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Estate Planning and the SECURE Act: Critical Considerations for Estate Planners and Administrators

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Estate Planning and the SECURE Act: Critical Considerations for Estate Planners and Administrators

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Overview

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Key Provisions of the Act

SECURE Act Overview

Enacted into law on December 20, 2019.

Provides for significant changes to retirement benefits including with respect to ERISA plans and IRAs.

Changes generally intended to encourage more employers to provide retirement benefits to their employees and for participants to save more for retirement:

- Focus on lifetime income for ERISA plan participants.
- Administration and compliance changes for ERISA plans.
- Changes in distribution rules for ERISA plans and IRAs.

Repeal of Age Limit on IRA Contributions

Under prior law, individuals age 70½ or older could not contribute to a traditional IRA.

- The restriction did not apply to ROTH IRAs.

The age limitation on contributions to IRAs has been repealed.

Deductible IRA contributions made after age 70½ will reduce the amount of qualified charitable distributions (QCDs) that the IRA owner may make.

- QCDs are transferred directly from an IRA to a charitable organization.
- They are possible only after the IRA owner reaches 70½ and are capped at $100,000 per year.
- The cap on QCDs is reduced by the amount of the owner's deductible IRA contributions made after 70½.

Later RMDs

To limit the period of tax-deferral, **individuals must generally begin to receive** "required minimum distributions" (RMDs) **from their account after attaining a certain age.**

- The Act increases the required beginning date (RBD) from age from 70½ to age 72.
- Participants receive the benefits of tax-deferral for a longer period of time.
- ERISA plans may continue to be more restrictive by requiring distributions at an earlier age (such as 65).

Change applies only to individuals who attain age 70½ after 12/31/19 (i.e., those born after June 30, 1949).

Accelerated Death Payouts

The Act makes drastic changes to the tax-deferral benefits available after the death of participants and will have a significant impact on financial, retirement and estate planning.

Prior to the Act, in many cases, death benefits from accounts could be made over the life expectancy of the beneficiary.

- Permitted long periods of tax-deferral where the beneficiary was young.

For all but a limited class of beneficiaries, the Act accelerates how quickly beneficiaries must receive their death benefits.

Applies to participants who die after December 31, 2019

Pre-Act Death Payout Rules and Estate Planning Techniques

Pre-Act Payout Rules

Mandatory distributions to beneficiaries of accounts depended on whether the beneficiary was a spouse, a (non-spousal) designated beneficiary or a non-designated beneficiary.

Designated Beneficiaries:

- Individuals
- See-through trusts with identifiable individual beneficiaries

Non-designated beneficiaries:

- Participant's estate
- A charity
- See-through trusts without identifiable individual beneficiaries
- Non see-through trusts

Rules for Non-Designated Beneficiaries

Mandatory distributions to non-designated beneficiaries depended on whether the participant died before or after his or her RBD:

- Pre-Act RBD was April 1 of the year after the participant turned age 70-½ (now, age 72).

If participant died before the RBD, a 5-year rule applied:

- Distribution must be made in full by the end of the calendar year which contains the 5th anniversary of the participant's death.

If participant died after the RBD: distributions must be made over the remaining life expectancy of the participant.

Rules for Non-spousal Designated Beneficiaries

Non-spousal designated beneficiaries were entitled to payout over their life expectancy (or to use non-designated beneficiary rules).

If the beneficiary used the life expectancy rule, distributions were required to begin on or before the end of the calendar year immediately following the calendar year in which the participant died.

Required minimum distributions were determined based on the life expectancy of the beneficiary and were required to be made each year.

Rules for Surviving Spouses

Upon the death of the IRA owner, a surviving spouse may elect to:

- treat the IRA as his or her own IRA; or
- treat it as an inherited IRA.

The decision affects when the spouse must begin receiving RMDs and the payout period.

Rules for Surviving Spouses (cont.)

