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New proposals would change estate planning for retirement accounts

A new proposal pending in Congress would affect estate planning strategies for retirement accounts. The proposal highlights the need to carefully consider beneficiary designations for these accounts – whether or not the law change passes.

Although the proposed changes under the SECURE Act, might eliminate a significant income tax benefit for some retirement account beneficiaries, some planning opportunities still would remain.

By way of background, the primary benefit of a retirement account, e.g., an IRA, 401(k), 403(b), etc., is the ability for the account to grow income tax free until the owner reaches the age of 70½.

The owner makes pre-tax contributions to the account until that age, at which point the owner must then start receiving annual required minimum distributions based on the owner's life expectancy, which are taxed as ordinary income.

If the owner dies before the retirement account is fully paid out, the balance of the account passes via beneficiary designation to the owner's designated beneficiary or beneficiaries. Importantly, these accounts don't pass by will, so it's essential to keep designations up to date.

Spousal beneficiaries have the option to perform a "spousal rollover," which essentially allows the spouse to treat the retirement account as if it was his or her own retirement account.

Non-spouse beneficiaries may elect to treat the retirement account as an "inherited IRA." Under current law, the new owner must begin taking required minimum distributions from the inherited IRA immediately, even if the new owner is under the age of 70 ½. But current law allows the new owner to calculate those required minimum distributions based on his or her own life expectancy, thereby allowing the income tax deferral to be "stretched" over the beneficiary's lifetime.

Essentially, under these circumstances, current law allows a retirement account to grow income tax free for two lifetimes: the original owner's lifetime *and* the non-spouse beneficiary's lifetime.

The SECURE Act presently pending in Congress would eliminate this significant benefit.

On May 23, 2019, the U.S. House of Representatives passed the SECURE Act by a practically unanimous margin (417 to 3). Although many analysts expected very quick passage of the SECURE Act in the U.S. Senate, the bill is currently stalled there thanks to the efforts of a few Republican senators.

The good news is that the SECURE Act would: (1) give more part-time workers the opportunity to participate in a 401(k) plan, (2) give people the chance to contribute to traditional IRAs for as long as they desire (current rules prohibit contributions to a traditional IRA by taxpayers who are age 70 ½ and older), (3) shift the required minimum distribution age for retirement accounts from age 70 ½ to 72, and (4) allow for penalty-free withdrawals under certain special circumstances.

The bad news is that the SECURE Act would eliminate the current ability of a non-spouse beneficiary to stretch out distributions from an inherited IRA over his or her life expectancy.

Under the SECURE Act, an inherited IRA must be distributed in full during the ten year period following the original owner's death. The ten year payout rule does have some flexibility: No annual distributions are required, but the inherited IRA must be fully distributed by the end of the tenth year. Income tax planning will dictate how an inherited IRA should be distributed to the beneficiary over the course of the ten year payout period.

There are certain exceptions to the ten year payout rule under the SECURE Act: (1) as under current law, a surviving spouse will still be allowed to perform a spousal rollover; (2) disabled or chronically ill beneficiaries will have the same option; and (3) minor beneficiaries will be allowed to use their life expectancies to measure annual required minimum distributions until they reach age 18, at which point the beneficiary will be subject to the ten year payout rule.

Planning for retirement accounts would change after the SECURE Act.

First, it should again be noted that whether or not the SECURE Act becomes law, retirement accounts pass via beneficiary designation, not by the terms of a will or revocable trust. Retirement account beneficiary designations *must* be drafted to work with your larger estate plan.

Second, there are no changes for spousal beneficiaries, who can still perform a spousal rollover, essentially allowing the spouse to treat the retirement account as if it was his or her own retirement account.

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Finally, for non-spouse beneficiaries, there is no doubt that the SECURE Act will cause the death of the stretch: non-spouse beneficiaries who inherit a retirement account after age 18 will be required to fully distribute the retirement account within ten years, not over their life expectancies.

But there are still some planning opportunities, particularly for minor beneficiaries. If the SECURE Act becomes law, retirement account owners may consider leaving some portion of their retirement accounts to minor grandchildren or other minor beneficiaries. Leaving a retirement account to a minor beneficiary would allow payout to be calculated based on the minor's life expectancy until age 18, at which point the retirement account would then need to be distributed over the following ten years, i.e., until age 28.

Prognosticators expect that the SECURE Act will pass the Senate in some form or another. At this point, commentators believe that the most-likely scenario for Senate passage and enactment is through the SECURE Act's inclusion in a year end omnibus spending bill. If and when the SECURE Act is signed into law, we recommend that individuals consult with their attorneys about changes to their beneficiary designations.

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