WRMarketplace

An AALU Washington Report

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TOPIC: Legacy and Retirement Planning Considerations After the SECURE Act

MARKET TREND: Retirement and estate plans involving "stretch IRAs" and "conduit trusts" may no longer achieve their intended goals, but other approaches, such as Roth IRA conversions, accumulation trusts, charitable remainder trusts, and irrevocable life insurance trusts, may serve as an effective alternative. New tax credits and other incentivizing rule changes should increase the number of small businesses that offer qualified retirement plans to employees.

SYNOPSIS: The SECURE Act brings a number of significant changes to retirement planning, including: (1) instituting a 10-year payout requirement for qualified retirement plans (e.g., traditional IRAs, Roth IRAs, and 401(k) and 403(b) plans) inherited by a non-spouse beneficiary; (2) eliminating the 70 ½ maximum age restriction for contributing to a traditional IRA; (3) increasing the age at which required minimum distributions ("RMDs") are triggered from 70 ½ to 72 years old; (4) expanding lifetime income and annuity product offerings inside qualified plans; (5) allowing penalty-free withdrawals up to $5,000 following the birth or adoption of a child; and (6) expanding access to qualified retirement plans to small businesses and part-time employees.

TAKE AWAY: The changes brought by the SECURE Act cannot be ignored. Advisors should evaluate its impact on clients' legacy plans, including retirement account beneficiary designations, and determine whether revisions are needed to meet clients' goals. While the SECURE Act reduces or eliminates the benefits of some popular planning approaches, other opportunities may be available. Advisors also should be prepared to guide small business owners through the process of joining a multiple employer retirement plan and qualifying for tax incentives available to offset related retirement plan start-up costs.

On December 20, 2019, President Trump signed into law the Setting Every Community Up for Retirement Enhancement Act (the "**SECURE Act**"), which brings significant changes to longstanding retirement planning rules and approaches along with new opportunities for individuals and small businesses. Below is a summary of select changes and planning considerations.

10-YEAR PAYOUT RULE

New Rule. For over 30 years, individuals could extend the tax-deferred status of qualified retirement plans long after the original owner's passing by receiving RMDs over their respective lifetimes. Similarly, income tax deferral could be extended using a "conduit" or "see-through" trust, which would distribute RMDs outright to the trust beneficiary (based on the beneficiary's life expectancy) but protect the balance of the account from the beneficiary's creditors. These "old rules" still apply to the initial designated beneficiary of inherited IRAs and qualified plans where the original account owner passed away prior to January 1, 2020.[1]

With limited exceptions, distributions from IRAs and qualified plans inherited on or after January 1, 2020 can no longer be stretched over a non-spouse beneficiary's life expectancy. Instead, the entire balance of the account must be paid to the beneficiary before the end of the 10th year following the owner's passing. The concept of RMDs no longer applies here, and a beneficiary can withdraw as much or as little as he or she desires up until the expiration of the 10-year period, at which time the entire balance must be paid out. The 10-year rule applies to conduit trusts as well.

An important exception exists for "**Eligible Designated Beneficiaries**," where RMDs may still be paid over such beneficiaries' lifetime based on his or her life expectancy. Eligible Designated Beneficiaries include: (1) a surviving spouse; (2) minor children of the original account owner; (3) disabled individuals;[2] (4) chronically ill individuals;[3] and (5) individuals not more than 10 years younger than the original account owner.

In the case of a minor child beneficiary, RMD rules apply until the child reaches the age of majority, then the 10-year rule is triggered. The minor child exception does <u>not</u> apply to minor grandchildren or any other minor child who is not a child of the account owner.

Planning Considerations.

- <u>Roth IRA Conversion</u>. As a result of the new 10-year payout rule, adult children who inherit a traditional IRA will be forced to realize additional income within a condensed period of time, which will likely occur during their peak earning years and result in a much higher income tax liability. Unlike a traditional IRA, Roth IRAs do not have RMDs during the owner's lifetime, so assets may continue to grow without income tax until the owner's passing, and income tax does not apply to withdrawals by the owner and future beneficiaries (as long as the account has been opened for 5 years).

A client may convert some or all of a traditional IRA to a Roth IRA, either all at once or over time, realizing taxable income in the year of conversion. For example, a client may target annual conversions in amounts sufficient to reach the top of his or her income tax bracket for that year. Although the amount converted is subject to income tax currently, the tax rate may be lower than in the future if the IRA owner is in a lower tax bracket than the future beneficiary, if he or she can make use of otherwise expiring deductions, or due to changes in the law. Accounting for substantial itemized deductions, like medical expenses incurred for long-term care facilities, can significantly increase the amount of a traditional IRA that may be converted to a Roth IRA without generating additional income taxes. In doing so, it is important to consider the effect that a Roth IRA conversion may have on income floors for Social Security benefits and the Medicare Income Related Monthly Adjustment Amount.

