NORTHERN TRUST

# CHECK THE TECHNIQUE: PROTECTING LEGACIES UNDER THE SECURE ACT

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The Setting Every Community Up for Retirement Enhancement Act of 2019, otherwise known as the SECURE Act, is the most comprehensive reform to the retirement landscape in years. Over the past three decades, retirement plan assets have amassed to nearly $25 trillion, accounting for over a third of all household financial assets. Planning with retirement assets to align with family priorities and financial goals, including tax management, differs under the new rules. Notable changes under the SECURE Act include –

- Opportunity for tax-minimized saving for retirement is enhanced, and
- Opportunity to stretch payouts to beneficiaries after the death of the account owner is diminished.

Now is the time to review retirement account savings, beneficiary designations and account payouts to assure that benefits for the account owner and beneficiaries are optimized.

If you are a business owner, review the new law with your company benefit advisors to align company plans with the new law.

If you are an executive or other retirement saver, learn how the new law affects your retirement savings options.

If you are a surviving spouse, know whether the SECURE Act impacts retirement account payouts to you and your beneficiaries.

If you intend to pass retirement account benefits on to children or grandchildren at your death, be aware of the new rules which may accelerate beneficiary payouts.

In all instances, confer with your financial, legal and tax advisors to update your retirement savings, gift and estate plans in light of the SECURE Act.

## WHAT HAS CHANGED FOR LIFETIME RETIREMENT SAVINGS?

The SECURE Act enhances the accessibility of workplace retirement accounts. For business owners, these changes are evident in the tax incentives for setting workers up with automatic enrollment in retirement plans, allowing workers an opportunity to join multiple employer plans, and making retirement plans available to long-term part-time workers with a decrease to the minimum number of hours worked.

The SECURE Act also provides for greater individual retirement savings. The 70 1/2 age limit on deductible contributions to traditional individual retirement accounts (IRAs) is eliminated beginning January 1, 2020. Now, traditional IRA contributions are allowed as long as an individual (or their spouse) receives compensation.

In addition, age 72 is the new 70 ½ for required minimum distributions. For individuals born on or after July 1, 1949, who turn 70 ½ after December 31, 2019, the age for taking required minimum distributions from traditional accounts is increased from 70 ½ to 72. However, those individuals born before July 1, 1949 are subject to the old required minimum distribution (RMD) rules requiring distributions after reaching 70 ½.

Qualified charitable distributions (QCDs) from traditional IRAs to qualified charities are still permitted beginning at age 70 ½. However, in order to prevent "double-dipping," there is an offset for individuals who both contribute to their IRAs and make qualified charitable distributions.

### Highlights of the SECURE Act:

- If you work part time you may become eligible to contribute to your employer's 401(k) plan.
- New parents who recently had a baby or adopted a child can take penalty-free withdrawals of up to $5,000 from their retirement accounts.
- You may now make deductible contributions to a traditional individual retirement account (IRA) for as long as you continue to work, no matter your age.
- If you were born on or after July 1, 1949, traditional retirement account required minimum distributions (RMDs) may be delayed to age 72.
- Qualified charitable distributions may still be made from IRAs to qualified charities for account owners age 70 ½ and over.
- Naming your surviving spouse as beneficiary of retirement accounts remains a viable option for flexibility and extended payouts.
- Most non-spouse beneficiaries are generally required to take full payout of retirement accounts no later than the end of the tenth year following the year of the account owner's death.
- If you name a trust as the beneficiary of your retirement account after your death, in many instances the new 10 year payout rule will apply and "stretch" payout over a beneficiary's life expectancy will not be available.

| Provision | Pre-SECURE Act (Old) | Post-SECURE Act (New) |
|---|---|---|
| Maximum Age for Making Traditional IRA Contributions | Individuals must be under age 70 ½ to make a deductible contribution to a traditional IRA | No age limit on deductible contributions to a traditional IRA |
| Age for Taking Required Minimum Distributions from Traditional Retirement Account | Generally, RMDs must start on April 1 of the calendar year following the year in which the individual turns 70 ½ | Generally, RMDs must start on April 1 of the calendar year following the year in which the individual turns 72 |
| Qualified Charitable Distributions | Individuals may exclude up to $100,000 per year of QCDs from an IRA from tax upon attaining age 70 ½ | QCDs may still be made on or after age 70 ½, but if an individual also makes deductible traditional IRA contributions on or after age 70 ½, the income exclusion from the QCD is reduced by the excess of the IRA deduction allowed for all taxable years ending on or after age 70 ½ over the amount of all prior year reductions |
| Withdrawals for New Parents | Withdrawals from an IRA or 401(k) before reaching age 59 ½ is generally subject to income tax and a 10% penalty | The early-withdrawal penalty generally still applies, but the SECURE Act now allows individuals who just had a baby or adopted a child to take a withdrawal of up to $5,000 from their IRA or 401(k) without the 10% penalty |

