The "stretch IRA" is mostly dead

For the past several years, attorney Natalie Choate has been the resident expert on inherited retirement benefits at the Heckerling Institute on Estate Planning. She was scheduled for two presentations at the 2020 Institute in January: “Can You Roll Over in Your Grave? What Executors, Trustees, and Beneficiaries Must Know About Inherited Retirement Benefits” and “Doing Well by Doing Good: How Charitable Giving with Retirement Benefits Can Help Your Charitable and Human Beneficiaries.” After the SECURE Act was enacted, an emergency early-morning session on its provisions by Ms. Choate was added to the program, and aspects of the new law dominated all three of her lectures. This review of the SECURE Act is informed by Ms. Choate’s observations.

Minor details

The SECURE Act includes a variety of tax provisions intended to promote retirement savings and increase access to qualified retirement plans. For individuals, the three most significant changes are:

- those over age 70½ are no longer prohibited from contributing to a traditional IRA (they must have compensation income to do so);
- Required Minimum Distributions (RMDs) are no longer mandated until age 72 (those who turned 70 before July 1, 2019, still must begin their RMDs as under prior law); and
- up to $10,000 may be distributed from a Section 529 plan to pay down student debt (that’s a lifetime cap, not an annual one).

To pay for the many tax breaks included in the SECURE Act, the treatment of inherited IRAs has been drastically changed, effective the first of the year.
"Stretch IRA"...continued

In general, an inherited IRA will have to be distributed by the end of the tax year that includes the tenth anniversary of the owner’s death. That works out to 11 tax years for receiving and reporting the IRA distributions. There is no requirement for annual distributions during the ten years—they may be front loaded, back loaded, or paid roughly equally over the period, which should provide the greatest tax efficiency.

Only “eligible designated beneficiaries,” as defined in the new law, are allowed to stretch the IRA payouts over their life expectancies, rather than ten years.

Eligible designated beneficiaries

There are five categories of those who can continue to have lifetime IRA RMDs:

Surviving spouses. The surviving spouse may use the life expectancy tables to take RMDs over his or her lifetime. A surviving spouse continues to have the option of making an inherited IRA his or her own. In that approach, RMDs won’t be required until the spouse reaches age 72, and then may be spread over the life expectancy.

Minor children of account owner. Until they reach the age of majority, the RMDs for minor children may be determined from the actuarial tables. Once they reach the age of majority, presumably 18 or 21 depending upon state law, the ten-year rule kicks in. Ms. Choate suggested that the definition of “age of majority” in the SECURE statute refers to an obscure ERISA section, the gist of which implies that if a student is still being educated, the age of majority may be deferred to 26, but this point is unsettled at the moment.

Note that the minor must be the account owner’s child, not simply a minor. This tax treatment is not available to grandchildren, nieces, or nephews.

Disabled beneficiaries. If the designated beneficiary is disabled within the meaning of IRC §72(m)(7), RMDs may be stretched over the lifetime. Entitlement to Social Security disability benefits may be a litmus test for eligibility. Note that eligibility is determined at the account owner’s death. If an able-bodied heir who has been receiving IRA distributions under the ten-year rule becomes disabled in, for example, year five, there is no ability to switch over to the life expectancy payouts. At the disabled beneficiary’s death, the ten-year rule must apply.

Chronically ill beneficiaries. A chronically ill designated beneficiary, as that condition is defined in IRC §7702B(c)(2), may stretch the payouts over his or her lifetime. Again, at this beneficiary’s death, the ten-year rule kicks in.

Less than ten years younger than the account owner. Life expectancy may be used if the heir is less than ten years younger than the account owner, such as a sibling. However, a blood relationship is not required.

Conduit trusts

Under the prior law, anyone who inherited an IRA had the right to take RMDs over his or her lifetime. However, some account owners did not trust that the heir would take this tax-minimizing approach. Thus the conduit trust was born, to make certain that the stretch really happened to the inherited IRA.

With a conduit trust, all RMDs from the retirement plan pass to the trust and then to the trust beneficiary, who will pay the income tax on the distributions. The conduit beneficiary is considered the only trust beneficiary for RMD purposes.

Conduit trusts should continue to work largely as before, according to Ms. Choate, depending upon the beneficiary. A conduit trust for a surviving spouse will be unaffected by the SECURE Act. But a trust for anyone other than one of the five categories of eligible designated beneficiaries will have to receive all of the IRA assets in ten years. If the IRA owner can accept that result, no change will be needed. If the conduit trust is used for a Roth IRA, which provides tax-free income, the only change is that the tax-deferred growth lasts only ten years. Query: For future estate plans,
will it be worth the effort to set up a conduit trust when the IRA payout must happen within ten years?