From an estate tax perspective, a Roth IRA conversion may help families with larger net worths. While the latent income tax liability present in a traditional IRA is not deductible for estate tax purposes, eliminating that liability prior to passing via a Roth IRA conversion creates a similar outcome. Paying the income tax during life reduces the gross estate value for estate tax purposes.

- <u>Charitable Giving and Life Insurance Planning</u>. It is clear that, under the SECURE Act, the overall tax burden for the original account holder's heirs will increase. A client may consider leaving some or all of the IRA or qualified plan to charity, eliminating both income tax and estate tax concerns. The assets passing to charity can be replaced by life insurance held in an irrevocable life insurance trust ("**ILIT**"), which may be funded during the IRA owner's lifetime using annual exclusion gifts. Life insurance owned by the ILIT can also provide liquidity at passing.

  A charitable remainder trust ("**CRT**") is a more advanced variation of this strategy which can (somewhat) replicate the effect of a stretch IRA or conduit trust. CRTs are generally structured to distribute an annual amount to a beneficiary, either for a term of years or for life, and then pay the remaining trust assets to charity at the end of the term. The CRT itself is tax-exempt, and income is slowly passed out to the beneficiary each year, effectively deferring the tax liability. Since the CRT is tax-exempt, upon the account owner's passing, a traditional IRA could be paid to (and grow within) a CRT without triggering an immediate income tax. The assets would then be paid to the trust beneficiary gradually over time (generally a minimum 5% annual payout is required), akin to the effect of a conduit trust. This strategy must be evaluated on a case by case basis, as the actuarial value of the charitable remainder interest must be at least 10% of the CRT's value. As noted above, the assets passing to charity can be replaced by life insurance held in an ILIT, if desired.

- Accumulation Trusts. Before the SECURE Act, conduit trusts were often utilized to pass RMDs to the primary trust beneficiary (based on the beneficiary's life expectancy) while protecting the balance of the retirement plan from the beneficiary's creditors, such as a divorcing spouse. The new 10-year rule reduces the effectiveness of the conduit trust because the entire retirement account will be paid out to the trust beneficiary and thus eventually subject to creditors.

  In lieu of a conduit trust, an "accumulation trust" may be considered. The retirement account must still be paid out within 10 years of the owner's passing, but the distributions may be accumulated inside the trust and remain shielded from creditors rather than distributed outright to the beneficiary. The trustee, in the exercise of fiduciary discretion, can then make trust distributions to the beneficiary. The tradeoff may be a significantly higher tax bill; tax brackets for trusts are dramatically compressed such that an accumulation trust would pay tax at the highest marginal rate starting at $12,950 in income (for 2020), whereas a conduit trust beneficiary would pay tax at the highest marginal tax rate for income over $518,400 as a single filer or $622,050 as a married joint filer (for 2020). This tax liability could be partially or completely offset with life insurance.

NO MAXIMUM AGE FOR TRADITIONAL IRA CONTRIBUTIONS

New Rule. To account for the reality that Americans are living longer and working beyond traditional retirement age, the SECURE Act eliminates the age ceiling for contributing to a traditional IRA. Previously, individuals were prohibited from contributing to a traditional IRA after age 70 ½. This change also aligns the rules for traditional IRAs with 401(k)s and Roth IRAs which do not have a maximum age contribution limitation.

Planning Considerations. Now, individuals can continue contributing to their traditional IRA as long as they are working and receiving compensation. Despite the new 10-year rule, the income tax deferral from a traditional IRA can still be significant. The lack of an age limit on traditional IRA contributions extends the time individuals can "back door" fund a Roth IRA, assuming their income exceeds the ceiling for regular Roth IRA contributions, by funding a traditional IRA then engaging in a Roth IRA conversion.

RMDs BEGIN AT AGE 72

New Rule. RMDs are now triggered at age 72, instead of age 70 ½. The age trigger had not been updated since it was originally applied in the 1960s, and this change accounts for the increase in overall life expectancy since then. Individuals who turned 70 ½ in 2019 must take their RMD by April 1, 2020, but individuals who turn 70 ½ in 2020 can wait until they turn 72.

Planning Considerations. The extended RMD age trigger means more time for pre-tax appreciation before RMDs must begin. Additionally, individuals now have more time to complete Roth IRA conversions without having to consider the effect of required distributions.

