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PCA Planning Commentary

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The SECURE Act - Part One

"Nothing is sure but death and taxes"

Note: This is the first of a three-part overview of the SECURE Act. Part 1 focuses on the changes to IRA distribution planning that will impact many individuals' family income and estate tax planning strategies. Part 2 will provide an overview of the benefits individuals may receive as a result of the act, and Part 3 will review changes that impact employers who seek to provide valuable retirement benefits for employees.

Who Needs This Information the Most?

This summary covers many of the important provisions of the newly passed legislation known as the SECURE Act. If you are wondering if the new law may impact your situation – do you fall into one of these categories?

- Individuals with large IRA balances ($1 million or greater), where the estate plan for those accounts had been to provide a long-term "stretch" payout for children and grandchildren.
- Individuals who will soon have large IRA balances, or whose IRA balances have time to grow
- Widows or Widowers with large IRA balances
- Individuals who have named a trust as a primary or contingent beneficiary of their IRA
- A parent or grandparent who is funding child or grandchild's college education

If none of these descriptions fits your situation, there are still many other areas where the SECURE Act could have an impact on you and your heirs.

Introduction

The $1.4 trillion spending package enacted on December 20, 2019, included the Setting Every Community Up for Retirement Enhancement (SECURE) Act, which had overwhelmingly passed the House of Representatives in the spring of 2019, but then subsequently stalled in the Senate. The SECURE Act comes just 2 years after the 2017 Tax Cuts ad Jobs Act – and results in a paradigm shift for those individuals whose retirement accounts make up a significant part of their estate planning.

Major Changes for Retirement Accounts

Elimination of the "stretch IRA"

While many of the provisions are good news for individuals and small business owners (to be discussed in Part 2), there is one notable drawback for investors with significant assets in traditional IRAs and retirement plans. These individuals should revisit their estate-planning strategies to prevent their heirs from potentially facing unexpectedly high tax bills.

The SECURE Act brings the elimination of longstanding provisions allowing non-spouse beneficiaries who inherit traditional IRA and retirement plan assets to spread distributions — and therefore the tax obligations associated with the distributions — over their lifetimes. This ability to spread out taxable distributions after the death of an IRA owner or retirement plan participant, over what was potentially such a long period of time, was often referred to as the "stretch IRA" rule.

The "Stretch-IRA" is "DOA":

- **Prior to SECURE Act:** With the life expectancy of a 45-year-old son or daughter being 38.8 years, or that of a grandchild or greatgrandchild being potentially over twice that length of time, this estate plan used for clients' retirement accounts was simple and popular.
- **After SECURE Act:** Now the 45-year old son or daughter who inherits Parent's IRA will have to withdraw the entire account within 10 years after Parent's death – meaning income taxes will be paid much sooner, and potentially at a higher rate.

- The new law generally requires any eligible designated beneficiary who is more than 10 years younger than the account owner to liquidate the account within 10 years of the account owner's death unless the beneficiary is a spouse, a disabled or chronically ill individual, or a minor child (See discussion concerning type of beneficiary below.).

The Type of Beneficiary Determines the Maximum Distribution Period
With the passage of the SECURE Act, there are now three categories of beneficiaries:

1. **Beneficiary who is not a designated beneficiary** (the participant's estate, a charity, or a trust that does not qualify as a "see-through" trust): 5-year rule for beneficiaries of a participant who died before his Required Beginning Date (RBD), or the participant's remaining life expectancy if participant died on or after RBD. (As part of the SECURE Act, the RBD is now moved to April 1 following the year the participant turns age 72.)

2. **Designated beneficiary** (individuals or see-through trust): Unless "eligible" (next category), a designated beneficiary must withdraw benefits within 10 years after the participant's death.

3. **Eligible designated beneficiary**: The following designated beneficiaries are still entitled to (a modified version of) the life expectancy payout method:

- **The surviving spouse** can still use the life expectancy payout.
- **Minor child of the participant.** The life expectancy payout applies to a child of the participant who has not reached the age of majority.
- **Disabled beneficiary.** The life expectancy payout applies to a designated beneficiary who is disabled.
- **Chronically ill individual.** The life expectancy payout applies to a designated beneficiary who is chronically ill.
- **Less than 10 years younger beneficiary.** The life expectancy payout applies to an individual who is not more than 10 years younger than the participant.

10-Year Payout Eventually Applies: At the death of the surviving spouse, disabled beneficiary, chronically ill individual, or beneficiary who is less than 10 years younger – the 10-year payout requirement applies. Also, when the minor child beneficiary attains age of majority, the 10-year payout requirement applies.

"See- Through Trusts"

Generally, two types of trusts may qualify as see-through trusts, "conduit trusts" (which automatically qualify) and "accumulation trusts" (which may or may not qualify).

- Under a conduit trust, all distributions made from the retirement plan to the trust during the lifetime of the beneficiary of the trust must be distributed immediately to the individual beneficiary.
- With an accumulation trust, the trustee can accumulate retirement plan distributions in the trust during the lifetime of the initial beneficiary(ies) for possible later distribution to another beneficiary. All beneficiaries who might ever be entitled to receive such accumulations are "counted" as beneficiaries for purposes of applying the minimum distribution rules, (except that a beneficiary who is a "mere potential successor" to another beneficiary is disregarded). If any "countable" beneficiary of an accumulation trust is not an individual (for example a charity), the trust does not qualify as a see-through.