## WHAT HAS CHANGED FOR BENEFICIARY PAYOUTS?

Under the SECURE Act there are now three (instead of two) categories of beneficiaries –

- **Non-designated beneficiaries (NDBs)** – beneficiaries without a measurable life expectancy, such as estates, charities and trusts that do not satisfy the "see-through" rules ("see-through trusts")
- **Eligible designated beneficiaries (EDBs)** – a limited class of individuals, including a surviving spouse, minor child of the account owner, disabled or chronically ill beneficiary and a beneficiary not more than 10 years younger than the account owner, and (subject to further guidance from the Internal Revenue Service), specialized see-through trusts
- **Designated beneficiary (DB)** – an individual beneficiary who is not an eligible designated beneficiary, such as an adult child, and see-through trusts

The identity of the beneficiary determines the payout period for the account after the death of the account owner.

| Beneficiary Status | Pre-SECURE Act (Old) | Post-SECURE Act (New) |
|---|---|---|
| Non-designated Beneficiary | • If the account owner dies before his or her required beginning date (RBD), the 5-year payout rule applies and the NDB is required to withdraw the entire account by the end of the year of the fifth anniversary of the account owner's death<br>• If the account owner dies on or after their RBD, the NDB may withdraw the balance over the account owner's remaining life expectancy | The SECURE Act does not change the rules applicable to NDBs |
| Eligible Designated Beneficiary | Not applicable | Payouts generally may be made over the life expectancy of the EDB whether or not the account owner has reached the date on which he or she is required to take RMDs |
| Designated Beneficiaries | • If the account owner dies before his or her RBD, the DB may take payouts over his or her life expectancy<br>• If the account owner dies on or after their RBD, payment may be made over the account owner's remaining life expectancy or the life expectancy of the DB, whichever is longer | Retirement plan benefits must be distributed to a DB by the end of the tenth year after the account owner's death, whether or not the account owner has reached his or her RBD |

## WHAT HAPPENED TO THE ABILITY TO STRETCH?

An important limitation under the SECURE Act is the severely restricted ability of a beneficiary to stretch payouts over their life expectancy, commonly referred to as a "stretch IRA". Before the SECURE Act, the stretch IRA enabled designated beneficiaries to extend the payout of an inherited IRA over the beneficiary's entire lifetime. The associated income tax on payouts was also stretched out. Under the SECURE Act, most beneficiaries must fully withdraw inherited IRAs by the end of the year of the tenth anniversary of the original account owner's death (the "10 year rule").

There are exceptions to the 10 year rule for EDBs. However, once a minor beneficiary of the account owner attains majority or an EDB dies, the 10 year rule applies. For all EDBs, the successor beneficiary to the EDB is subject to the 10 year rule.

| Eligible Designated Beneficiary | Applicable Rule |
|---|---|
| Surviving spouse of the account owner | Payout over the life expectancy of the surviving spouse. On the death of the surviving spouse, the exception will not apply and the 10 year rule is enforced. |
| Minor child of the account owner | Applicable to children of the account owner who have not yet reached the age of majority at the death of the account owner. Payout over the life expectancy of the minor child until the age of majority. Once the child reaches the age of majority, which varies by state, the 10 year rule will apply. This exception does not include a minor grandchild of the account owner or any other minor beneficiary.<br><br>*Note: subject to future guidance from the Internal Revenue Service, a child may be treated as not having reached majority if he or she has not completed a "specified course of education" and is under the age of 26.* |
| Disabled beneficiary | Applicable to individuals deemed to be disabled as defined by the Internal Revenue Code.[1] Payout over the life expectancy of the disabled beneficiary. Disabled beneficiaries must provide proof of their disability. Entitlement to Social Security disability benefits may suffice to show proof of disability. On the death of the disabled beneficiary, the exception will not apply and the 10 year rule is enforced.<br><br>*Note: a special needs trust established for one or more disabled or chronically ill EDBs generally qualifies for the exception to the 10 year rule as long as no person who is not a disabled or chronically ill EDB may become a current beneficiary until after the death of all the disabled or chronically ill EDBs.* |
| Chronically ill beneficiary | Applicable to individuals deemed to be chronically ill as defined by the Internal Revenue Code.[2] Payout over the life expectancy of the chronically ill beneficiary. On the death of the chronically ill beneficiary, the exception will not apply and the 10 year rule is enforced.<br><br>*Note: a special needs trust established for one or more disabled or chronically ill EDBs generally qualifies for the exception to the 10 year rule as long as no person who is not a disabled or chronically ill EDB may become a current beneficiary until after the death of all the disabled or chronically ill EDBs.* |
| Beneficiaries not more than 10 years younger than the account owner | Payout over the life expectancy of the beneficiary. On the death of the beneficiary who is not more than 10 years younger than the account owner, the exception will not apply and the 10 year rule is enforced. |

