Secure Act Redux: Surprises and New Flexibility for IRA Beneficiary Trusts

In early 2020, we alerted you about Congress's enactment of the "Secure Act" in a two-part article series. For the most part, this new federal law ended "stretch" inherited individual retirement accounts allowing beneficiaries to withdraw IRA funds over the course of their entire lifetime. In so doing, the new law threatened the benefits of conduit-type Inheritance Trusts serving as IRA beneficiaries.

On February 24, 2022, the Treasury Department issued its Proposed Regulations outlining how it interpreted and proposed to implement the Secure Act. These Proposed Regulations contained a number of surprises for tax practitioners. However, they contained generally good news with regard to accumulation-type inheritance trusts. This redux highlights some of the surprises and benefits provided by the Treasury Department's 275 page document for the vast majority of inherited IRA beneficiaries not included in the five classes of exception "eligible designated beneficiaries" discussed in our prior articles.

Why Are the Proposed Regulations Important?

Congress has delegated to the Treasury and Labor Departments (and especially the Internal Revenue Service) important authority to interpret its qualified retirement account laws. Treasury Regulations are the primary source for such interpretation with regard to income taxation. Labeled as "Proposed", the new interpretations are likely to be followed by Final Regulations after Treasury's receipt of comments due in May and a June hearing. The Proposed Regulations, by their express terms, nonetheless apply for determining required minimum and other IRA distributions for calendar years beginning on or after January 1, 2022. For the 2021 distribution calendar year, "taxpayers must apply the existing regulations, but taking into account a reasonable, good faith interpretation of the [Secure Act amendments]. Compliance with these proposed regulations will satisfy that requirement."

Surprise #1: Beneficiaries from IRA Participants Who Die After Their Required Beginning Date Must Take Annual Required Minimum Distributions

When the Secure Act was first enacted, the one benefit that practitioners saw for their beneficiary clients was that most beneficiaries would not to be subject to taking minimum required distributions prior to the final required distribution date (December 31st of the tenth year after the participant's death). The Secure Act clearly provided that the 10-year distribution rule would operate just like the then existing 5-year rule for IRAs without a tax-qualified "designated beneficiary". That 5-year rule did not and does not require interim distributions until the final year when the 100% payout is required.

For beneficiaries of IRAs from participants dying **before** their required beginning date (April 1 of the year after the year containing the participant's 72nd birthday), the Proposed Regulations tell us that this perceived interpretation is true. For inherited IRAs from such participants, no distributions will be required until the final year' 100% payout.

However, the Proposed Regulations say that this is not the case for inherited IRAs from participants dying **after** their required beginning date. The Proposed Regulations explain this difference on the basis that the old law's "at least as rapidly rule" was not repealed by the Secure Act. Previously, the "at least as rapidly rule" was used as an exception to the 5-year payout requirement for IRAs not having tax-qualified designated beneficiaries to allow distribution of the IRA over a longer period equal to the remaining life expectancy of the participant immediately prior to death (the participant's "ghost life-expectancy"). The Proposed Regulations now tell us that, for participants who die after their IRA distributions required beginning date, the "at least as rapidly rule" dictates that beneficiaries must make annual distributions from the IRA each year prior to the required 10th year 100% distribution. As such, inherited IRA beneficiaries from decedents dying after their required beginning date must take annual distributions prior to the final year as follows:

- If the decedent failed to take his or her required minimum distribution in the calendar year of the decedent's death, the IRA must distribute the decedent's undistributed portion of his or her required minimum distribution for that year;
- For succeeding years prior to the final year with its mandated 100% distribution, the beneficiary must take annual distributions from the IRA based on the beneficiary's remaining life expectancy or the decedent's "ghost life expectancy".

Surprise #2: The IRA Age of Majority is Now 21 years, Regardless of State Law

As we discussed in our prior article, the IRA inherited by a child of the original IRA participant is not required under the Secure Act to be fully distributed until December 31st of the year that is 10 years after the child attains the age of majority. The age of majority varies from state to state and, for federal income taxation purposes, can be argued to be as late as age 26 for "children" still being educated. The Proposed Regulations now standardize the age of majority for inherited IRA purposes to be age 21. This is a benefit for Maryland residents because the age of majority in Maryland would otherwise only be age 18. As such, inherited IRAs left to Maryland children of the participant who are under 21 can remain tax-free for three years longer: until December 31st of the year that the child reaches age 31. (Note, however, that required annual distributions must be made to or for the benefit of the child during this extended period.)

