How "SECURE" Are You About Planning With Your Clients With Retirement Accounts? A Guide to Estate and Special Needs Planning After the SECURE Act

By Michael S. Kutzin and Tara Anne Pleat

On December 20, 2019, President Trump signed into law the Further Consolidated Appropriations Act, 2020 (the "2019 Tax Act"),[1] which included some of the most significant changes governing the taxation of retirement accounts in recent memory.

These changes, which were incorporated by the 2019 Tax Act in the final incarnation of a freestanding tax law change called the SECURE Act,[2] modified the way most, but not all, death beneficiaries of inherited retirement accounts will have to withdraw funds and the planning involving them.

With one exception, the manner in which original owners of defined contribution retirement accounts, such as individual retirement accounts, 401(k) accounts and 403(b) accounts will be taxed remains the same. The individual owner continues to be required to withdraw, on an annual basis, his or her required minimum distribution (RMD) every year after attaining a particular age. Prior to the year 2020, the plan participant generally was required to begin taking distributions no later than April 1st in the year following the year that the participant attained age 70½, and if the participant waited until then, he or she would be required to take a double distribution in that first year.

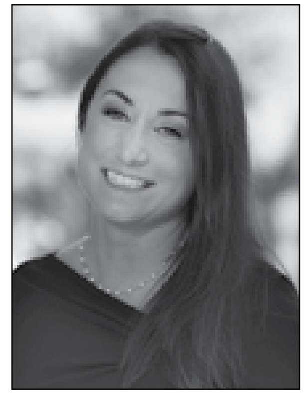
The SECURE Act, as it was finally enacted, changed the required beginning date for taking RMDs from the April 1st of year following attaining age 70½ to age 72.[3] Unfortunately, this change was not grandfathered, so someone who had already attained age 70½ before December 31, 2019 but had not yet attained age 72 before the year 2020 cannot take advantage of the more liberal required beginning date.

The more significant changes affect beneficiaries of retirement accounts.

Prior Law: Under prior law, if a "designated beneficiary" was named (as is explained in greater detail below), upon the death of the plan participant, that person could take RMDs over his or her single life expectancy. In the absence of there being a designated beneficiary (for example, the plan participant's estate became the beneficiary), then the monies would need to be paid out over five years if the plan participant had not begun taking RMDs during lifetime (they could be taken at one time or in any other manner of distributions as long as emptied over five years). If the plan participant had already begun taking RMDs before death but there was no designated beneficiary, then the RMDs would be taken over what remained of the deceased plan participant's single life expectancy.[4]

The advantage of being a "designated beneficiary" under prior law was the opportunity to stretch RMDs over a long period of time, which would defer taxation (for plans with pretax dollars) and permit continued tax deferred (or tax free) growth over prolonged periods of

Michael S. Kutzin



Tara Anne Pleat

Michael S. Kutzin is a partner in the White Plains, New York law firm of McCarthy Fingar LLP. He is the co-chair of its Guardianship Practice and also practices in the areas of Estate Litigation, Estate Planning and Administration.

Tara Anne Pleat is a member of the law firm of Wilcenski & Pleat PLLC. She is the Immediate Past Chair of NYSBA's Elder Law and Special Needs Section and a Member of the Board of Directors of the Special Needs Alliance, a national network of leading special needs planning attorneys. Tara is also a Fellow of the American College of Trust and Estate Counsel (ACTEC) and recently received the designation of Certified Elder Law Attorney (CELA)* from the National Elder Law Foundation.

Later this year, Michael and Tara will become the new authors of New York Elder Law, published by Matthew Bender & Co., succeeding longtime authors David Goldfarb and Joseph Rosenberg.special needs.

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time. For example, if a person age 80 died leaving her $1 million IRA to nephew, who was 40 years old in the calendar year after his aunt's death, the nephew could take RMDs over his remaining single life expectancy, which, based on IRS tables, was 43.6 years.[5] So in the first year, nephew would be required to take $22,935.78 from the IRA and incur taxation on that amount, while the remainder could continue to grow on a tax deferred basis.[6]

A "designated beneficiary" was (and still remains), an individual.[7] When a trust for the benefit of one or more individuals is named as the beneficiary of a retirement account, the designated beneficiary is either the beneficiary of a "conduit provision" (where all withdrawals, be they mandatory RMDs or discretionary withdrawals from the plan) are distributed to one individual beneficiary,[8] or the oldest potential beneficiary of an "accumulation trust."[9] An "accumulation trust" cannot pass to an estate or charity without eliminating the possibility of a life expectancy payout, and the oldest potential beneficiary must be determinable at the date of the plan participant's death.

> "The SECURE Act has favorable rules not only for persons named directly as beneficiaries, but also for properly structured trusts for their benefit."

Unlike from a conduit trust, the RMDs (or, for that matter, any other plan withdrawals) could be accumulated for the beneficiaries inside the trust.

