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Subject: Martin M. Shenkman, Jonathan G. Blattmachr, Robert S. Keebler & Joy Matak on the SECURE Act - Planning Ideas for Practitioners to Consider

"The SECURE Act makes significant changes to how IRAs (other than Roth IRAs) and certain qualified retirement benefits must be treated post-death to avoid additional taxes. These changes are so significant that all plan participants and IRA owners, sometimes referred to as a 'plan holder,' should confirm their wishes and be advised on how their estate plans may be affected."

Martin M. Shenkman, **Jonathan G. Blattmachr**, **Robert S. Keebler** and **Joy Matak** provide members with comprehensive commentary on the SECURE Act.

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Joy Matak, JD, LLM, is a principal at **CohnReznick** and Co-Leader of the Firm’s Trusts and Estates Practice. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in providing tax services to multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals and their trusts and estates. Joy provides clients with wealth transfer strategy planning to accomplish estate planning and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning. Before joining CohnReznick, Joy was a senior tax manager at a Top 20 accounting firm. Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; the Greater Middlesex/Somerset Estate Planning Council; and the Society of Financial Service Professionals. Joy has authored or co-authored articles for the Tax Management Estates, Gifts and Trusts (BNA) Journal; Leimberg Information Services, Inc. (LISI); and Estate Planning Review The CCH Journal), among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. She recently co-authored a book on the new tax reform law entitled Estate Planning: Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017.

Here is their commentary:

EXECUTIVE SUMMARY:

The SECURE Act makes significant changes to how IRAs (other than Roth IRAs) and certain qualified retirement benefits must be treated post-death to avoid additional taxes. These changes are so significant that all plan participants and IRA owners, sometimes referred to as a "plan holder," should confirm their wishes and be advised on how their estate plans may be affected.

COMMENT:

Action Steps

The SECURE Act may prompt the following actions:

- Revision of beneficiary designation forms.

- Revision of wills and trusts that include provisions creating so-called conduit or accumulation trusts intended to hold IRAs and qualified plan benefits and preserve the stretch IRA or plan benefits while the plan holder is still alive.

- Possible modification of existing conduit trusts (defined below) that are not modified before the plan owner's death to address how the SECURE Act might undermine the intent of that trust when the will or trust providing for it was created.

- Complete rethinking and restructuring of the planning for the IRA or qualified plan account. This might include designating a charity as a beneficiary of the account and, perhaps, using life insurance to address the economic value of what is given to charity. Another possible alternative is paying the IRA or plan balance to a Charitable Remainder Trust ("CRT") on death that will stretch out the distributions to the beneficiary of the CRT over that beneficiary's lifetime under the CRT rules. That plan might be paired with a life insurance trust to replace the assets ultimately passing to charity under the CRT requirements.

Some of these will be explained in more detail below.

What the Secure Act Does to IRAs and Qualified Plans

While there are many changes affecting a variety of tax laws, the most talked about change of the SECURE Act is the death of the so-called "stretch IRA" or "stretch plan" for most beneficiaries inheriting IRAs or plans after 2019. For most of those inheriting an IRA or plan after 2019, the SECURE Act will require all IRA or plan assets to be distributed by the end of the tenth calendar year following the death of the IRA owner or plan participant. (In fact, in some cases, the period will be the end of the fifth calendar year following the death of the owner or participant as it was before the SECURE Act where the proceeds were or, in some cases, may be payable to a non-individual, such as an estate or charity.) This requirement is intended to enhance tax revenues to the government as contrasted with the long stretch periods that had previously been available.

No withdrawals have to be made during the 10-year period so long as the entire balance in the IRA or plan is withdrawn at the end of the 10-year period following the date of the IRA owner's or plan holder's death although if a conduit trust is used, the trust will be required to take minimum required distributions (MRDs) or face additional heavy taxes imposed by Section 4974(c).

Death of the Stretch

The stretch IRA or plan is a planning technique that permitted an heir to defer IRA or plan distributions over a long period of time, allowing the heir to defer the income tax while allowing the IRA or plan balance to compound income tax free (until distributed). Following the death of the IRA owner or plan participant, retirement benefits passing to a named qualified beneficiary called a “designated beneficiary” would be payable over the life expectancy of the designated beneficiary. RMDs were reset based on life expectancy of the designated beneficiary, allowing a smaller amount to be distributed and, therefore, become taxable while the balance remaining in the account could continue to grow income tax-free.

The deferral with its accompanying income tax benefit had been a consideration that made many IRA owners and plan participants comfortable bequeathing large IRA or plan balances outright, knowing that the designated beneficiary should appreciate having a stream of income for life (although, because life expectancy, other than for a surviving spouse, was not recalculated, the payments could end before death).

Other taxpayers sought more protection for larger accounts and had the IRA or plan paid to a special type of trust called a “conduit trust” that would flow the RMDs to the beneficiary, thus realizing the stretch, but protecting the balance of the plan for future years. The use of such a trust has been used to insulate a large plan balance from the beneficiary’s imprudence if the plan had instead been paid outright.

All these assumptions have been changed by the SECURE Act, and taxpayers and their advisers should reevaluate:

- Beneficiary designations for IRAs and other plans. For example, if the taxpayer had relied on the income tax benefits of the stretch IRA rules to dissuade an otherwise imprudent beneficiary not to withdraw, spend, or worse, squander, plan assets, that assumption should be reconsidered. Naming a so-called “accumulation trust” as the beneficiary of the IRA or plan may be a preferred alternative to protect IRA or plan distributions as well as the plan balance from a beneficiary’s fiscal irresponsibility. The plan owner might consider any negative income tax consequences a worthwhile price to pay in order to protect assets that the beneficiary might otherwise withdraw and spend too soon. If the plan owner does not feel that cost is worthwhile then other options might need to be considered (e.g. the CRT option mentioned).

