Navigating the New Landscape of Legacy Planning After the SECURE Act

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If you haven't heard or read about the so-called "Death of the Stretch" by now, I'm going to assume that you've been on an extended tropical vacation out of the country. The rest of us, however, woke up to news that, in the late-night hours of December 20, 2019, the Further Consolidated Appropriations Act (H.R. 1865) was signed into law to avoid a government shutdown.[1]

What is so surprising about that, you ask? This has happened before; some of you may recall the passage of the Bipartisan Budget Act in late 2015, which snuck in substantial changes to certain Social Security claiming strategies.[2] That's exactly what happened this time around, as the bill incorporated the Setting Every Community Up for Retirement Enhancement (SECURE) Act under Division O of H.R. 1865. The SECURE Act contains the most expansive set of legislative changes to impact retirement plans in more than a decade.

One of the most dramatic changes was the virtual elimination of the Stretch IRA, including the Stretch Roth IRA, for all but a few categories of designated beneficiaries. The practical implications to tax, estate, and legacy planning require you to understand not only how the rules changed, but how the change could impact the landscape of plans already in place.

Prior to the SECURE Act, one of the most attractive features of qualified plan and IRA assets was the ability to leave a lasting legacy to one's heirs by allowing designated beneficiaries to stretch post-death distributions over a period, based upon the beneficiary's life expectancy. The post-death stretch opportunity was available to any designated beneficiary, including grandchildren, or even a conduit trust that met certain conditions, allowing for carefully crafted estate plans to provide a legacy that lasted long after the death of the IRA owner.

The SECURE Act effectively eliminated the life expectancy option for most beneficiaries and replaced it with a 10-year rule, requiring designated beneficiaries to completely distribute the IRA or qualified plan by December 31 of the year containing the tenth anniversary of death (I will refer to IRAs throughout the article but, unless specified, the same rules apply to qualified plans). It's important to note that there is no annual requirement to distribute one-tenth of the account balance. The only required minimum distribution (RMD) is the one that comes out at the end of year 10. The 10-year rule also applies regardless of whether the IRA owner dies before or after their required beginning date (April 1 of the year following the year an individual turns age 70 1/2), which is a significant change from the rules prior to the SECURE Act.[3]

Example: Joe died in 2020, leaving his $500,000 traditional IRA to his adult son, Ben. Ben must completely distribute his father's IRA no later than December 31, 2030. Failure to do this by year 10 will create an excess accumulations penalty of 50% of the missed RMD, or $250,000.

Exceptions to the New 10-Year Rule

Grandfathered Designated Beneficiaries

Designated beneficiaries, or beneficiaries that have a measurable life expectancy, of decedents who passed no later than December 31, 2019, may operate under the pre-SECURE Act rules. In other words, stretching IRA distributions over the life expectancy of the beneficiary(s) is still permitted, provided the first annual RMD is satisfied no later than December 31 of the year following death and each year thereafter.

Example: Using our hypothetical Joe from the previous example, let's assume that Joe died on November 23, 2019, and therefore is grandfathered into the pre-SECURE Act rules for post-death distributions. His 52-year old son, Ben, may elect to receive annual distributions over a period, based on his life expectancy, provided he takes his first annual distribution no later than December 31, 2020. Because Joe's death occurred prior to January 1, 2020, Ben may elect to receive annual distributions beginning in 2020 over a period of 31.4 years.

Non-Designated Beneficiaries

These are beneficiaries for which there is no measuring life expectancy, such as an estate, a charity, or a trust that does not qualify as a conduit trust. Non-designated beneficiaries apply the pre-SECURE Act post-death distribution rules. Therefore, if the IRA owner dies prior to his/her required beginning date, the account must be distributed no later than December 31 of the year containing the fifth anniversary of death. If death of the owner occurs after the required beginning date, distributions to the non-designated beneficiary must be made annually over the remaining life expectancy of the decedent. In most cases, these types of beneficiaries would most likely request a lump-sum distribution.

Employee or Owner of a Qualified Irrevocable Annuity

If an employee, prior to the date of enactment (December 20, 2019), began annuity payments over the life expectancy of the employee and the designated beneficiary, those payments may continue under the rules prior to enactment. If annuity payments have not yet commenced, but the employee made an irrevocable election as to the method and amount of the payments to the employee and the designated beneficiary prior to enactment, these irrevocable elections will also not be subject to the new 10-year rule. From a practical standpoint, unless the annuity payments had already commenced, it is unlikely that many would fall into the second category, since the election would have had to be made prior to an awareness of the new rules.

A New Type of Beneficiary—The Eligible Designated Beneficiary

Prior to the change, there were two "types" of beneficiaries, a non-designated beneficiary and a designated beneficiary, which, as previously discussed, is a beneficiary with a measurable life expectancy. This could have also included a conduit or "see-through" trust, in which post-death distributions could be stretched over a period, based upon the life expectancy of the oldest trust beneficiary. A non-designated trust is one in which no measurable life expectancy could be ascertained, like an estate or a charity.