Surviving spouse elects to treat the IRA as the surviving spouse's own IRA:

Spouse is required to commence RMDs on his or her RBD.

RMDs are calculated under the rules applicable to IRA owners but treating the spouse as the IRA owner (i.e., generally more favorable life expectancy tables).

Spouse could also roll over the IRA into the spouse's own existing IRA or a new IRA in order to reach a similar result.

Rules for Surviving Spouses (cont.)

Surviving spouse elects to treat the IRA as an inherited IRA:

Owner dies before RBD:

- Spouse is required to commence on owner's RBD.
- RMDs are calculated over spouse's life expectancy (or option of 5-year rule).

Owner dies after RBD:

- Spouse is required to commence in the year following the year of death.
- RMDs are calculated based on the longer of the owner's life expectancy or the spouse's life expectancy.

Rules for Trusts Named as Beneficiaries

When a "see-through" trust is the designated beneficiary of the account, the payout rules look to the beneficiaries of the trust to determine which distribution rules apply.

A trust qualifies as a "see-through" trust if:

- The trust is a valid trust under state law;
- The trust is irrevocable upon death of the participant;
- The trust beneficiaries, who are beneficiaries with respect to the retirement benefits, must be identifiable from the trust instrument; and
- Certain documentation is provided to the plan administrator.

Rules for Trusts Named as Beneficiaries – Trust Types

Two types of see-through trusts:

Conduit trusts

Accumulation trusts

Rules for Trusts Named as Beneficiaries – Trust Types

Conduit Trusts

Requires that account distributions be distributed to one or more identifiable individual beneficiaries immediately upon being distributed to the trust.

- No portion of the account distributions may be accumulated.

Beneficiary pays tax on the distribution at his or her own tax rate.

Rules for Trusts Named as Beneficiaries – Trust Types

Accumulation Trusts

Does NOT require that account distributions be distributed to the trust beneficiary currently. They may be accumulated for later distribution to the current beneficiary or to future beneficiaries.

- I.e., the account distributions must be distributed to the trust when required but do not have to be in turn distributed to the trust beneficiary. Instead, they are distributed in accordance with the terms of the trust.

The trust pays tax on the undistributed assets at the higher trust income tax rates (the highest marginal rates).

Rules for Conduit Trusts as Beneficiaries

Only the current beneficiary was considered to determine whether there is a designated beneficiary or to determine the distribution period.

Potential future beneficiaries were not taken into account for purposes of determining whether the trust's beneficiary is a designated beneficiary or in determining the distribution period.

The current beneficiary's life expectancy (or the life expectancy of the oldest current beneficiary) determined the distribution period.

Rules for Accumulation Trusts as Beneficiaries

Pre-Act, the life expectancies of all potential beneficiaries were considered in determining the beneficiary with the shortest life expectancy, which determined the distribution period.

If any current or potential future beneficiary of an accumulation trust was not an individual, the trust could not take advantage of the life expectancy rule.

- The non-designated beneficiary rules apply.

Exception: "Mere potential successors" are not taken into account. Very limited application.

Conduit Trust Example

A created a trust and named the trust as the beneficiary of his retirement account. The terms of the trust are:

- All account distributions to B currently, during B’s life.
- After B's death remainder to C.

Only B would be taken into account to determine if there is a designated beneficiary or the distribution period:

- If B is A’s granddaughter, the designated beneficiary rules apply.
- If B is a charity, the non-designated beneficiary rules apply.
- If B had a 30 year life expectancy the distribution period would have been 30 years.
- C is disregarded.

Accumulation Trust Example

A created a trust and named the trust as the beneficiary of her retirement account. The terms of the trust are:

- Income to B in the discretion of the Trustee.
- After B's death all principal to C.

Both B and C would be taken into account to determine if the beneficiaries are designated beneficiaries.

The life expectancies of both B and C would be considered in determining the distribution period.

