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RETIREMENT PLANNING

IRA Distributions Under the Secure Act

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Before the Secure Act (Setting Every Community Up for Retirement Enhancement Act of 2019), individual IRA beneficiaries could "stretch" required minimum distributions ("RMDs") over their lifetimes. This allowed for relatively low RMDs, continued tax deferred growth of the IRA, and often resulted in IRA account balances growing in value, even after the death of the IRA owner.

The Secure Act was passed in 2019 and became effective in 2020. The Secure Act made significant changes to the law governing IRAs and retirement plans but the changes also left some issues up for interpretation. The IRS released Proposed Regulations for the Secure Act in February 2022 which helped clarify some of the questions that arose after passage.

A summary of the new rules follows.

Required Beginning Date

The required beginning date ("RBD") is the date by which RMDs are required to start being taken from an IRA. The Secure Act increased the RBD from age 70½ to age 72. Provided the account owner has earned income, individuals can now continue making contributions to traditional IRAs after their RBD.

Distribution Payout Period

No Designated Beneficiary

If an IRA does not have a Designated Beneficiary or Eligible Designated Beneficiary (as those terms are defined below), and the account owner dies prior to the RBD, the entire balance of the deceased owner's IRA must be withdrawn within 5 years of the owner's date of death. RMDs are not required during the 5-year payout period. If the account owner dies after the account owner's RBD, RMDs can be taken based on what would have been the deceased account owner's remaining life expectancy (based on IRS tables).

Designated Beneficiary

Designated Beneficiaries must deplete an inherited IRA account by the end of the year that contains the tenth anniversary of the IRA account owner's death ("10 Year Rule"). A Designated Beneficiary is defined as "any individual designated as a beneficiary by the employee." That means any individual beneficiary will qualify as a Designated Beneficiary. Certain trusts can also be considered to be Designated Beneficiaries (see discussion below). Neither a deceased IRA owner's estate nor charities qualify as a Designated Beneficiary.

When the Secure Act was originally passed, it was believed that a Designated Beneficiary could wait until the end of the maximum ten-year payout period before taking any distributions from an inherited IRA. The Proposed Regulations clarified that would be true only if the account owner dies before their RBD.

Many practitioners were surprised by the position the Proposed Regulations took on IRA distributions after the RBD. If the IRA owner dies after their RBD, the Proposed Regulations provides that not only does the IRA have to be distributed in its entirety under the 10 Year Rule, but annual RMDs must also be taken in years one through nine of the ten-year payout period. The RMDs during the 10-year payout period must be based on the beneficiary's life expectancy.

Eligible Designated Beneficiary

The Secure Act created a new category of beneficiaries called Eligible Designated Beneficiaries. Eligible Designated Beneficiaries are the only beneficiaries entitled to take RMDs based on their life expectancy without limitation by the 10 Year Rule. Eligible Designated Beneficiaries include:

- » Account owner's spouse. A surviving spouse can maintain the IRA in the deceased owner's name and wait until the end of the year in which the deceased participant would have reached age 72 before taking RMDs. Under this option, the surviving spouse would take RMDs based on their single life expectancy. Surviving spouses also have a second unique option which is to rollover the IRA into their own name and take distributions based upon uniform life expectancy tables, provided RMDs start in the year following the account owner's death. The second option also enables the surviving spouse to name her own beneficiaries.
- » Individual who is not more than 10 years younger than the account owner.
- » Disabled or chronically ill individual. The beneficiary must be disabled or chronically ill as of the date of the participant's death. Disabled or chronically ill beneficiaries must provide proper documentation of their condition by October 31 of the year following the account owner's death.
- » Account owner's minor child. A minor child of the participant may take distributions over his or her life expectancy until they reach the age of majority (defined as age 21) at which time the remaining payments must be paid within 10 years.
- » Beneficiary of account owner who died before January 1, 2020. The beneficiary of an IRA whose owner died prior to the provisions of the Secure Act going into effect are still subject to the rules that existed prior to the Secure Act.

At the death of an Eligible Designated Beneficiary who survives the account owner, the remaining account balance is required to be paid out according to the 10 Year Rule.

Separate Accounting Can Still Provide Valuable Benefits

The use of separate accounting is still helpful when multiple IRA beneficiaries are named. A beneficiary's status is still determined as of September 30 of the year following the IRA account owner's death. If separate accounts are created and maintained for each beneficiary by December 31 of the year following the account owner's death, each beneficiary will be treated as the sole beneficiary of that account. That allows beneficiaries to avoid the negative effects of being in a class of beneficiaries with shorter payout options. For example, if an IRA names a surviving spouse, a child, and a charity as equal beneficiaries of an IRA, the use of separate accounts can allow each beneficiary to take distributions in a manner most advantageous to their own situation.

Trusts as Beneficiaries

The use of trusts as IRA beneficiaries has always been fraught with pitfalls. Prior to the Secure Act, however, significant benefits were also available when naming a trust as an IRA beneficiary. That was because the IRS permitted "see-through" treatment for individual trust beneficiaries. This means, the trust could be "looked through" and the life expectancy(ies) of individual trust beneficiaries could be used when determining eligibility for stretch-IRA treatment. See-through treatment is still available under The Secure Act but, if a trust beneficiary is a Designated Beneficiary (which will be the case for most individual trust beneficiaries), the maximum payout period will generally be ten years. This eliminates most of the life expectancy "stretch" benefits that were available by using see-through trusts prior to the Secure Act. As a result, unless an Eligible Designated Beneficiary exists, naming a trust as beneficiary of an IRA generally isn't going to provide much benefit.

