INSECURE INHERITANCE TRUSTS

In late December of 2019, Congress enacted new legislation designed to allow older Americans additional tax-deductible ways to grow their qualified retirement plans. Unfortunately, this Setting Every Community Up for Retirement Enhancement Act (the SECURE Act) ends the right of most non-spouse inherited individual retirement account (IRA) beneficiaries to stretch out the withdrawal of inherited IRA funds over their lifetimes. Instead, the SECURE Act imposes a new requirement that all IRA funds for such designated inherited IRA beneficiaries must now be withdrawn by plan beneficiaries within 10 years. Because planning to maintain the benefits of what were previously lifetime “stretch IRAs” has long been a fundamental part of estate planning, **the dramatic effect of the SECURE Act’s new measures makes immediate review of prior planning imperative.** This is especially true where estate planning has utilized the benefits of Inheritance Trusts.

The Death of the Stretch IRA

Many of the SECURE Act’s provisions were commendable. As of the SECURE Act’s effective date, January 1, 2020, the Act authorizes anyone that has earned income to make tax-deductible contributions to a traditional IRA regardless of age. Previously, this was not allowed for anyone who had reached age 70½. The SECURE Act also extends the required beginning date (RBD) for a plan participant to April 1 of the year after the participant attains age 72 rather than the prior rule’s age 70½. The SECURE Act additionally:

- allows penalty-free withdrawals of no more than $5,000 for births and adoptions by participants under age 58½,
- allows for certain tax-free withdrawals from Section 529 plans for certain apprenticeship programs and up to $10,000 of qualified educational loans,
- and expands employer tax benefits and opportunities for retirement plan startup costs, adoption of automatic enrollment arrangements for 401k or SIMPLE IRA plans or joining Multiple Employer Plans.

For Congress, the question became how to pay for all these benefits while minimizing additional budget deficits. Its answer was to **end the “stretch” inherited IRA** after a participant’s death for **all but five** types of “eligible designated beneficiaries” (EDBs):

(1) the spouse of the original plan participant;

(2) a person who is 10 or fewer years younger than the original plan participant (for example, siblings and unmarried partners no more than 10 years younger than the participant);

(3) a child of the original plan participant who is under the age of majority (age 18 in Maryland and most other states) for the period of their minority;

(4) a person who is disabled within the meaning of the Social Security Act; and

(5) a person who is "chronically ill" (e.g., unable to perform at least 2 of certain specified daily living functions for a period of 90 days because of loss of functional capacity).

For all other designated beneficiaries (including the beneficiaries of see-through trusts) who otherwise would previously have qualified for distributions under their respective life expectancies, **beneficiaries are now required to withdraw all IRA assets from their inherited IRA on or before December 31st of the year that is 10 years after the date of death of the original participant.** We refer to this new SECURE Act requirement as "the New 10 Year Rule."

Problems with Including IRAs in Inheritance Trusts

For many years, Inheritance Trusts have been our clients' vehicle of choice for leaving property to their loved ones after their deaths. Generally speaking, nothing worries clients more than a creditor or divorcing spouse depriving their loved ones of the assets they worked so hard to pass on.

Inheritance Trusts provide protections from these threats while allowing the beneficiary to maintain control of his or her funds. They can also provide a necessary management device if the beneficiary becomes incapacitated and can often keep any remaining Inheritance Trust assets from being subjected to estate taxes when the beneficiary dies. In addition, Inheritance Trusts have long been used to manage funds for minors and other special needs beneficiaries who would otherwise have trouble maintaining them.

Individual retirement accounts (IRAs), however, have always been one of the more difficult types of property to place in an Inheritance Trust. The principal advantage of an IRA is to defer income taxation of IRA assets for as long as possible. Only IRA beneficiaries who are individuals (i.e., persons with a calculable life expectancy) could before now “stretch out” distributions from an inherited IRA over their respective lifetimes. Trusts therefore could only gain the benefit of such stretched out distributions if all of the beneficiaries of that trust were identifiable individuals with a measurable life expectancy per IRS tables (as opposed to a non-identifiable individual such as an estate, corporation or charity). Where a trust had multiple beneficiaries (or differing beneficiaries at different stages), the oldest such identifiable individual became the measuring life.

