Tax Client Alert

SECURE Act: Major Change Impacts Estate Planning for 401(k) and IRA Distributions

Background

Federal budget legislation that included provisions commonly known as the Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act") was enacted by Congress and signed by the President on December 20, 2019. The SECURE Act contains important changes in the federal tax and employee benefit laws governing employer sponsored retirement plans and individual retirement accounts ("IRAs").

For individuals who have qualified retirement plan accounts or an IRA, the SECURE Act made a very significant change in federal tax law that can impact estate planning. The SECURE Act changes Internal Revenue Code provisions imposing required minimum distributions ("RMDs") for employer defined contribution plan accounts of individual employees, and for individual retirement accounts ("IRAs") owned by an individual.

The change applies to distributions from a plan or IRA in the event an individual dies prior to beginning distributions from the account. The new law could have significant tax effect for surviving designated beneficiaries of an individual plan participant or IRA owner who has a large plan account or IRA balance at the time of death.

In event of death, individuals who have a plan account or IRA and have designated beneficiaries should review the plan and IRA documents that have previously been signed and determine the application and effect of this SECURE Act change on the plan account or IRA and the designated beneficiaries. Changes should be made, as needed, to best plan and provide for the application of the new RMD rules going forward.

New 10-Year Rule for RMDs from Plan Accounts and IRAs

The new rule generally provides that all distributions to a designated beneficiary after death of the plan participant or IRA owner must be made by the end of the 10th calendar year following the year of death (new "10-Year Rule"), subject to certain exceptions.

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Under the new 10-Year Rule designated beneficiaries, such as children, will no longer be able to "stretch" out the period of time during which they can receive RMDs from a plan account or inherited IRA longer than 10 years, such as using their life expectancy, which has previously been allowed under prior law.

For example, under the new 10-Year Rule for an individual IRA owner who dies prior to commencing the distributions, an adult child of the IRA owner who is a designated beneficiary will not be able to plan and enjoy more lengthy federal income tax deferral by taking taxable distributions from the IRA over an extended period of time longer than 10 years.

Income Tax Planning to Deal With 10-Year Rule

In a case where the 10-Year Rule will apply, a designated beneficiary or a large plan account or IRA will likely need to carefully consider and continue to monitor the timing of RMD distributions in order to comply with the 10-Year Rule and also optimize the beneficiary's after-tax financial benefits from the account or IRA.

It appears that a designated beneficiary of a plan account or IRA subject to the 10-Year Rule will not be required to periodically or ratable take distributions from the account or IRA over the 10-year period, as long as the entire amount is distributed to the beneficiary by the end of that 10-year period.

Nevertheless, a designated beneficiary may be well advised to try to spread out RMD distributions, or plan to receive them in part periodically during the 10 year period. This could be advisable to achieve federal taxation of RMDs at lower rates and reduce the total federal income tax payable because of application of the 10-Year Rule. This would seem particularly important when the account or IRA has a very large balance at the beginning of the 10-year period.

Trusts as Designated Beneficiaries

The change to the new 10-Year Rule also should be considered carefully if an individual has designated a trust as a plan or IRA beneficiary that has children or other individuals who are beneficiaries of the trust. This is to assure the trust provisions are not in conflict with or prevent achieving compliance with the new 10-Year Rule, and that it can be applied in the most advantageous way.

Exceptions to 10-Year Rule

As exceptions, the 10-Year Rule, requiring RMDs within 10 years after the death of the plan participant or IRA owner will not apply if the designated beneficiary is an "eligible beneficiary." "Eligible beneficiary" is defined to mean a beneficiary designated by the plan participant or IRA owner who, as of the date of death of the plan participant or IRA owner, is either (1) a surviving spouse, disabled, chronically ill, not more than 10 years younger than the plan participant or IRA owner, or (2) a child of the plan participant or IRA owner who has not reached the age of majority.

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Effective Date

This change is generally effective for distributions by reason of death of an employee or IRA owner after December 31, 2019.

If you have questions about the SECURE Act and other changes in the law involving tax, retirement plans, IRAs and estate planning, please contact any attorney at GableGotwals you know or those who work in those practice areas named below.

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