[1] IRC § 72 (m)(7)
[2] IRC § 7702B (c)(2)

## SECURE ACT AND EXISTING ESTATE PLANS

We recommend that you review your estate plan and retirement account beneficiary designations in light of the SECURE Act to determine whether your plan and beneficiary designations align with your goals. While you may continue to be satisfied with outright designations of a spouse, children or charity, designations of see-through trusts, for beneficiaries who are not eligible designated beneficiaries, may no longer serve their original intended purpose. Importantly, the extended payout over the life expectancy of the much younger beneficiary who is not an eligible designated beneficiary is no longer possible; instead, the IRA will be required to be paid out to conduit and accumulation trusts for even much younger beneficiaries under the 10 year rule.

## CONDUIT AND ACCUMULATION TRUSTS

A common estate planning strategy for individuals with substantial retirement plan assets has been to name a "see-through" trust as the beneficiary of the account in order to use a beneficiary's life expectancy to determine the payout period following the death of the account owner. There are two types of see-through trusts–conduit trusts and accumulation trusts.

For a trust to qualify as a conduit trust all distributions made from the retirement account to the trust must be paid out to the individual beneficiary of the trust currently. They cannot be accumulated in the trust, thus the conduit designation.

Conduit trusts have commonly been used for administration of retirement accounts for adult children to allow for both extended payout over the child's life expectancy and the added benefit of administration in trust, such as investment management, discretionary distributions and some protection from the creditors of the beneficiary. Conduit trusts have also been used for a spouse beneficiary where extended payout, qualification for the estate tax marital deduction, control over the disposition of assets upon the spouse's death, and the benefits of administration in trust are desired. While the SECURE Act does not preclude the use of conduit trusts, payouts from the account to the trust (and from the trust to the beneficiary) will now be required to be made under the 10 year rule, unless the beneficiary is an eligible designated beneficiary (such as a minor child or spouse), in which case the trust is entitled to the beneficiary's life expectancy payout. In some instances, without the benefit of extended payout over the beneficiary's life expectancy and because of the requirement that the trust distribute in full to the beneficiary under the 10 year rule, use of a conduit trust may no longer be desired.

Accumulation trusts take a different approach to achieving "look-through" trust status. Instead of requiring the trustee to act as a conduit between the IRA and the beneficiary for all IRA distributions, accumulation trusts exclude beneficial interests that would not qualify as a designated beneficiary if named directly, for example, a charity or an estate. Distributions from the IRA can be retained in trust as the trustee determines in its discretion.

Under the SECURE Act, payment from a retirement account to a typical accumulation trust is required to be made under the 10 year rule, not the life expectancy of the oldest beneficiary of the trust, with limited exceptions for specialized accumulation trusts for disabled or chronically ill beneficiaries. Thus, the income tax associated with distributions from a retirement account to an accumulation trust will be accelerated under the SECURE Act. And any income accumulated in the trust will be taxed at the trust's income tax rates, which reach the highest marginal rate at a modest level of income. While the 10 year payout limits the tax stretch, if a trust is being used for non-tax reasons, an accumulation trust may still be useful. Because no distributions are required during the 10 year period, payout may be deferred to the end of the 10 year period if desired, or amortized over the 10 year period, which may offer some tax planning benefit.

