Congress Takes the Stretch Out of IRAs (and Other Retirement Assets)

January 6, 2020

Recent changes in the tax law make 2020 an ideal time to review the beneficiary designations on your retirement accounts. In particular, if you have designated a trust as your beneficiary, new legislation makes it advisable to revisit that decision to determine whether that designation is still appropriate for your estate plan.

Historically, a beneficiary who inherited a retirement account could defer income taxes (or, in the case of Roth IRAs, extend the period of tax-free growth) by taking distributions from the account as slowly as possible over the beneficiary's life expectancy. Specially designed trusts, often called "see-through trusts" or "conduit trusts," allowed certain trusts named as beneficiaries to receive the same preferential treatment. These inherited retirement accounts are often referred to as "Stretch IRAs" since the payments can be stretched over the beneficiary's life expectancy. Many of our clients have taken advantage of this type of tax planning, including by incorporating "see-through trusts" into their estate plans.

However, Congress has enacted a new law -- the SECURE Act -- that impacts much of this tax planning. Effective for accounts of individuals who die after December 31, 2019, most beneficiaries will be able to defer distributions for no more than ten years after the participant's death. The new rules apply to Roth IRAs as well as traditional IRAs and other similar retirement plan accounts.

Prior law defined two categories of beneficiaries, those who were "designated beneficiaries" (eligible for "stretch" treatment) and those who were not. The new law preserves those classifications, changes the treatment of designated beneficiaries, and adds one additional category, "eligible designated beneficiaries." Different rules apply to each category. Prior law also made a distinction in the treatment of designated beneficiaries of inherited retirement accounts, depending on whether the participant died before her required beginning date for taking distributions from retirement accounts or after. The new law does away with that distinction.

<u>Eligible Designated Beneficiary</u>. Under the new law, eligible designated beneficiaries are the only beneficiaries who can stretch out IRA payments for more than 10 years. The only eligible designated beneficiaries are the surviving spouse of the participant, a minor child of the participant (other minors, such as minor grandchildren, do not qualify), a disabled individual, a chronically ill individual, or an individual who is not more than 10 years younger than the participant. A minor child must take distributions within a 10-year period beginning at her age of majority. Other eligible designated beneficiaries, including a surviving spouse, may take distributions over their life expectancies.

<u>Designated Beneficiary</u>. The new law does not change the definition of a designated beneficiary. Thus, all individuals and "see-through" trusts remain designated beneficiaries. However, under the new law, all designated beneficiaries (who are not eligible designated beneficiaries) must take the funds out of the retirement account

within ten years after the participant's death. Note that the payments do not have to be spread ratably over the ten-year period. For example, all of the funds could be taken out in the tenth year to maximize deferral.

There are two types of "see-through trusts" that qualify as designated beneficiaries. The first is a "conduit trust" that passes out all of the distributions it receives from the retirement account to the beneficiaries. Certain "accumulation trusts" can also qualify. However, under prior law, we generally avoided using accumulation trusts because the rules regarding the computation of the relevant beneficiaries' life expectancies were unclear. Now, however, the beneficiaries' life expectancies will no longer be a factor in determining the payout period. Moreover, depending on how your "conduit trust" provision is drafted, it may not work under the new law, meaning payments may not be able to be delayed for the maximum ten years. Thus if you currently have an estate plan that utilizes a conduit trust solely for the intended "stretch" income tax benefits, you may wish to consider switching to an accumulation trust so that the distributed retirement assets remain in trust and benefit from any advantages of doing so (e.g., generation-skipping transfer tax planning and creditor protection).

Not a Designated Beneficiary. As under prior law, a beneficiary (such as an estate, a charity, or a trust that is not a "see-through trust") who is not a designated beneficiary must take the funds out of the retirement account within five years after the participant's death, if the participant died before she was required to begin taking distributions, and otherwise over the participant's remaining life expectancy.

Other Options. There are estate planning techniques that mimic the payment schedule of the old stretch payout from a retirement plan. One such technique is to name a charitable remainder trust as the beneficiary of the retirement account. The individual or individuals named as beneficiaries of the charitable remainder trust would receive a stream of payments for life, with any remainder passing to charity at their death. Because a charitable remainder trust is itself exempt from tax, the individual would pay income tax only as the annual payments are received.

Please contact a member of our Private Client Group if you would like to discuss potential changes to your beneficiary designations.

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