- Trusts named as beneficiary of plan or IRA assets. There are two types of trusts that can be used as beneficiaries of IRA or plan assets: an accumulation trust and a conduit trust. The accumulation trust, as its name implies, may accumulate plan or IRA distributions inside the trust. The second is a conduit trust which must pass all IRA and plan distributions promptly to the beneficiary. If the trust was a conduit trust designed to take advantage of the stretch rules under pre-SECURE Act law, that plan balance may not only have to be distributed in 10 years thereby eliminating the income tax benefit (as generally will also be the case for an accumulation trust), but worse, expose plan assets to the possible imprudence of the beneficiary and potentially creditors or divorcing spouses of the beneficiary. Now the entire plan or IRA must be distributed essentially ten years after death (unless, in some cases, the beneficiary of the conduit trust is an Eligible Designated Beneficiary, discussed below.) In some cases, the IRA or plan owner might prefer instead to name an accumulation trust to hold plan assets although, in general unless the income is distributed to an individual beneficiary, it will be taxed to the trust at its very high compressed income tax brackets (reaching the top bracket at about $13,000 of taxable income). A potential option for an accumulation trust is to make it a so-called Section 678 trust or beneficiary defective trust (commonly referred to as a BDIT); see PLR 200949012 (not precedent). That way the income will be attributed to the individual beneficiary who is treated under that section as the income tax owner of the trust but need not receive all income (although it seems likely the trust will distribute the amount needed by the beneficiary to pay the income taxes on all such income imputed to him or her under Section 671). Some commentators are uncertain as to whether the IRS would respect this planning technique for an accumulation trust.

Overview of the Exceptions to the 10-Year Rule

There are exceptions from the new 10-year SECURE Act payout rule. Those heirs who meet the definition of a new term “eligible designated beneficiaries” (“EDBs”), are not subject to the 10-year payout rule (except for a minor child of the plan participant once majority is reached). See Section 401(a)(2).

Eligible designated beneficiaries include:

- The surviving spouse of the IRA owner or plan participant.

- Chronically ill heirs as defined in Section 7702B(c)(2).

- Disabled heirs as defined in Section 72(m)(7) with certain modifications.

- A person 10 or fewer years younger than the plan holder.

- A minor child of the IRA owner or plan participant.

These eligible beneficiaries are permitted to withdraw plan assets over their life expectancy (unrecalculated, except for the surviving spouse), except for a minor child of the IRA owner or plan participant.

Minor children of the plan participant or IRA owner are also considered eligible designated beneficiaries so that the 10-year payout will not apply to them until such date when such beneficiary reaches the age of majority. Once the minor beneficiary reaches the age of majority, the 10-year rule will apply so that plan or IRA assets must be paid out by the end of the tenth calendar following the year in which the minor beneficiary attains majority. It is uncertain whether this will be determined by state law (normally providing for majority to occur at age 18) or whether it will not occur until the child of the plan holder completes a "specified course of education" within the meaning of Section 409(a)(9)(F).

10-Year Rule – Plan Pay Out After 10 Years

It seems quite certain that the plan or IRA balance will have to be distributed by the end of the calendar year (December 31) which year includes the 10th anniversary of the plan holder's death. Thus, the post-SECURE Act "stretch" can be slightly longer than 10 years from the date of death, as it lasts to the end of the 10th year from the year in which the plan holder died. For example, if the IRA owner dies on January 1, 2020, the entire amount in the IRA (subject to special rules discussed elsewhere) must be distributed by December 31, 2030, or significant (additional) taxes would be imposed within Section 4974.

Those taxpayers who had previously determined the disposition of IRA or plan assets may wish to reconsider the planning strategies. By way of example, some taxpayers relied on the assumption that valuable income tax deferral and tax-free growth inside the plan, as permitted under the law before the SECURE Act, would dissuade an otherwise imprudent beneficiary from withdrawing the plan balance faster than the long-term or "stretched" payout period over the beneficiary's life expectancy. These taxpayers may have reasoned that using a trust to hold the IRA plan would be unnecessary since the beneficiary would wait to take distributions anyway in order to achieve the income tax benefits of the stretch. With the loss of this motivating tax benefit and a requirement under the SECURE Act to distribute the IRA or plan completely within 10 years, these taxpayers may need to reconsider their approach.

Given the horror stories and statistics on how fast many individuals burn through an inheritance, IRA, or "windfall," it may not have been reasonable in any event for taxpayers to rely on heirs to wait patiently for RMDs from inherited IRAs, despite the valuable tax benefits. This is most likely the main reason why so many taxpayers with significant IRA balances named trusts as beneficiaries of their IRAs or plans rather than the intended heir directly. (Trusts may also provide enhanced asset protection for plan assets).

A conduit trust may not accumulate distributions received from a qualified retirement plan, rather it must pay out any plan distributions to the beneficiary immediately. To the extent that a beneficiary of a conduit trust does not qualify as an eligible designated beneficiary, then the entire plan balance will have to be paid out by the end of the 10th year following the year of the plan holder's death. This requirement would limit both the tax deferral and asset protection benefits of the trust to about 10 years for many plan beneficiaries. Indeed, because all plan or IRA assets must be distributed promptly to the beneficiary of any conduit trust, no part of the plan or IRA can be protected beyond the end of the tenth calendar year following the year of death of the plan holder.

10-Year Rule – Income Tax Considerations

The long-life expectancy payout under prior law often resulted in small and more manageable income tax consequences since the annual payment may not have pushed the receiving beneficiary into a much higher income tax bracket. Post-SECURE Act, a large lump sum payment of an entire plan balance (other than from a Roth IRA) to a trust could expose those dollars to a potentially much higher marginal tax rate significantly increasing the tax burden. Further, if there is a change in administration in

Washington and Democratic proposals to increase the marginal tax rates are enacted, that burden could be magnified.

