Is Retirement Planning Getting More SECURE? *Think Again!*

Setting
Every
Community
Up for
Retirement
Enhancement

The SECURE Act, a new retirement legislation that took effect on January 1, 2020, has far reaching implications for retirement planning. For years, estate planners and tax attorneys have recommended leaving tax-deferred retirement accounts, such as traditional IRAs, Roth IRAs and 401Ks, to a designated beneficiary who can stretch out the distribution payments for as long as possible, maximizing the tax benefits. However, the passage of the SECURE Act, which stands for Setting Every Community Up for Retirement Enhancement, has made achieving this goal much more difficult. It significantly shortens the payout period for many beneficiaries, reducing it from their entire life expectancy to a maximum of 10 years. This erodes the value of many carefully constructed estate plans, which were designed to pass along tax-deferred assets from the owners of retirement accounts ("owners") to successive generations of children and grandchildren. In light of this seismic change, we recommend reviewing your beneficiary designations to determine if they are optimal and if any adjustments are warranted.

In this article, we review the most salient points of the SECURE Act ("SECURE") and discuss how it might affect your thinking about retirement planning going forward.

Understanding the SECURE Act

Congress passed the SECURE Act with the intention of modernizing existing retirement legislation and encouraging retirement savings. Among other changes, the new law:

1. **Increases the Required Minimum Distribution Age**
   It raises the starting age for required minimum distributions (RMDs) from retirement plans to age 72 from age 70½, acknowledging that Americans are living and working longer.[1]

2. **Eliminates the Maximum IRA Contribution Age**
   Individuals can now make contributions to traditional Individual Retirement Accounts (IRAs) at any age, whereas previously it was not allowed beyond age 70½.

3. **Allows Penalty-Free Retirement Withdrawals for Birth or Adoption Expenses**
   It permits penalty-free withdrawals up to $5,000 for qualified birth or adoption expenses. This applies on an individual basis, so a married couple may receive a penalty-free withdrawal up to $10,000.

4. **Changes the Kiddie Tax**
   It repeals the kiddie tax rules so that a child's unearned income will now be taxed at the parents' tax rate. Under the Tax Cuts and Jobs Act, passed in December 2017, a child's unearned income had been taxed at the trust/estate rates.

5. **Eliminates the Stretch Retirement Plan**
   It requires that beneficiaries of a defined contribution plan, traditional IRA or Roth IRA withdraw the entire balance of the account by the end of the 10th year following the owner's death. This new 10-year payout rule applies for beneficiaries who inherit retirement accounts from an owner who passes away after January 1, 2020, when the law went into effect.[2]

While these changes are all meaningful, by far the most impactful provision of SECURE for estate planning is the last one. Under the prior legislation, the beneficiary of a 401K or IRA had their entire life (based on life expectancy calculations) to benefit from the tax-deferred status of the retirement account. It was common practice for an owner to designate younger successors, including children and grandchildren, as beneficiaries, recognizing that they have longer life expectancies and therefore are able to defer taxes for a longer period of time. These beneficiaries could take the required minimum distribution each year and let the rest of the money compound tax deferred for years.

This estate planning strategy no longer makes sense under the new legislation because most designated beneficiaries can only benefit from the tax deferral for a maximum of 10 years after the owner's death. For example, under the prior law, if you inherited a $1 million traditional IRA from your parent or grandparent when you were 35 years old, based on the current IRS life expectancy table, you would have 48.5 years over which to spread out distributions. Upon receiving the IRA, you would start taking a minimum required distribution each year, calculated by dividing the account balance as of the end of the previous year by your remaining life expectancy. The first withdrawal would be $20,619 ($1,000,000/48.5 years) and this amount would be taxed at your current tax rate as ordinary income. Future annual distributions would vary depending on the investment return and your age.