Enter the new third type of beneficiary, aptly named the “eligible designated beneficiary.” It is important to understand who qualifies as an eligible designated beneficiary as these are the only beneficiaries that will be permitted to stretch distributions over life expectancy, unless one of the above exceptions applies.

An eligible designated beneficiary is:

1. The surviving spouse of the employee or IRA owner. A surviving spouse retains all the same rights and privileges that they enjoyed prior to enactment, including treating the IRA of the deceased spouse as their own, treating the IRA as an inherited IRA (most commonly used in cases in which the surviving spouse is younger than age 59 ½ and needs income from the IRA, thus avoiding the 10% early withdrawal penalty), or transferring the proceeds to an IRA in the surviving spouse’s name.
2. A disabled individual within the meaning of Section 72(m)(7). An individual who has received a disability award certificate, based upon the definition of disability that is used to grant disability benefits under Social Security.
3. A chronically ill individual under the meaning of Section 7702(B)(c)(2). This individual would need to be certified by a licensed health care professional to be unable to perform at least two activities of daily living for at least 90 days, or one who requires substantial supervision due to severe cognitive impairment.
4. A child of the IRA owner or employee who has not reached the age of majority. Once the child reaches the age of majority, the child is no longer considered an eligible designated beneficiary and must distribute the remaining balance within a 10-year period of such date. Grandchildren do not qualify under this category.
5. An individual (not described in any of the categories above) who is no more than 10 years younger than the employee or IRA owner.

Practical Considerations

Absent a beneficiary qualifying under one of the exceptions above, the new landscape could have some practical implications for both an owner and the beneficiary.

Income Tax Acceleration for the Beneficiary

The rapid acceleration of income taxes due to the beneficiary(s) of a qualified plan or traditional IRA is obvious for those who would have historically opted for the life expectancy option. Keep in mind that the only required minimum distribution is in year 10. On significant pre-tax inheritances, it may make sense for the beneficiary to mitigate tax liability by drawing the inherited monies down over the 10-year period, rather than taking the entire distribution in the final year. In the case of Roth IRA beneficiaries, the opposite may make sense. A qualified Roth IRA distribution to the beneficiary is tax-free, so your Roth beneficiary clients may wish to consider waiting until year 10 to take the RMD, to allow for maximum deferral of tax-free growth after the death of the original Roth IRA owner.

Trust as Beneficiary of an IRA

Naming a trust as beneficiary of an IRA, prior to the SECURE Act, was a practical way to not only leave a legacy that could expand over the lifetimes of children and grandchildren, but often used to protect the interests of a spendthrift beneficiary or to create a lasting legacy that could be carried out beyond the grave. The SECURE Act essentially removed the ability, in most cases, to allow the trust to work as intended. The Act does specifically allow for a chronically ill or disabled beneficiary, even of a multi-beneficiary trust, the ability to apply the life expectancy option separately for the portion of the trust that is left to the eligible individual.

Therefore, it is a good idea to visit with your clients and prospects who have trust beneficiaries to ensure that their legacy plan does not need to be modified. Those most affected will be those who plan to leave a large amount of their qualified assets to trust beneficiaries; these clients should be contacted first. Encourage them to meet with their tax and legal professionals to ensure that they are made aware of the potential need to re-evaluate plans already in place.

Example: Mary Smith has her trust named as her IRA beneficiary. According to the terms of her trust, three children are to collect only the annual RMD, split equally, upon her death. Since the only RMD that is due under the 10-year rule is not until December 31 of year 10, not only does this disallow her children from collecting any income from the trust until year 10, but it also creates a much higher tax liability than it would have under the pre-SECURE Act rules.

Pivot to New Planning Strategies

With any significant change to tax law, the first order of business is to understand how the new rules differ from the old. The next is to understand how the new regime affects plans that your clients and prospects had in place prior to the change. The third order of business, and where you provide the most value to your clients, is your ability to offer potential solutions that will better align their goals with the new rules, or at least mitigate the potentially negative impact of them. Keep in mind that you are not your clients' tax advisor, nor their legal counsel, so never encourage your clients to make changes to their existing plans without a blessing from those critical advisors. Working in conjunction with your clients' other trusted advisors is the most effective way to ensure that each advocate brings the required perspective to the table.

Roth Conversions

Roth IRAs and Roth accounts are often considered a useful way to tax diversify assets saved for retirement. Many individuals have the lion's share of their retirement monies inside a qualified plan or traditional IRA. And, eventually, they must pay the piper in the form of RMDs. On a side note, the SECURE Act also extended the age at which RMDs must begin to the year that the IRA owner reaches age 72, for individuals who turn age 70 ½ on or after December 31, 2019.

Example: Susan will be 70 ½ on May 1, 2020. Her first RMD will be due by April 1, 2022, for calendar year 2021, since this is the year she turns age 72. If she elects to wait until April 1, 2022, to satisfy her first RMD for 2021, she will need to satisfy a second RMD for 2022 by December 31, 2022. Note that, in the case of qualified plans in which an employee continues to work beyond the age of 72, the employee may be able to delay RMDs until the year that he/she retires, if later than age 72.

