first spouse's death, the need for income from the inherited IRA, the type of IRA and whether there are any creditor protection issues. For example, transferring assets to an inherited IRA may make sense if the surviving spouse is under age 59½ and needs to access some or all the late spouse's IRA assets now, or before he/she reaches age 59½. The surviving spouse will not be subject to a 10% penalty when he/she takes withdrawals from an inherited IRA prior to age 59½ as he/she would be if he/she withdrew assets from a non-inherited IRA. Once the surviving spouse reaches age 59½, or no longer needs to use those assets, he/she might want to transfer the inherited assets into his/her own IRA.

Surviving spouses also have additional rules regarding the timing of RMDs for inherited IRAs. The surviving spouse can begin taking RMDs in the year after the year of death, or he/she can delay beginning RMDs until the deceased spouse would have turned age 70½. This option is important if the surviving spouse was older than the deceased spouse. As noted above, the RMD amounts will be based on the IRS Uniform Lifetime Table, based on the deceased spouse's age. Once the surviving spouse reaches the year that the deceased spouse would have turned age 70½, he/she also could transfer the inherited assets into his/her own IRA.

The surviving spouse also can invoke the 5-year rule. As long as the first spouse was under age 70½ when he/she died, the surviving spouse has 5 years during which he/she can withdraw assets from an inherited IRA at any time, in any amount, as long as all the assets are withdrawn by December 31 of the 5th year following the deceased spouse's death. These larger distributions could push the survivor into a higher tax bracket, however.

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[3] This may be necessary where the deceased spouse's plan required a lump-sum distribution and the surviving spouse wants to defer the payout from the plan and the ability to roll the assets over into her own plan.

[4] Income tax basis would arise from non-deductible contributions made to the individual participant's IRA account, from after-tax contributions made to a qualified plan, from an employee's basis in life insurance included in a qualified plan, and rollover of after-tax money from a qualified plan to an IRA

Disclaimers. Finally, in some cases, it may make sense for a surviving spouse to disclaim all or a portion of the first spouse's retirement benefits. If the surviving spouse disclaims (i.e., refuses to inherit) the first spouse's benefits, the retirement assets will pass to the contingent beneficiaries named on the IRA beneficiary designation form. This could include children, grandchildren, other relatives, a charity, or a trust. A disclaimer must be filed within 9 months following the first spouse's death to be effective for estate and income tax purposes and before the surviving spouse takes possession of the assets being disclaimed.

Non-spouse beneficiary(ies) of any age who want to "stretch" the IRA over their own life expectancies. RMDs are mandatory for traditional or Roth IRAs and must start no later than December 31 of the year following the year of the original account holder's death. In the case of most inherited IRAs prior to the SECURE Act, each beneficiary's age and remaining life expectancy are used to figure RMDs using the Single Life Expectancy Table. Non-spouse beneficiary(ies) of any age who want to "stretch" the IRA over the life of someone else (beneficiary-of-a-beneficiary scenario). Again, RMDs are mandatory for the initial beneficiary, and must start no later than December 31 of the year following the original account holder's death. Should the initial beneficiary die or pass the IRA to another beneficiary prior to the effective date of the SECURE Act, that second beneficiary must use the remaining life expectancy of the original beneficiary to calculate RMDs.

How the SECURE Act Changes Things.

The SECURE Act does not change the rules for spousal beneficiaries, so all of the discussion above relating to surviving spouses remains relevant and very important. For non-spouse beneficiaries, the new Act would impose a new 10-year distribution maximum[5] for death benefits paid from IRAs and defined contribution plans (including 401k plans). This is a radical change for account holders who previously had the ability to stretch the benefits and income tax consequences of receiving assets from an IRA or 401k plan over the lives of their designated beneficiaries.

The impact of this change cannot be understated. Let's say Tina, a non-spouse beneficiary, is age 16, when she is entitled to receive a distribution of her late aunt's IRA account assets. If Tina's guardian[6] elects to roll over the account into an inherited IRA prior to the effective date of the SECURE Act, Tina would be able to spread out the RMDs from the account over her remaining life expectancy, which is 66.9 years under the Single Life Table. Assuming the IRA assets are valued at $1 million as of the year prior to the year in which distributions are to begin. The first distribution would equal $14,947.68 ((1/66.9) * 1,000,000). Each subsequent year's distribution would be determined by multiplying the revalued account balance by a fraction, the denominator of which decreases by 1 every year. Assuming the IRA account balance at the end of year 2 is $1,030,000, the RMD would be $15,629.74 ((1/65.9) * $1,030,000), and so on into the future. If Tina's aunt dies after the effective date of the SECURE Act, the initial distributions arguably could be made on an equal basis over 10 years, or paid out in a lump-sum by year 10 when she is 26 years old. In the latter case, Tina would be forced to take a distribution of the balance of the undistributed IRA account, resulting in income of over $1 million taxed at ordinary

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[5] Again, the Senate version has a 5-year distribution rule but allows continued stretching for up to $450,000 aggregate assets.