Under the new law, distributions from the inherited $1 million IRA can only be spread out over a maximum of 10 years. However, it is important to note that there is no minimum required distribution; the beneficiary can choose to have entire balance of the IRA distributed at the end of the 10th year following the owner's death. This option may be appealing to a beneficiary who wishes to maximize the tax benefits of the IRA and let it grow tax deferred for 10 years. In that case, the beneficiary would receive a lump sum of $1,000,000 plus any investment return in year 10 – and a very hefty tax bill!

Of course, a beneficiary who wishes to avoid such a large tax bill in year 10 can opt to spread out the distributions from the IRA. If the distributions are spread out evenly over the full 10 years, the first annual withdrawal would be $100,000 ($1,000,000/10 years). While this option reduces the tax bill compared with taking a lump sum, this distribution is still significantly higher than under the prior law.

The bottom line is that under the new regime, deciding when to take distributions is much more complicated. Planning will involve more complex modeling to understand how to maximize the tax benefits for each individual beneficiary.

[1] Individuals who turned 70 ½ prior to December 31, 2019 will not be able to take advantage of this new minimum distribution age and will still be required to start taking minimum distributions at 70 ½.

[2] Beneficiaries of a retirement account that was inherited from an owner who passed away prior to January 1, 2020 are grandfathered in and are not subject to the change in regulation.

EXCEPTIONS TO THE 10-YEAR RULE

The law makes some noteworthy exceptions for a category of Eligible Designated Beneficiaries (EDBs) who are still able to take annual distributions over their life expectancy and are not subject to the 10-year payout rule. EDBs are limited to: 1) the owner's surviving spouse, 2) the owner's minor child (after the child turns the age of majority, the 10-year rule takes effect)[3] 3) a disabled beneficiary (upon his or her death, the 10-year rule takes effect), 4) a chronically ill beneficiary (upon his or her death, the 10-year rule takes effect) or 5) a beneficiary who is less than 10 years younger than the owner (most likely a sibling or a friend).

Even taking these exceptions into account, the SECURE Act significantly changes the incentives to pass down retirement assets to future generations.

Implications of the SECURE Act

The SECURE Act upends the conventional approach to planning for retirement and makes many current estate plans less tax effective than originally intended. Owners should seize this opportunity to review their plans, especially their beneficiary designations, to understand how they will be affected. Below we review some thoughts and strategies to consider as you undertake this review.

Look to the Youngest Generation of Minors

Under SECURE, the qualification of minors as EDBs means that they have the greatest ability to stretch out the tax deferral of the retirement account. Assuming that your child is no longer a minor, a better option may be to leave your retirement account to your minor grandchildren. A newborn beneficiary will have a full 28 years (10 years after turning 18) for the account to compound tax-free. This is still significantly less impactful than their lifespan, but an improvement over the 10-year limit for many other beneficiaries.

Weigh the Trade-offs of Paying Taxes Now vs. Later

Following the passage of SECURE, it is even more important that any planning strategy consider the tax trade-offs of paying taxes now vs. having a beneficiary pay them in the future. For some beneficiaries, such as a young adult without substantial earnings, the compressed 10-year distribution period, and subsequent higher annual income, will force them into a higher tax bracket. If you are in a lower tax bracket today, you may want to consider a full or partial conversion from a traditional IRA to a Roth IRA. By converting and paying taxes today, the beneficiaries of your Roth IRA avoid paying taxes on future distributions. In addition, the payment of income taxes during your life reduces your gross estate value for estate tax purposes and therefore reduces your future estate tax bill. Moreover, as the Roth IRA owner, there is no required annual distribution so the account compounds tax-free as long as you are alive.

It is worth noting that the SECURE Act also applies to Roth IRAs, so one downside is that the 10-year payout limits the time for the retirement income to grow tax-free after the owner's death. Therefore, it may only make sense if you think that your current tax rates are lower than they will be in the future and/or are lower than your beneficiary's tax rate is likely to be.

