

Retirement Plan Post-Death Distributions after the SECURE Act: A Roadmap

"Unquestionably, there is progress. The average American now pays out twice as much in taxes as he formerly got in wages."

— H. L. Mencken

"Progress might have been all right once but it has gone on too long."

— Ogden Nash

Many owners of IRA and retirement benefits need to rethink their beneficiary designations, and soon, especially where trusts may be desirable.

Individual Retirement Accounts (IRAs) and other retirement plans are a major source of individual wealth accumulation. Indeed, for many, these investment vehicles are the largest part of their net worth, thanks to the magic of tax-free compounding. Historically, beneficiaries after the death of an Account Owner have continued to benefit as well, through "inherited IRAs" that could be paid over the beneficiaries' life expectancies, known as "stretch-out IRAs." Congress has changed much of that dramatically, with the passage of the SECURE[1] Act.

Effective Jan.1, 2020, funds in IRAs and qualified retirement accounts must generally be distributed to the named beneficiary of a deceased owner within 10 years, accelerating both distributions and income taxes. Account Owners with beneficiaries who need a trust will find it far more difficult to plan for them. Careful planning, drafting and rethinking of beneficiary designations is now more important than ever.

The chart on the next page outlines the new rules.

Definitions

The Required Beginning Date (RBD) is April 1 following the year the IRA Account Owner turns age 72 [age 70½ if born before July 1, 1949].

A Required Minimum Distribution (RMD) is an annual minimum distribution, commencing at the RBD, and calculated according to life expectancy tables issued by the IRS. Account Owners use the Uniform Lifetime Table during their lives. However, if there is a spouse more than 10 years younger who is named as sole beneficiary, the Account Owner uses the joint life table, which reduces the RMD. Beneficiaries, on the other hand, may be subject to a variety of payout requirements.

A Non-Designated Beneficiary (NDB) is a charity, an estate or any other non-individual, except that a trust can be carefully designed to qualify as a Designated Beneficiary. An NDB is typically subject to a maximum 5-year payout.[2] An exception exists where the Account Owner dies on or after his RBD, in which case the Account Owner's life expectancy ("ghost" life expectancy) can continue to be used, but under IRS Table I, which requires more rapid payout than the Uniform Lifetime Table in effect during the Account Owner's life.

A Designated Beneficiary (DB) is an individual who is designated as a beneficiary under the terms of the IRA or retirement plan, usually on a beneficiary designation form. A DB is subject to a 10-year payout rule rather than a 5-year payout.[2] It is important that under either the 5-year rule or the 10-year rule, there are no longer any RMDs, so that payouts can be deferred to the very end of the 5 or 10 years.

An Eligible Designated Beneficiary (EDB) is a DB who is *also* one of the

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following, and thus qualifies for continued deferral of taxation:

(1) The surviving spouse (must be lawfully married);

(2) A minor child of the Account Owner (not a minor child of anyone else, not even a grandchild of the Account Owner);

(3) A beneficiary who is not more than 10 years younger than the Account Owner (such as a sibling);