Might Roth conversions provide an offset to the new 10-year rule? Perhaps. Since there is no income tax consequence to a lump sum payment of a Roth IRA in year 10, the income tax bite of the 10-year rule might seem to be mollified. However, does that suggest that a plan holder convert a traditional IRA to a Roth IRA today to achieve that benefit? Perhaps not. If a plan holder has a large IRA and converts it to a Roth IRA today, there will be a current income tax cost incurred now as the amount converted will be included in the gross income of the IRA owner who so converts. A large conversion today might push the plan holder into similarly high-income tax brackets that the 10-year rule might push a trust (or an individual beneficiary) into it in the future. There may be a benefit to timing Roth conversions over many years to avoid the highest income tax brackets on a conversion. However, if the plan holder attributes a meaningful probability to a change in administrations to Democratic, and an increase in marginal income tax rates, converting before that occurs may prove the more prudent tax minimization step. Conversion of a traditional IRA to a Roth IRA is a complicated decision dependent upon a myriad of factors such as "guessing" what the tax laws will be in the future, whether state income tax may be avoided, and how long the plan participant or IRA owner (and successors) will live. Moreover, it could be that the tax law will change in the future and provide that increases in Roth IRAs are income taxable. It seems, in any case, that it may be appropriate to take a hard look at the possibility of conversion just before death (if that becomes known).

<u>10-Year Rule – Beneficiary Imprudence, Divorce and Creditors</u>

The SECURE Act requirement that a plan or IRA balance has to be paid out in 10 years from the plan holder's death has a second potentially negative consequence. It can result in a beneficiary receiving a large lump sum payment thereby exposing that payment to the beneficiary's financial irresponsibility, contrary to what the plan holder presumably wanted.

This 10-year payout rule will cause many plan holders to revisit their planning since that deferral is much shorter than what may have been anticipated by the plan holder when that trust was created. That result could put a large IRA balance in the hands of an imprudent or vulnerable beneficiary much sooner than was anticipated. This is the precise worry that many articles have cautioned plan holders about since it could undermine their goals for the plan.

Certainly, a trust could be used to hold the plan assets after the plan has to payout after 10 years but only if it is an accumulation trust and not a conduit trust. (A trust that is neither an accumulation trust nor a conduit trust could be the recipient, but that will mean that proceeds must be paid out by the end of the fifth calendar year following the death of the plan holder.) Not only will the economic value be diminished by an income tax cost in that year, further tax deferred growth will be lost after that point. However, the trust could still serve to do what trusts are designed to do: protect the beneficiary from his or her own fiscal imprudence or claims against the beneficiary.

The use of a trust, even with the reduced economic advantages in the wake of the SECURE Act, may also serve to keep the assets' character as a separate inherited asset intact which may be valuable if the beneficiary later divorces or otherwise faces claims. A risk of the 10-year rule for not trusteed plan assets is that, once distributed, the former plan assets might face a greater likelihood of being commingled with marital assets and thereby lose any protected status if the heir later divorces.

A more nuanced analysis of the impact of the SECURE Act's 10-year rule is necessary. If the named beneficiary falls into one of the five categories of EDBs (see discussion under the "Exceptions" below), they will continue to qualify for a life expectancy payout for their lifetimes. Thus, for these categories of beneficiaries the existing estate/retirement/trust plan may still work largely as anticipated and the SECURE Act may have limited impact. Thus, as is so often the case with new tax laws, each taxpayer's plan has to be reviewed in light of that taxpayer's personal circumstances. Generalizations can be misleading.

<u>**Exceptions from the 10-Year Rule – Additional Thoughts**</u>

There are five categories of beneficiaries who can continue to withdraw inherited IRAs over their life expectancies (except a minor child of the plan holder who must switch to a ten-year payout upon reaching the age of majority) instead of the likely much shorter 10 years essentially mandated under the SECURE Act. The exceptions are for a surviving spouse, chronically ill or disabled people, minor child of the employee of the plan or IRA owner, or person not more than 10 years younger than the plan holder. (These folks are called “eligible designated beneficiaries,” or “EDBs”). A conduit trust for one of these beneficiaries should generally qualify for the longer life expectancy payout under the SECURE Act. (A conduit trust is one the requires that all plan distributions must be immediately distributed to the trust beneficiary.) An accumulation trust may be used for a disabled and chronically ill beneficiary and still benefit from the life expectancy payout. However, an accumulation trust cannot be used for a spouse, minor child or not more than 10-years younger beneficiary as the 10-year rule, not the life expectancy payout rule, will apply.

Also, when the surviving spouse, chronically ill beneficiary or disabled beneficiary, or 10-year or less young beneficiary, dies, and another beneficiary inherits, or when the minor beneficiary reaches the age of majority, the new SECURE Act 10-year rule will apply. So, if a surviving spouse is an EDB of a conduit trust, on that spouse’s death any remaining plan balance will have to be fully distributed by the end of the tenth calendar year following the calendar year of that spouse’s death. (Note that the plan or IRA itself must permit these deferred payments—so if it is anticipated that such deferral is desirable, it is important to check the plan or IRA terms.)

Each of these EDBs will be examined in more detail below.

<u>EDB – 1: - Surviving Spouse</u>

The surviving spouse of the plan participant or IRA owner can rollover the plan or IRA assets to his or her own employer plan, if the plan so permits, or an IRA just as under prior law. The SECURE Act does not change that. If a conduit trust is used to hold the plan balance it can be withdrawn over the spouse’s life. The distributions under pre-SECURE Act law had to have begun in the year the deceased spouse would have attained age 70 ½; now it’s the year the deceased spouse would have attained age 72 since the SECURE Act deferred the time to begin Required Minimum Distributions (“RMDs”) to age 72.

