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Tax & Estate Planning for Your Retirement Savings

To Track SECURE, Consider an IRA Trust

Guest IRA Expert

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The new Setting Every Community Up for Retirement Enhancement (SECURE) Act introduces a 10-year rule for many beneficiaries of IRAs and employer-sponsored retirement plans. Following this rule will require extensive tracking and failure to comply could generate a penalty equal to 50% of the amount involved.

One way to address this risk is to name a trust as IRA beneficiary, shifting tracking responsibility from the retirement plan beneficiary to the trustee of the IRA trust. Depending on a client's choice of beneficiary, it may be an astute move to begin discussions of an IRA trust this year.

Eligible Beneficiaries

Effective for deaths occurring in 2020 and later years, certain beneficiaries remain eligible for life expectancy-based required minimum distributions (RMDs). These eligible beneficiaries are surviving spouses, disabled and chronically ill individuals, minors (until they reach the age of majority), and individuals who are less than 10 years younger than the deceased IRA account owner.

The old rules, with certain modifications, apply to such beneficiaries. Indeed, stretching RMDs, tax-deferred, may become even more appealing for some heirs, under new IRS life expectancy tables.

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Done in a Decade

For all other individual beneficiaries, including most adult sons and daughters, the new 10-year rule will be effective. There will be no annual RMDs but the inherited retirement account must be emptied within 10 years following the year of death of the IRA owner.

Indeed, one IRA-related issue created by the SECURE Act relates to this 10-year rule. Technically, the new law indicates that designated beneficiaries can wait for 10 years before taking any distributions. Realistically, though, it's likely that the intent of the new law includes keeping the old law's rules on year-of-death RMDs.

Example: Suppose Alice dies in July 2020 at age 80 and leaves her IRA to her 50-year-old daughter Jenny, who is neither disabled nor chronically ill. Jenny would be subject to the 10-year rule with no distributions required until December 31, 2030.

That said, suppose that Alice had been taking $3,000 a month from her IRA, to satisfy her 2020 RMD. At her death, she had received 7 monthly payouts, for a total of $21,000.

Jenny, the IRA beneficiary, probably is still expected to withdraw the $15,000 RMD balance by the end of 2020, under the old rules. Hopefully, the U.S. Treasury Department will release some written guidance for clarification.

Missing the Mark

Assuming that a year-of-death RMD is required, and Jenny complies, she would have to withdraw all the remaining money from Alice's IRA (after a timely payout of the $15,000 remaining year-of-death RMD, in this example) by the end of 2030.

If Jenny takes no interim distributions, seeking maximum potential long-term investment buildup, she might face a steep income tax bill for 2030. However, 10 years of untaxed investment compounding could still bring her a substantial payout, after tax.

On the surface, this sounds straightforward. Inherit the money (and pay any remaining year-of-death RMD), let the account build for 10 years, distribute all the money, pay the tax, and emerge with a nice pile of cash.

Except, who will make sure that Jenny actually follows the plan? Not the IRA custodian, because financial firms have no obligation to do so. As things stand now, an IRA beneficiary probably will receive no notice of future mandated account liquidation by the end of the 10th year, from any source.

Perhaps Jenny's tax preparer (or some other advisor) will timely inform her of the year-of-death RMD and the 2030 deadline, but there is no assurance that will be the case. Even if Jen is so informed, there is no certainty that she'll be working with the same advisor in 2030, and will receive a timely reminder.

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Will Jenny, herself, remember? Perhaps, but many things can happen in 10 years. Jenny might lose some of her mental capacity. She might be so involved with family concerns that this inherited IRA slips her mind. And so on. If this IRA still exists for even one day in 2031, the entire amount could be subject to a 50% penalty.

Untimely Second Death

In another scenario, Jenny might die in, say, 2028, before the 10-year deadline, without emptying this inherited IRA. *What will happen to this account?* (Note: Any contingent beneficiaries of the original IRA account owner will not be recognized, once Jenny has inherited the account.)

Ideally, Jenny will have filled out a successor beneficiary form, naming her two children, soon after inheriting the IRA from her mother. If so, this inherited IRA could pass to Jenny's two children.

Will those new beneficiaries know they have two more years of untaxed investment buildup, followed by a full payout in 2030? Will they mistakenly believe that the 10-year clock starts over, giving them until 2038 to cash in? Or will they be totally ignorant about any distribution rules for this IRA?