Increased Flexibility for IRA Beneficiary Trusts

As we noted in our article on "Insecure Inheritance Trusts", it had long been difficult to make Inheritance Trusts flexible. If they inherited IRA assets, Treasury Regulations denied extended payout

periods to IRA beneficiary trusts unless absolutely all potential trust beneficiaries were individuals who could be determined from the commencement of the trust. While earlier Treasury Regulations provided that "mere potential successor" beneficiaries need not be determinable, no safe harbor was ever provided by this exception in the form of guidance as to who might be a "mere potential successor". In addition, it was necessary at all times to be able to determine the age of the oldest potential trust beneficiary because that was the beneficiary whose life expectancy would be used to calculate annual IRA required minimum distributions to the trust. Only by using "conduit type" provisions for trust IRA distributions could these problems be avoided, but such conduit trust provisions forced planners to lose the protective benefits of accumulation trusts for IRA assets.

By mandating IRA payouts over a fixed maximum period, the Secure Act largely eliminated any need for calculation of life expectancy-based distributions for beneficiaries other than the limited special classes of "eligible designated beneficiaries" authorized to take distributions under the old rules. However, prior to the Proposed Regulations, the mandatory requirement for determination of the age of the oldest potential trust beneficiary nonetheless remained in place.

The Proposed Regulations now fortunately provide that, while all trust beneficiaries must be "identifiable" individuals, that term no longer means that it must be possible to "identify" the oldest trust beneficiary. Trusts are also now tested only for identifiable individual beneficiaries based on more limited circumstances when persons can receive trust distributions. To count toward the test of "identifiability", we need only consider those who can presently receive IRA assets that are neither contingent upon, nor delayed until, the death of another trust beneficiary ("Tier 1") and those individuals who can receive IRA assets not distributed to tier 1 beneficiaries during their lifetimes ("Tier 2"). We can now ignore potential trust beneficiaries who would receive IRA assets only if they survive the beneficiaries in Tier 1 and Tier 2. For example, if a trust provides that IRA assets are to pass to a decedent's children during their lifetime, to the decedent's grandchildren on the death of their parent, and then to a charity after the grandchildren have died, the charity can now be ignored even though the trust has a non-individual beneficiary.

Additionally, the Proposed Regulations now provide generous provisions dealing with the possibility that the identity of trusts beneficiaries might change after the IRA participant's death. Planners have long used "powers of appointment" to allow trust beneficiaries to direct where trust assets should go after that beneficiary's death. Such language provides flexibility for the future and better achieves the freedom in handling trust assets that trustmakers desire for their family members. For IRA assets, however, such "powers of appointment" were a disqualifying problem because of the potential that trust beneficiaries might appoint trust assets to non-individuals or to persons older than the initially known trust beneficiaries. The possibility of trust reformation or decanting posed similar problems. These problems were only avoided by using the "conduit type" trusts that the Secure Act made generally undesirable.

Under the Proposed Regulations, the mere possibility that trust beneficiaries may be changed in the future by the exercise of powers of appointment, decanting, or judicial reformation no longer causes a trust to be disqualified under the "identifiable beneficiaries" test. First, if a power of appointment is exercised or the trust is altered in some way before the "beneficiary finalization date" (September 30th

of the year after the year of the IRA participant's death), the alteration is given effect as if the change had been made prior to the participant's death. More importantly, if the changes are made after the "beneficiary finalization date", the trust is retested for designated beneficiary status only when a change is actually made. Changes after the "beneficiary finalization date" will not cause retroactive disqualification or catchup distributions; and if the changes affect the year when final distribution of the IRA is required, such 100% distribution won't be required earlier than the year after the year following the change. In short, potential changes in trust beneficiaries caused by powers of appointment, decanting, and judicial reformation **will not disqualify a trust's designated beneficiary status until the changes actually occur**. If those changes occur after the Secure Act's 10 year deadline for final IRA withdrawals, they won't matter.

In general, the Proposed Regulations now allow us to provide considerably more flexibility in using "accumulation type" IRA beneficiary trusts where beneficiary creditor, divorce, and generation-skipping transfer tax advantages are desirable.

Conclusion

Aside from the new requirement for a majority of IRA beneficiaries to make annual distributions from inherited IRAs prior to the required 10th year 100% distribution, the Proposed Regulations were generally favorable to IRA beneficiaries, especially those having the benefit of Inheritance Trusts that have been modified since the Secure Act was enacted. We recognize, however, that navigating this highly technical area of the law is difficult. If we can help you with specific questions or problems in this area, please feel free to contact us.