[6] Since Tina is under the age of majority, her legal guardian will need to act for her.

income rates (currently 37% federal plus state income tax), arguably at a time when her income tax rate otherwise would be much lower. The benefits of stretching the income over 67 years would be lost.

To protect against the risk of having an 18-year old control a significant IRA asset,[7] many estate planners recommend using trusts as recipients of IRA and 401k benefits following the death of the account holder. If the trusts are regarded as "see-through" trusts, the trust's beneficiaries are deemed to be the designated beneficiaries of the trust, allowing for "stretch" treatment. If the trusts do not qualify for stretch treatment, the IRA or 401k must be distributed within 5 years. If the trusts qualify, at least prior to enactment of the SECURE Act, they can receive and regulate distribution of IRA/401k assets in a way that allows for the income to be spread out over the beneficiary's life expectancy, while providing some level of asset protection.

The two basic types of qualifying "see-through" trusts are "conduit" trusts and "accumulation" trusts. In the case of "conduit" trusts (usually built-in to the provisions of a revocable living trust), all RMD's from an IRA must be distributed to or for the benefit of the trust beneficiaries. An "accumulation" trust allows distributions from the IRA to accumulate within the trust, but special rules apply in deciding which beneficiaries of the trust must be counted for purposes of determining the life expectancy to be used.

In a conduit trust, anyone can be named as a remote or remainder beneficiary of the trust without tainting the favorable income tax treatment of the trust. On the other hand, you must count remainder beneficiaries and certain potential recipients under a power of appointment that may destroy or substantially shorten the payout to an accumulation trust beneficiary.

For example, let's say you name a grandchild as the beneficiary of a trust that receives your IRA benefits. If the grandchild does not survive and leaves no children of his own, you name a charity or your 75-year old sister to receive the assets. A charity is not an individual and therefore cannot be a designated beneficiary of the trust. Your sister may have a life expectancy of only 13.4 years under the Single Life Expectancy table. Assuming your grandchild is 12, she will have a life expectancy of 70.8 years. So, if the trust is treated as a conduit trust, the charity and your sister can be ignored, and under current law, the grandchild can spread the IRA payments over 71 years. By contrast, if the trust is an accumulation trust, the IRA would have to be paid out within 5 years to your grandchild if the remainder beneficiary is a charity or over 13.4 years if the remainder beneficiary is your sister, losing substantial deferral under the stretch IRA rules.

Again, the SECURE Act would change these results for see-through trusts. Instead of being able to stretch the IRA distributions over the beneficiary's life expectancy, the IRA must be distributed in no more than 10 years, defeating the benefits of using a stretch IRA.

Does this mean that all conduit trusts will be obsolete and that you must change your estate planning documents if you use conduit trusts and the SECURE Act is enacted? Also, how do the proposed changes affect accumulation trusts? Do beneficiary designations need to be changed in light of the SECURE Act? Are there any planning suggestions to mitigate the effects of the SECURE Act?

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[7] The ability to stretch out IRA and retirement plan benefits not only can generate significant income tax savings, it also yields strong asset protection benefits, particularly if the assets are paid to a trust for the benefit of the ultimate beneficiary.

Planning After the SECURE Act.

First, there are ***several important exceptions*** to the mandatory 10-year distribution rule under the SECURE Act. In addition to the surviving spouse being excluded from the mandatory 10-year rule, disabled[8] or chronically ill[9] individuals also will be excluded. Minor children (generally referring to children under the age of 18) will be excluded from the 10-year rule, until they reach the age of majority, at which time the 10-year clock starts ticking and distributions will have to be made in the 10-year period following the age of majority. Finally, the rule does not apply if the designated beneficiary is not more than 10 years younger than the deceased employee or IRA owner.

Note: The new rule does not apply to employees or IRA owners who die on or before December 31, 2019; this date may change depending upon what happens in the Senate. Also, the 5-year rule under prior law is extended to 10 years under the SECURE Act for distributions to beneficiaries who are not designated beneficiaries.

With all of that said, the conduit trust described above may create disastrous income tax consequences if left unchecked. Remember, the conduit trust requires all RMDs to be paid as they are received. This may have worked well under the life expectancy rules (i.e., to minimize income taxes and stretch payments out over the beneficiary's lifetime), but it could prove disastrous under the 10-year rule.

Let's assume a beneficiary of a conduit trust is 30 years old when distributions under an IRA are to begin. Further assume that the IRA is $1 million and grows tax-deferred at 7% per annum. In year 0, the beneficiary would receive $18,762 under the Single Life Table, and $37,417 in year 10 when the beneficiary is 40, for total aggregate distributions during the 10-year payout period under the current method of $298,381. By contrast, if the beneficiary takes distributions in equal annual installments, he/she would receive annual distribution of $142,378 per year ($1.566 million over 10 years) or $1,967,151 in year 10 if taken in a lump-sum distribution. At current rates using the current RMD method and assuming he/she is filing as a single taxpayer, the maximum federal rate on that income (assuming no other income) would be 12%, while it would double to 24% for the annual equal payments and skyrocket to 37% if taken out in a lump-sum in year 10.