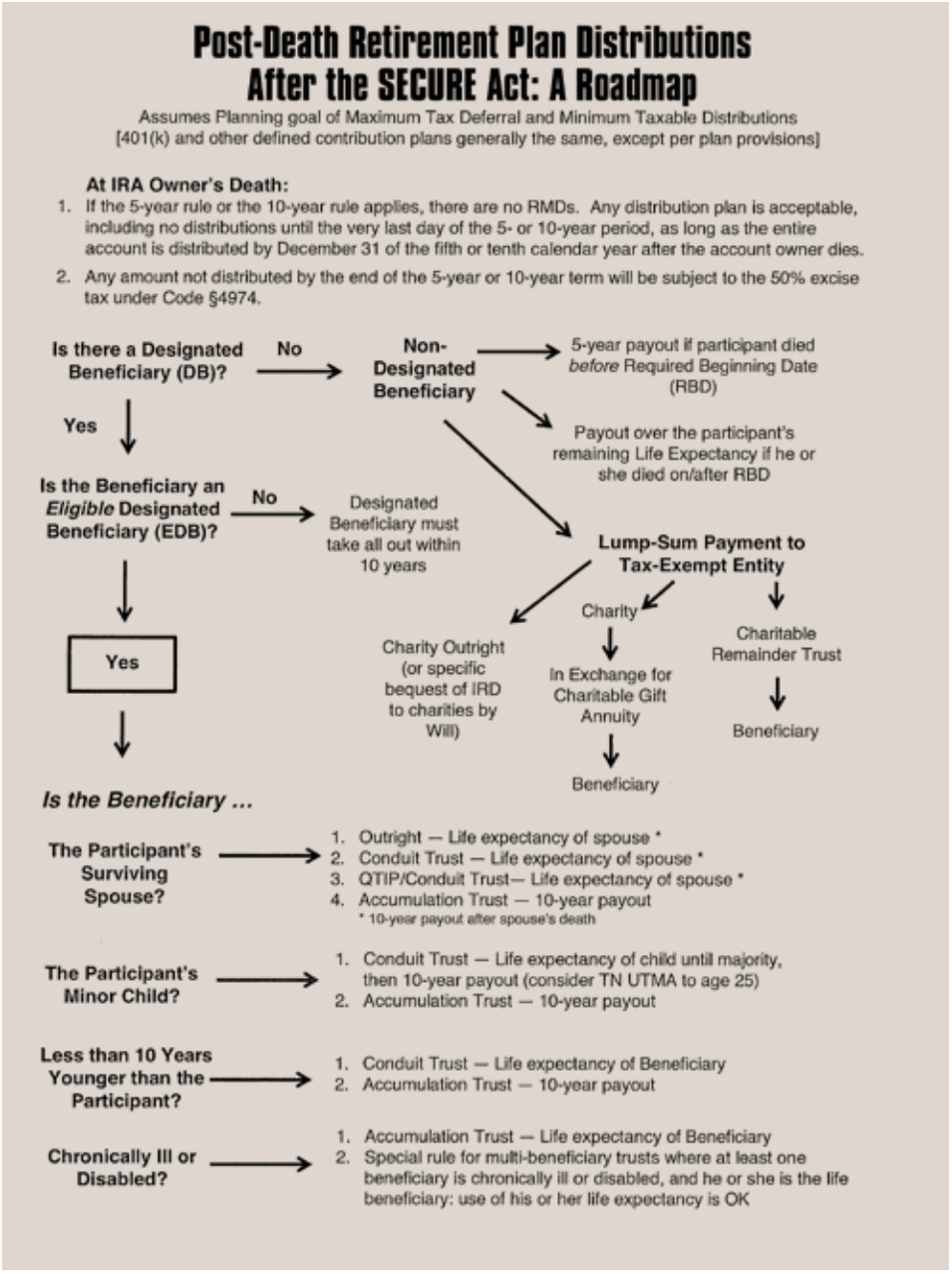
(4) A beneficiary who is considered "disabled" under Internal Revenue Code §72(m)(7); or

(5) A beneficiary who is considered "chronically ill" under Internal Revenue Code §7702(B)(c)(2).

A See-Through Trust qualifies as a DB by treating one individual beneficiary of the Trust (or multiple beneficiaries in the case of an Accumulation Trust) as the DB rather than the Trust itself. Thus, the 10-year rule would apply, rather than the 5-year rule, stretching out the payment twice as long. Or the trust may qualify for longer tax deferral if the individual beneficiary is an EDB.[3] As under prior law, there are several other minimum legal requirements.[4] There are two types, a Conduit Trust and an Accumulation Trust.

A **Conduit Trust** requires that all IRA distributions, including not only RMDs but other distributions, must be immediately paid out in full to or for the benefit of the individual beneficiary. Prior to 2020, the advantage of a conduit trust was that the Trustee had control in order to prevent the individual beneficiary from taking out any distributions beyond the RMD. After 2020, the Trustee's control can delay distributions completely, but only until the end of the 10-year required payout period. Planners should be wary of using Conduit Trusts any more.

