IPB Tax, Trusts & Estates
NEWSLETTER

Retirement Account Planning Under the SECURE Act

The Setting Every Community Up for Retirement Enhancement (SECURE) Act, effective January 1, 2020, changed the landscape of retirement planning. Among its many modifications are: (i) allowing retirement contributions to continue until age 72, (ii) delaying required minimum distributions (RMDs) from age 70 ½ to age 72, and (iii) largely eliminating the "Stretch IRA" that deferred taxation of inherited accounts over a non-spousal beneficiary's lifetime. The following FAQ offers approaches to managing the tax and other consequences of the new law:

- Application of RMD Rules
- Time Frames for Distributions
- Trusts Named as Beneficiaries
- Contributions to a Charity
- Strategies for Roth Accounts

The new rules mean that plan sponsors, IRA account owners and participants in retirement plans have decisions to make. For example, the combination of the SECURE Act changes along with stock market volatility may make Roth conversions and contributions to Roth 401(k) plans even more desirable. Plan sponsors may wish to consider making plan design changes to benefit their participants, such as allowing in-plan Roth conversions of pre-tax 401(k) contributions or after-tax contributions, and/or permitting trusts as designated beneficiaries. IRA account owners and retirement plan participants should review beneficiary designations, and understand how trusts and charitable contributions could be used to manage income tax liability.

Our Benefits & Compensation and Estate Planning attorneys are available to answer questions about the SECURE Act's changes to retirement accounts.

APPLICATION OF RMD RULES

NOTE: Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted March 27, 2020, qualified defined contribution plans (401(k) and 403(b) plans) and IRAs are not required to make RMDs in 2020. If an RMD has already been made for 2020 from a retirement plan, it can be treated as an eligible rollover distribution and rolled over to an IRA within 60 days. This relief is not limited to accounts held by those affected by coronavirus. The strategies discussed in this section will continue to apply after the RMD relief of the CARES Act expires.

Q: Under the new RMD rules, how can I avoid an RMD in my 401(k) plan?

If you are employed, you may be able to delay an RMD under your current employer's 401(k) plan even beyond age 72. This is because most 401(k) plans allow participants to defer an RMD until April 1st following the *later* of the year in which the participant reaches age 72 or terminates employment. (Note that this deferral strategy does not apply to 5% owners of the business.) If you maintain a 401(k) plan account at a prior employer, it usually may be rolled over into your current employer's plan to delay the RMD in the same manner. This rollover would need to occur before January 1 of the year in which you reach age 72.

Q: How do the RMD rules apply to my Roth 401(k) balances?

This is a tricky one. Although a Roth IRA is exempt from the RMD rules, Roth contributions in a 401(k) account are not. Consider withdrawing these Roth funds from the 401(k) plan prior to retirement and rolling them over into a Roth IRA. This will exempt them from RMDs altogether. Alternatively, treat the Roth 401(k) assets like the rest of your 401(k) plan assets, and defer RMDs until termination of employment (or age 72 if later).

Q: What about avoiding an RMD in my Individual Retirement Accounts?

Your traditional IRA. If you plan to work beyond age 72 and want to avoid RMDs in all IRAs, consider rolling over your pre-tax traditional IRA into your current employer's 401(k) plan as well. This will enable you to delay RMDs until you terminate employment with your current employer. Similar to a rollover from a prior employer's 401(k) plan, this rollover needs to occur before January 1 of the year in which you reach age 72. Another idea is to convert to a Roth IRA, as discussed in "Strategies with Roth Accounts."

Your Roth IRA. Easy! Roth IRAs are exempt from RMDs. No action needed.

TIME FRAMES FOR DISTRIBUTIONS

Q. *What are the new time frames for taking distributions from an inherited IRA?*

A spousal beneficiary may still take distributions from an inherited IRA over the spouse's life expectancy. A non-spousal beneficiary, with certain exceptions and depending on plan rules, will now have to withdraw the entire account balance no later than the end of the calendar year in which the 10th anniversary of the owner's death occurred. The distributions may be taken on a regular basis, such as monthly or annually, in episodic payments, or as a lump sum at the conclusion of the 10-year period. This is known as the 10-year rule. The same requirements apply for taking distributions from a 401(k) account following the participant's death.

Q: *How can I preserve the "Stretch" feature following the death of both my spouse and me?*

Many account owners name their spouses as the beneficiaries of their 401(k) accounts and IRAs. In blended families, however, this is not always the case. Under ERISA rules, a 401(k) account owner must obtain consent from a spouse to name someone else as the account's beneficiary (even when the beneficiary designation was made before the marriage). Consent may also be required for certain IRA accounts (e.g., in community property states). While a surviving spouse may stretch distributions over his/her life expectancy, the only opportunities for preserving the stretch upon death are to name one or more of the following as beneficiary:

- A disabled or chronically ill individual (or certain trusts for such person);
- A beneficiary no more than 10 years younger than you; or
- Your minor child (but not grandchild) until the age of majority.

The same SECURE Act changes generally apply to 401(k) plans as well. In some cases, however, the 401(k) plan document may require distributions to beneficiaries within five years. It's important to check the plan terms before modifying your beneficiary designation.

Q. *How does the 10-year rule affect a beneficiary's income tax liability?*

Under prior law, a beneficiary of a traditional IRA or 401(k) plan paid income tax on distributions made during a given year at the individual's ordinary income tax rate for that year. For distributions based on life expectancy, the income tax burden was spread over the beneficiary's lifetime. Now a non-spousal beneficiary must pay 100% of taxes due on the account value within the 10-year time frame (also at ordinary income tax rates), unless an exception to the 10-year rule applies. The 10-year rule has effectively reduced the income tax deferral planning opportunities. For accounts with larger values, the shortened withdrawal window may also result in higher marginal income tax rates.