For those of you who have prepared your estate planning documents using revocable trusts that employ conduit trusts for retirement benefits, you may want to consider amending your documents to remove the conduit language and replace it with accumulation trust language. In that case, you will need to be very careful of the wording in the trust to ensure the maximum possible deferral. If the trust is now

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[8] An individual is considered "disabled" if he/she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration. See I.R.C §72(m)(7). An example would include certain progressive diseases which have resulted in physical loss or atrophy of limbs, such as multiple sclerosis. *See, e.g., Treas. Reg. §1.72-17(f)(2)(viii).*

[9] A "chronically ill" individual means any individual who has been certified by a licensed health care practitioner as being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite and lengthy period of time, or who requires substantial supervision to protect him/her from threats to health and safety due to severe cognitive impairment. See I.R.C §7702B(c)(2), as modified by the SECURE Act.

irrevocable (i.e., because the account owner has passed away), your trustee may want to consider reforming the trust to remove the offending conduit trust language.

Other solutions to consider.

• **Standby Charitable Remainder Unitrust.** You can protect your retirement plan assets and avoid the 10-year payout requirement by using a standby charitable remainder unitrust ("SCRUT") as a beneficiary of your qualified retirement plan or IRA. The SCRUT could be named as a primary beneficiary or contingent/secondary beneficiary of the plan. The SCRUT remains unfunded until you die, or the primary beneficiary passes away. So, no tax returns or other expenses (other than the cost of drafting the trust) are incurred until then. This technique does not distribute the noncharitable interest using IRS life expectancy tables; rather, it is paid out over the actual lifetimes of the individual named as the non-charitable beneficiaries. And, while the SECURE Act would still require distribution within 10 years, the receipt of the distribution is non-taxable to the SCRUT. Distributions are not taxed until they are paid out to the individual beneficiaries.

The SCRUT contains a fixed percentage annual payment for the beneficiary over his/her lifetime. The payout is recalculated every year using the same fixed percentage and applied to the value of the trust assets at the end of the year. The fixed percentage cannot be less than 5% or greater than 50%. Keeping the percentage low allows the principal to grow, which can be distributed to the beneficiary during life and to the charity at death.

• **Married clients who are charitably inclined** and who want to provide for each other could name the SCRUT as the primary beneficiary of the retirement accounts. This plan would generate a marital deduction for the first spouse's estate when the IRA or qualified plan is transferred into the SCRUT for the remaining lifetime of the surviving spouse. It would generate a charitable deduction on the death of the surviving spouse, if the remaining assets go to charity, resulting in no estate tax on the plan assets.

• **Married clients who want to provide for each other and children** also can use a SCRUT. The SCRUT would provide for the surviving spouse first during his/her lifetime, then be distributed to the children for their lifetimes, then to charity. This structure does not qualify for the marital deduction, but the present value of the charitable interest would qualify for a charitable deduction from the estate of the first spouse to die. The charitable interest deduction would be based upon life expectancy assumptions under IRS tables, even though the beneficiaries may outlive the table life expectancies. Note: the charitable remainder beneficiary must be at least 10% of the value of the trust assets.

• **A surviving spouse or single client who wants to provide for sequential beneficiaries** can use a SCRUT to provide for children, partners, parents, siblings or other individual beneficiaries. The same rules apply as above, i.e., the estate gets a charitable deduction for the remainder gift to charity, which must equal or exceed 10% of the value of the trust assets at funding. Permutations on this theme are available (i.e., ensuring the payout is over a specific number of years rather a lifetime or have a guaranteed term after one person's lifetime, etc.).

• **Fund an irrevocable trust with life insurance.** One strategy to generate regular, flexible payments currently available in a stretch IRA would be to fund an irrevocable trust with a life insurance policy. The IRA owner would take a distribution from the IRA to buy a life insurance policy, which would generate estate and income tax-free proceeds at death and which then could be used to fund an income stream

for the trust beneficiaries. While the growth in trust assets would not be tax deferred as they are in an IRA, the trust can be structured to allow for flexible distribution amounts similar to an IRA. Distributions from the trust could be made indefinitely, rather than being limited to the 10-year maximum under the SECURE Act.

• **Charitably disposed individuals** should consider distributing retirement assets to charity if this technique accomplishes their overall estate planning goals. However, where the retirement assets comprise a significant portion of their assets, the SCRUT may prove to be a logical choice. Other solutions to analyze include (depending on the individual's facts and circumstances):

- Roth conversions
- Multigenerational spray trusts, and
- IRA trusts that escape state income tax.

Conclusion.

As the legislation winds its way through Congress to the President's desk, we will be watching it closely for changes and for ways of minimizing the adverse impact of eliminating the ability to stretch retirement benefits to or for the benefit of non-spouse, individual beneficiaries. Stay tuned!