- If B were A's daughter and C were A's granddaughter, the trust beneficiaries would be deemed designated beneficiaries and the life expectancy rule is available.
- However, if B were A’s daughter but C was a charity, the trust beneficiaries would not qualify as designated beneficiaries and the non-designated beneficiary rule would apply.
- If B were A’s granddaughter with a 50 year life expectancy and C were A’s sister with a 12 year life expectancy, the trust would have had a 12 year distribution period.

Separate Account Rule Does Not Apply to Trusts

Separate Account Rule:

- If an account (as opposed to a trust) with multiple beneficiaries is divided into separate accounts for each beneficiary by December 31 of the year following the participant's death, the designated beneficiary of each separate account will be determined separately.

Separate Account Rule does not apply to trusts:

- Example: If A created a trust for his three children that divided into three trusts after A's death, the original trust (not the separate trusts) would be considered and the life expectancy of the oldest child would have determined the distribution period.

Changes to the Death Payout Rules under the Act

Payout Rules under the Act

The distribution rules for non-designated beneficiaries remain unchanged:

- If participant died before the RBD: the 5-year rule.
- If participant died after the RBD: remaining life expectancy of the participant.

The Act eliminated the life expectancy rule for designated beneficiaries other than “eligible designated beneficiaries” (EDBs) and replaced it with a 10-year payout rule.

10-Year Payout Rule

The participant's entire interest must be distributed by the end of the calendar year that contains the 10th anniversary of the participant's death.

Unlike the life expectancy rule, there is no requirement for annual minimum distributions.

- The entire amount may be taken in one or more lump sums at any time up to December 31 of the 10th year.

10-Year Payout Rule

The Act is effective for participants who die after December 31, 2019.

If a participant died prior to 2020, the participant's designated beneficiary is entitled to the pre-Act rules.

However, once the designated beneficiary dies post-2019, the 10-year rule applies to his or her designated beneficiary. For example:

- A dies in 2016 and designates an individual, B, as his beneficiary.
- B is entitled to use Pre-Act rules and has a 30 year life expectancy. Therefore, payments will be made over 30 years.
- B designates an individual, C, as her beneficiary.
- B dies in 2021; her remaining life expectancy is 25 years.
- Pre-Act, C would have had a 25 year payout period.
- Post-Act, C is subject to the Act's 10 year payout rule.

Eligible Designated Beneficiaries

Surviving Spouse

Children who have not yet reached the age of majority

Disabled and chronically ill beneficiaries

Beneficiaries who are not more than 10 years younger than the participant

EDB – Surviving Spouse

Rules applicable to a surviving spouse remain unchanged except that, upon the death of the surviving spouse, the 10 year rule will apply to his or her designated beneficiary.

EDB – Minor Child

May use life expectancy to determine payout period during minority. The 10-year rule applies once the child reaches the age of majority.

To determine majority look to state law (generally 18 or 21 years old).

The Act postpones majority in certain circumstances:

- Postponement until age 26 if the child is enrolled in a "specified course of education"
- If a child is disabled upon reaching the age of majority, majority may also be postponed for so long as the child continues to be disabled.

Only minor children of the participant count as eligible designated beneficiaries (not, e.g., grandchildren).

EDB - Disabled & Chronically Ill – Disability

The individual 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.

Individual must provide proof of disability.

EDB - Disabled & Chronically Ill – Chronic Illness

The individual cannot perform at least 2 “activities of daily living” (e.g. eating, bathing, using the bathroom) without substantial assistance from another person due to loss of functional capacity.

- The individual must provide certification showing that this condition is expected to be “lengthy in nature” and not a temporary malady.

The individual requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment.

EDB - Disabled & Chronically Ill

Beneficiary must be disabled or chronically ill as of the date of death of the participant. Therefore, a beneficiary who later becomes disabled or chronically ill will not be entitled to the life expectancy rule.

A disabled or chronically ill beneficiary's distribution period is determined based on life expectancy.

The ten year rule applies after the death of the disabled or chronically ill beneficiary.

