Wealth Planning Insights

Year-End Tax Law Impacts Every Taxpayer With an IRA or Other Retirement Account

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Highlights

- The recently passed Setting Every Community Up for Retirement Enhancement Act (SECURE Act) meaningfully impacts IRAs and other retirement accounts.
- Among the many significant changes are a fundamentally revised "stretch" distribution period for inherited IRAs and other retirement accounts, an increase in the required minimum distribution age for IRAs and other retirement accounts, the repeal of age limitations for IRA contributions, and the implementation of a single excise tax rate for private foundations.
- It's important to review the potential impact of these major new tax provisions on your retirement accounts as soon as possible — particularly if you have significant retirement account balances.

The spending bill passed by Congress on December 19 and signed by the president the following day includes many important and wide-ranging tax provisions. One of the two separate tax bills that were enacted is the Setting Every Community Up for Retirement Enhancement Act (SECURE Act). This major legislation includes some noteworthy changes to retirement accounts and will require individuals to revisit their current planning. All provisions take effect on January 1, 2020, unless otherwise stated.

Key Tax Provisions Impacting Bessemer Clients

- **Elimination of the "stretch" distribution rules for inherited IRAs and retirement accounts.** Perhaps the change in tax law creating the most discussion, and requiring the most immediate attention, is the complete overhaul of the long-standing rules that had permitted non-spouse beneficiaries to stretch retirement account distributions (and the related income taxes) over their lifetimes. This ability to extend the distribution period for inherited IRAs and retirement accounts created a potential lifetime annuity for beneficiaries and, for Roth accounts, one that was entirely tax free. For clarity, inherited IRAs refer to retirement accounts where the beneficiary is a non-spouse.

  Starting in 2020, barring a few exceptions mentioned below, non-spouse beneficiaries of retirement accounts will be required to draw down, or distribute, their entire inherited retirement account balance within 10 years. This can be done in up to 10 annual installments to manage the related income tax liability, or deferred in full until year 10. For Roth retirement accounts, full deferral until year 10 will typically be recommended. This new rule will undoubtedly require taxpayers to review their existing beneficiary designation forms and may result in the consideration of alternative planning strategies.

  Exceptions to the new 10-year distribution period are created for disabled or chronically ill beneficiaries as well as minor children. Spousal beneficiaries still retain the ability to roll over retirement accounts in their own names and avoid these new inherited retirement account restrictions.

- **Required minimum distribution (RMD) age increased to 72.** The SECURE Act raises the required starting age for IRA and retirement account distributions to age 72. This amendment applies to RMDs required to be made after December 31, 2019, for individuals who turn age 70.5 after this date. Anyone who attains age 70.5 before this date cannot take advantage of this change in RMD start date. When coupled with the new life expectancy tables taking effect in 2021, this provision will enable taxpayers to increase the tax-deferred growth inside retirement accounts.

- **Removal of age limits for IRA contributions.** Beginning in 2020, the SECURE Act repeals the age-limit rule, which prohibited contributions to IRAs (deductible or not) after age 70.5. As was always the case, anyone contributing to an IRA must have earned income equal to the contribution amount. Spousal IRAs are included here, meaning that either spouse over age 70.5 can each make IRA contributions as long as one spouse has sufficient earned income. Earned income is defined as income subject to payroll taxes. The maximum IRA contribution for 2020 is $6,000 per person, with an additional $1,000 catch-up permitted for anyone age 50 or older. This expands the opportunity for Roth IRA contributions for older clients.

- **Private foundation excise tax simplification.** Private foundations have historically been subject to a 2% excise tax on net investment income, though if certain conditions are met, this could be reduced by half to 1%. As a result of the spending bill, starting in 2020, there will be a single simplified rate of 1.39%.

The Planning Implications

The SECURE Act will require a fresh look at some income tax and estate planning strategies associated with IRAs and other retirement accounts. Listed below are a few observations that immediately come to mind.

- **Qualified charitable distributions.** The $100,000 annual limit on qualified charitable distributions (QCDs) will still be permitted for anyone with an IRA who is over age 70.5. However, this total will be reduced for any deductible IRA contributions made.

- **Naming a trust as beneficiary of an IRA or retirement account.** Many taxpayers with sizable retirement account balances have named trusts for the benefit of children and/or grandchildren as their designated beneficiaries. Generally speaking, two types of trusts are used here, conduit trusts and accumulation trusts. A conduit trust is less flexible since it requires that all of the distributions from the IRA be paid out to the beneficiary of the trust on a current basis. Accumulation trusts are more flexible since they allow the trustees to distribute or accumulate the distributions from the IRA as they see fit. You should revisit your planning as it relates to naming a trust as a beneficiary so that it aligns with the rest of your estate plan. Conduit trusts are of particular concern. The SECURE Act will now require distributions in full to conduit trust beneficiaries within 10 years, which would potentially remove the protection previously sought through the use of a trust.

- **Considering a charitable remainder trust (CRT) as retirement account beneficiary.** A CRT could be a potential strategy to extend the distribution period of an IRA or retirement account beyond the new 10-year inherited-IRA distribution period.

  A CRT is required to distribute a percentage of trust assets to one or more individual beneficiaries for life or for a term of up to 20 years, with the remainder going to a charity at the end of the trust term. The payments can be fixed based on the value of the trust at the inception (a charitable remainder annuity trust, or CRAT), or may vary based on the value of the trust each year (a charitable remainder unitrust, or CRUT). Since a CRT is a tax-exempt entity, the transfer of an IRA as a lump sum will not be a taxable event. Although use of a CRT as an IRA beneficiary may replicate some of the tax advantages under prior law, it should be noted that a CRT is less flexible than an accumulating trust.

- **Roth IRA conversions.** Roth IRA conversions have become a popular multigenerational planning strategy for high net worth taxpayers. Bessemer's Tax and Financial Planning group has prepared hundreds of Roth conversion analyses that typically reflect a long-term economic benefit for families who earmark Roth IRAs for children and/or grandchildren. The new 10-year distribution rule for inherited retirement accounts will clearly impact the long-term benefit of Roth conversions, but our modeling still suggests that Roth IRA conversions are worthy of consideration for many high net worth families. We would be happy to prepare a Roth conversion analysis to help you understand the potential benefit of a Roth IRA over a traditional IRA.

- **Naming grandchildren as retirement account beneficiaries.** Under the old life expectancy rules, retirement account required minimum distributions could be stretched over the life expectancy of the beneficiary. Naming grandchildren, often utilizing a trust, was a strategy employed by some high net worth taxpayers. Given the new 10-year limit on inherited retirement account withdrawal, choosing grandchildren as retirement account beneficiaries may no longer make sense.

Next Step: Review Retirement Account Beneficiary Designations

The drastic changes to inherited retirement account distribution rules necessitate a review of all beneficiary-designation forms, and potentially the rethinking of how retirement accounts fit into a family's overall generational planning. Individuals with significant retirement account balances would be wise to address the potential impact of these new tax provisions as soon as possible in 2020.

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