In short, naming either a conduit trust or an accumulation trust as the beneficiary of retirement assets should be considered carefully under the SECURE Act, and understanding beneficiary status is crucial to this decision. The following chart shows the effect of each strategy for every beneficiary type.

| | | TYPE OF BENEFICIARY | | | | | |
|---|---|---|---|---|---|---|---|
| | | **Designated Beneficiary (Non-EDB)** | **Surviving Spouse** | **Eligible Minor Child** | **Person Less Than 10 Years Younger** | **Disabled Beneficiary*** | **Chronically-ill Beneficiary*** |
| TYPE OF TRUST | **Conduit Trust** | 10 Year Rule | Life Expectancy Payout | Life Expectancy Payout (Until child reaches majority then 10 Year Rule) | Life Expectancy Payout | Life Expectancy Payout | Life Expectancy Payout |
| | **Accumulation Trust** | 10 Year Rule | 10 Year Rule | 10 Year Rule | 10 Year Rule | Life Expectancy Payout | Life Expectancy Payout |

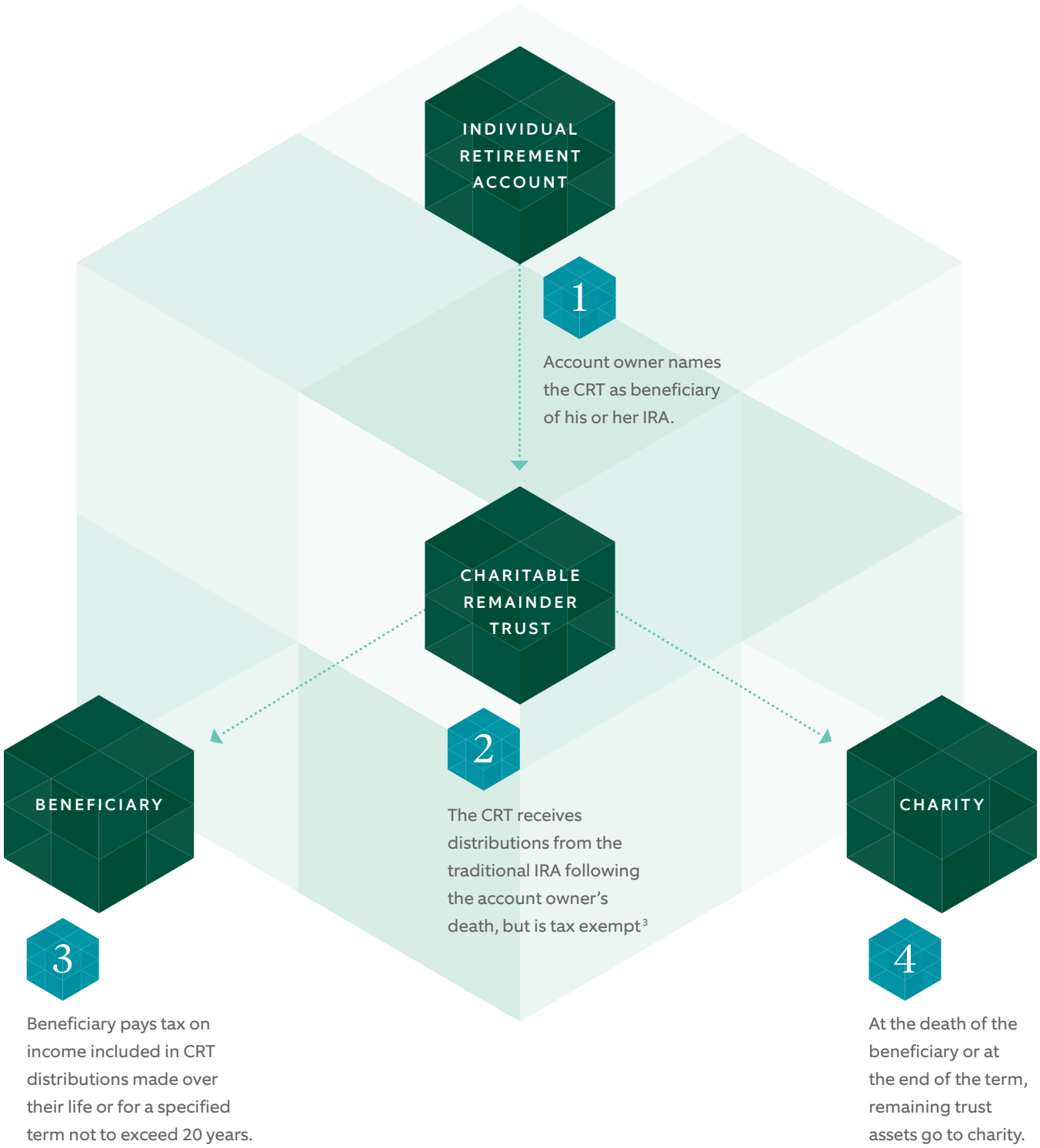
*Mandatory distributions may push the beneficiary above the income and/or property thresholds to prevent receipt of many government benefits.