An **Accumulation Trust** allows the Trustee to accumulate distributions received from an IRA within the Trust itself. Such distributions are then taxed to the Trust, where compressed rate schedules cause distributions to reach top income tax brackets quickly. Thus, an Accumulation Trust is most useful when income can be "sprinkled" among the trust beneficiaries who have lower income tax brackets.[5]



Further Explanations

Spouse. If the EDB is the surviving spouse and is the only beneficiary, without any trust, the spouse is treated as an Eligible Designated Beneficiary and still has the option to roll over the benefits tax-free to an IRA in the spouse's name alone, which is often the best choice for tax purposes. The spouse will begin to take the benefits out over his or her life expectancy after reaching age 72. By contrast, if the benefits are payable to a Conduit Trust (or QTIP/Conduit Trust)[6] for the surviving spouse's benefit, the spouse will be required to start taking distributions by the end of the year in which the deceased Account Owner would have reached age 72. The distributions are based on the spouse's life expectancy, recalculated annually. Upon the death of the surviving spouse, beneficiaries are subject to the remaining rules, presumably requiring a 10-year payout.

Minor. If the EDB is the minor child of the Account Owner, the benefits will be distributed over the life expectancy of the child until he or she reaches majority,[7] at which point all benefits will have to be withdrawn by the end of the following 10 years.[8]

Chronically Ill or Disabled. If the EDB is chronically ill or disabled, and if an Accumulation Trust is created for the special

needs of the beneficiary, payout can be based on the life expectancy of the special needs beneficiary; thus, the benefits can be managed by his or her Trustee for the beneficiary's special needs. But when the life beneficiary dies, all benefits must be distributed by the Trustee to the "remainder beneficiaries" by the end of the following 10 years. Standards for "disabled" and/or "chronically ill" may be difficult to meet.

Less Than 10 Years Younger. If the EDB is less than 10 years younger than the plan participant, and if he or she is named to receive the benefits outright or in a Conduit Trust, then he or she can withdraw the plan benefits over his or her life expectancy, and at his or her death, the 10-year requirement on further distributions will commence.[9, 10]

Planning for Current Account Owners

Spouses. Traditionally, IRA owners left all to spouse, who rolled over to their own IRA, then left it to children at the second death. Under the SECURE Act, distributions to children must be distributed in full within 10 years of the surviving spouse's death. In order to stretch out distributions over a longer term, potentially saving income taxes payable by the children by avoiding higher brackets, consider having the first spouse to die leave a portion of his or her IRA directly to children, triggering a 10-year payout. Then after the death of the surviving spouse, a second 10-year payout would follow.

Multi-Beneficiary Trust for Chronically Ill or Disabled Beneficiaries. The SECURE Act has a special provision allowing a multi-beneficiary trust to use the life expectancy of a chronically ill or disabled beneficiary even though there are other individual beneficiaries of the trust. Once the chronically ill or disabled beneficiary dies, the 10-year rule commences, but such a trust can defer payouts for multiple beneficiaries.

Roth Conversions. Roth IRAs are not income taxable, either to the Account Owners during their lifetime or to the beneficiaries after the death of the Account Owner. An Account Owner may convert all or part of an existing IRA to a Roth IRA by paying all the income tax on such portion in one year, leaving the Roth completely non-taxable thereafter. Although the 10-year distribution rule applies to Roth IRAs as well, some commentators suggest conversion may be desirable as a response to the SECURE Act.[11]

Charity. For an Account Owner with charitable intent, the best way to make charitable gifts following death (including death of spouse) may be to designate charities as the direct beneficiaries of some or all of the IRA (or similarly, to name the estate as beneficiary under a will that makes charitable bequests, and require that such charitable bequests be funded by the IRA distributions). Although a charity is not a DB, it is a tax-exempt entity, likely to take a tax-free lump-sum distribution. Further, the charity can be a Donor Advised Fund (DAF) with the children as advisors, allowing the Account Owners to make philanthropists of the children, with minimum paperwork or difficulty.

Charity Plus Lifetime Income. An Account Owner intending to benefit both charity and an individual beneficiary could designate as beneficiary a Charitable Remainder Trust, which provides either a fixed annuity to the individual beneficiary for life or a period of years, after which the trust terminates outright to the charity as remainder beneficiary. Alternatively, an Account Owner can designate a charity as direct beneficiary of the IRA, in exchange for a Charitable Gift Annuity paying a benefit outright to the individual for life.[12]

Life Insurance. An Account Owner could consider using his RMDs to purchase life insurance on his or her life, with the beneficiaries of the life insurance being the ultimate IRA beneficiaries (or trusts for their benefit). Theoretically, the non-taxable insurance proceeds could more than make up for the limited tax deferral and higher rates occasioned by the 10-year payout.