Rapid Withdrawal Consequences for Non-Qualifying Trusts

If all of the beneficiaries of a trust are not such identifiable individuals, the trustee of the trust owning an IRA must within a short period withdraw all of the assets from the IRA and realize all of the taxable income with respect to those assets. The precise length of that period depends on whether the original IRA participant had reached the required beginning date (RBD) for IRA withdrawals at the time of his or her death (i.e., April 1 of the calendar year after the original participant reached age 70½ if the original participant died before 2020 or age 72 for deaths thereafter).

For non-qualifying trusts created by original participants who have not yet reached their RBD, this period only lasts until December 31 of the calendar year that is 5 years after the original participant’s death. For non-qualifying trusts created by original participants who reach their RBD, the required period for withdrawal lasts until the later of (1) December 31 of the calendar year that is 5 years after the original participant’s death or (2) December 31 of the year of the original participant’s predicted life expectancy immediately before his or her death. (To simplify this text, we will refer to this distribution period for non-qualifying IRA beneficiaries as “the Minimum Distribution Period.”)

IRA Rules for Identifiable Beneficiaries

Trusts would ordinarily not be deemed to be individuals. However, the IRS has fortunately given us some rules that disregard the trust structure and tax withdrawals for a “see-

through" trust to its identifiable individual beneficiaries instead. To qualify as a "see-through" trust whose beneficiaries were entitled to lifetime "stretch" benefits under the old rules or as a trust whose beneficiaries are now allowed to use the New 10 Year Rule, **trusts must be either "Conduit Trusts" or "Accumulation Trusts."** All other trusts must withdraw IRA funds over the Minimum Distribution Period or face significant 50% penalties for noncompliance.

These types of trusts track two basic beneficial IRS rules for determining when the beneficiaries of a trust are "identifiable." First, if the trustee is required by the trust instrument to distribute to one individual trust beneficiary any distribution the trustee receives from a retirement plan during that beneficiary's lifetime, the individual beneficiary is treated as the sole beneficiary of the trust, regardless of who might become beneficiaries after the death of the individual. The trustee merely provides a "conduit" for distribution of the IRA assets to the individual beneficiary.

Inheritance Trusts that use this rule are known as "**Conduit Trusts**" because the trustee has no power to accumulate any plan distributions in the trust. Theoretically, the trust beneficiary of a Conduit Trust will receive all of the IRA assets over the course of his or her lifetime even if only required minimum distributions are withdrawn. Conduit Trusts have the benefit that they can be flexible. Beneficiaries can control who future beneficiaries will be without those future beneficiaries having to be identifiable at the time of the original participants death. The potentially significant problem with Conduit Trusts under the SECURE Act is that all inherited IRA assets will now have to be distributed out of the trust to the trust beneficiary within 10 years.

As a second alternative, applicable Treasury Regulations provide that "[t]he members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it is possible to identify the class member with the shortest life expectancy." As a result, before the SECURE Act, trusts could in fact use an individual's life expectancy to determine annual required minimum distributions and accumulate IRA distributions if it was possible to identify the oldest trust beneficiary. Inheritance Trusts that use this second rule are known as "**Accumulation Trusts.**"

Under federal and state income taxation rules, IRA distributions to Conduit Trusts (and subsequently to the individual beneficiary who is treated as the sole beneficiary of the trust) will just about always be taxed to the individual beneficiary at that beneficiary's applicable tax rate based on his or her income (including the IRA distribution).

IRA distributions to Accumulation Trusts are taxed to the trust itself at the trust's applicable tax rate (if and to the extent that they are accumulated and not distributed to beneficiaries under the terms of the trust). The significant problem with an Accumulation Trust is that its applicable income tax rate is very likely to be higher than that of a trust beneficiary. In 2020, trusts are subject to the maximum federal income tax rate of 37% once the trust has income in excess of only $12,950. For single taxpayers, that income tax rate would require a taxable income of $518,400; for married taxpayers, the same rate would only apply once the couple reaches $622,050 in taxable income. Trustees of Accumulation Trusts can, however, minimize such income taxation by making distributions to beneficiaries under the terms of the trust and thereby transfer taxation of the income to the beneficiary's tax rate rather than the trust's. Such distributions need to be made very carefully, however, because any such distributions will lose the advantages of the Inheritance Trust.

