UBS

The SECURE Act

Changes to “stretch” IRA rules

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The SECURE Act aims to improve the nation's current retirement savings policy by implementing a number of new rules to encourage more Americans to either begin saving for retirement or to bolster already established retirement savings plans.

On December 16, 2019, lawmakers released the 2020 spending bill that funds federal departments and agencies through the fiscal year ending on September 30, 2020. The funding bill is on track to be passed and signed into law by President Trump prior to midnight on Friday, December 20th, eliminating the threat of a government shutdown. In addition to funding government operations, the bill contains funds for election security, and repeals of three major healthcare taxes. The 2020 funding bill also contains the Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019. The SECURE Act aims to improve the nation's current retirement savings policy by implementing a number of new rules to encourage more Americans to either begin saving for retirement or to bolster already established retirement savings plans.

According the Federal Reserve System, one-quarter of all non-retired adults have no retirement savings or pension, and of those who do, only 36% feel their retirement savings is on track.[1] The SECURE Act aims to improve these figures by implementing regulations that incentivize small business owners to establish plans for their employees, allow long-serving part-time employees to participate in their employer's retirement savings plans, and increase the Required Minimum Distribution (RMD) age to allow for extended tax-deferred asset growth.

While the SECURE Act contains incentives to begin or to increase saving for retirement, it may penalize wealthy investors who have long benefited from using the tax-advantaged "stretch" IRA strategy to bequeath assets to their heirs, using the beneficiary's lifespan to stretch-out the RMDs and further defer income taxation. Instead, the SECURE Act will require all IRA plan distributions to individuals and irrevocable trusts, other than to: a) a surviving spouse, b) individuals who are disabled or chronically ill, individuals not more than 10 years younger than the IRA owner, or a minor child, be distributed in full by the end of the tenth calendar year following the IRA owner's death after December 31, 2019.[2] Current inherited IRA beneficiaries and trusts already receiving RMDs will not be subject to the new 10-year mandatory distribution rule.

Other key provisions contained in the SECURE Act include:

- Increasing the beginning traditional IRA required distribution age from 70½ to 72
- Repealing the maximum traditional IRA contribution age, currently set at 70½
- Increasing the tax credit for small employer plans and the auto-enrollment safe harbor
- Allowing penalty-free withdrawals from retirement plans in the year of a birth or adoption for qualified expenses
- Allowing long-term part-time workers to participate in his/her employer's defined contribution plan
- Easing the rules restricting Multiple Employer Plans (MEPs), which will allow unrelated employers to join a pooled employer plan
- Expanding 529 Plan education savings accounts to cover costs associated with registered apprenticeships, private elementary schools, private secondary schools, religious schools, and up to $10,000 for qualified student loan repayments

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There are a number of alternatives to consider when planning around the new 10-year distribution requirement:

1. Traditional IRA to Roth IRA Conversions: Converting a traditional tax-deferred IRA to a tax-free Roth IRA could incur a hefty up-front income tax bill at the owner’s ordinary income tax rate, but will provide a number of long-term benefits for both the owner and the beneficiary. For the Roth IRA owner, there are no required minimum distributions. Investors who are not relying on their IRA assets to fund their retirement can benefit from continued tax-free growth within their Roth IRA account until their death. Although the SECURE Act’s proposed mandatory 10-year withdrawal rule will still apply to Roth IRA accounts, the beneficiary would receive these distributions income-tax free, regardless of the inherited account value. Distributions from inherited Roth IRA accounts are not taken into account when calculating the beneficiary’s income tax bracket, unlike distributions from traditional IRAs which may push the beneficiary into a higher bracket. Careful consideration should be used to determine if the upfront payment of income tax on the IRA Roth conversion is worth the tax-free growth potential during the owner’s remaining years, as well as the beneficiary’s tax-free receipt of the retirement plan’s assets.

2. Using Trusts as IRA Beneficiaries: Under the old retirement savings law, some investors opted to name a trust as their retirement plan beneficiary. Two of the most commonly used retirement trusts are conduit trusts and accumulation trusts. Both trusts are designed as “see-through” trusts, in that the age of the trust beneficiary is used to determine the amount of the RMDs of the “stretch” IRA. Trusts not drafted as “see-through” trusts must distribute all assets within a five-year period following the plan owner’s death. Conduit trusts, which calculate the RMDs using the age of the single primary beneficiary, require the distribution of all RMDs to the beneficiary from the trust, with income tax paid by the beneficiary at the time of distribution. Accumulation trusts, which calculate the RMD based on the oldest of the current or remainder trust beneficiaries, allow the trustee to accumulate the annual RMDs inside of the trust and to distribute these assets to the beneficiaries as the trustee sees fit. The accumulation trust, rather than the individual trust beneficiary, pays the income tax on the accumulated RMD calculated using the trust’s income tax rate.

   The SECURE Act will drastically change how trusts hold and distribute inherited retirement assets to the beneficiaries. Under the new law, retirement trusts will no longer be permitted to calculate the annual RMD payments based on a beneficiary’s age. All retirement plan assets must be distributed to the beneficiary (of a conduit trust), or distributed to and retained by an accumulation trust for his/her benefit, within 10 years from the death of the retirement plan owner. Distributions or accumulations of retirement plan assets can be made over the course of the 10 year period, or in a lump-sum distribution in year 10 (ideal for Roth IRAs).

