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Estate Planning & Settlement Newsletter

TAX AND ESTATE PLANNING UPDATE | DECEMBER 2020

THE SECURE ACT

New tax laws affecting the inheritance of retirement accounts went into effect on January 1, 2020, with the enactment of the SECURE Act. This update focuses on how those changes impact estate planning for retirement assets.

REQUIRED MINIMUM DISTRIBUTIONS

The SECURE Act raised the age at which an account owner must begin taking annual required minimum distributions ("RMDs") from tax-deferred retirement accounts, including traditional IRAs, traditional 401(k) plans, 403(b) plans, and 457(b) plans. Account owners who reached the age of 70½ prior to 2020 are still governed by the old rule requiring the account owner to begin taking RMDs on April 1 after the year in which the account owner reached the age of 70½. Under the new law, account owners born after June 30, 1949, generally must begin taking RMDs on April 1 of the year after reaching age 72. A Roth account holder is still not required to take RMDs during his or her life.

INHERITING RETIREMENT ACCOUNTS

The most significant impact of the SECURE Act is in how beneficiaries will inherit retirement assets, including both traditional and Roth accounts.

Prior law enabled many inherited retirement accounts to be distributed or "stretched" over the life expectancy of the beneficiary, allowing for continued income tax deferral. Under the SECURE Act, a non-spouse beneficiary must now withdraw the entire account within 10 years following the original account owner's death, thereby significantly accelerating the income taxation of traditional retirement accounts. This limits the period of income-tax-free growth for Roth accounts and the period of tax-deferred growth for traditional accounts. Under the 10-year rule, the beneficiary is not required to take distributions each year, but can take the distributions as he or she chooses, as long as the account is exhausted at the end of the 10 year period. In deciding when to take distributions from tax-deferred retirement accounts, beneficiaries are advised to consider strategies to reduce the income tax impact based upon the beneficiary's personal income tax situation.

The SECURE Act establishes exceptions to the 10-year rule for the following beneficiaries who are permitted to use a life expectancy payout: (1) a surviving spouse; (2) a minor child of the account holder; (3) a disabled beneficiary; (4) a chronically ill beneficiary; and (5) a beneficiary who is less than 10 years younger than the account holder. The exception for a minor child only lasts until the child reaches the age of majority (age 18 in Connecticut), at which point the 10-year rule will apply.

Existing inherited retirement accounts eligible for stretch payout as a result of a death that occurred before 2020 are still subject to the old minimum distribution rules. However, after the beneficiary's death, the new rules of the SECURE Act will apply.

TRUSTS AS BENEFICIARIES OF RETIREMENT ACCOUNTS

Many clients have designated a trust as the beneficiary of their retirement account in order to restrict a beneficiary's access to the funds or to protect the assets from creditors or estate taxation. There are two types of trusts that are typically used to receive retirement assets: "conduit" trusts and "accumulation" trusts. A conduit trust is designed to pass all distributions the trust receives from a retirement account directly to the beneficiary in order for those distributions to be taxed at potentially lower individual income tax rates. In contrast, an accumulation trust enables the trustee to retain the distributions from a retirement account in the trust for current or future distribution to the beneficiary. Where a conduit trust previously would have enabled the trustee to gradually make distributions from the retirement account to the beneficiary each year based on the beneficiary's life expectancy, under the new rules, a conduit trust for a non-spouse beneficiary will generally result in the beneficiary receiving the balance of the retirement account within 10 years. For clients concerned with asset protection, this may not be a desired result. If your estate plan currently utilizes a conduit trust, you may wish to consider amending your revocable trust to establish an accumulation trust. Note that retirement account distributions retained by a trust are often taxed at higher tax rates because trusts are subject to compressed income tax brackets.

You may name a trust for the benefit of an individual who qualifies for one of the five exceptions to the 10-year rule as the beneficiary, but the terms of the trust should be reviewed to ensure that the trust will qualify for payout on the basis of the beneficiary's life expectancy.

OPPORTUNITIES FOR CHARITABLE PLANNING

If charitable giving is an important component of your estate plan, there are several planning options to consider. Distributions to a charity named as a beneficiary of all or part of a retirement account are not subject to income tax or estate tax. When a charitable remainder trust is named as the beneficiary of a retirement account, one or more individual beneficiaries can receive a lifetime stream of income, after which the remainder will be paid to one or more charitable organizations tax-free.

NEXT STEPS

If you would like to discuss how the SECURE Act impacts your estate plan, or if you think it is time to have your documents reviewed, please contact us. In particular, if you have named a trust as the beneficiary of your retirement account, please contact your attorney to discuss whether you should make changes to your estate plan. We generally recommend that you review your estate planning documents at least every five years, and more frequently when you have significant assets that are affected by tax law changes or you have a change in family circumstances that could affect your plan.

If you would like to discuss how the estate tax laws affect your estate plan, or if it is time to have your documents reviewed because of changes in family circumstances, please contact us. We carefully customize estate plans to our clients' individual circumstances and personal objectives.

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