Think Twice About Putting an IRA in a Trust

The SECURE Act makes certain types of IRA trusts less appealing. Conduit (or "see through") trusts have long been a popular planning tool because the beneficiary receives the annual RMDs outright (similar to a traditional IRA), but the underlying principal of the IRA has an added layer of asset protection because it remains in the trust. The trust, as the "conduit" to the beneficiary, insulates the assets from any imprudent behavior on the part of the beneficiary and from any claims from a creditor or divorcing spouse.

Under SECURE, a conduit trust would effectively blow up after 10 years (assuming the IRA is the only asset in the trust), and the entire account would pass to the beneficiary outright. This would have negative tax consequences for the beneficiary of the trust, making him subject to greater income tax as a result of receiving the IRA distributions in a shorter time frame (than over his life expectancy). It would also limit the time frame of the trust's asset protection. At the end of the 10-year period, the funds would pass from the care of the trustee to the beneficiary, making them available to creditors or to potential squandering.

Instead of using a conduit trust, owners might consider an accumulation trust. With an accumulation trust, annual distributions from an IRA are accumulated within the trust structure. Under SECURE, distributions still must be paid out to the trust within 10 years of the owner's passing, but the assets can remain in the trust for as long as the trust terms dictate, preventing them from being distributed outright to the beneficiary. Although the accumulation trust will likely be subject to a higher tax bill, the creditor protections can extend for a longer period of time.[4]

[3] The age of majority, or the age at which you become an adult, varies by state although it is 18 in a majority of states.
[4] Trusts are subject to the highest marginal tax rate at $12,950 in income for 2020.

Consider Naming a Charitable Trust as Beneficiary

If you are charitably inclined, it may make sense to name a charitable entity, such as a charitable remainder trust (CRT), as a beneficiary. The treatment of CRTs is not affected by the SECURE Act and it can somewhat replicate the effect of a stretch IRA. Upon the death of the owner, the CRT receives the IRA and can make annual distributions (generally a minimum 5% payout is required) to certain designees, such as children or grandchildren, for a term (limited to 20 years) or for the remainder of their lives. 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 CRT's initial funding value. After the beneficiaries pass away, the remainder goes to a charity (or charities) that you have designated. The CRT is tax-exempt, and therefore, similar to a traditional IRA, the assets can be paid to (and grow within) a CRT without triggering an immediate income tax event. In addition, the CRT will generate an estate tax deduction – your estate is reduced by the charitable deduction and therefore you pay less in estate tax.

Consider Splitting Up the Primary Beneficiary

Typically, owners name their spouse as the primary beneficiary and children or grandchildren as the contingent beneficiary. Under the SECURE Act, it may make sense to name both your spouse (or another EDB) and children as primary beneficiaries so that they split the distributions, and therefore get smaller distributions each year. The children can start taking smaller distributions at the death of the first parent and then will start the second half at the death of the second parent. As a result, they are stretching their distribution for up to twice as long and may pay less in taxes.

Concluding Thoughts

With 2020 ushering in a new era for retirement planning, we strongly encourage you to conduct a thorough review of your estate plan to understand whether it is affected by the SECURE Act. Planning factors that were important pre-SECURE, such as the age and tax status of owners and beneficiaries, deserve even more scrutiny to plan effectively post-SECURE. Many of the best practices that were widely accepted up until this year will no longer make sense.

In our role as your investment office, Hirtle Callaghan can offer objective advice as to what planning strategies may work best in the context of your estate plan and investment plan. For over 30 years, we have served as fully transparent, trusted advisors to families and family offices, taking a holistic approach to preserving and growing wealth. We have extensive experience working with complex families to model out various investment and tax scenarios. In addition, we often work closely with estate and tax attorneys and can serve as a resource to review the implications of the SECURE Act on your retirement plan.

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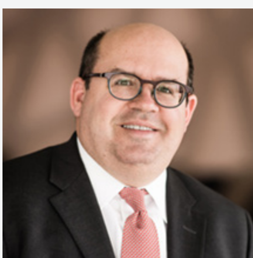

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