Modifying Irrevocable Trusts Named as Beneficiaries. Not only may many wills and revocable trusts need to be amended, but existing irrevocable trusts named as beneficiaries may need to be modified or decanted in order to provide proper planning.

In summary, many owners of IRA and retirement benefits need to rethink their beneficiary designations, and soon, especially where trusts may be desirable. ⚖

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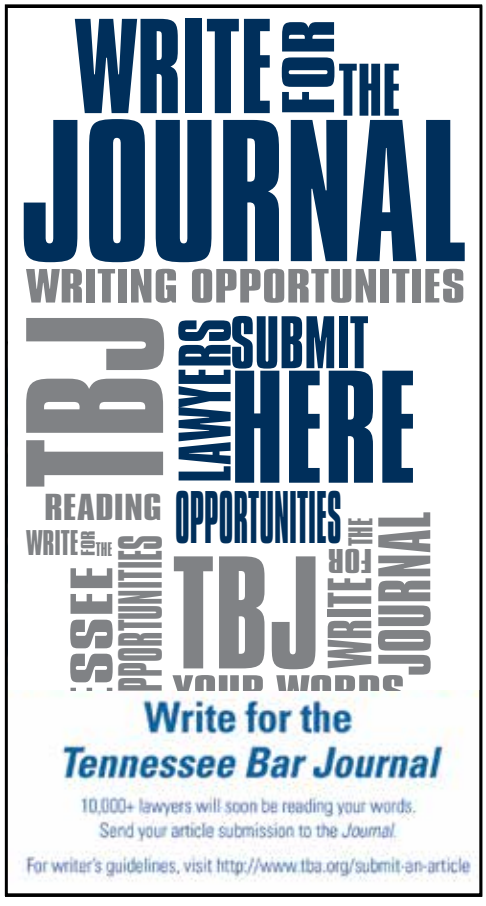
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NOTES

1. Setting Every Community Up for Retirement Enhancement (SECURE) Act.

2. The identity of a DB does not have to be finally determined until Sept. 30 of the year after the account holder's death, allowing time to pay any share to an NDB. So if a charity is named to receive 50% of the IRA on a beneficiary

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designation form, and the only child is named to receive the other 50% of the IRA, then so long as the charity receives its entire 50% interest before Sept. 30 of the year after death, the child will automatically become a Designated Beneficiary.

3. See-Through Trusts offer the protection of oversight by a Trustee, which can be crucial if a beneficiary of an IRA is young or foolish or unfortunately-married and may be tempted (or persuaded) to over-withdraw from the account. Further, such a Trust allows the original Account Owner to have greater control over where the benefits go after the death of the first DB. For example, in a blended family in which both spouses have their own children, the first spouse to die can designate as beneficiary a See-Through Trust for the benefit of the spouse, allowing the original Account Owner to name the Account Owner's own children as successor beneficiaries after the spouse's death. See-Through Trusts can also offer protection to the assets they hold. If an IRA is held by the Account Owner, or by his or her spouse, it enjoys certain protections from creditors or court judgments. However, the U. S. Supreme Court has held that a "non-spouse beneficiary" such as a child or grandchild does not have those protections. If an IRA is left to an individual other than spouse, outside of a See-Through Trust, and he or she is successfully sued, experiences financial difficulties, or is divorced, the assets in the account could easily be vulnerable to court judgments, creditors' claims, or a divorce settlement.

4. The basic requirements to be a DB are that the trust must be valid under state law; the beneficiaries of the trust must be individuals, and these individuals must be identifiable from the trust instrument (meaning that it must be possible to determine that all persons who could ever qualify as a beneficiary of the trust are "designated beneficiaries" as of Sept. 30 of the year after the year in which the Account Owner died); the trust must be irrevocable (as is a testamentary trust created by a Will), or the trust must, by its terms (like the type of trust normally included in a revocable living Trust), become irrevocable upon the death of the Account Owner; and the Trustee must provide certain documentation concerning the trust provisions to the "plan administrator" no later than Oct. 31 of the year following the year in which the Account Owner dies. The requirement that all trust beneficiaries must be individuals can be difficult to meet. For example, if the trust authorizes (directly or indirectly) the payment of funeral expenses, debts or estate taxes from any part of the plan benefits that are payable to the trust, the "all individuals" requirement will not be met. The IRS insists that a plan participant's estate is not an individual for this purpose. And, if a charity is named as a direct or potential beneficiary in some circumstances, the charity is not an individual, and so no beneficiaries will then be considered individuals (even if they are individuals), and the trust will not qualify as a DB.

