ILLINOIS STATE BAR ASSOCIATION

JULY 2019 VOL 66 NO. 1

Trusts & Estates

The newsletter of the Illinois State Bar Association's Section on Trusts & Estates

The SECURE Act poised to eliminate common estate planning technique

BY LAWRENCE J. GREGORY

According to a recent study, one in three Americans have less than $5,000 in retirement savings, and one in five Americans have no retirement savings at all.[1] Given this dire state, it is no wonder that increasing the ability to save for retirement is one of the few issues that has garnered bipartisan support. On May 23, 2019, the U.S. House of Representatives passed the Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") with an overwhelming majority vote of 417-3.[2] The legislation will make it easier for individuals to save for retirement, primarily through increased access to retirement vehicles and more options to contribute to tax advantaged accounts such as 401(k), 403(b), and IRAs. However, in order to pay for these new saving options, the SECURE Act restricts a popular estate planning technique commonly used to preserve and grow qualified assets for future generations and defer its eventual taxation.

The SECURE Act

Some of the SECURE Act's more noteworthy changes to the current rules are to increase tax incentives for small employers to offer retirement plans, allow part-time workers to participate in 401(k) plans, increase the age for required minimum distributions from qualified accounts from 70½ to 72, and eliminate the prohibition on traditional IRA contributions for those 70½ or older.[3]

However, these changes come at the cost of federal tax revenues. To offset the decrease in tax revenue, the SECURE Act all but eliminates an account beneficiary's ability to take only the minimum distribution over such individual's life expectancy (the "stretch-out").[4] Instead, the SECURE Act imposes a 10-year payout for all such beneficiaries.[5] Where the life expectancy stretch-out would allow more of the account to grow tax deferred over a longer period of time, the SECURE Act would require a full withdrawal (and all income taxes paid) within 10 years.[6] This new rule will eliminate the qualified account planning most advisors use to achieve maximum tax deferral for the account owner's beneficiaries.[7] Typically, advisors will recommend an account owner's children be the beneficiaries; and in some instances, their grandchildren to utilize an even longer life expectancy. Depending on the size of the accounts and the generation appointed as beneficiary, the tax-deferred growth could be well into the millions.

There are some exceptions to the proposed 10-year payout rule. For example, the rule will not apply to a beneficiary who is: a surviving spouse, a child who has not reached majority, a person with a disability, a person with a chronic illness, or a person who is not more than 10 years younger than the account owner.[8] Any beneficiary who falls under an exception would continue to qualify for the life expectancy stretch-out.[9] Upon closer examination, however, the exceptions only appear to appreciably benefit disabled or chronically ill beneficiaries.[10] For instance, while the surviving spouse is an exception, it is of minor benefit compared to the spousal rollover rules which would still apply.[11] Additionally, the exception for a child who has not reached the age of majority is also similarly limited. The SECURE Act provides that on the day a minor beneficiary becomes of majority, the 10-year payout rule applies as of that date.[12] For example, if the age of majority is 18, the new rules will require the account balance to be fully distributed by age 28.

The Conduit Trust Vulnerability

For estate planning purposes, it is important to remember that only individuals (and certain trusts) can qualify as a beneficiary entitled to the life expectancy stretch-out upon the death of the account owner. Trusts must qualify as either a "conduit trust" or an "accumulation trust" to use the life expectancy of the trust's beneficiaries for minimum distribution purposes.[13] If the trust fails to qualify as either, then the entire qualified account balance must be withdrawn (and income taxes paid) within five years.[14]

Ever since the Treasury Regulations regarding conduit and accumulation trusts were finalized in 2002,[15] most standard revocable living trusts are now generally drafted to qualify as a conduit trust. One critical requirement of the conduit trust is that all qualified account withdrawals made by the trustee must "be paid directly to" the beneficiary, and may not be retained in the trust.[16]

By drafting a revocable living trust as a conduit trust, then depending on the beneficiary's age, only a relatively small amount of the qualified account balance must be withdrawn and distributed each year, allowing the remaining balance to continue to grow tax deferred.[17] Conduit trusts can also be drafted as discretionary spendthrift trusts to provide a layer of asset protection over the trust assets, including any balances remaining in qualified accounts. However, when a conduit trust's requirement to distribute all account withdrawals is applied against the SECURE Act's accelerated 10-year withdrawal rule, any discretionary spendthrift trust provisions will not apply to the fully distributed account balance after 10 years.

