Inheriting Retirement Benefits After the SECURE Act

What planners need to know.

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Analysis of the recently enacted Setting Every Community Up for Retirement (SECURE) Act was an anticipated part of this year's Heckerling Institute on Estate Planning. Natalie B. Choate, of Nutter McClennen & Fish delivered a session titled "Can You Roll Over in Your Grave? What Executors, Trustees, and Beneficiaries Must Know About Inherited Retirement Benefits." In this follow-up to an earlier session in which she provided an overview of the SECURE Act, Choate focused on SECURE Act questions she's been receiving about inherited individual retirement accounts and other retirement benefits.

Act Quickly

Choate noted that not only is the SECURE Act a major tax change, but it also affects everyone differently. Practitioners will need to assess each client's situation. This task will be more difficult because of the short time between enactment of the SECURE Act, on Dec. 20, 2019, and the effective date of the act, on Jan. 1, 2020. With the SECURE Act already in place, clients will need to move quickly to change beneficiary designations or revise their trusts.

Know Your Trust Types

Choate emphasized that the SECURE Act didn't change the basic definitions related to inherited IRAs and other retirement plan benefits. It's still important to know the difference between a conduit trust and an accumulation trust, and the different results when each is named as the beneficiary of an IRA. Although the SECURE Act has eliminated the lifetime payout for “regular designated beneficiaries," the basic structure for determining designated beneficiaries and required minimum distributions (RMDs) remains the same.

Conduit Trusts—Problematic

Conduit trusts are likely to be the most problematic. Under a conduit trust, all distributions that are made to the trust from an IRA or other retirement plan account must be passed out to the individual life beneficiary of the trust. This is the "designated beneficiary" for purposes of determining the RMD calculations. Now, for a post-SECURE Act death, a regular designated beneficiary of a conduit trust will be subject to the new 10-year payout rule. This is likely an unintended result for a trust creator who expected distributions to be made to the beneficiary over the beneficiary's lifetime.

A conduit trust will still work when the beneficiary is an "eligible designated beneficiary" (EDB). Under the SECURE Act, EDBs include the surviving spouse of the participant, a minor child of the participant, a disabled or chronically ill individual and an individual who’s not more than 10 years younger than the participant. Such an EDB can still receive a life expectancy payout, whether she’s named as a direct beneficiary of the IRA or as a beneficiary of a conduit trust.

An extreme example of a problematic conduit trust, said Choate, is one in which the only permitted distributions to the life beneficiary are RMDs from an IRA. In such a case, in a SECURE Act world, there’s only one RMD—at the end of the 10-year payout period. Thus, the beneficiary will not only receive all IRA assets sooner than the trust creator expected but also will receive them in a lump sum, with no distributions for 10 years.

Accumulation Trusts—Understand Payout Rule Versus Trust Terms

An accumulation trust allows the trustee to accumulate IRA or other retirement plan distributions during the lifetime of one or more beneficiaries. If all countable beneficiaries of an accumulation trust are identifiable individuals, then the trust is a see-through trust and, under the SECURE Act, the RMD payout period will be over 10 years. If the trust doesn't qualify as a see-through trust, then the RMD payout period will remain the same as before the SECURE Act, with a payout of five years. It will no longer be necessary to determine the age of the oldest beneficiary of a see-through accumulation trust, because the payout is simply based on 10 years, not the life expectancy of any beneficiary. Choate doesn't believe that a see-through accumulation trust will qualify for life expectancy payout even if the lifetime beneficiary is an EDB, because it's possible that the remainder (non-EDB) beneficiaries will receive the retirement benefits.

Choate said to remember that the RMD payout rules are separate from trust terms regarding distributions. Just because a distribution must be made from an IRA to a trust under the RMD payout rules doesn't mean that the distribution will be carried out to trust beneficiaries. Distribution to the beneficiaries depends on the trust terms. Thus, an accumulation trust may still meet a client's goals regarding distribution of assets over time to a beneficiary, but the SECURE Act will affect the timing, and taxation, of the transfer of assets from the IRA to the trust.

Direct to Spouse Is Best

Leaving retirement plan benefits outright to a spouse is often a better option than using a trust and dealing with trust definitions and trust terms. Choate described a "hat trick" of benefits: The surviving spouse can postpone any RMDs until age 72; the surviving spouse can calculate RMDs based on the uniform life expectancy table, which is based on the joint life expectancy of the surviving spouse and a hypothetical 10-year younger person; and, on the surviving spouse's death, the full 10-year payout rule will apply.

If benefits are left to a spouse through a trust (or estate) that doesn't qualify for a life expectancy payout, a spousal rollover is still the best cleanup strategy for getting assets to the spouse. Choate says that there's a long history of private letter rulings that show that if a surviving spouse has the power to withdraw trust assets without the consent of any other person, then the spouse can roll over the IRA into her own name. Choate warned that not all IRA providers are willing to do a rollover through a trust or estate (instead of a distribution), so don't attempt the rollover until confirming that the provider will do it.

Retroactive Effect of the SECURE Act

Choate cautioned that even though the effective date of the SECURE Act is Jan. 1, 2020, the new law will affect pre-2020 deaths. In the case of a participant who died prior to 2020 and left an IRA to a designated beneficiary, on the death of the designated beneficiary, the new 10-year payout rule will now apply.

For example, assume a mother died prior to 2020 and left her IRA to her adult son. The son started a 34-year payout based on his life expectancy. The son dies in January 2020, only 12 years into the payout period. His adult daughter is the successor beneficiary. Even though there are 22 years left in the original payout period, the daughter will be subject to the new 10-year payout period, and the entire amount of the IRA must be distributed to her by Dec. 31, 2030. Under the old rules, the daughter would have been able to stretch out the payments for the remainder of the original 34-year payout period.

A successor beneficiary may get caught with a very limited time to complete a payout. If a designated beneficiary dies in Year 10 of the payout period, her successor beneficiary will still need to complete the payout by the end of the year. This is similar to when a decedent dies after age 72 (new age to begin RMDs under the SECURE Act), late in the calendar year, and hasn’t taken the RMD for that year. The beneficiary (not the decedent's estate) is responsible for taking the RMD and has only until the end of the year to do so.

If a beneficiary misses taking the RMD, she should do so as soon as learning about it. There is a 50% penalty, which can be waived by the IRS if the beneficiary submits a Form 5329 and provides evidence of reasonable cause. Choate cautioned that when listing the amount of shortfall on the Form 5329 (Line 54), be sure to list "0," with an "RC" (for "reasonable cause") next to it, instead of listing the amount not distributed.

SECURE Act's Rough Edges

Although the SECURE Act didn’t change existing definitions, regulations are needed to clarify some situations. If a pre-2020 decedent left an IRA to an accumulation trust with multiple beneficiaries, it’s not clear when the 10-year rule will begin to apply. The RMD rules refer to "when the designated beneficiary dies," but in a trust with multiple beneficiaries, whose death matters? Choate's opinion is that all designated beneficiaries must die before the 10-year rule will apply. Another unknown area is what happens when a trust has multiple EDBs. Individual EDBs can still use a lifetime payout, but it’s not clear if that will be true for successor EDBs within a trust.

In light of the SECURE Act's effect on post-death plans for retirement plan assets, practitioners will need to carefully review their client's estate plans and work with clients to make necessary changes.