Typically, third party supplemental needs trusts would be accumulation trusts in order to prevent disqualification from governmental benefits or to otherwise cause distributions to be budgeted as income that would need to be paid to a nursing home or spent down by a Community Medicaid recipient. However, under prior law, use of supplemental needs trusts as accumulation trusts could limit the benefit of having a designated beneficiary for tax planning purposes.

For example, suppose that a parent established a third party supplemental needs trust for the benefit of an incapacitated son, age 50, and named that trust as the beneficiary of his retirement accounts. As the parent had no other children or surviving spouse, he named his sister, age 80, as a remainder beneficiary, and then if the 80-year-old sibling does not survive the disabled child, the remainder passes to the parent's nieces and nephews, all being younger than his sister. Under the prior law, the measuring life for determining RMDs would have been the 80-year-old sister instead of his 50-year-old son, which would have sharply accelerated the money which would have had to have been withdrawn annually into the trust.

The same would have been true even if the parent had only named his 80-year-old sister as a contingent beneficiary only if all nephews and nieces had predeceased his incapacitated son.

The tax cost of accelerated distributions to the supplemental needs trust can be exacerbated by the fact that the marginal tax rates for trusts that accumulate income (i.e., trusts that are neither grantor trusts nor "simple trusts" in which all trust income must be distributed annually) are compressed. To the extent the undistributed taxable net income exceeds $12,950 (in the year 2020), the marginal tax rate on each additional dollar is 37%[10]—the maximum income tax rate for individuals.

As will be discussed below, however, in many cases, the changes in tax law by the SECURE Act may ameliorate some of the tax problems faced when establishing third party supplemental needs trusts.

SECURE Act. The SECURE Act substantially changed the way beneficiaries of inherited IRAs and other retirement accounts must be distributed. Except for certain favored beneficiaries ("eligible designated beneficiaries," described below), the SECURE Act provides that a designated beneficiary (i.e., an individual) of a retirement account must empty the account within 10 years, regardless of his or her age.[11] This sharply curtails the tax advantage to younger beneficiaries of retirement accounts and accelerates taxation.

However, "eligible designated beneficiaries" are treated more favorably. "Eligible designated beneficiaries" are the following persons:

1. A surviving spouse;
2. A minor child of the plan participant;
3. A beneficiary who is disabled;
4. A chronically ill individual; and
5. A beneficiary who is less than 10 years younger than the plan participant.[12]

The determination of whether a person qualifies as an eligible designated beneficiary is made at the time of the death of the plan participant.

These eligible designated beneficiaries remain able to take RMDs over their life expectancies, except that for minor children, upon their attaining majority, the exception ceases and the beneficiary must then withdraw the retirement assets over the next 10 years. [13]

For a designated beneficiary who meets the statutory definition of being "disabled" or "chronically ill," the SECURE Act has favorable rules not only for persons named directly as beneficiaries, but also for properly structured trusts for their benefit. "Disabled" is defined as a person who is

> unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.[14]

This language is almost identical to the statutory definition of disability for eligibility to receive Social Security Disability or SSI:

> inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months[15]

There can be little question, then, that someone who receives SSD or SSI will be treated as "disabled" for purposes of being treated as an eligible designated beneficiary.

The SECURE Act also provides the lifetime stretch for inherited IRAs and other defined contribution plans for designated beneficiaries who qualify as "chronically ill individuals." In order to be considered to be "chronically ill," and therefore an eligible designated beneficiary, the person must have been certified by a licensed health care provider as

1. Being unable to perform (without substantial assistance from another individual) at least two activities of daily living for a period of at least 90 days due to a loss of functional capacity or with similar levels of inability as permitted by Treasury regulations promulgated in consultation with the Department of Health and Human Services, or

2. Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.[16]

If the person is to qualify as chronically ill because he or she cannot perform two activities of daily living without substantial assistance, there must be a certification in place that the inability is an indefinite one which is reasonably expected to be lengthy in duration.[17] Many groups including the American College of Trust and Estate Counsel (ACTEC), the National Academy of Elder Law Attorneys (NAELA) and the Special Needs Alliance (SNA) have made recommendations and requested clarification from the Internal Revenue Service and the Department of the Treasury on the mechanics of the certification process.

The SECURE Act also provides an additional benefit to persons who are eligible designated beneficiaries by virtue of their being disabled or chronically ill: the opportunity to take advantage of a stretch of the RMDs in a trust that does not permit distributions of deferrable retirement benefits to anyone other than the disabled or chronically ill individual during his or her lifetime.[18] The trust itself must qualify as an accumulation trust—in other words, no beneficiaries other than individuals[19]—but if it does, then the RMDs should be based upon the life expectancy of the disabled or chronically ill beneficiary, regardless of whether or not tthe disabled or chronically ill beneficiary is the oldest beneficiary of the trust.[20] Upon the death of the eligible designated beneficiary, the other beneficiaries are treated as beneficiaries of the disabled or chronically ill beneficiary subject to withdrawal of the remaining retirement assets over 10 years.[21]

The authors believe that if a discretionary trust or, more particularly, a third party supplemental needs trust, provides that the disabled or chronically ill beneficiary is the only person who can receive distributions of any deferrable retirement benefits during his or her lifetime, then the trust may take the RMDs over the disabled or chronically ill beneficiary's life expectancy.

