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TRUST AND ESTATES LAW ALERT | NIXON PEABODY LLP

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## **SECURE Act changes the payout rules for designated beneficiaries**

By Sarah M. Richards

On December 20, 2019, the Setting Every Community Up for Retirement Enhancement (SECURE) Act was signed into law. The Act makes significant tweaks to retirement plans to give Americans more and easier access to setting aside their own funds for retirement, but also imposes significant new timing restrictions on distributions for certain beneficiaries of these plans. The Act became effective January 1, 2020.

### **Who is affected by the SECURE Act's New Retirement Plan Distribution Requirements?**

The Act has substantial effects on the estates of people who will leave significant sums in their IRAs and 401(k)s and on the beneficiaries of those plans. For plan owners, retirement assets may be a significant component in their estate planning. The beneficiaries who inherit those assets at the owner's death have to plan for the income tax consequences of receiving distributions and may need to re-think their estate own plans.

The SECURE Act imposes tightened distribution requirements on many of the beneficiaries of inherited retirement plans. Those requirements may have a negative impact on estate and financial planning.

### **How did the pre-SECURE Act "Stretch IRA" work?**

Before the SECURE Act, certain beneficiaries of IRAs had the ability to stretch out the minimum required distributions ("MRDs") over their own life expectancies — the so-called "Stretch IRA." Since most IRAs accumulate tax-free and are subject to income tax only upon distribution to the plan holder or beneficiaries, this stretched-out timeframe allowed disciplined beneficiaries to continue to grow their IRAs and spread the income tax hit over (potentially) many years.

Estate planning for retirement assets often involved naming a client's trust as the designated beneficiary of his/her IRA, thus braiding the Stretch IRA into the trust. The stretched-out IRA distributions would merge into the decedent's trust over time. Proper estate and income tax planning required either that the trust include provisions requiring the IRA payments to be distributed to the trust's beneficiaries on a current basis, or carry out a complex analysis of highly

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technical rules permitting accumulation of retirement plan benefits in a trust. This type of careful planning minimized the income tax consequences inherent to traditional IRAs and 401(k)s, and allowed the IRA distributions to benefit the decedent's spouse and children/grandchildren over as long a period as possible.

### **What are the designated beneficiary payout rules under the SECURE Act?**

The SECURE Act eliminates the stretch for most beneficiaries designated by the plan owner. For IRAs of people who die after December 31, 2019, the IRA must be paid to the designated beneficiary over 10 years *unless* the beneficiary falls into one of five exceptions:

1. The beneficiary is the surviving spouse of the IRA owner. The surviving spouse can either use the life expectancy payout method or roll the IRA into an account in his/her name. At the death of the surviving spouse, the 10-year rule applies for any balance remaining in the account.
2. The beneficiary is a minor child of the IRA owner. The life expectancy payout method applies until the child reaches the age of majority, at which point, the 10-year rule applies.
3. The beneficiary is disabled to the extent of being unable to engage in any substantial gainful activity. The life expectancy method applies.
4. The beneficiary is certified as chronically ill. The life expectancy method applies.
5. The beneficiary is less than 10 years younger than the owner. The life expectancy payout applies.

### **What happens under the SECURE Act when a trust is the designated beneficiary?**

With the elimination of the Stretch IRA, trusts may become problematic beneficiaries of retirement plan assets. The forced compression of inherited IRA payments will not necessarily work well in a trust framework. The SECURE Act's mandatory distribution rules may conflict with the trust settlor's goals of providing for all family members over as long a period as possible.

Furthermore, because most retirement plan distributions are subject to income tax, this collapsed payout forces the income tax due on the distributions to be accelerated. The accelerated payment schedule means that the inherited IRA assets will not enjoy long-term tax-sheltered growth and that the distributions may push the beneficiaries' income into a higher tax bracket.

### **What is the projected income tax impact of the SECURE Act?**

The impact of the elimination of the Stretch IRA and the imposition of a 10-year distribution period can be measured by the government's assessment of the income tax that will be collected as a result of the change. The Congressional Research Office reported that an additional \$15.7 billion in revenue would be raised as a result of the shortened distribution period.

## **The SECURE Act does more than just change the designated beneficiary payout rules**

The SECURE Act, [among many other provisions](#), also:

- Re-sets the age at which retirement plan participants must take MRDs from 70½ to 72.
- Allows retirement plan participants to continue making contributions to retirement plans at any age.
- Allows the designated beneficiaries of inherited IRAs subject to the 10-year payout rule to take distributions from the IRA plan at any time until December 31 of the 10-year anniversary of the plan owner's death. There are no annual minimum required distributions. For example, the plan assets can all be taken in the 10th year.
- Allows certain part-time workers to participate in employer retirement plans.
- Allows employers more options in setting up retirement plans and reduces their liability for certain options.
- Requires sponsors of 401(k) plans to provide a participant with an estimate of the monthly lifetime payments they would receive based on their plan's account balance. These statements must be produced annually, and will be based on the assumption that the plan's funds were used to purchase an annuity for the participant and the participant's surviving spouse.

### **What actions should individuals take as a result of the SECURE Act?**

People with significant retirement plan assets should speak with their estate planning counsel to understand how the SECURE Act affects their planning and to adjust their estate plans and beneficiary designations accordingly.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

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