## SECURE ACT AND CHARITABLE CONSIDERATIONS

Many aspects of charitable planning with retirement accounts are unaffected by the SECURE Act. Charities may still be named as the beneficiary of a retirement account and no tax will be paid by a tax-exempt charity on traditional retirement account distributions. In addition, the ability to make qualified charitable distributions was not significantly changed by the SECURE Act. Donors age 70 1/2 and over may still make QCDs directly from a traditional IRA to a qualifying charity (even though required distributions have been deferred to age 72). The QCD counts toward the donor's required minimum distribution for the year. In addition, the distribution is generally excluded from adjusted gross income. However if the individual also makes tax deductible contributions to a traditional IRA after reaching age 70 ½, in order to avoid "double dipping," the amount distributed directly to a qualified charity that is excludible from income is reduced by the amount of such contributions.

Naming a charitable remainder trust (CRT) as the beneficiary of a traditional IRA is a strategy for deferring IRA income taxation that may be more attractive now that the SECURE Act has diminished the inherited IRA stretch payout.

A CRT may be administered for the benefit of an individual beneficiary for their life or for a term not to exceed 20 years, with the remainder then payable to charity. Known as a split-interest trust due to its clear split between charitable and non-charitable beneficiaries, no income tax is paid by the trust, but instead all of the untaxed income is catalogued and treated as received directly by the non-charitable beneficiary(ies) with their distributions, even distributions made many years after the income was received by the trust. Thus, all of the IRA assets distributed to the CRT remain undiminished by income taxation unless/until they are distributed to the non-charitable beneficiary(ies). Because the CRT can be designed to pay out over that beneficiary's lifetime, the CRT taxation scheme mimics the length of the pre-SECURE Act income stretch-out. However, the price paid is that a portion of the trust assets are dedicated to charity; at the death of the beneficiary or at the end of the specified term, the remainder passes to one or more charities. Importantly, the actuarial value of the CRT's charitable remainder must be equal to at least 10% of the value of the trust at inception. Thus, naming a CRT as beneficiary of the IRA is a strategy best explored by those wishing to contribute a significant portion of their assets to charity.




[3] The Internal Revenue Code sets forth the rules for the trust to qualify for tax-exempt status.

## ROTH CONVERSIONS AFTER THE SECURE ACT

Converting a traditional IRA to a Roth IRA is a strategy to provide for tax-free retirement account distributions to the account owner in retirement and tax-free distributions to beneficiaries after the death of the account owner. There is, however, a cost to conversion. Income tax is payable for the tax year of the conversion based on the value of the account at the time of the conversion.

Roth conversions are a strategy to consider when an account value is lower due to market conditions, the account owner does not expect to need the account as a source of income in retirement, and the account owner expects tax rates to be higher when they or their beneficiaries draw down the account. These considerations have not changed with the SECURE Act. What has changed is the beneficiary payout period following the death of the account owner. The 10 year payout with the exceptions for eligible designated beneficiaries discussed above applies to Roth accounts. Taking a careful look at the economics of conversion with the limited beneficiary payout period may be advisable. Again, while income tax is due upon a conversion of a traditional IRA to a Roth IRA, account owners have the benefit of tax-free growth and distributions during life and beneficiaries have the benefit of tax-free growth and distributions following the account owner's death.

## MOVING FORWARD

The SECURE Act has changed the retirement and estate planning landscape. Now is a good time to review retirement savings, retirement account beneficiary designations and your estate plan to assess whether your savings, designations and plans are aligned to meet your goals. Working with your trusted financial, legal and tax advisors will greatly assist in understanding the implications of the changes under the SECURE Act. Plan now to protect your financial future and your legacy later.

## FOR MORE INFORMATION

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