Beneficiary Less Than 10 Years Younger than Participant

Distribution period is determined based on life expectancy.

The 10 year rule applies after the death of the beneficiary.

Rules for Conduit Trusts as Beneficiaries

Only the current beneficiary is considered to determine whether there is a designated beneficiary or an EDB.

Potential future beneficiaries are not taken into account for purposes of determining whether the trust's beneficiary is a designated beneficiary or an EDB.

Rules for Accumulation Trusts as Beneficiaries

If any current or potential future beneficiary of an accumulation trust is not a designated beneficiary, the trust can not take advantage of the 10 year rule (or the life expectancy rule for EDBs).

- The non-designated beneficiary rules apply.

Exception: "Mere potential successors" are not taken into account. Very limited application.

Conduit Trust Example

A creates a trust and names the trust as the beneficiary of his retirement account. The terms of the trust are:

- All account distributions to B currently, during B's life.
- After B's death remainder to C.

Only B would be taken into account to determine if there is a designated beneficiary or an EDB:

- If B is A's granddaughter, the designated beneficiary rules apply.
- If B is a charity, the non-designated beneficiary rules apply.
- If B is A's daughter and is a minor, the EDB rules apply.
- C is disregarded.

Accumulation Trust Example

A creates a trust and names the trust as the beneficiary of her retirement account. The terms of the trust are:

- Income to B in the discretion of the Trustee.
- After B's death all principal to C.

Both B and C would be taken into account to determine if the beneficiaries are designated beneficiaries.

- If B were A's daughter and C were A's granddaughter, the trust beneficiaries would be deemed designated beneficiaries and the 10 year rule applies.
- However, if B were A’s daughter but C was a charity, the trust beneficiaries would not qualify as designated beneficiaries and the non-designated beneficiary rule would apply.

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Accumulation Trust Example (cont.)

Both B and C would also be taken into account in determining if there is an EDB:

- Since the Act does not contemplate EDB remaindermen, even if B and C were both minors, the life expectancy rule would not be available.
- The 10 year rule would apply.

Impact of Separate Account Rule Not Applying to Trusts

Separate Account Rule does not apply to trusts.

There should be a separate trust for each beneficiary – pre death.

Example:

- If A creates a trust for his three children, only one of whom is a minor, that divides into separate trusts for the three children at A's death, the original trust will be considered and the EDB rules will not apply to the minor's trust. The 10 year rule will apply.

Special Rules for Applicable Multi-Beneficiary Trusts

Only applies in the case of disabled or chronically ill beneficiaries.

Applicable Multi-Beneficiary Trust Requirements:

- A trust that has more than one beneficiary;
- All of the beneficiaries are designated beneficiaries; and
- At least one of the beneficiaries is disabled or chronically ill.

If an Applicable Multi-Beneficiary Trust is to be divided into separate trusts for each beneficiary immediately on the death of the participant, each separate trust will be considered separately.

Special Rules for Applicable Multi-Beneficiary Trusts (cont.)

If, under the terms of the trust, no beneficiary has a right to distributions from the account until the death of all disabled or chronically ill beneficiaries, then any other beneficiaries are disregarded in determining whether the trust has an EDB.

This is a modification of the accumulation trust rules:

- Unlike other accumulation trusts, the payout rules look at only the lifetime beneficiaries of the Applicable Multi-Beneficiary Trust to determine if there is an EDB.

Significant because conduit trusts would not meet the needs of a disabled or chronically ill beneficiary.

These special rules only apply to disabled and chronically ill beneficiaries, not other EDBs.

Critical Estate Planning Considerations and Challenges

Consequences of the Changes under the Act

10 year payout rule will result in:

Larger than desired distributions to the beneficiary at an earlier age than expected.

In order to maximize tax deferral, there might be one large distribution in year 10.

Conduit Trusts as Beneficiaries

The changes under the Act may undermine the participant's intent in setting up the trust.