<u>EDB - 2: Disabled Beneficiary</u>

A disabled heir is defined in Code Section 72(m)(7):

> *For purposes of this section, an individual shall be considered to be disabled if he 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. An individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require*.

Though this definition is quite limited, it mirrors the standard set forth in Reg. §404.1505(a), which governs the requirements to qualify for social security disability benefits:

> *The law defines disability as the inability to do any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than 12 months.*

Given the apparent nod to the Social Security Disability standards, a plan participant who wanted to benefit an individual with substantial health challenges should review the regulations to confirm whether the impairment could qualify the heir for disability benefits. The regulation continues:

> *To meet this definition, you must have a severe impairment(s) that makes you unable to do your past relevant work (see § 404.1560(b)) or any other substantial gainful work that exists in the national economy. If your severe impairment(s) does not meet or medically equal a listing in appendix 1, we will assess your residual functional capacity as provided in §§ 404.1520(e) and 404.1545. (See §§ 404.1520(g)(2) and 404.1562 for an exception to this rule.) We will use this residual functional capacity assessment to determine if you can do your past relevant work. If we find that you cannot do your past relevant work, we will use the same residual functional capacity assessment and your vocational factors of age, education, and work experience to determine if you can do other work. (See § 404.1520(h) for an exception to this rule.) We will use this definition of disability if you are applying for a period of disability, or disability insurance benefits as a disabled worker, or child's insurance benefits based on disability before age 22 or, with respect to disability benefits payable*

> *for months after December 1990, as a widow, widower, or surviving divorced spouse.*

Thus, if the heir can engage in "any substantial gainful activity," even if very limited, that heir will not qualify as an EDB. Thus, the terminology in the definition alone will restrict the applicability of this provision.

<u>EDB – 3: Chronically Ill Beneficiary</u>

A chronically ill heir is defined in Section 7702B(c)(2) with certain modifications. This Section provides:

> (A) In General - *The term 'chronically ill individual' means any individual who has been certified by a licensed health care practitioner as—*
> *(i) being unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days due to a loss of functional capacity, (ii) having a level of disability similar (as determined under regulations prescribed by the Secretary (in consultation with the Secretary of Health and Human Services) to the level of disability described in clause (i), or (iii) requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Such term shall not include any individual otherwise meeting the requirements of the preceding sentence unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements.*
> *(B) Activities of daily living: For purposes of subparagraph (A), each of the following is an activity of daily living: (i) Eating. (ii) Toileting. (iii) Transferring. (iv) Bathing. (v) Dressing. (vi) Continence*.

The above definition suffers from the same overly restrictive terms as the definition of "disabled" above. Many intended heirs are living with challenges that may limit or even prevent gainful employment, but they are not so severely incapacitated as to meet the requirements of chronically ill according to the above definition. Yet, these same people who need the protections of a trust, and who may desperately need the economic benefits from the plan assets to be bequeathed, will be forced to have the plan balance distributed in 10 years and lose the continued tax deferred growth, etc.

Any plan holder planning on an heir meeting the requirements of being "disabled" or "chronically ill" to qualify as an EDB under the SECURE Act should carefully evaluate the stringent requirements involved.

Fortunately, to the extent that an individual beneficiary of a plan does qualify as "disabled" and/or chronically ill, the SECURE Act allows for plan distributions to be paid to an accumulation trust. It is noteworthy that only disabled or chronically ill EDBs are eligible for this benefit; a trust for the benefit of any other EDB, as noted above, must be a conduit trust which pays all plan distributions outright and free of trust in order to qualify for life expectancy payouts. Finally, the disabled or chronically ill beneficiary must meet those requirements on the plan holder's death. So, if a beneficiary becomes disabled at a later date, the life expectancy payout will not be available.

<u>EDBs - Additional Rules for Chronically Ill or Disabled Beneficiaries</u>

There are a few additional leniencies permitted to chronically ill or disabled beneficiaries.

A trust can be created for their benefit that has multiple beneficiaries. If on the death of the plan holder that trust is divided into separate trusts for each beneficiary, the post-division trust for the chronically ill or disabled beneficiary will qualify as an EDB for life expectancy payout treatment. Without this change each of those separate trusts for each beneficiary would have to have separately been indicated to be a beneficiary.

Also, in contrast to a spouse or minor child who require a conduit trust to qualify for the special life expectancy payouts as EDBs, a chronically ill or disabled heir can be the beneficiary of an accumulation trust as well. (An accumulation trust is one having more than one individual beneficiary each of whom can be identified.) Even though the accumulation trust may name beneficiaries on the death of the chronically ill or disabled beneficiary the trust for the chronically ill or disabled beneficiary will be permitted to withdraw pursuant to the life expectancy rules rather than the 10-year payout.

<u>EDB – 4: Minor Children</u>

Minor children of the plan participant or IRA owner are also considered eligible beneficiaries so that the 10-year payout will not apply to them during minority. The SECURE Act specifically limits this to a child of the IRA plan holder. It is not applicable to any other minor (such as a minor grandchild of the plan holder). (See Section 401(a)(2)(E)(ii)(II): "…subject to clause (iii) [for disabled EDBs], a child of the employee who has not reached majority…")

The age of majority, i.e. when the child is no longer a minor, would seem to be 18 or 21 depending on state law, but some have suggested that other rules might apply to lengthen that period. Under Section 409(a)(9)(F) a child has not reached age of majority if they are under 26 years of age and not acquired a "specified course of education." And that remains the rub of the SECURE Act: many parents will not wish to have a child receive their plan balance in full by age 18 or 21 although a conduit trust could dribble out the IRA or plan proceeds for ten years following the attainment of majority. But an even greater concern with the explosion of alternative family arrangements and relationships (the "modern" family), is that many plan holders will bequeath IRA or plan assets to young beneficiaries who are not "children" of the employee (e.g., stepchildren) as restricted by the SECURE Act so that those young beneficiaries will not qualify as EDBs (i.e., a conduit trust that was created for them will not qualify for life expectancy payout) and they will have to receive the full distribution of the plan balance by the 10-year SECURE Act date regardless of age.