Keep in mind that the SECURE Act is very much in the news now, with many articles in print and online, so advisors are all-too-well aware of the 10-year rule. The first chance for violation of this rule won't occur until 2030, and no one can know what will be happening in the world then, so the media focus on this deadline might be scant.

Unintended Successors

The preceding paragraphs assume that Jenny, the primary IRA beneficiary, completes a successor beneficiary form, naming her children.

In reality, this may not happen, so many IRAs will not have designated successor beneficiaries. In these situations, where the original beneficiary dies in the gap period with money still in the IRA but with no completed successor beneficiary form, the IRA custodian's default rules will apply to naming successors, and those provisions will vary from one financial firm to another. Alice's IRA may then pass to Jenny's husband – *even if Jenny and her husband are in the midst of hostile divorce negotiations* – rather than to Alice's beloved grandchildren.

Other scenarios also could result in an IRA passing to someone that the IRA owner would not have chosen. The IRA instead could pass to the original beneficiary's estate, with uncertain consequences – *and perhaps a more extensive probate process.*

What's more, such an unintended successor beneficiary might not realize that the original beneficiary was part-way through a 10-year countdown. The deadline could be missed, possibly resulting in steep taxes and penalties.

In yet another possible situation, suppose that Jenny's two children have succeeded Jenny as IRA beneficiaries after Jen's death, as explained. Further, suppose that one (or both) of the successor beneficiaries dies before 2030, leaving an IRA that has not yet been depleted.

If so, the same sequence of events will unfold. With a successor beneficiary form in place, a new co-beneficiary or co-beneficiaries will replace the one who died.

If there is no completed successor beneficiary form – *a likely outcome* – the IRA custodian's default rules will determine the replacement successor beneficiary. At this point, there may be little chance that the 10-year rule will be followed, so the 50% penalty on insufficient distributions may be triggered after 2030.

Time for a Trust

If clients plan to leave their retirement assets to recipients who are not eligible for life expectancy-based RMDS and are unwilling to subject such future beneficiaries to the risks described here, one way to address the problem is to name a trust as beneficiary of their IRA or employer plan account. Then, retain competent counsel to draft the trust.

Such an IRA trust might call for no payouts to the IRA trust beneficiary during the first 9 years, then a full distribution to the trust beneficiary during year 10.

The trustee also could be given the ability to pay out some cash to the trust beneficiary prior to full depletion of the IRA account.

With this arrangement, or something similar, the trustee will become responsible for following the 10-year rule created by the SECURE Act. Assuming the named trustee is a human, successor trustees could be named to step in if the original trustee dies or becomes incompetent.

Such a trust might be established immediately, as an IRA owner or plan participant could die at any time. Moreover, the trust creation should be handled by a knowledgeable estate planning attorney, as the SECURE Act poses challenges.

Show Them the Money

Advising clients to name a trust as IRA beneficiary is one thing, but convincing them to pay upfront for a trust may be a bit more of a challenge.

An experienced estate planning attorney might spend 10-15 hours to produce a solid IRA trust that meets a client's needs. The total cost would be the actual amount of hours involved, multiplied by the relevant billing rate, so the initial outlay could be thousands of dollars.

Fortunately, the IRA owner won't have to bear continuing administrative costs, if this is a newly-created trust that becomes effective at the IRA account owner's death. The future costs to the trust can be worthwhile, if the trustee helps avoid SECURE Act snares.

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The bottom line is that advisors' clients (and future retirement account beneficiaries) may be at-risk if they flunk the 10-year test. Similarly, headaches may also arise when an eligible designated beneficiary is the beneficiary of a retirement account. Advisors should be warning clients about potential future consequences.

Advisor Action Plan

- Discover the identities of clients' beneficiaries for their IRAs and employer-sponsored retirement plans.
- See if the beneficiaries are not eligible for life expectancy-based RMDs, as explained in this article.
- Inform clients with ineligible designated beneficiaries that the 10-year rule will apply to those beneficiaries, under the SECURE Act.
- Suggest to these clients that naming an IRA trust may be a worthwhile outlay of time and money, because their beneficiaries could be spared potentially adverse tax penalty consequences. ■

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Mr. Goldberg has been quoted in major publications including the New York Times, Forbes and the Wall Street Journal. He was formerly associated with the IRS and has been involved in conducting continuing education outreach programs with the IRS. He has authored guides for the American Bar Association and the American Institute of Certified Public Accountants on IRA compliance issues. Mr. Goldberg is the recipient of Outstanding Discussion Leader Awards from both the AICPA and the Foundation for Accounting Education. His IRA guides can be found in well over 100 law school libraries.

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