Unless the beneficiary of the trust is an EDB, all assets of the account must be withdrawn from the account and distributed to the trust beneficiary within 10 years.

For non-EDBs and EDBs who are minor children, the Act limits the period during which a conduit trust can provide the protection for beneficiaries that the trust structure was designed to provide.

Accumulation Trusts as Beneficiaries

Accumulation trusts are not appropriate for EDBs other than disabled or chronically ill beneficiaries.

All beneficiaries, including contingent remaindermen, are considered in determining if the trust has a designated beneficiary.

10 year rule will apply and taxes will be accelerated (and taxed at higher trust rate).

But distributions to the beneficiary may be made in accordance with the terms of the trust over whatever period the grantor provides.

Estate and Trust Planning Techniques and Suggestions

Designated Beneficiaries (other than EDBs)

Pre-Act the most common trust was a conduit trust.

With the removal of the life expectancy rule for designated beneficiaries who are not EDBs, accumulation trusts may now be preferred.

- Trustee will have to withdraw the retirement account proceeds within 10 years (and pay tax at trust rates) but, unlike a conduit trust, the trustee does not have to distribute the proceeds to the trust beneficiaries during that period.

Accumulation trusts avoid frustrating the grantor's intent to distribute to the trust beneficiaries in accordance with the trust terms.

Avoids having large distributions to beneficiaries in the first 10 years of the trust.

Surviving Spouse

Name surviving spouse (outright) rather than a trust as the beneficiary to permit a roll over to the spouse's own IRA or an election to treat participant's account as his or her own.

If naming a trust, make it a conduit trust to delay distributions until participant's RBD and to enable the spouse to take distributions over his or her life expectancy.

QTIP Trusts:

- QTIP Trusts are a popular means of providing for a surviving spouse and continue to be a viable option after the Act.
- To qualify for the Estate Tax Marital Deduction, trusts for a surviving spouse are often QTIP Trusts.
- To qualify for QTIP treatment, among other requirements, the spouse must receive all of the income of the trust at least quarter annually.
  - This alone is not sufficient to make a trust a conduit trust.
  - Beneficiary must receive the greater of income or all account distributions.

Minor Children

Use conduit trusts to allow use of the life expectancy rule until the child reaches majority:

Required distributions during minority will be small.

The ten year rule will kick in when the child reaches majority.

Therefore, the entire account balance will be paid to the child within 10 years of reaching majority (as early as age 28, or as late as age 36).

Disabled & Chronically Ill Beneficiaries

May continue to use accumulation trusts.

Trusts for multiple beneficiaries which divide into separate trusts for each beneficiary immediately on the death of the participant will be considered separately.

Beneficiary 10 Years or Less Younger than Participant

Entitled to distribution over the beneficiary's life expectancy determined on the date of death of the participant (subtracting by 1 each subsequent year).

Use conduit trust so that potential future beneficiaries will not be considered.

Charitable Giving

Charities have always been attractive beneficiaries of IRAs because they avoid the income tax entirely. Perhaps they will be even more attractive.

A testator might name a charity as a contingent beneficiary, which would give the beneficiary the option of disclaiming the IRA and having it pass to the charity.

To provide lifetime or long term income for a beneficiary, name a Charitable Remainder Trust (CRT) as beneficiary of a retirement account.

Charitable Giving (cont.)

Charitable Remainder Trusts

The account proceeds will pass to the CRT tax free.

Annuity payments can be made to the beneficiary over a term of years or the beneficiary's lifetime.

The beneficiary will be taxed only on the income and capital gains earned in the CRT that are included in the annuity payment.

Provided that the annuity is at least 5% of the value of the CRT and the remainder interest is at least 10% of the value.

- Will not be able to have a CRT for the lifetime of a minor that qualifies because of these requirements (beneficiary must be 27 or older).

Additional Suggestions

Purchase life insurance to help pay accelerated and increased tax bill.

Consider converting conventional IRAs into Roth IRAs, particularly if leaving IRAs to trusts, which pay tax at the highest tax marginal rates.

