Ringing in the New Year with Changes to Retirement Plan Benefits

Effective January 1, 2020, the Setting Every Community Up for Retirement Enhancement (SECURE) Act implements a number of new rules for retirement savings plans. Most notably, the SECURE Act makes changes to the Required Minimum Distribution (RMD) age for traditional IRAs, repeals the maximum contribution age for traditional IRAs, and eliminates the tax efficient "stretch" rules on qualified plans for nearly all non-spousal beneficiaries.

INCREASES THE RMD AGE TO 72

IRA owners younger than age 70 ½ on December 31, 2019 will now have until age 72 to take their first RMD. This will allow for an additional period of growth in a traditional IRA before the account owner must begin drawing down the account based on life expectancy. For account owners older than age 70 ½ on December 31, 2019, there is no change to the RMD age. There is also no change for ROTH IRA account owners, as no distributions are required from ROTH IRAs during the account owner's lifetime.

NO MAXIMUM TRADITIONAL IRA CONTRIBUTION AGE

The contribution age limit of 70 ½ is now repealed, allowing workers of any age with earned income to contribute to a traditional IRA. For 2020, the traditional IRA contribution limit is $6,000 (with an additional $1,000 contribution permitted for those 50 and older).

ELIMINATION OF THE "STRETCH" RULES FOR NON-SPOUSAL BENEFICIARIES AND IRREVOCABLE TRUSTS

Under prior law, RMDs for qualified plans (including IRA, ROTH IRA, 401K, 403(b), 457(b) ESOPs and 401(a) plans) could be "stretched out" over a beneficiary's life expectancy for spouses, individuals, and qualifying see-through trusts. For plan owners passing after December 31, 2019, the Act eliminates the tax efficient "stretch out" for all but a small subset of beneficiaries, defined as "Eligible Designated Beneficiaries." Eligible Designated Beneficiaries include: (1) spouses, (2) minor children of the account owner, (3) disabled or chronically ill individuals, and (4) persons less than 10 years younger than the account owner. Thus, while a surviving spouse will still be able to stretch out distributions over the spouse's life expectancy (or roll the deceased spouse's qualified plan into an IRA for the surviving spouse), all other beneficiaries not qualifying as an Eligible Designated Beneficiary (which would include healthy adult children and irrevocable trusts) will have to withdraw 100% of the qualified plan by the 10th calendar year following the plan owner's death. This withdrawal can occur at any time within the 10-year payout period; no annual distributions are required.

EXAMPLE

John Smith names his granddaughter, Sarah age 21, as the beneficiary of his qualified plan. Under prior law, Sarah would have been able to stretch out the minimum distributions from that plan over her life expectancy of 62 years. Under the Act, Sarah will have to withdraw the entire balance within 10 calendar years after John's passing. Assuming a $3,000,000 account balance and equal distributions in years 1-10, Sarah will add $300,000 worth of taxable income to her tax liability each year.

For those families that sought to combine the tax efficiency of the stretch payout with the asset protection benefits of naming an irrevocable trust as the beneficiary of the qualified plan, the Act presents additional considerations.

QUALIFICATION AS A SEE-THROUGH TRUST

Irrevocable trusts that qualify as a "see-through trust" receive the same treatment as individual beneficiaries for determining the maximum time period for distributions. To meet the see-through qualifications, planners traditionally incorporated very specific language in trusts directing that assets "eligible for a life expectancy payout" be held in either a conduit trust or an accumulation trust. A conduit trust is one that directs distributions outright to the beneficiary, with the income tax liability passing to the beneficiary. An accumulation trust is one that directs the Trustee to hold all distributions in the trust, with the income tax liability remaining with the trust. As life expectancy payouts are now only available to Eligible Designated Beneficiaries, trusts for children and grandchildren should be reviewed to ensure that the appropriate language is included to provide for the maximum 10-year payout. Without the appropriate language in the trust document, the qualified plan must be paid out in 5 years (or the plan owner's remaining life expectancy if the owner died before taking RMDs). For this reason, estate plans should be carefully reviewed by counsel to confirm that distributions from qualified plans with irrevocable trusts as a beneficiary are directed to qualifying see through trusts that will allow for the maximum distribution period applicable to the named beneficiaries.

EXAMPLE

John's qualified plan names an Irrevocable trust for the benefit of his granddaughter, Sarah, as the beneficiary. Unless the appropriate language is included in the trust, the entire plan must be paid out within 5 years.

TAX PLANNING OPPORTUNITIES WITH TIMING OF RMD

Since the only distribution requirement for qualified plans passing to non-Eligible Beneficiaries is that the entire plan be paid out prior to the end of the 10th calendar year following the plan owner's passing, the timing of distributions within that 10-year period may provide tax planning opportunities.

EXAMPLE

John's qualified plan names a Trust for the benefit of his granddaughter, Sarah, as the beneficiary. The Trustee coordinates with Sarah to distribute out the entire plan to her while she is in medical school, as she will be in a lower tax bracket as a student.

10 YEAR TIME PERIOD PRESENTS ASSET PROTECTION CONCERNS

Under prior law, the ability to stretch out distributions over a beneficiary's life expectancy meant that each year only a small portion of the plan balance would be distributed. Now that the distribution period for all non-Eligible Beneficiaries has been shortened to a maximum of 10 calendar years following the plan owner's passing, greater asset protection considerations arise. For this reason, it is worthwhile to consider naming an accumulation trust as the beneficiary of qualified plans for all Non-Eligible Designated Beneficiaries. Allowing the Trustee to accumulate the distributions in the trust provides for post-distribution control of these funds, potentially shielding the entire account value from creditor or marital claims.

EXAMPLE

John names his granddaughter, Sarah, as the direct beneficiary of his qualified plan. Sarah decides to delay taking any distributions from the plan until the 10th calendar year following John's passing. Just as the entire plan balance is being paid outright to her, Sarah's spouse files for divorce. The proceeds may now become an available asset in the divorce proceeding. Had John named an accumulation trust for Sarah's benefit as the beneficiary of the qualified plan, the Trustee would have had the discretion to retain the entire plan balance in the Trust and protect it from such claims.

NO CHANGES TO GRANDFATHERED PLANS

There will be no change for those beneficiaries (and trusts) already receiving RMDs based on the prior "stretch out" rules, as these beneficiaries will be permitted to base the distributions based on their life expectancies. The Act, however, does require that when those "stretch out" beneficiaries pass, the limitations of the 10-year period would apply for the remainder beneficiaries of those inherited plans.

QUALIFIED CHARITABLE DISTRIBUTIONS STILL AVAILABLE

The Act makes no changes to the regulations regarding qualified charitable distributions. Account owners retain the right to direct up to $100,000 a year of their RMDs directly to qualified charities (of which donor advised funds and private foundations do not qualify). The Act does, however, provide limitations on charitable deductions in the event that tax deductible contributions are made to the IRA after age 70 ½. Additionally, the Act makes no changes to the regulations regarding a qualified charity as the beneficiary of a qualified plan.

We recommend that your current beneficiary designations on all qualified plans be reviewed to confirm whether these designations still meet your planning intentions under the SECURE Act. Please reach out to a member of your Biltmore Family Office relationship team to discuss how these important changes may impact your estate plan.

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