EDB – 5: Beneficiary Not More than 10-Years Younger

A beneficiary who is not more than 10 years younger than the plan holder (or a conduit trust for his or her benefit) may take distributions over his or her (unrecalculated) life expectancy. This will permit a life expectancy payout for the named beneficiary but the application of this EDB exception is likely quite limited. The plan holder would have to name a friend or family member (perhaps, a sibling) who is not more than 10 years younger, which certainly will exclude children and other typically named beneficiaries.

Example: Plan holder is age 80 and has an unmarried partner (so the spouse EDB exception will not apply) who is age 71 who, if named, will qualify as an EDB under this exception and be permitted to withdraw the plan balance over his or her life expectancy.

Planning for Younger Beneficiaries

The problem illustrated above for minor children who might inherit an IRA or plan is obvious. Too much money might have to be distributed to the beneficiary at age 28 (assuming 18 as the age of majority plus 10 years), or earlier if the minor is not a child of the plan holder. Many plan holders (parents, or other benefactors) will not want that result.

So, the answer for some plan holders will be to revise their estate planning documents and substitute an accumulation trust in place of the conduit trust. But the result will be that after the 10th year the entire IRA plan balance will have to be distributed to the trust bunching that income into a single high trust tax year. Since trusts face compressed income tax brackets much of that income may be pushed into the highest tax bracket.

One partial solution might be to take distributions during the 10-year period (not defer them all until the 10th year) to spread out the income tax into hopefully lower tax years.

Another approach might be to coordinate life insurance with the income tax that is estimated to be due on the plan or IRA proceeds. A simple Irrevocable Life Insurance Trust ("ILIT") might be set up to hold life insurance on the plan holder that would be collected on the plan holder's death and be held in that ILIT to pay the income tax due at the end of the tenth calendar year when the distribution of the plan balance is required to avoid onerous additional taxes under Section 4974. That same ILIT might be used to fund estate tax costs on the plan if estate taxes are due. But creating both an accumulation trust and an ILIT, and funding an insurance plan, is complex and costly and not a solution some plan holders will accept.

Another approach might be to use plan assets to benefit different beneficiaries in light of the SECURE Act changes and make other bequests to the intended minor beneficiary.

Example: Taxpayer had $1 million in her estate and $1 million in her IRA. She is single and has a child age 35. Her second and most recent spouse had a child who is now age 5 who was never adopted by her, so that minor will not qualify as her child and hence will not qualify as an EDB under the act. Under pre-SECURE Act, she named the minor as sole beneficiary of a conduit trust to get a long stretch on the IRA payments. She named her adult child as beneficiary under her estate for an equivalent amount. Post-SECURE Act, perhaps flipping her estate plan might suit her goals. The 35-year-old adult child can be named as beneficiary of her IRA as a payout in year 10 might not be as concerning. The minor can be named as beneficiary under her will so that those assets can be held in a longer-term trust without the issues that a 10-year payout to an accumulation trust might trigger. This plan is also subject to various issues. For example, how should the tax effect of the change in a dispositive scheme be factored into the planned distributions?

Revision of Beneficiary Designation Forms

Taxpayers should review their IRA and plan beneficiary designations forms, and if they have professional advisers, involve them in the process, as the decisions for many may be complicated. Some taxpayers may have named a conduit trust as beneficiary and might wish to revise that trust into an accumulation trust to avoid the beneficiary receiving a large lump sum distribution after 10 years. Others may opt to bequeath (or gift while alive) some portion or even all of their IRA or plan outright and instead place assets passing under their will in trust. Then in other situations, the IRA owner or plan participant might wish for the IRA or plan assets to pass into a CRT. If the IRA or plan participant owner had bequeathed some or all IRAs to grandchildren to maximize the stretch, there will no longer be a benefit to that planning since the assets will have to be paid out over 10 years. These taxpayers might revisit their plan and decide instead to leave the IRA assets to children who will obtain the same maximum 10-year deferral (assuming that they are not eligible designated beneficiaries).

All of this should be coordinated with what is done under the will (or revocable trust as the case may be) and as part of a comprehensive reconsideration of the new rules. For example, if an IRA holder’s plan was to bequeath IRA assets to grandchildren and they had a life insurance trust purchase life insurance to benefit children, the entire plan might warrant reconsideration. Perhaps, the IRA can be redirected to the children, but then what of the life insurance trust?

Revision of Wills and Trusts

One revision to consider making to an IRA owner's will is, perhaps, to change the conduit trust that had been designed to hold IRAs and distribute the RMDs to the beneficiary as they are paid into a different type of trust called an "accumulation trust."

But there is another change some IRA owners might want to consider, and that might include an almost complete revamping of their estate plan.

Example: The IRA owner might have had IRA assets held in trust and the remainder of the estate distributed outright without any trust to heirs. The thought might have been that the IRA distributions will be stretched, so why not give the remaining assets outright? Now that the "stretch" is limited to 10 years (as a general rule), the plan or IRA owner might consider leaving a conduit trust to hold IRA or plan assets for that 10-year period and then bequeathing the remaining estate into another trust so that those assets can be held longer in the trustee's discretion. That might amount to a "flip-flop" of the dispositive scheme with all assets previously bequeathed outright now going into trust. The trustee of the non-retirement assets, perhaps, could make discretionary distributions to approximate what the prior plan might have accomplished.

Reclaim a "Stretch" using a CRT

An IRA owner might revise the beneficiary designation for his or her plan to designate a Charitable Remainder Trust (a "CRT") as the named beneficiary. On death, the IRA would be paid to the CRT which could accomplish something approximating the "stretch" which had been formerly available before the SECURE Act.