Therefore, unless treated, the SECURE Act's 10-year payout rule will act as a virus that infects standard revocable living trusts by leveraging their conduit (direct payment) provisions to force assets out of an otherwise healthy discretionary spendthrift trust at an accelerated rate. The vaccine, it seems, would be to hold such accounts in a trust free of any conduit provisions, such as an accumulation trust, or as discussed below, even intentionally failing the conduit or accumulation trust rules, in favor of a more flexible discretionary spendthrift trust. All trustees of both revocable and irrevocable trusts should review their current trusts and amend or modify, as applicable, though a trust protector, decanting, or other judicial or non-judicial means, to account for the resulting failure of the conduit provisions to achieve the trust's intended spendthrift objectives.

Although a trust can also be structured as an accumulation trust, which would allow for both the life expectancy stretch-out and the spendthrift protection over the amounts withdrawn from the qualified accounts, drafting a standard revocable living trust to qualify as an accumulation trust is exponentially more difficult than qualifying as a conduit trust.[18] In fact, the struggle to qualify as an accumulation trust has given rise to the prevalence of the stand-alone retirement trust.[19]

With the life expectancy stretch-out shaping up to be all but eliminated, the SECURE Act might create a scenario where the need to qualify as a conduit or accumulation trust may no longer be of primary importance.[20] Specifically, the SECURE Act's 10-year payout rule applies only to individuals (and those trusts qualifying as conduit or accumulation trusts). Any other non-qualified beneficiary remains subject to the current 5-year default payout rule.[21] In practice, the mental gymnastics necessary to qualify any given trust as a conduit or accumulation trust, and the planning restrictions inherent to those structures, is only providing the beneficiary an extra five years of tax deferred growth. Therefore, falling into the 5-year default payout rule, whether intentional or unintentional, might be preferable in certain circumstances.

So, What Next?

If the SECURE Act becomes law, it will significantly curtail the ability of advisors to plan for the life expectancy stretch-out. Some techniques to mitigate the adverse effects of this change include the increased use of Roth contributions and conversions, and the implementation of a spray trust. Additionally, charitable remainder trusts ("CRT") might also be a unique planning opportunity to mimic the stretch-out rules.

Roth Conversions. For anyone over the age of 70½, contributions to Roth accounts can be recommended where appropriate,[22] since contributions to traditional accounts above such age are prohibited.[23] While traditional accounts under the SECURE Act will achieve parity with respect to the unlimited contribution age as its Roth counterpart, Roth accounts may still be beneficial as they do not require minimum distributions at any age.[24] Although the SECURE Act increases the age for required minimum distributions to 72, Roth accounts never require minimum distributions while the account owner is alive. As a result, to the extent an account owner will not need to access Roth funds during his or her lifetime, a Roth account can help maximize the amount of funds that can remain in the qualified account until the account owner's death.

In addition to contributing to a Roth account at any age,[25] another approach is to convert traditional funds to Roth funds through the Roth conversion process.[26] In a Roth conversion, traditional funds are transferred to a Roth account, and the owner pays income tax on value of the funds at the time of conversion. Whether Roth conversions will benefit any given account owner is based on a large number of different factors, so the "numbers should be run" in any given case to determine whether converting some or all of the traditional funds will garner greater tax savings in light of the possible new SECURE Act rules.

Spray Trust. With only a relatively limited window of 10-years in which to distribute qualified accounts, making the account beneficiary a spray trust might provide the trustee the ability to reduce overall income taxes amongst its beneficiaries. A "spray trust" is a trust with multiple beneficiaries, where the trustee has the discretion to distribute assets in equal or unequal proportions amongst those beneficiaries. The trustee ostensibly has the ability then to control who will receive qualified account income. The tax reduction is accomplished by shifting qualified account income on an annual basis to the specific beneficiaries in the lowest tax bracket. While increasing the taxes on the low-bracket beneficiary, the overall tax burden of the entire class of beneficiaries is reduced.[27]