5. Since distributions among beneficiaries based solely on income tax rates may provide significantly unequal distributions, the trust may provide for compensating distributions to equalize the ultimate benefits. One commentator has entitled this a "Twin Tax Efficient Accumulation Pot Trust," or TEAPOT Trust.

6. Sometimes (usually in a second marriage), the Account Owner wants to direct that the surviving spouse's interest should be distributed into a trust solely for the surviving spouse's lifetime but authorizes the Trustee to accumulate a portion or all of the distributions from the IRA within the trust. A "QTIP Trust" for a surviving spouse that is not also drafted as a Conduit Trust would NOT qualify as an EDB, and all benefits would have to be paid to the marital trust within 10 years after the Account Owner's death.

7. In Tennessee, the age of majority is 18. However, the SECURE Act references Treas. Reg. §1.401(a)(9)-6, A-15, for the definition of reaching majority: "A child may be treated as not having reached the age of majority if the child has not completed a specified course of education and is under the age of 26." The term "specified course of education" is not defined. This language suggests that careful planning might defer distributions to a minor until age 26, after which the 10-year rule begins, ultimately deferring distributions to age 36.

8. If the minor child is named as beneficiary outright, without the benefit of a Uniform Transfers to Minors Act (UTMA) account or a trust, then normally a legal guardianship must be instituted, with annual accountings and court supervision, including the posting of a bond, etc., until the child reaches majority, at which point the child would become the outright owner of the account. Instead, (1) if an UTMA account is named for the child and a specific reference to age 25 is made in the beneficiary designation pursuant to *Tenn. Code Ann.* §35-7-121(a)(1), then the custodian can control the payouts prior to the end of the 10-year payout period at least until age 25; and (2) if a Conduit Trust is created for the minor, the benefits can be managed by the child's Trustee for the child's benefit, using the child's life expectancy, but when the minor reaches majority, all benefits must be withdrawn by the Trustee and fully distributed to the child by the end of the following 10 years.

9. A "chronically ill" person is any individual who has been certified by a licensed health care practitioner as being unable to perform, without assistance, at least two activities of daily living [eating, toileting, transferring, bathing, dressing and continence] for at least 90 days; or requiring substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. An individual is considered "disabled" if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.

10. An interesting case on the issue of "disability" originated in Tennessee: *Pendergast v. Commissioner of Internal Revenue*, United States Tax Court, Docket No 25409-14S. Taxpayer Pendergast was diagnosed with alcoholism in 1990, and his affliction continued through the events occurring in 2012 that gave rise to tax litigation. The judge determined that this taxpayer was "unable to engage in his customary, or any comparable, substantial gainful activity because of his alcoholism." Because his physician's letter stated that "his alcoholism will likely cause his death," and because the proof showed that his condition was "so chronic and severe in 2012 that it rendered him unable to take the steps necessary to break his more than 20-year chain of addiction with reasonable effort and safety," the court determined that he was "disabled within the meaning of that term in section 72(m)(7)…."

11. The purpose of converting an IRA to a Roth IRA is to use the Account Owner's (potentially lower) current income tax brackets to pay tax on the Roth IRA funds, leaving income-tax-free retirement funds to live on when brackets may increase, and leaving tax-free funds to the beneficiaries following death. Essentially, the Account Owner doing a Roth conversion is betting on living long enough to make the gamble of paying tax now pay off. Roth IRAs should be paid to a DB in order to qualify for a 10-year payout rather than a 5-year payout after death, allowing maximum duration of tax-free accumulation. Such decision requires taking into account current and future income tax brackets; the health and age of the Account Owner and spouse; and the approximate income tax brackets of the individuals who will receive the benefits after both the Account Owner and spouse are gone.

12. In PLR 200230018, the IRS blessed funding a testamentary charitable gift annuity with an IRA.