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CLIENT ALERT

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The SECURE Act Eliminates the Stretch IRA and Fundamentally Changes Inherited Retirement Plan Distribution Rules

By J. Aaron Bennett

Retirement plan accounts, like 401(k)s and IRAs, are becoming an increasingly larger portion of many estates, especially since funds have the potential to accumulate in a tax-deferred manner for many years. The tax-deferral attributes of retirement accounts, however, have resulted in specific rules that impact how these accounts are treated after death.

Given that distributions from inherited retirement accounts are taxable as part of a beneficiary's ordinary income, Congress has instituted rules governing the timing of these distributions, called the "required minimum distribution" rules.

Up until recently, a beneficiary could manage the income tax exposure of inherited tax-deferred retirement accounts by "stretching" inherited account distributions over his or her life expectancy – potentially extending the income tax deferral benefits over several decades.

However, in late December of 2019, Congress made sweeping changes to the required minimum distribution rules applicable to inherited retirement plan accounts. The new minimum distribution rules are contained in the SECURE Act and apply to retirement plan accounts associated with account owners who pass away after December 31, 2019.

Rules Under the SECURE Act

For account owners who pass away in 2020 and beyond, the new SECURE Act eliminates the beneficiary's ability to "stretch" inherited tax-deferred account distributions over the beneficiary's life expectancy. Instead, a beneficiary must withdraw, and pay income tax on, the entire plan account balance by December 31st of the year that contains the tenth anniversary of the decedent's death (the "10-year rule").

There are a few notable exceptions to the "10-year rule." Specifically, special rules apply to the following categories of designated beneficiaries:

1. **The decedent's surviving spouse**, who may either "roll over" the inherited benefits to his or her own IRA, or elect a life expectancy payout.
2. **The decedent's minor child**, whose distribution period begins with the life expectancy payout method, but once the child reaches eighteen the "10-year rule" applies.
3. **A disabled or chronically ill beneficiary**, who can receive a life expectancy payout.
4. **A beneficiary less than ten years younger than the decedent**, who is entitled to a life expectancy payout.

In addition, retirement accounts can be left to a specially designed trust for the benefit of one of the above-mentioned categories of beneficiaries, but careful planning is needed to make certain that the trust meets certain IRS requirements.

The SECURE Act's Impact on Planning

As a result of these sweeping changes, most non-spousal retirement account beneficiaries will be faced with having to deplete inherited retirement accounts within ten years. This shorter distribution period (relative to the life expectancy payout method) may result in more income tax being paid over time. Fortunately, beneficiaries can stagger plan distributions over the ten-year period, pulling out as little or as much as they want in years one through nine, as long as the entire account is depleted by the end of the tenth year.

The SECURE Act's greatest impact on planning involves those situations where there is a considerable need to prevent benefits from being paid outright to a beneficiary (or even over a ten-year period), including situations in which the beneficiary is not be ready to handle a significant distribution due to financial immaturity, substance abuse, or creditor concerns. Trusts have traditionally been used in these scenarios and are still viable despite the SECURE Act, although the trust may be faced with an accelerated tax bill.

Despite the far-reaching impact of the SECURE Act, there are a few options for minimizing the accelerated tax burden borne by beneficiaries. For instance, account owners who would rather have a defined stream of income paid out to their beneficiary, as opposed to a ten-year payout, and who also have charitable goals, may consider leaving retirement benefits to a charitable remainder trust. The tax-exempt treatment of a charitable remainder trust ("CRT") allows for a fixed amount to be paid to the beneficiary over lifetime, with a relatively modest remainder interest passing to charity. Although the periodic payments to the beneficiary are taxable, the initial lump sum distribution to the CRT is not.

In addition, we may also see account owners turn to life insurance with a tax-free death benefit as a means to help fund the additional taxes associated with the accelerated income tax on inherited retirement accounts. Individuals may also be more inclined to consider Roth retirement accounts. Roth accounts, which are retirement accounts where owners contribute after-tax dollars that are not subject to tax upon withdrawal, are still subject to the "ten-year rule" after death, but Roth distributions are received by the beneficiary income tax-free.

Whether changes to an individual's estate plan are necessary in light of the SECURE Act depends on several factors. Please contact one of Carruthers & Roth's estate planning attorneys if you have any questions or would like to discuss your particular situation.

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