If Susan had been age 70 ½ by December 31, 2019, she would disregard the new RMD rules and continue taking RMDs beginning for 2019, the year she turned age 70 ½.

Roth conversions have the delayed benefit of removing the lifetime RMD requirement and providing tax-free income in retirement (and to beneficiaries) on qualified Roth distributions. Of course, the up-front opportunity cost is having to pay income tax at the time of conversion and an assumption that taxes in retirement will be more than they are at the time of the conversion. Recall that the Tax Cuts and Jobs Act of 2017 lowered marginal income tax rates, making Roth conversions potentially more attractive through the end of 2025, when the lower brackets are expected to sunset.[4] Keep in mind that, if monies are converted in any year for which an RMD is due, the RMD must first be satisfied before any additional monies may be converted.

Within the landscape of the new 10-year post-death distribution rule that applies to most non-spousal beneficiaries, the Roth conversion may become even more attractive to those who desire to leave a legacy. Consider clients who have inherited sizable IRA assets from non-spousal decedents. It isn't uncommon for those beneficiaries to be in their late 50s or early 60s. Not only could this be the beneficiary's prime earning season, but it could also be a time when they are claiming Social Security and signing up for Medicare. The potential impact of a sizeable pre-tax inheritance, even if spread over a 10-year period, could have a ripple effect by subjecting a portion of Social Security to taxes or bumping the beneficiary up to a higher Medicare premium band for Parts B and D.

Name a Charity as Beneficiary and use Life Insurance to Equalize the Legacy to Heirs

A potential strategy to consider, particularly for individuals who have already amassed significant wealth in the pre-tax arena, is to change the beneficiary of a Traditional IRA to a favorite charity and fund a life insurance policy that will pay a tax-free benefit to heirs. RMDs that are required but not needed may be used to fund the life insurance policy and the IRA, while included in the decedent's taxable estate, will receive an offsetting deduction for the balance left to charity.

Life Insurance as a Beneficiary Planning Pivot

Suppose the client you are working with is the beneficiary of a sizeable IRA and is facing an accelerated 10-year payout. Unfortunately, you can't fix the tax ramifications of the post-death required distributions, but, perhaps, directing the net RMDs to a 10-pay life insurance policy designed to supplement income in retirement and to provide a death benefit to the beneficiary's own family is a way to put the inheritance to good use.

The opportunity to highlight the many uses of life insurance, including retirement income, tax, estate, and legacy planning received a huge push with the death of the stretch IRA. Capitalize on it to help your clients understand the many hats it can wear.

Name a Charitable Remainder Trust as Beneficiary

A Charitable Remainder Trust (CRT) is a complex planning tool that is beyond the scope of this article. In brief, a CRT is typically established to transfer highly appreciated assets, such as real estate or stock, before selling the asset. In doing so, the capital gain is realized inside the trust, rather than all at once by the transferee. In exchange for transferring these assets, the transferee realizes an upfront charitable deduction for the remainder interest to the trust. The individual must also receive income over a period of years or over life expectancy, paying taxes on the income in a tiered fashion, subject to specific rules. Once the income beneficiaries pass away, the remaining interest goes to the charity.[5] The rules are complex, so consider this a summary. It's important to understand that transferring an IRA, a qualified plan, or a non-qualified annuity to a CRT during the lifetime of the owner will create immediate taxation of the taxable portion to the IRA owner, as changing ownership on these types of assets is a taxable event at the time of transfer.

However, since the SECURE Act passed, advanced planning practitioners have suggested that naming a CRT as beneficiary of an IRA or qualified plan provides the closest replication to the pre-SECURE Act life expectancy option available to income beneficiaries. It's also a way to create an income stream to a spendthrift beneficiary that otherwise would have complete access to the IRA at the time of death.

Example: Margaret is a widow who has a sizeable IRA and is concerned about the impact the new 10-year payout rule will have on her son, Max, her only adult child and beneficiary. Margaret names a CRT as the beneficiary of her IRA, naming Max as the CRT's income beneficiary. Upon Margaret's passing, the IRA passes to the CRT, which doesn't pay income taxes on the transfer nor any future gains it earns. However, Max will pay income taxes on the income payments he receives, which can be set up to continue for as long as he lives.

As you can see, the CRT is a complex planning tool that requires a reputable attorney to both draft the CRT and ensure that it meets the requirements to enjoy the benefits it can provide.

Conclusion

I think we would all agree that tax law changes are often not for the faint of heart. Just when we think we have it down, the rules change, causing us to re-learn and re-examine strategies to help our clients and prospects reach their goals, whether that be to mitigate taxes, maintain a steady income in retirement, or leave money to those most important to them. The good news is that this ever-changing landscape makes you, along with other trusted advisors, a valuable resource to your clients.

Sources

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