**Accumulation trusts**
In general, accumulation trusts that keep retirement plan distributions for later distribution to beneficiaries will be subject to the new ten-year rules, even if they are see-through trusts, according to Ms. Choate, because an eligible designated beneficiary is not the sole beneficiary of the trust. However, an exception is made for a trust for a disabled or chronically ill beneficiary.

**Charitable remainder trusts**
One emerging strategy to provide lifetime income payments to an heir from an IRA is to create a charitable remainder trust, either an annuity trust or a unitrust. The entire IRA may be paid to the trust, which will be tax exempt and so no income tax will be due. Therefore all the assets will be available to create the income interest, which may last for the beneficiary’s life.

This strategy may be appropriate for an IRA owner who has philanthropic desires to be satisfied through his estate plan, according to Ms. Choate, but it does not really “beat” the new limits of the SECURE Act.

**Direct gifts to charity**
Current law permits IRA owners who are at least 70½ to make a direct transfer of up to $100,000 from their IRA to charity. The transfer will not be included in the owner’s income, but it will satisfy the RMD requirement. This rule is not changed by the SECURE Act. The 70½ age rule applies even though RMDs are no longer needed until age 72.

**Caveat:** If one is working and makes contributions to a traditional IRA after age 70½, the $100,000 limit is reduced by the amount of the IRA contributions. This determination happens cumulatively. For example if Taxpayer makes a $6,000 traditional IRA contribution in Year 1, when he is 70½, and he makes no transfers to charity in Year 1 or Year 2, in Year 3 his maximum exclusion for a direct gift to charity from the IRA would be limited to $94,000. The offset is extinguished once it is used, so in Year 4 he could exclude up to $100,000 for a direct charitable gift from his IRA.

**Retroactive effect**
Someone who inherited an IRA before 2020 and who is taking life expectancy RMDs may continue to do so. However, when that individual dies in 2020 or later, the ten-year rule comes into play. Under the prior law, if the individual’s remaining life expectancy at death was, for example, 18 years, his or her heir would succeed to that 18-year period. Not anymore.

**Unanswered questions**
As with any new law, there are a host of unresolved issues. One of the most important, Ms. Choate suggested, is what happens with trusts that have multiple beneficiaries? What about a surviving spouse who is also disabled, and so is eligible under two criteria? Who chooses which set of rules to apply?

This promises to be an unusually interesting year for estate planners.

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**PARTIAL SALT CAP REPEAL PROPOSED**

The House Ways and Means Committee approved limited changes to the $10,000 cap on the deduction for state and local taxes (SALT). H.R. 5377, the Restoring Tax Fairness for States and Localities Act, would:

- boost the cap to $20,000 for tax year 2019 for marrieds filing jointly;
- repeal the cap for tax years 2020 and 2021;
- restore the $10,000 cap for tax years 2022 through 2025 (the cap sunsets in 2026 already); and
- pay for the $184.5 billion cost of this limited repeal by restoring the 39.6% top tax rate.

The vote in the Committee was 24–17 along party lines. In half of the states, the average SALT deduction is $10,000 or less, but in the high-tax states it was considerably more. In New Jersey, for example, the average SALT deduction in 2017 was $19,162.

The House passed the bill on a 218–206 vote on December 19, 2019. It has been received in the Senate and referred to the Committee on Finance. Observers don’t expect Senate approval this year.
Briefly noted

Zeroed out CLAT formula is OK

Taxpayer’s estate plan includes a marital deduction trust should his spouse survive him. At the spouse’s death, the trust becomes a charitable lead annuity trust (CLAT). The annuity will be 5% of the initial value of the trust. The term of the trust will be the number of years required to create a charitable deduction large enough to bring federal estate tax obligations down to zero.

Should the spouse die first, the CLAT will be created by Taxpayer’s estate, with the same formula—a 5% annuity for the number of years needed to zero out the federal estate tax then due. (Separate trusts were created to use of the value of the unified transfer tax credit.)

The IRS holds that the formula will provide numbers that are determinable as of the date of creation of the CLAT, and therefore the charitable deduction will be allowed [Private Letter Ruling 201933007]. If this element of the estate plan is not earlier amended, there will be no estate tax due for either Taxpayer or spouse, regardless of the order of death.

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