The CRT would make distributions to a named non-charitable beneficiary (or beneficiaries) for a term of years (up to 20 years) or for life, with the remainder to a qualified charity. In general, a CRT must pay out a minimum of 5% (but not more than 50%) to noncharitable beneficiaries annually. The annual payments to the non-charitable beneficiary (or beneficiaries) could either be based on a percentage of the value held by the CRT (a "unitrust") each year or else could be a fixed amount (an "annuity") calculated as of the date the CRT is established. The actuarial value of the charitable remainder must be at least ten (10%) percent of the value contributed to the CRT, determined as of the date of funding and, if it is an annuity trust, cannot fail the 5% probability of exhaustion test under

Rev. Ruling 77-374. The IRA owner's or participant's estate would be entitled to an estate tax charitable deduction for the present value of the remainder interest passing to charity.

Given that the plan or IRA proceeds will constitute income in respect of a decedent (except in the case of a Roth IRA) under Section 691(a), they will not be entitled to any basis step-up on death and will be considered ordinary income as it is distributed to a non-charitable recipient. Distribution to a charitable beneficiary (such as a CRT) changes the dynamic. A CRT would not have any tax liability on income earned received from the plan or IRA. Thus, complete distribution of the entire balance in the IRA or plan to the CRT will not result in tax liability in year 1. Thus, the CRT can liquidate the IRA or plan in year 1 and make distributions to one or more noncharitable beneficiaries over time, in accordance with the rules in section 664 governing CRTs. The trustee of the CRT would be able to consider the tax effect of investments on a going-forward basis and consider how the trust might limit the taxable income distributable to the noncharitable beneficiary.

As the CRT makes distributions to the noncharitable beneficiary or beneficiaries, each individual beneficiary will receive an allocable share of the CRT's tax income.

Pursuant to the ordering rules set forth in IRC Sect. 664(b), distributions from a CRT will be taxable to the noncharitable beneficiary as follows:

1. First, "as amounts of income (other than gains, and amounts treated as gains, from the sale or other disposition of capital assets) includible in gross income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years;"
2. Second, as a capital gain to the extent of the capital gain of the trust for the year and the undistributed capital gain of the trust for prior years;
3. Third, as other income to the extent of such income of the trust for the year and such undistributed income of the trust for prior years; and
4. Finally, "as a distribution of trust corpus…"

Thus, to the extent that any distribution exceeds the ordinary income earned by the CRT in the current tax year or as had accumulated from any prior tax year, each noncharitable beneficiary would recognize an allocable share of the capital gains income up to the trust’s recognized gains in the current tax year or as remain undistributed from any prior tax year. Each noncharitable beneficiary’s allocable share of income flowing from the CRT will be reflected on a Schedule K-1 and will be subject to income taxes (including the 3.8% net investment income tax) on the individual beneficiary's personal income tax return at such individual beneficiary’s tax rates. One advantage of the CRT plan is that the plan or IRA proceeds can be paid immediately after death of the plan holder and without any income tax being due as the trust is income tax exempt.

The CRT plan has been widely discussed in the commentary. Any such CRT would need to be structured appropriately depending upon the age of the noncharitable beneficiary and the intentions of the plan participant. The plan participant considering a CRT option would need to be charitable inclined and the tax advisors should consider whether there are other alternatives that accomplish the plan participant’s goals besides setting up a CRT which will need to be administered.

Illustration:

Thea Taxpayer (age 84) leaves an IRA with a fair market value as of the date of her death of $3.1 million on January 1, 2020. Her entire gross estate (including the IRA) is worth $14.58 million. Thea made no gifts during her lifetime and she was unmarried as of the date of her death. She was a resident of the State of Florida (with no real estate or tangibles in a state with an estate tax), so while there is no state estate tax, Thea’s executor needs to consider whether the estate is subject to a federal estate tax with an exemption of $11.58 million.

Scenario 1: Thea Taxpayer creates a testamentary Charitable Remainder Unitrust Trust (“CRUT”) and designates the CRUT as the named beneficiary of her IRA. In addition to the IRA contribution to the CRUT, Thea’s will calls for an additional contribution outright to a qualified charity of an amount that, when combined with the funding of the CRUT, will reduce the value of Thea’s estate below the federal taxable estate threshold.

The noncharitable beneficiary of the CRUT will receive a unitrust amount, which will be calculated annually based on the fair market value of the assets in the trust. The noncharitable beneficiary will receive the same percentage of the value in the trust annually regardless of the trust's actual income. The value of the IRA as of the date of funding the CRUT is $3.1 million. The §7520 rate as of February 2020 is 2.2%. The trustee of the CRUT liquidates the IRA on February 15, 2020, recognizing the entire balance in the IRA as of that date in a non-taxable transaction.

Thea's estate optimizes the CRUT to ensure that the value of the charitable deduction is not more than 10% of the value of the assets ($310,000) contributed to the trust by providing for a 15.02% payout to Sam. Assuming that the CRUT assets have 3% growth and earn 5% income annually, the distribution to Sam from the CRUT will vary over the course of his remaining lifetime (approximately 21 years) from a high in the first year of $466,612 down to approximately $95,336 in the final year.[i]

In this scenario, most of the annual payments to Sam will be reportable by him as taxable income under the CRT four-tier system as set forth under IRC Sect. 664(b):

> a. ordinary income to the extent of the trust's cumulative undistributed ordinary income for the current and all previous years,
> b. capital gain to the extent of the cumulative undistributed net capital gain for the current and all previous years,
> c. nontaxable income to the extent of such undistributed income for the current and all previous years, and
> d. a distribution of trust principal.

Since this scenario contemplates that the IRA will be immediately liquidated upon receipt by the CRT, each distribution to Sam will be mostly made up of ordinary income. So, while the result is similar to a stretch, there are tradeoffs which must be considered when invoking this option.