See-through trusts are classified as either a conduit trust or an accumulation trust. The difference between these two types of trusts rests with how RMDs must be distributed from the trust.

Conduit Trusts

A conduit trust requires that the trustee pay out all annual RMDs to the trust beneficiaries. By limiting maximum IRA payout periods to ten years for see-through Designated Beneficiaries of trusts, rather than permitting RMDs over their lifetime, the Secure Act eliminated the potential lifetime stretch IRA benefit afforded by conduit trusts. Having said that, conduit trusts can still be used by Eligible Designated Beneficiaries of conduit trusts to take RMDs over their lifetime.

Accumulation Trusts

An accumulation trust provides the trustee with discretion whether to retain RMDs in trust or distribute them out to the trust beneficiaries. Accumulation trusts with Designated Beneficiaries are subject to the 10 Year Rule. If the trust beneficiary is an Eligible Designated Beneficiary, then distributions can be taken over the beneficiary's life expectancy. Because the maximum tax rate of 37% kicks in for trusts at only $13,451 of income (in 2022), the use of an Accumulation Trust may create unfavorable income tax consequences.

Contingent Beneficiaries

Prior to the Secure Act, if there was any potential trust beneficiary that was not considered a Designated Beneficiary, a trust might not qualify as a see-through trust and life expectancy could not be used. For example, the use of a charity as a contingent trust beneficiary could disqualify the trust from see-through status.

The Proposed Regulations have changed that analysis and now a three-tiered system is employed to determine whether a trust beneficiary qualifies for see-through status as a Designated Beneficiary or Eligible Designated Beneficiary. The first tier is comprised of trust beneficiaries who are eligible to receive trust distributions upon the account owner's death. The second tier is comprised of trust beneficiaries who are eligible to receive trust distributions only after the death of a first-tier beneficiary. The third tier is comprised of trust beneficiaries who are entitled to received trust distributions after the death of a second-tier beneficiary. When determining whether a trust qualifies as a Designated Beneficiary or an Eligible Designated Beneficiary, the following checklist is used:

- First-tier beneficiaries will always be considered.
- Third-tier beneficiaries are always disregarded. For example, if a charity is listed as a remote contingent beneficiary, the trust can still qualify for see-through treatment.
- For a conduit trust, second-tier beneficiaries are disregarded.
- For an accumulation trust, second-tier beneficiaries generally count.

Special Needs Trusts

As was mentioned, disabled or chronically ill individuals are classified as Eligible Designated Beneficiaries. This permits them to take RMDs based on their life expectancy. However, in order to receive government benefits, a disabled person is limited in the amount of income they can receive and the amount of assets they can own. If RMDs are paid directly to a disabled person, it will likely disqualify them from receiving government benefits. The use of a special needs trust allows a disabled person to qualify for government benefits while still being able to use trust funds for certain expenses.

The question then arises, does the use of a special needs trust, in lieu of directly naming a disabled or chronically ill person as the IRA beneficiary, allow for RMDs to be made based on the life expectancy of the disabled trust beneficiary? Fortunately, the answer is yes. The Secure Act created a new type of trust called an "applicable multi-beneficiary trust," or AMBT. An AMBT can make distributions only to the disabled or chronically ill trust beneficiary while they are alive. If this condition is satisfied, the use of the life expectancy payout option is allowed.

Failure to Take RMD in 2021 or 2022

The Designated Beneficiary section above referenced the belief by many, prior to the issuance of the Proposed Regulations in February 2022, that beneficiaries subject to the 10 Year Rule would not have to take any distributions prior to the ten-year anniversary of the decedent IRA owner's death. After the Proposed Regulations were issued and it was discovered that RMDs did have to be taken during the ten-year payout period for certain decedent IRAs, commentators expressed concern to the IRS because it subjected taxpayers who had failed to take RMDs to an excise penalty equal to 50% of the amount of the RMD that should have been taken. In response, the IRS recently issued Notice 2022-53. The Notice states that no excise penalty will be imposed on RMDs that were not taken from inherited IRA accounts in 2021 and 2022 due to the confusion about this issue.

Roth IRAs

Roth IRAs are not subject to RMDs while the account owner is alive. This allows for continued tax-free growth after age 72. The Proposed Regulations also provide that all Roth IRA owners are considered to have died before their RBD. That means Designated Beneficiaries of Roth IRAs will not be required to take RMDs within the 10-year payout period. For Designated Beneficiaries, that provides another 10 years of tax-free growth after the account owner passes. The tax-free nature of Roth IRA distributions also eliminates the problem of pre-RBD Designated Beneficiaries waiting until year 10 to take a single lump sum distribution of IRA account balances causing their income to go into the highest income tax bracket in Year 10. For accumulation trusts, the tax-free nature of Roth IRA distributions does not trigger tax issues when a distribution is taken from the IRA . However, if the Roth IRA proceeds remain invested in the accumulation trust, the income generated by the reinvested proceeds will still likely trigger most accumulation trusts to fall into the maximum income tax bracket of 37% (currently at $13,451 of trust income).

Where Do Things Go From Here

The Secure Act is clearly designed to curtail the use of stretch IRA planning in most situations. Although the Proposed

Regulations cleared up some questions about how the Secure Act would be implemented, they are not final regulations. In Notice 2022-53, the IRS stated that they are working on final regulations for the Secure Act, but they would not be effective any earlier than 2023. The likelihood is that the Proposed Regulations will remain largely intact. Decisions about IRA beneficiaries should be made with that in mind. The 10 Year Rule that applies to Designated Beneficiaries makes Roth IRA conversions an even more attractive alternative to consider in many situations.

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