   As income tax on the traditional IRA RMD is paid by the conduit trust beneficiary at their personal income tax rate, a large lump-sum distribution in year 10 could trigger an enormous tax bill for the recipient instead of

paying the income tax over 10 years of installments. If the trustee of an accumulation trust opts to retain the traditional IRA RMDs, instead of distributing the assets to the beneficiaries, the trust would owe income tax at the trust's tax rates (in 2019, this is 37% after $12,750 of ordinary trust income). Unlike a conduit trust that mandates the transfer of all RMD assets to the beneficiary, RMDs retained by an accumulation trust provide asset and creditor protection, as well as oversight on transfers to younger beneficiaries. While retirement trusts will not shield the IRA assets from the SECURE Act's 10-year mandatory distribution laws, they can offer discretionary (instead of mandatory) distributions for trust beneficiaries, equalization of after-tax transfers of the RMDs between beneficiaries in different income tax brackets, and a controllable stream of income for trust beneficiaries.

The SECURE Act makes no changes to the regulations regarding qualified charitable distributions of retirement plan assets.

3. Life Insurance and IRA Trusts: Obtaining a life insurance policy on the life of the retirement plan owner, and holding that policy in an irrevocable trust, could provide a number of solutions to alleviate the tax and estate planning obstacles arising out of the SECURE Act. Life insurance death benefits always pass income tax-free to beneficiaries. Additionally, if the life insurance policy is purchased and owned by an Irrevocable Life Insurance Trust (ILIT), then the policy's death benefit will not be included in the insured's gross taxable estate at death. Current IRA account owners could direct a portion of the retirement plan assets, or annual RMDs if applicable, to the payment of the life insurance policy's premiums. After the insured's death, the life insurance proceeds could be used by the irrevocable trust to: a) provide liquidity to pay the income taxes on a conversion from a traditional IRA to a Roth IRA, b) pay the income tax on any traditional IRA RMDs on the behalf of the beneficiary, or c) to mimic the "stretch" IRA distributions by providing the beneficiary with a steady stream of income during his/her lifetime.

4. Retirement Planning for the Charitably-Inclined: The SECURE Act makes no changes to the regulations regarding qualified charitable distributions of retirement plan assets. Retirement account owners will retain the right to direct up to $100,000 a year of RMDs directly to qualified charities (donor advised funds and private foundations do not qualify). Owners may also name a charity as the beneficiary of their qualified retirement plan, which could reduce or eliminate the income and estate taxes that may otherwise be imposed at their death.

   Individuals looking to mimic the "stretch" IRA distributions throughout a beneficiary's life, while receiving a charitable deduction on estate taxes, may consider naming a Charitable Remainder Trust (CRT) as a beneficiary on a retirement plan. At the grantor's death, the retirement plan assets will be distributed to the CRT. The CRT will make annual distributions, based on a fixed percentage, to a named non-charity beneficiary throughout their lifetime (or for a term not to exceed 20 years). Upon the beneficiary's death, any assets remaining in the CRT will pass to a charity. Due to their charitable nature, CRTs will not owe income tax on the distribution received from the grantor's retirement plan, nor will the CRT be taxed on income earned within the trust. This allows the distributed IRA assets contained in the CRT to continue to grow tax-deferred beyond the SECURE Act's 10-year mandatory distribution period. While the trust beneficiary will owe income tax on each annual distribution from the CRT, the applicable income tax rate will be calculated based on the character of the income

earned (ordinary income, then capital gains, then tax-exempt income, then non-taxable return of income), [3] rather than the entire distribution taxed as ordinary income under a non-CRT traditional IRA RMD. Keep in mind that this strategy would work best for traditional IRAs. While Roth IRAs will also lose the "stretch" feature under the SECURE Act, they do not have the same issues with acceleration of income tax.

The SECURE Act will undoubtedly affect a large number of retirement plan holders and their subsequent beneficiaries. Investors should carefully review their current estate plan, see- through trusts, and retirement plan beneficiaries with their financial advisor, estate planning attorney, or accountant.

– *Carrie Larson*, Wealth Strategist

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See important notes and disclosures on the next page.

[1] Report on the Economic Well-Being of US Households in 2018, Board of Governors of The Federal Reserve System, March 2019: *https://www.federalreserve.gov/publications/files/2018-report-economic-well-being-us-households-201905.pdf*.

[2] The Setting Every Community Up For Retirement Enhancement Act of 2019 (The SECURE Act), House Committee on Ways and Means, April, 2019: *https://waysandmeans.house.gv/sites/democrats.waysandmeans.house.gov/files/documents/SECURE %20Act%20section%20by%20section.pdf*. Note that some practitioners are concerned that these exceptions, while helpful, may not be sufficient when applied to an accumulation trust that has remainder beneficiaries who do not qualify for these exceptions.

[3] Internal Revenue Code §644(b).

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