Legislative Update

The SECURE Act and Elimination of the Stretch IRA

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Just when we thought that we were going to finish out the year 2019 without any major tax law changes, some significant retirement savings reform legislation was signed by the President on December 20, 2019.

The Setting Every Community Up for Retirement Act (SECURE Act) passed the House earlier this year back in May. Then, it got stalled in the Senate. With strong bipartisan support, it made the cut into the FY 2020 spending package. Many of the provisions in the SECURE Act have been under consideration for a number of years. So, we have been anticipating some of these changes. There are changes that impact both individuals and employers. This article will focus on the changes that impact individuals and, more importantly, on the biggest provision that affects estate planning -- the elimination of the "Stretch IRA".

Highlights of the SECURE Act Provisions:

For individuals:

- The SECURE Act will allow contributions to Traditional IRAs after age 70 ½ as long as the individual is still working.
- The SECURE Act also pushes back the age at which retirement plan participants need to take required minimum distributions (RMDs), from 70½ to 72. This would apply to those who have not yet reached age 70 ½ by the end of 2019.
- The SECURE Act introduces a dual eligibility requirement that will allow part-time workers to participate in the defined contribution plans of their employer. Part-time workers are defined as those who work at least 1,000 hours in one year (roughly 20 hours per week) or three consecutive years of at least 500 hours.
- Under the SECURE Act, the entire IRA or retirement plan would have to be distributed within 10 years of the death of the employee or IRA owner.
- The SECURE Act permits qualified defined contribution plans, section 403(b) plans or governmental section 457(b) plans to make a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA of lifetime annuity investments or distributions of a lifetime annuity investment in the form of a qualified plan distribution, if a lifetime annuity investment is no longer authorized to be held as an investment option under the plan. This change will permit participants to preserve their lifetime annuity investments and avoid the surrender of charges and fees.
- The SECURE Act provides penalty-free withdrawals from retirement plans for any "qualified birth or adoption distributions."
- The SECURE Act requires benefit statements provided to defined contribution plan participants must include a lifetime income disclosure at least once during any 12-month period. The disclosure will provide more useful information to plan participants in correlating the funds in their defined contribution plans to lifetime income.

Elimination of the "Stretch IRA"

The "Stretch IRA" was a way to maximize the tax deferral nature of Traditional IRAs as long as possible, thus increasing wealth to future generations. Under past law, if a child or grandchild was named as beneficiary either individually or through a trust that qualified as a see-through trust, there was a way to structure it so that the IRA assets could be distributed based upon the life expectancy of the child or grandchild. Under prior law, the worst-case scenario would be immediate distribution, fully taxed, or if an IRA was payable to a nonqualified beneficiary, it had to be distributed under a five-year rule.

Under the SECURE Act, all IRAs and Qualified Plans will need to be withdrawn over 10 years, rather than over a lifetime. There will be some exceptions for certain beneficiaries. These exceptions include the surviving spouse of the employee (or IRA owner), children of the employee (or IRA owner) who have not reached the age of majority (not grandchildren or any other children), disabled or chronically ill individuals, or individuals not more than 10 years younger than the employee (or IRA owner). Remember that this rule applies to beneficiaries of someone who dies after the end of 2019. If you have an existing inherited employer plan or inherited IRA, you can still draw down the account over a lifetime.

What does this mean for those who have named a trust as their IRA or plan beneficiary? If you have a significant qualified plan or IRA, you probably did this so that you could maintain control over the distributions and to preserve the value of the IRA for as long as possible. Now, you may have to reconsider your beneficiary designations. Your plan will no longer work as far as meeting your estate planning objective of controlling the funds after your death and qualifying for the stretch IRA. IRA trust planning will need to be revisited.

There are basically two types of IRA trusts: a conduit trust and an accumulation trust.

With a conduit trust, the Required Minimum Distributions (RMDs) are paid from the inherited IRA to the trust and then paid out to the trust beneficiaries each year. No RMDs remain in the trust. The beneficiaries pay tax on the distributions at their own personal tax rates.