Because of this income tax problem and because clients most often want to preserve flexibility for their Inheritance Trust beneficiaries to potentially add future beneficiaries (such as siblings or spouses) who are older, we frequently used Conduit Trust provisions for IRA distributions to Inheritance Trusts before the SECURE Act became law. In most of these situations, clients believed that the relatively small annual amounts of required minimum distributions over the lifetime of the individual beneficiary would be acceptable leakage of Inheritance Trust protection while minimizing income taxes. In many fewer situations, we created separate Accumulation Trusts (called Retirement Plan Trusts) for clients who were willing to accept potential increased income taxation as an acceptable trade-off for creditor protection and/or professional management for special needs beneficiaries or where they anticipated that trust beneficiaries would be in the maximum income tax bracket in any event. As discussed below, these decisions should now be reexamined in light of the ramifications of the new SECURE Act. Even if Accumulation type Retirement Plan Trusts were implemented, it may be desirable to amend them if and when the Treasury Department no longer imposes an age restriction for individual beneficiaries.

Impacts of the SECURE Act for Inheritance Trusts

To implement the New 10 Year Rule, Congress did not amend or replace its original IRA statutory provisions or the Treasury Department's existing regulations. It merely layered the SECURE Act's new provisions on top of the existing rules. The New 10 Year Rule replaces the life expectancy payout method previously used for all but the five categories of EDBs and beneficiaries who must use the Minimum Distribution Period and who elect to withdraw IRA funds over the original participant's predicted life expectancy immediately before his or her death. Because the New 10 Year Rule is merely layered over the previously existing IRA rules, non-EDB trust beneficiaries can still only avoid the Minimum Distribution Period (and get 10 years to withdraw IRA assets) if their Inheritance Trusts are structured as Conduit Trusts or as Accumulation Trusts comprised of beneficiaries who are "identifiable individuals."

As noted above, with the exception of Inheritance Trusts for spouses or individuals not more than 10 years younger than the original IRA plan participant, the death of the Stretch IRA and the New 10 Year Rule require that we reexamine the decisions previously made with regard to whether to make Inheritance Trusts either Conduit Trusts or Accumulation Trusts. Client documents that include Inheritance Trusts that will now be subject to the New 10 Year Rule are likely to need amendments. Conduit-type Inheritance Trusts will become ineffective to the extent that trustees are required to distribute significant assets out of the trust within the period encompassed by the New 10 Year Rule. Conduit Trusts with large inherited IRAs will be denuded by the 10th year. Even the beneficiaries of Inheritance Trusts that own only modest inherited IRAs will be adversely impacted if they have current actual or potential creditors or face future divorce or estate taxation. Accumulation-type Inheritance Trusts may face massive income taxation issues when they are required to withdraw IRA assets under the New 10 Year Rule. At the very least, we need to review currently drafted Conduit and Accumulation Inheritance Trusts to make sure these impacts of the SECURE Act do not change clients' prior decisions.

The good news is that if clients act now (or at least prior to death), a number of these impacts can be minimized or avoided. The old lifetime "stretch" distribution income taxation deferral benefits may be mimicked using charitable remainder trusts (CRTs) if clients are willing to allow some of their remaining IRA funds to go to charity after the deaths of their beneficiaries and to limit what beneficiaries can receive from the CRT annually. Reasonably healthy original participants and EDBs who remain entitled to use lifetime

withdrawal distributions can use relatively small lifetime distributions to replace IRA funds with life insurance that can be received tax-free by Inheritance Trusts or directly by their loved ones.

In addition, it seems likely that in the near future Accumulation Trusts may no longer be limited by the requirement that it must be possible to determine the trust's beneficiary with the shortest life expectancy. Under the SECURE Act, Inheritance Trusts for individuals other than EDBs no longer need to make IRA withdrawals under the New 10 Year Rule based on the life expectancy of any particular trust beneficiary. Thus, while we are currently subject to the Treasury Regulation requiring identification of the oldest potential beneficiary, it seems likely that the Treasury Department will now eliminate that rule to merely require that trust beneficiaries need only be individuals, regardless of their age. Such a change will greatly enhance the flexibility of Accumulation Trusts.

The bottom line is that the SECURE Act makes it **imperative** that clients review with advisors what should happen to their IRA assets after their deaths. Decisions made about Inheritance Trusts in the era of lifetime "stretch" IRAs now need to be reexamined since the SECURE Act ends that era. Alternative strategies are available, but whether and the extent to which they are used will depend on individual client answers to a number of questions about their personal circumstances and goals. **We will review those questions in detail in our accompanying article, Reviewing Estate Plans after the SECURE Act**. If you would like to review these questions or reexamine your personal IRA and estate planning with me in light of the impacts of the SECURE Act, please do not hesitate to contact us.