If more than one beneficiary is planned:

- Name the beneficiaries outright (and not in a trust) to permit dividing the account into separate accounts by December 31 of the year after the participant's death.
- Provide separate trusts for each beneficiary before death.

Open Questions under the Act

Elections by Designated Beneficiaries

Pre-Act, a designated beneficiary could elect to use the non-designated beneficiary payout scheme:

- 5 year rule, if participant died before RBD.
- Over participant's remaining life expectancy if participant died on or after RBD.

It is unclear if the designated beneficiary still has the option under the Act's rules.

Important because a participant's remaining life expectancy will in many cases be greater than 10 years.

- Under IRS proposed actuarial schedules to take effect in 2021, if the participant dies between ages 73 and 81, their remaining life expectancy will exceed 10 years.

Multi-Beneficiary Trusts for Minor Children

How would a conduit trust for multiple minor beneficiaries be treated?

- Would they all be considered EDBs entitled to life-expectancy distributions?
- Whose life expectancy?
- The oldest?

How would a trust for multiple children be treated if some were and some weren't minors?

- Separate account rules do not apply to multi-beneficiary trusts except in the case of disabled or chronically ill beneficiaries.
- Without further authority, the trust would fail to qualify. Perhaps applicable multi-beneficiary trust rules could be extended to this situation.

Pre-Act Participant Deaths

If a participant died pre-2020 and left his account to multiple designated beneficiaries and separate accounts were not elected, when does the 10-year rule apply once the designated beneficiaries begin to die post-2019?

- Upon the first designated beneficiaries' death? Upon the oldest's death? Once all of them have died?

How does the effective date rule apply when both the participant and the participant's designated beneficiary died pre-2020?

- The participant's original designated beneficiary would have been grandfathered had he or she survived beyond 2019 but the Act does not appear to grandfather any designated beneficiary other than the participant's.
- Is the inherited IRA disqualified from using the pre-Act rules?
- If so, when does the 10-year payout period begin for the successor beneficiary?

Action Items for Practitioners

Action Items – Assess Impact on Existing Estate Plans

Identify estate plans that are unaffected by the Act:

- E.g, the account's beneficiary is a charity.

Identify those plans that are minimally affected or require few changes:

- E.g., the designated beneficiary of the account is the surviving spouse or a conduit trust for an EDB (other than a minor child).

Identify those plan that will require major overhaul:

- E.g., "stretch IRAs" that designated conduit trusts for a young person in order to obtain the tax deferral benefits of the pre-Act life expectancy rule.

Action Items – Review Beneficiary Designations

If the designated beneficiary is not an EDB, is designating an EDB an option?

If there is no EDB, is designating a charity or CRT a better choice?

If multiple designated beneficiaries are contemplated, is it better to designate them outright rather than designate a trust for their benefit?

- Designation outright will permit use of the separate account election.
- Alternatively, consider establishing separate trusts before death.

Action Items – Evaluate Tax Brackets if There is No EDB

Participant's tax bracket is lower than the current and expected future tax bracket of the intended beneficiary:

- Consider a Roth conversion during the participant's lifetime.
- Designating a conduit trust versus an outright designation may be tax neutral.

The intended beneficiary's current and expected future tax bracket is lower than the participant's:

- Consider naming the beneficiary outright or a conduit.

Both the participant and beneficiary are in the highest tax bracket:

- Designating an accumulation trust versus an outright designation may be tax neutral.
- Consider the purchase of life insurance to help pay for the accelerated and increased tax bill.

Action Items – Reevaluate Trusts as Beneficiaries

Does naming a trust as the designated beneficiary of the account still achieve the participant’s goal?

Will a different type of trust get the participant closer to his or her objective?

- Conduit trusts
- Accumulation trusts
- QTIPs
- CRTs

In cases where the 10-year payout rule applies, is the cost and administration of a trust worth only 10 years of protection?

Questions?

Thank You

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