<u>Scenario 2</u>: Thea creates a testamentary Net Income with Makeup Charitable Remainder Unitrust Trust ("NIMCRUT") and identifies the NIMCRUT as the named beneficiary of her IRA. In addition to the IRA contribution to the NIMCRUT, Thea's will calls for an additional contribution outright to a qualified charity of an amount that when combined with the funding of the NIMCRUT will reduce the value of Thea's estate below the federal taxable estate threshold.

During the term of the NIMCRUT, just as with a CRUT, the noncharitable beneficiary will receive a percentage of the value of the trust (not less than 5%), as revalued annually. However, to the extent that the NIMCRUT does not have sufficient fiduciary accounting income ("FAI") in any given year, the trust will only distribute the FAI earned. Then, to the extent that the trust earns income in a later year, the trust will make up the shortfall by distributing such income to the noncharitable beneficiary.

This is a somewhat more complicated structure than in the prior Scenario 1. Further, since the NIMCRUT may not have sufficient income to make distributions, the beneficiary's desire to receive distributions more regularly would need to be considered.

There are unlimited variants on this strategy which IRA owners might wish to consider. These options are fairly complicated and will require careful planning.

Probably what is best in this instance is to leave $3 million of the IRA (or all of it) directly to charity and leave the assets that do not represent the right to income in respect of a decedent under Section 691, and which will get a stepped up basis upon death under Section 1014, to family members.

<u>Life Insurance Variant</u>: An IRA owner might also purchase life insurance on his or her life to replace the value of the estimated assets required to be paid to charity at the end of the CRT which must be at least 10% under the CRT rules. That insurance might be held by an insurance trust. This is similar to a planning concept some had called "a wealth replacement trust" but applied in the new post-SECURE Act context.

To the extent that the IRA owner wishes to establish an insurance trust, such an owner would be wise to fund the trust before the 2020 election. It is possible that a Democratic victor would cap the annual exclusion for gifts at $20,000 per donor, making it difficult to fund most insurance plans gift tax free.

In any event, practitioners should make their clients aware of the additional costs and complexities of creating and administering any plan that involves a Charitable Remainder Trust and/or life insurance trust.

What Can Be Done About Old Conduit Trusts If the IRA Owner Dies Before Changing the Trust Terms?

The reality is that most taxpayers ignore warnings and recommendations from the media and even their own advisers. Few enjoy discussing planning for death, and even fewer the professional fees charged by practitioners to update documents. It is likely that many taxpayers will not revise their wills and or trusts to modify pre-SECURE Act conduit trusts, e.g. changing them into accumulation trusts to prevent a large lump sum distribution to a beneficiary (e.g. a non-child minor beneficiary) after 10 years.

Nonetheless, there may be some opportunities (even post-death) to modify the trust:

- Many states permit a non-judicial modification of a trust by agreement of the settlor, trustee, and beneficiaries. However, if the plan participant whose will or trust is at issue is deceased, a non-judicial modification may not be a viable option.
- Alternatively, a court might permit reformation of an existing conduit trust into an accumulation trust, but only if it can be demonstrated that the enactment of the SECURE Act would force a result contrary to the testator's or settlor's intent. That is to say, the purpose of most conduit trusts was to gain a stretch so that distributions could be limited over a beneficiary's life expectancy. An interested party would likely seek judicial reformation on the grounds that the trustor or settlor would have strongly opposed payment of the entire plan to the beneficiary within ten years. It is not clear, however, that this might not have adverse tax consequences (e.g. might a five-year rule apply?). Hopefully, the IRS will provide some leniency when it issues guidance on the Secure Act to enable taxpayers to protect vulnerable beneficiaries from the risks of receiving a large lump sum payment in the 10th year. This could be important for minor beneficiaries who don't qualify as a child of the plan holder, and for special needs beneficiaries needing protection but who are disabled or become chronically ill after the plan holder's death, etc.

Of course, these options carry significant risks and cannot be relied upon as a cure-all. The best alternative would be for plan participants to address concerns raised by the SECURE Act before death by updating their plans. Perhaps, clients just need to be convinced that a professional fee is a lesser evil than depletion of their retirement accounts to ne'er-do-well beneficiaries?

What about IRAs Inherited before 2020?

The SECURE Act only applies to retirement plans that are inherited after January 1, 2020, so the complex distribution rules that existed under prior law will continue to apply to many heirs. So, when any heir or adviser is considering advice on an inherited IRA or other plans, they will first have to determine which set of rules apply.

Change in Age for RMDs to Begin

The SECURE Act increases the age at which retirees must begin taking RMDs from April 1 following the year they turn 70½ to April 1 following the year they turn 72. This gives an economic nod to longevity. With taxpayers living longer they can now leave assets inside a plan growing tax deferred for a bit longer. Presumably, that may help with funding retirement for those plan holders who can afford to wait until 72 for their distributions. Section 114 of the SECURE Act amended Code Section 401(a)(9)(C)(i)(I).

One planning technique was not adversely affected by this extension of RMDs. Plan holders can direct up to $100,000 of IRA funds to be paid directly to charity. This is called a Qualified Charitable Distribution ("QCDs"). That has the effect of a dollar-for-dollar deduction for charitable contributions for the plan holder. Although plan participants and IRA owners can now wait until 72 before being required to take RMDs, QCDs may still be made once the IRA owners reaches age 70 ½.

Contributions Without Age Restriction

Under pre-SECURE Act law, contributions to IRAs had to stop at age 70 ½ (the same age at which RMDs had to begin under prior law). If the taxpayer would turn 70½ before the end of the tax year, additional contributions to an IRA were not permitted. Under the SECURE Act, there are no longer any limits on the age through which contributions can be made. Many people continue working long past the traditional age-65 retirement and this change will give them the flexibility to continue contributing to tax advantageous IRAs. SECURE Act Section 107 repealed Section 219(d)(1).