NEW LIFETIME INCOME AND ANNUITY PRODUCT OPTIONS

New Rule. The SECURE Act provides retirement plan sponsors an optional safe harbor to satisfy the fiduciary prudence requirement with respect to selecting insurers for guaranteed retirement income products, such as annuities, and protects them from liability in the event an insurer is unable to satisfy its obligations under the product contract. The new rule aims to remove ambiguity about applicable fiduciary standards so plan sponsors can offer lifetime income benefit options to retirement plan participants. The income products must be portable as well, so individuals who change jobs can roll over the annuity purchased under their prior employer's plan to their new employer's plan without incurring surrender charges and fees.

Planning Considerations. It will likely take some time before lifetime income products are regularly offered by defined contribution plan sponsors, but when the time comes, individuals will be presented with yet another financial decision to make: should they convert liquid assets in their qualified plan into a guaranteed income product? It will be important for advisors to understand the nuances of the various products offered in their clients' plans and to communicate the financial implications of choosing to purchase a lifetime income product in lieu of maintaining a mix of traditional liquid assets.

PENALTY-FREE WITHDRAWAL AFTER CHILD BIRTH OR ADOPTION

New Rule. Withdrawals from IRAs and qualified plans prior to age 59 ½ are subject to federal income tax and a 10% early withdrawal penalty, with limited exceptions for qualified higher education expenses, unreimbursed medical expenses, and first-time home purchase down payment. The SECURE Act adds another exception for withdrawals up to $5,000 within one year of having a baby or adopting a child under 18 years old. If both spouses have retirement plans, each could withdraw $5,000 from his or her own respective account for a total of $10,000. The withdrawal is not treated as a loan and does not need to be paid back, but it can be repaid if desired. The exception applies only after a child is born or adopted, so funds cannot be withdrawn and used to pay costs beforehand without incurring the 10% penalty.

Planning Considerations. Advisors should help clients weigh the opportunity costs of withdrawing qualified retirement funds to pay expenses associated with a new child. Even though the 10% penalty may be avoided, the amount withdrawn must be added to household income and will be subject to federal and state income tax. The additional income tax liability effectively reduces the net amount of the withdrawal. The pre-tax growth forgone by withdrawing qualified assets should be compared against the cost of using other funding sources, like revolving credit or a short-term loan. Although retirement assets are now more easily accessible, they may not be the best funding source to tap first.

SMALL BUSINESSES AND PART-TIME EMPLOYEES

New Rule. The SECURE Act includes a number of provisions to increase access to the benefits of qualified retirement plans. Generally, beginning in 2021, employers that offer a 401(k) plan can no longer exclude access to part-time employees who complete either one year of service of at least 1,000 hours or three consecutive years of service of at least 500 hours. In part, this new rule aims to help primary caregivers, who are more likely to be employed part-time.

The legislation also encourages smaller companies to begin offering a qualified retirement plan where, until now, setting up and maintaining such a plan for employees was cost prohibitive. The maximum tax credit for small business retirement plan start-up costs has been increased from $500 to $5,000. In addition, a new separate $500 tax credit is available for three years for start-up costs for forming 401(k)s and SIMPLE IRAs that include automatic enrollment, or for converting existing retirement plans into automatic enrollment plans. Beginning in 2021, unrelated businesses will be permitted to join a multiple employer plan administered by a pooled plan provider. Previously, only related businesses could participate in such a plan. The economies of scale and reduced administration costs of pooled plans may make it more feasible for smaller businesses to offer and maintain a retirement plan for their employees.

Planning Considerations. New tax credits and the expansion of multiple employer retirement plans can be expected to incentivize small businesses to create qualified retirement plans for their employees. Business owners will need guidance on how to create such plans and ensure they realize the greatest tax benefit while doing so. Advisors should be prepared to help business owners navigate the new legal and financial landscape when these provisions of the SECURE Act take effect in January 2021.

TAKE AWAY

The changes brought by the SECURE Act cannot be ignored. Advisors should evaluate its impact on clients' legacy plans, including retirement account beneficiary designations, and determine whether revisions are needed to meet clients' goals. While the SECURE Act reduces or eliminates the benefits of some popular planning approaches, other opportunities may be available. Advisors also should be prepared to guide small business owners through the process of joining a multiple employer retirement plan and qualifying for tax incentives available to offset related retirement plan start-up costs.

NOTES

[1] For accounts inherited prior January 1, 2020, the 10-year payout rule appears to apply to successor beneficiaries if the initial designated beneficiary passes away before his or her life expectancy, but the statutory language is unclear.

[2] A disabled beneficiary is defined under Internal Revenue Code ("**IRC**") §72(m)(7) as an individual who 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."

[3] A chronically ill beneficiary is defined under IRC §7702B(c)(2) as an "individual who has been certified by a licensed health care practitioner as: (i) being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of 90 days due to a loss of functional capacity, (ii) having a level of disability similar to the level of disability described in (i), or (iii) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment."