The SECURE Act

Are You SECURE in Your Planning for Retirement Accounts?

By Nicole D'Ambrogi

The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) took effect on January 1, 2020, and is the most sweeping federal legislation to affect retirement planning in more than a generation. The most significant changes under the new law relate to how distributions from a retirement plan must be paid out following the plan participant's death (and the death of his or her surviving spouse). With certain exceptions, the previous "stretch" distribution rules have been largely eliminated in favor of a ten-year payout.

What should your clients look out for? Should they look at alternative investment forms in light of this new act? What solutions might your clients consider to avoid a large tax bill for their heirs?

DISSECTING THE PROPOSED REGULATIONS UNDER THE SECURE ACT

The SECURE Act took post-mortem retirement planning and flipped it on its head. What was once well-established law was turned into the murky water of unknown territory for most planning professionals. The lack of instructions for implementation left many people without any direction on what to do with their retirement accounts upon their death, resulting in considerable tax consequences for their heirs.

Finally, on February 24, 2022, the *Federal Register* published the proposed regulations from the Internal Revenue Service (IRS), Treasury, clarifying and refining the distribution rules under the SECURE Act (https://tinyurl.com/27jefvzp). Advising clients on the most effective tax strategies for structuring their retirement plans within their estate starts with understanding how the proposed regulations will impact distributions upon their death. (It is essential to keep in mind, however, that the regulations remain proposed until they are adopted into law.)

There are two key things to keep in mind. First, under the SECURE Act, a spouse is still entitled to roll over a deceased spouse's qualified retirement account into their own. Also, most inherited qualified retirement accounts will be subject to the ten-year distribution rules under the SECURE Act.

However, there are some exceptions. As planning professionals, we must understand how these new regulations impact our clients' long-term goals. We need to know when the exceptions apply, if the distributions under the exceptions make sense for the heirs, and if our clients

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would benefit from alternative forms of investments considering the new regulations under the SECURE Act.

To simplify a very complex subject, this article focuses on the primary areas of the SECURE Act that pertain to the distribution regulations planning professionals need to look out for.

MINIMUM DISTRIBUTION AGE AND REQUIRED BEGINNING DATE

The SECURE Act pushed back the date at which a participant must start taking minimum distributions, also known as the required beginning date, to April 1 in the year after the participant turns 72 or retires, whichever comes later. However, suppose the participant is a 5 percent owner of the business sponsoring the retirement plan, or an individual retirement account (IRA) owner. In that case, the required beginning date is April 1 of the calendar year following the calendar year in which the individual turns 72, even if the individual is not retired.

Regarding required distributions to a beneficiary following the participant's death, the rules will be applied differently depending on whether or not the participant died before or after the required beginning date and who is the named beneficiary. To determine which rule applies and when, you need to understand the various rules and the classifications of beneficiaries.

DISTRIBUTION RULES

The SECURE Act has three main distribution rules: five-year, ten-year, and life expectancy.

Five-year rule (Section 1.401(a)(9)(B)(ii)). This rule requires that the entire interest of the participant be distributed within five years of the participant's death, regardless of who or what entity receives the distribution. For the five-year rule to be satisfied, the participant's entire interest must be distributed by the end of the calendar year that contains the fifth anniversary of the date of the participant's death.

Ten-year rule (Section 1.401(a)(9)-3(c)(3)). Under this rule, no amount is required to be distributed until the end of the tenth calendar year following the calendar year of the participant's death. In that year, the entire amount to which the beneficiary is entitled under the plan must be distributed. And because the distribution is treated as a required minimum distribution, it is not eligible for rollover distribution into another tax-deferred account. However, suppose the ten-year rule applies to a *designated beneficiary* (more on which below). In that case, any distribution made prior to the required distribution in the tenth calendar year following the participant's death is eligible for rollover if it otherwise meets the requirements of this section.

Life expectancy rule (Section 1.401(a)(9)(B)(iii), (iv)). This rule requires that any portion of a participant's interest payable to (or for the benefit of) a *designated beneficiary* be distributed, commencing within one year of the participant's death, over the life of such beneficiary (or over a period not extending beyond the life expectancy of such beneficiary). The life expectancy rule is applied differently depending on whether or not the beneficiary is the surviving spouse of the participant or if the beneficiary is an *eligible designated beneficiary*.

Spousal beneficiary. If the participant's surviving spouse is the sole designated beneficiary, distributions must begin on or before the later of (1) the end of the calendar year immediately following the calendar year in which the participant died or (2) the end of the calendar year in which the participant would have attained age 70.5.

For example:

John, who died in 2022 at the age of 68, was born just after the stroke of midnight on July 1, 1954; had he lived, he would have turned 70.5 on January 1, 2025. This means that his surviving spouse would not be required to start taking distributions until the end of that calendar year: December 31, 2025.

Don, John's twin brother, also died in 2022 at the age of 68. But Don was born just *before* the stroke of midnight, so his birthday is June 30, 1954; as a result, he would have turned 70.5 on December 30, 2024, and his spouse would be required to start taking distributions at the end of *that* calendar year: December 31, 2024.

However . . .

If John or Don dies in 2025 at age 71, his surviving spouse could delay taking distributions until December 31, 2026, which is the end of the calendar year immediately following the calendar year of his death.

Non-spouse beneficiary. If the designated beneficiary is not the participant's spouse, distributions must commence on or before the end of the calendar year immediately following the year in which the participant died.

For example: If John died in November 2021 and left his 401(k) to his younger sister Sally (who was nine years younger than him), Sally would have to start taking distributions beginning December 31, 2022.

A quick reference chart that can assist in determining which distribution rule will apply can be found in Tables 1 and 2, at right.

BENEFICIARY CLASSIFICATION AND DESIGNATIONS

There are three main classifications of beneficiaries: non-designated beneficiary, designated beneficiary, and eligible designated beneficiary. A simple way of remembering these classifications is thinking of the beneficiary as either an entity, an individual, or an individual +.

Non-designated beneficiary (entity): Any beneficiary named by the participant that is not an individual (example: estate, charity, or trust (exceptions for certain trusts)).

Designated beneficiary (individuals): A designated beneficiary is any *individual* designated as a beneficiary by a participant.

Eligible designated beneficiary (individual +): An eligible designed beneficiary is any designated beneficiary who, as of the date of the participant's death, is:

1. the surviving spouse of the participant;
2. a child of the participant who has not reached the age of majority (21); this designation status ends when the child reaches the age of majority;
3. disabled within the meaning of section 72(m)(7);
4. chronically ill within the meaning of section 7702B(c)(2); or
5. an individual not more than ten years younger than the participant.

TABLE 1. PLAN PARTICIPANT DIES BEFORE THE REQUIRED BEGINNING DATE

	Five-Year Rule	Ten-Year Rule	Life Expectancy Rule
Non-Designated Beneficiary (entity beneficiary / non-individual)	This rule applies. No annual RMDs.		
Designated Beneficiary (named individual)		This rule applies. No annual RMDs.	
Eligible Designated Beneficiary (named individual +)			This rule applies. Generally, no annual RMD, unless beneficiary is required to take RMD based on his or her own life expectancy.

TABLE 2. PLAN PARTICIPANT DIES AFTER THE REQUIRED BEGINNING DATE

	Ghost Life Expectancy	Ten-Year Rule & Life Expectancy	Life Expectancy Rule
Non-Designated Beneficiary (entity beneficiary / non-individual)	This rule applies. Annual RMDs apply.		
Designated Beneficiary (named individual)		This rule applies. Annual RMDs apply.	
Eligible Designated Beneficiary (named individual +)			This rule applies. RMDs required based on the beneficiary's life expectancy.

WHICH DISTRIBUTION RULE APPLIES AND WHEN

The key to understanding the SECURE Act and crafting the most advantageous plan for your client is being able to determine which distribution rule applies and when. This requires knowing if the participant died before or after the required beginning date. The key difference in applying the rules is the annual required minimum distribution (RMD).

Table 1, above, will help determine which distribution rule applies if the participant dies before the required beginning date.

If the participant dies after the required beginning date, the "ghost life expectancy" rule replaces the five-year rule, and the beneficiary will be required to take annual RMDs. The ghost life expectancy is the life expectancy of the decedent using the single life table, which sets forth the life expectancy of an individual at each age. Details can be found in Table 2 on page 14.

PLANNING TAX-EFFECTIVE STRATEGIES

The SECURE Act and proposed regulations left many planning professionals and clients wondering if they could implement any tax-efficient estate planning strategies to replace the traditional stretch IRA.

The good news is there are options; however, each alternative has its own set of tax rules, and not every option will advance the client's planning objectives.

Roth conversion. Unlike traditional IRAs, Roth IRAs are not subject to RMDs, and there is no required beginning date. Therefore, the distribution rules will be applied as if the participant died before the required beginning date. For most beneficiaries, the ten-year rule will apply and allow the assets inside the Roth to continue growing tax-free for up to ten years.

The drawback to the Roth conversion is the client will be stuck with the tax liability at the time of the conversion. In determining if this is an appropriate strategy, you, as the planning professional, must help the client evaluate the tax consequences of converting the account now versus having the beneficiary subject to the distribution rules under the SECURE Act.

Charitable remainder trusts. Depending on the size of the account, a charitable remainder trust may be the most advantageous strategy for reducing the tax liability imposed on individual beneficiaries. Using a charitable remainder trust allows the client to provide for a beneficiary with annual income, taxed to the beneficiary as ordinary income, for a specified duration or life.

Whatever remains at the end of the distribution period passes to a named charity.

Although there is no way to avoid paying the taxes and passing all the assets to an individual beneficiary, there are ways to reduce the tax liability to any one individual and benefit a charitable organization that has meaning to the client.

Life insurance pre-funding. The client may wish to consider purchasing a life insurance policy to help the beneficiary curb any tax liability during the distribution period. Some estate planning and financial professionals recommend this strategy for participants who have already passed the required beginning date and are receiving RMDs.

However, it is essential to consider that insurance policies will be more challenging to obtain on a life after the required beginning date. Also, the policy premiums may exceed the client's RMD. Curbing income tax liability for a beneficiary with a life insurance policy is an excellent strategy if planned for in advance and when the client is in optimal health.

AND NOW THE SEQUEL: THE SECURE ACT 2.0

The original SECURE Act increased the age that retirement account holders were required to take distributions from their accounts to age 72. However, legislators wanted to strengthen retirement accounts for seniors and introduced the SECURE Act 2.0 (Securing a Strong Retirement Act of 2021, H.R. 2954, 117th Cong. 2021).

The SECURE Act 2.0 is currently before Congress and is expected to pass in some form this session. This bill would increase the RMD age to 73 in 2022, 74 by 2029, and 75 in 2032, allowing some seniors three more years of avoiding tax liabilities on their retirement accounts.

CONCLUSION

Keeping up with tax laws and legislation is usually too complex and time-consuming for most clients. It is helpful to keep them up-to-date on changes that will affect them and their families. And the SECURE Act and the SECURE Act 2.0 affect almost everyone with a retirement account.

FURTHER READING

Robert Bloink & William H. Byrnes, *3 Stretch IRA Alternatives after IRS' Secure Act Surprise*, ThinkAdvisor (Mar. 16, 2022), https://tinyurl.com/bddu7x2y.

Death Before Required Beginning Date, 26 C.F.R. 1.401(a)(9)-3 (2022), https://tinyurl.com/3ksxzc54.

Required Minimum Distributions: A Proposed Rule by the Internal Revenue Service, 87 Fed. Reg. 10,504–67 (Feb. 24, 2022), https://tinyurl.com/27jefvzp. ■

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