However, any QCD is reduced by the amount contributed under this new more liberal tool under the SECURE Act.

More Liberal Withdrawal for Birth and Adoption Costs

The SECURE Act now permits withdrawals of up to $5,000 IRAs and certain other plans to pay expenses for the birth or adoption of a child. Under prior law such a withdrawal could have been subjected to penalties, but no longer. SECURE Act section 113 amending Code Section 72(t)(2). This leniency will be available for distributions from an eligible retirement plan to an individual if made during the 1-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized. An adopted child is one who has not attained age 18 or who is physically or mentally incapable of self-support.

Pre-SECURE Act Rules Continue to Apply

Under prior law, if the IRA plan holder named a beneficiary who qualified as a "designated beneficiary," that beneficiary could withdraw the plan balance in annual increments over his or her life expectancy. If a trust was named as the beneficiary, the life expectancy of the oldest beneficiary of that trust could be used to determine withdrawals, if the trust met the requirements of being a conduit or so-called "see-through" trust. If the named trust did not qualify as a conduit or see-through trust, then the rules in the following paragraph would have applied.

If the beneficiary did not meet the requirements of a designated beneficiary, e.g. a non-see-through trust or the estate of the plan holder, then the funds had to be distributed over a mere 5 years if the plan holder died before their required beginning date ("RBD"). If the plan holder died after their RBD, then over the plan holder's life expectancy (which would generally be much shorter than the beneficiary's life expectancy had the beneficiary been a "designated beneficiary."). These rules continue to apply post-SECURE Act non-designated trusts.

Since the SECURE Act rules apply to IRAs inherited after 2019, it would seem that beneficiaries of those plan holders who died before 2020, would be exempt from the new 10-year rule. But they will not entirely be exempt because when the beneficiary dies the 10-year rule will then apply.

Conduit Trusts Post-SECURE ACT

A common trust used as a receptacle for plan benefits is the so-called conduit trust. This trust requires that the trustee distribute IRA or plan distributions the trust receives to the trust beneficiary right away. Prior to the SECURE Act (and for EDBs under the SECURE Act) the plan payout over life expectancy often resulted in a modest payment through the conduit trust to the beneficiary each year.

Following is an excerpt from a conduit trust provision based on language used by Interactive Legal: "*Conduit Trust Provisions…with respect to the Grantor's interest in any Retirement Benefits which are payable (either directly or by reason of the provisions above) to the Trustee thereof: 1. Each year, beginning with the year of the Grantor's death, the Trustee of such trust shall withdraw from any such Retirement Plan the Minimum Required Distribution for such Retirement Plan payable to such trust for such year, plus such additional amount or amounts as the Trustee (excluding, however, any Interested Trustee) deems advisable in the Trustee's sole discretion. All amounts so withdrawn (net of expenses) shall be distributed to the Beneficiary… free of trust... 2. The following definitions shall apply in administering these provisions relating to such trust. The Minimum Required Distribution for any year shall be, for each Retirement Plan: (a) the value of the Retirement Plan determined as of the preceding year end, divided by (b) the Applicable Distribution Period; or such greater amount (if any) as the Trustee shall be required to withdraw under the laws then applicable to such Retirement Plan to avoid penalty*."

The above illustrative provision suggests that when the 10-year SECURE Act distribution requirement applies, the trustee of a conduit trust will receive the distribution of the IRA balance and then distribute it out to the conduit trust beneficiary. This outright distribution should be a concern for many plan holders.

SECURE Act Trust Drafting Considerations

Given that the SECURE Act is so new, commentators will refine planning recommendations over time, and there is so much uncertainty in the tax system, plan holders revising estate planning documents (e.g., a revocable trust that includes conduit trust provisions for plan assets) might consider including in the revised trust a trust director (also called a trust protector). This person is often granted specified powers in the instrument to provide for flexibility (e.g., to change the situs and governing law of the trust). The same trust protector might also be given powers to modify the terms of any trust indicated to receive IRA assets. In some instances, it appears that it may be beneficial to revise governing documents to eliminate the use of a conduit trust and instead draft an accumulation trust to provide protection after the 10th year because, unlike a conduit trust, an accumulation trust is not required to distribute all plan or IRA assets received by the trust. Perhaps, the protector can be given the express power to transform a conduit trust into an accumulation trust and vice versa. In that way, if circumstances change or the preferable planning approach becomes clear, the trust protector may exercise the express authority to change these trusts. Example: Plan holder has a revocable trust that includes a conduit trust for a named beneficiary. The idea was that the beneficiary would be able to benefit from a long stretch of the payout of the IRA when the plan holder dies, and the conduit trust would provide for protection of the beneficiary from claimants or divorce as well.

After the SECURE Act, the plan holder feels that the protection of an accumulation trust may be more useful. The simple approach might be to revise the revocable trust and substitute an accumulation trust provision for the conduit trust provision. But what if the beneficiary is later disabled or subject to a chronic illness? In that case, having a conduit trust which would benefit from the life expectancy payout as the beneficiary would be an EDB. Incorporating this flexibility into the trust instrument may permit that type of change. If this type of provision is included consider whether the trust protector designated in the trust is acting in a fiduciary capacity, or whether state law requires that characterization. If so, it may be preferable to designate another person to hold these powers who expressly is not acting in a fiduciary capacity in order to facilitate that power holder to make those changes.

Conclusion

The SECURE Act includes a number of other provisions that are relevant to estate and related planning. The SECURE Act provisions discussed above are complex and many nuances and interpretations are still being considered. So, proceed with caution, but do proceed because many estate plans, trusts, and beneficiary designations will require rethinking and revision.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

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CITE AS:

CITATIONS:

[i] Calculations verified using NumberCruncher by Leimberg Information Services, Inc.