Q. *Does timing distributions based on tax brackets provide benefits under the new 10-year rule?*

Possibly. It depends on the account's value, how the account is invested, the existence (or lack) of state income tax, and the beneficiary's total income from all sources. For example, a beneficiary of an inherited account could take annual distributions that do not push total income above a certain bracket, such as the 32% tax bracket. At the end of 10 years, the beneficiary may have preserved more of the account's value than if he/she had (i) taken a lump sum withdrawal immediately upon the account owner's death, or (ii) waited to take all distributions at the end of 10 years.

TRUSTS NAMED AS BENEFICIARIES

Q. Can a trust for a non-spousal beneficiary be named to hold the retirement account?

A retirement account may be made payable to a trust, the terms of which allow the Trustee to elect to treat the trust as either a "conduit trust" or an "accumulation trust" (when the plan sponsor or IRA custodian permits a trust to be a beneficiary). Whether this is desirable depends on the circumstances at the time of the account owner's death (the account's value, the ages of the beneficiaries, and in the case of traditional IRAs and 401(k) plans, the beneficiary's income tax situation). Under either type of trust, the entire account will have to be distributed out to the trust within 10 years and in the case of a conduit trust, further distributed out to the beneficiary within that timeframe.

Q. Which kind of trust is preferable?

An accumulation trust may be preferable, especially if there's a minor beneficiary. Unlike for a conduit trust, the Trustee is not required to distribute the balance of the account outright 10 years after the beneficiary reaches the age of majority. An accumulation trust allows the trust to pay taxes at the end of the 10-year period, rather than requiring the individual beneficiary to receive all assets and pay all taxes within that time frame. The disadvantage of this structure is that income tax on a trust starts at $2,600, and the highest tax bracket of 37% kicks in at $12,950 of ordinary trust income. A trust which will hold a retirement account should be drafted with as much flexibility as possible to allow the Trustee to mitigate the overall impact of income taxes.

CONTRIBUTIONS TO A CHARITY

Q. What are the considerations when the account owner wishes to bequeath assets to charity?

Of all the different assets a person might own and wish to give to charity, traditional IRA and 401(k) accounts have always been excellent candidates. That is because the income tax liability inherent in an account disappears when that account passes to charity. Given the loss of the stretch feature, charitably inclined individuals have an even greater incentive to name a charity as the beneficiary of a retirement account and give more income-tax-efficient assets to family members instead.

For those who don't mind a more complex solution, a testamentary charitable remainder trust (CRT) can be used to split the benefit of the account between a family member and a charity. The CRT owns the account and makes annual distributions to the named family member. These distributions are calculated based on the beneficiary's life expectancy or the term of the trust, as applicable. The CRT does not owe income tax on the account assets, and income earned within the trust is not taxed. This allows assets from the retirement account to continue to grow tax-deferred beyond the 10-year time period allowed under the SECURE Act.

Q. Can a retirement account be used for charitable contributions during lifetime?

Yes. An owner of a traditional IRA who has reached age 70½ may make Qualified Charitable Distributions (QCD) during the owner's lifetime. This allows the owner to direct up to $100,000 a year of RMDs to a nonprofit organization, other than a donor advised fund or private foundation. A QCD is paid directly to the charity, does not become part of the account owner's taxable income, and counts toward the RMDs for the year. Note, however, that if an owner makes any contributions to the account after age 70 ½, those contributions will reduce the amount of his/her account that can be paid to a charity as a QCD.

STRATEGIES FOR ROTH ACCOUNTS

Q: Should I be making contributions to a 401(k) plan or to a Roth 401(k) plan?

It depends on your individual circumstances. A Roth 401(k) contribution offers two attractive features compared to a "pre-tax" contribution to a 401(k) plan:

- Because a Roth 401(k) contribution is made with "post-tax" dollars, this approach allows you to maximize the amount available to your heirs on a tax-free basis. Distributions of principal and earnings will not be subject to income tax. This is the case regardless of whether you take distributions during your lifetime or leave the account to your beneficiaries after your death (and assuming the five-year holding period has been satisfied).
- Although Roth 401(k) assets are subject to the RMD rules, these funds can be rolled over to a Roth IRA, which is exempt.

Q. Are there any other strategies to reduce income tax liability under the SECURE Act?

Yes. While all 401(k) accounts payable to a non-spousal beneficiary must be fully distributed according to the 10-year rule, the beneficiary receiving Roth 401(k) assets does not have to pay income tax on account distributions. Therefore, an account owner may do a Roth conversion of traditional IRA or pre-tax 401(k) assets and pay the taxes upon conversion to eliminate the beneficiary's income tax liability. The desirability of this strategy depends on (i) the account owner's income tax bracket, (ii) the beneficiary's income tax bracket, (iii) the value of the account, and (iv) the existence of sufficient funds outside of the traditional retirement account to pay the income tax due. A Roth conversion is more desirable during times of market volatility because when the account's value decreases, the income tax burden decreases as well. While some plan sponsors allow an in-plan Roth conversion of pre-tax 401(k) assets, others do not. Given stock market volatility in 2020, some plan sponsors may want to consider adding an in-plan Roth conversion feature to 401(k) plans this year.

Please contact us with any questions.