There are a number of practitioners around the country, however, who believe that this issue requires clarification from the Internal Revenue Service and the Department of the Treasury. In sum, they believe the SECURE Act permits a third-party supplemental needs trust that is structured in this manner to withdraw RMDs over a single life expectancy as opposed to 10 years, ***but over whose*** life expectancy is unclear. Some believe that this provision simply continues prior law regarding the use of life expectancies, since the SECURE Act provisions are an overlay (and not a replacement) of the existing laws and regulations, we still must consider the life expectancy of the oldest possible beneficiary of the accumulation trust. Many believe that this is the reason the language of the SECURE Act requires "designated beneficiaries" as the only other beneficiaries in an Applicable Multi-Beneficiary Trust. Again, NAELA and the SNA have submitted requests for clarification on this issue.

Moreover, many practitioners who represent parents of children with special needs would like the opportunity to name a charitable organization as beneficiary of a third-party supplemental needs trust that will benefit their child during his or her lifetime. Often that charity is the disability service agency which supported and served their child. Without a change to the statutory language regarding Applicable Multi-Beneficiary Trusts,[22] charities cannot be named as remainder beneficiaries.

The SNA has raised this issue with the Internal Revenue Service and the Treasury, as Congressional intent is clear that if only a chronically ill or disabled beneficiary can receive deferrable retirements benefits from a trust during his or her lifetime, then the life expectancy of the disabled or chronically ill beneficiary governs the applicable distribution period without regard to the remainder beneficiaries. It is the position of the SNA that it should not matter whether the remainder beneficiaries are individuals or charitable organizations.

For other eligible designated beneficiaries, such as minor children, however, there is no similar statutory relief for retirement assets naming a trust as a beneficiary. It appears that the only way to be able to stretch RMDs for these other eligible designated beneficiaries is to establish a conduit trust which effectively ignores any other potential beneficiary, and at a maximum will result in the entire account being paid out to the child 10 years after attaining the age of majority.

CONCLUSION

This article was intended to be an overview of the new post-SECURE Act world. Needless to say, this article merely scratches the surface of the issues and planning opportunities for clients with substantial retirement accounts. What is clear, however, is that planning may be a little easier for people who have loved ones with special needs, and that planning may be more complex, and with more considerations, for wealthier clients whose intended beneficiaries do not.

Endnotes

1. P.L. 116-94.
2. An acronym for The "Setting Every Community Up For Retirement Enhancement" Act.
3. IRC § 401(a)(9)(C)(i).
4. IRC § 401(a)(9)(B).
5. Table 1—Single Life Expectancy, Appendix B, Internal Revenue Service Publication 590-B.
6. Treas. Reg § 1.401(a)(9)-9 Q & A 1. For simplicity sake, the authors ignored the final RMD distribution that would have to be taken for the decedent in her year of death.
7. IRC § 401(a)(9)(E)(1); Treas. Reg. 1.401(a)(9)-4 Q & A 3.
8. Treas. Reg. §1.401(a)(9)-5 Q & A 7(c)(3)(Ex.2).
9. Treas. Reg. §1.401(a)(9)-5 Q & A 7(c)(3) (Ex. 1).
10. Rev. Proc. 2019-44. 2019-47 IRB 1093. In comparison, a married couple filing jointly are not taxed at the 37% marginal rate until their net income exceeds $622,050.
11. IRC § 401(a)(9)(H)(i).
12. IRC § 401(a)(9)(H)(ii).
13. IRC §§ 401(a)(9)(E)(3); 401(a)(9)(H)(ii) and (iii).
14. IRC § 401(a)(9)(E)(ii)(III), cross referencing IRC § 72(m)(7). The cross reference indicates that proof thereof as may be required by Treasury is a condition for meeting the standard for disability under the tax rules for annuities, but there do not appear to be any requirements at this time to qualify.
15. 42 U.S.C.A. § 423; 42 U.S.C.A. § 1382c(3)(A).
16. IRC §§ 401(a)(9)(E)(II)(iv); 7702B(c)(2). There are no regulations that have been promulgated regarding an expansion of the definition of "chronically ill" for purposes of the cross-referenced standard under the definition of a qualified long term care insurance policy as modified.
17. *Id.*
18. IRC § 401(a)(9)(H)(iv).
19. IRC § 401(a)(9)(H)(v).
20. IRC § 401(a)(9)(H)(iv).
21. IRC § 401(a)(9)(H)(iii) and (iv).
22. IRC § 401(a)(9)(H)(v)(II).