With an accumulation trust, the trustee has the discretion on whether to pay out the RMDs to the trust beneficiaries or to retain the funds. If the funds are retained, they are taxed at potentially higher trust tax rates. If they are paid out to the beneficiary, they are taxed to the beneficiary at their own personal tax rate.

The elimination of the stretch IRA is more of a problem for conduit trusts. At the end of the 10-year term, the entire balance would need to be paid out to the beneficiaries, leaving no funds protected inside of the trust and potentially getting money into the hands of a beneficiary who is not yet capable of handling the funds responsibly yet, not to mention the huge tax bill to the beneficiary (and potentially kiddie tax that could apply). With an accumulation trust, although the inherited IRA funds would have to be paid out of the IRA by the end of the 10-year term, the funds could still remain in the trust and continue to be protected.

Albeit, those funds would be taxed at the trust's higher tax rates. What are the implications of the killing the stretch IRA? These are still to be determined. But, here are a few considerations that you may learn about in the following months:

Trust Reformation or Decanting?

You may potentially be able to reform or decant a trust in order to avoid this situation. Maybe a trust can be reformed to remove the conduit language and replaced with accumulation type language. In the future, maybe we will see more IRAs set up to be payable to trusts drafted as accumulation trusts.

Roth Conversions

Can I use the time available now to turn some of my Traditional IRA to a Roth IRA? The idea here is to spread out the distributions over many more years (than just the 10 years) and potentially take advantage of lower tax bracket years. Just remember that although there are no RMD requirement for Roth IRAs during lifetime, there are RMDs on inherited Roth IRAs.

Use of Multi-Generation Spray Trusts

What if a trust had multiple beneficiaries and the IRA distributions could be spread out over many beneficiaries, potentially all in lower tax brackets than the IRA owner? The tax bite could be more spread out. For example, if you have a $100,000 IRA distribution sprayed out over 10 different beneficiaries, that would be a $10,000 distribution to each beneficiary, potentially at the lowest tax bracket (beware of kiddie tax though).

Spousal Rollovers & Disclaimer Planning

In the past, married individuals were likely told to name the spouse as the beneficiary of an IRA. In that way, the spouse could treat the IRA as his or her own and not be required to take RMDs until age 70 ½. Now, it may be better to begin distributing the IRA earlier in order to minimize the exposure to higher tax brackets later on.

What if the spouse doesn't need the IRA money to support their lifestyle? What if a spouse could disclaim some portion of the IRA and it goes to a see-through trust for children who can use their life expectancy until they are 21 and then the 10-year payout thereafter?

IRAs payable to Charitable Remainder Trusts (CRTs)

If an IRA names a CRT as the designated beneficiary, you may be able to stretch the distributions out over the beneficiary's life (or up to 20 years if selecting a method other than "for life"). Instead of a 10 years payout, you get 20 years or longer. Also, this strategy may have the ability to convert what would have been ordinary income to capital gain income, depending on the investment strategy of the CRT.

IRAs to Charity as Designated Beneficiaries

Maybe you should consider leaving your IRA, or a larger portion of it, to charity in your beneficiary designation form now and consider leaving other assets to heirs.

The new law does not address any changes to being able to make distributions to charities up to $100,000 per year during your life, once you are over the age of 70 ½ . It is still a valid strategy and tax efficient gifting strategy, but we will need to pay attention to modifications to these rules in the following months since it would seem natural to shift this age qualification to 72 with the new legislation.

Life Insurance – A Better Alternative?

Will life insurance be a more tax-efficient planning vehicle? Tax-free life insurance proceeds can be paid to a trust and are currently not subject to any required distribution rules. Should you withdraw your IRA money now and pay tax at today's lower tax rate and reinvest the after-tax balance in a life insurance policy? Should you take IRA distributions now in order to fund premium payments for a life insurance policy that could accomplish your desired wealth transfer objectives?

These are just a few of the strategies to consider as we move forward in the coming months and receive more clarification on the new law. In the meantime, contact your Key Private Bank advisor if you think your IRA planning needs revisiting in light of the new law.

For more information, please contact your Key Private Bank Advisor.

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