So Now What Do We Do?

In addition to possibly reevaluating beneficiary choices, it may make sense to once again consider converting traditional IRA funds to Roth IRAs, which can be inherited income tax free. Although Roth IRA conversions are taxable events, investors who spread out a series of conversions over the next several years may benefit from the lower income tax rates that are set to expire in 2026.

Roth Conversions – It's more than just the numbers

- For older individuals, the amount of the time the ROTH has to grow tax-free is limited, particularly, in light of the fact that the SECURE Act was just passed – reducing the amount of time that IRA can stay intact for beneficiaries to 10 years after the death of the owner.

- There are often significant income taxes due upon a Roth Conversion, and if the IRA owner pays the taxes using money from the IRA that was converted, he/she will lose the potential benefits of tax-free growth on that amount. This significantly reduces the effectiveness of the conversion.

- As we write this (Jan. 2020) we could be at the peak of a market cycle, meaning that you run the risk of converting, paying the tax, and then seeing the account values significantly reduced by market volatility. A recharacterization back to a traditional IRA is no longer be available.

- Congress could change the law (again) taking away or at least modifying the tax benefits of the Roth IRA. While we do not see this on the horizon, it is at least a consideration.

For many people with large retirement accounts, their estate plans may not accomplish what they had intended – that is, spreading the income tax liability over their children's lifetimes. Following are some considerations for estate plans where retirement benefits are intended to benefit individuals:

- If the individual's chosen beneficiary is an Eligible Designated Beneficiary, the individual's existing plan will probably continue to work, with some changes possibly being required to accommodate the SECURE Act. However, the 10-year distribution requirement will eventually apply to that beneficiary (or his/her beneficiary).

- An individual who simply leaves his IRA outright to various individuals (e.g. his adult children) may have nothing to change. The children will have to pay taxes sooner than was previously expected, and that in turn may mean the taxes will be higher than if more spread out. A conversion to a Roth IRA during the owner's lifetime may be considered, but for the reasons already discussed, that consideration should be undertaken with great care.

- Accumulation trusts can still work - the trustee may determine the how fast or slow the amounts are distributed to beneficiaries. However, the trustee will be faced with a substantially accelerated tax bill, since all benefits must be distributed from the plan to the trust within 10 years, and the trust tax brackets graduate much more quickly than brackets for individuals. There are very limited options to avoid that tax bill, so one may consider the role of Life Insurance to provide liquidity for this need.

- Conduit trusts are now problematic. The IRA owner had been planning for his/her children to receive the remaining IRA balance over their lifetimes, at potentially very low tax brackets. Now, the beneficiary is faced with a 10-year payout requirement. The IRA owner may want to switch to naming an accumulation trust as beneficiary, despite the accelerated taxes at high trust rates, or consider coordinating the retirement plan beneficiary designation with a charitable remainder trust as part of his overall estate plan.

- Charitable Remainder Trusts (CRTs) may have more appeal now for an individual who has charitable intent and a desire to leave a lifetime income stream to the beneficiary rather than a 10-year payout taxed at high rates. Traditional retirement benefits can be paid income tax-free into the CRT, which then pays a lifetime

Terra (Somewhat) Incognito

The IRS has yet to release regulations on the provisions of the SECURE Act. As with any new legislation, there are and will be questions about how specific provisions apply to unique situations, and to what extent the IRS' and tax practitioners' opinions on the accuracy of the application may differ.

Uncertain at this time is how the SECURE Act will apply to trusts with multiple beneficiaries. For example, at death, an IRA owner leaves his $1 million IRA to a conduit trust for his three minor children. If he left the IRA in equal shares to three separate conduit trusts, one for each child, each child's trust would be entitled to the life expectancy payout, changing to the 10-year rule as each child reached majority. If all three children are beneficiaries of the same trust, it is not certain this is the case.

Conclusion

The recently passed SECURE Act brings many benefits to both individuals and employers. However, as a means of funding the $1.4 trillion spending package, Congress has curtailed the ability for most individuals to defer paying income tax on their retirement accounts over the lifetime of their beneficiaries. Taxes will be due sooner, and in many cases, at a higher rate. The Act makes profound changes to retirement, education, and estate planning. Individuals and business owners should seek the advice of their professional financial and tax planners to ensure they make any necessary adjustments to accommodate the latest changes to tax legislation.

Please contact the financial planning team at Pallas Capital Advisors to discuss the SECURE Act or any other aspect of your financial planning objectives.

2002 Life Expectancy Tables - Time for Change?

- An individual's Required Minimum Distributions (RMD) are based on life expectancy tables that were developed using mortality rates in 2002. In August 2018, President Trump signed an executive order directing the IRS to examine the life expectancy tables and determine if they should be updated.

- Life expectancies have increased since 2002, and in early
- November 2019 the IRS issued proposed regulations with new, updated life expectancy tables. The tables would reduce RMDs accordingly.

- The new life expectancy tables would apply to all accounts that have RMDs, including IRAs, employer retirement plans (especially 401(k)s), annuities and more.

- The public has an opportunity to comment on the proposed regulation. The IRS then reviews the comments and makes any changes it deems appropriate.

- Although subject to change, the IRS expects that the proposed tables will be effective for distribution calendar years that begin on or after January 2, 2021.

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