Charitable Remainder Trust. The use of charitable remainder trusts ("CRT") has relatively declined in recent years given the increase in the federal estate tax exemption amount ($11.4 million for 2019). However, under the SECURE Act, these trusts may be poised for a renaissance, as CRTs can mimic some of the stretch-out benefits currently received by qualified account beneficiaries. Under a CRT, the grantor contributes assets to an irrevocable trust and bifurcates the assets into an annuity stream for the beneficiaries, and a remainder amount which eventually goes to charity. The annuity can be for the life of a beneficiary, the lives of beneficiaries in multiple succession, or if there is no measuring life, for 20 years.[28]

By making a CRT the beneficiary of a qualified account, the CRT beneficiaries will be entitled to annual annuity payments from the trust for the remainder of their lives. As an asset of the CRT, the qualified funds will grow tax deferred, and income tax will only be paid on the annual payments to the beneficiaries. The majority of the annuity payments will be ordinary income and payable over the lives of the named beneficiaries.[29] As a result, the CRT does a decent job of mimicking the current stretch-out rules.

The caveat, however, is that at least 10% of the qualified funds must eventually go to charity.[30] It is called a *charitable* remainder trust, afterall. The CRT cannot be structured so that 100% of the funds are distributed to the non-charitable beneficiaries. Additionally, under the CRT rules the annuity payments are relatively fixed,[31] and the beneficiary cannot receive more than the annuity payment in any given year. Under the current stretch-out rules, a qualified account beneficiary has the ability to withdraw more than the required minimum each year.

In short, if the grantor is willing to cut charity in for at least a 10% piece of the qualified accounts, and is comfortable with the restriction on withdrawing more than the annual annuity, he or she could mimic the maximum stretch-out the beneficiaries could have enjoyed if the SECURE Act is signed into law.

Charity as Direct Beneficiary. While naming a charity as a direct beneficiary of a qualified account has always been a planning option, such option may garner more interest as a means to completely dispose of the 10-year payout issue. If the account owner is charitably inclined, he or she can name a charity directly on the beneficiary designation form, and the account will pass to the charity upon the account owner's death. Giving a qualified account to a charity is preferable to giving other assets to the charity, since charities do not pay any income tax on the account withdrawals.

RESA and RSSA

As of the writing of this article, the SECURE Act has been sent to the Senate for consideration and possible vote. However, since 2016, the Senate has attempted to pass their version of retirement savings reform under the Retirement Enhancement and Savings Act ("RESA"). RESA was re-introduced as recently as April 1, 2019, and contains many of the same changes as the SECURE Act, with some modifications. Both the SECURE Act and RESA eliminate the age limit on contributions to traditional IRAs, and they both modify the minimum distribution payout rules.

However, RESA's 10-year payout rule is reduced to 5-years and only applies to the aggregate qualified account balances in excess of $400,000. Presumably, any amounts under $400,000 can follow the current stretch-out rules. Additionally, RESA does not have a similar provision increasing the required minimum distribution age to 72, but another bill introduced in the Senate, the Retirement Security and Savings Act (RSSA) increases the age to 75.

From what this author understands, there is no mechanism for which to reconcile these bills under a reconciliation procedure. It appears that the SECURE Act, as introduced in the Senate, must be given a vote as an entire package. As of the writing of this article, the SECURE Act apparently is being held up by disagreements on provisions of the SECURE Act unrelated to anything discussed in this article. Despite the disagreement, their remains bipartisan support for the bill and most commentators are hoping the legislation gets passed before the Senate breaks on August 2, 2019. ■

Lawrence J. Gregory, JD, CPA is a partner at the Estate & Business Law Group PC and of counsel with SmithAmundsen LLC. He concentrates his practice in estate planning and business law, and can be reached at gregoryl@eblawgroup.com.

1. Northwestern Mutual (2018, May 8).*1 in 3 Americans Have Less Than $5,000 in Retirement Savings*. Retrieved from https://news.northwesternmutual.com/2018-05-08-1-In-3-Americans-Have-Less-Than-5-000-In-Retirement-Savings.
2. "Setting Every Community Up for Retirement Enhancement Act of 2019 (H.R. 1994): Roll Call 231." Congressional Record 165:87 (May 23, 2019) p. H4124.
3. Title I-IV of the SECURE Act.
4. IRC §401(a)(9)(B)(iii);
5. §401 of the SECURE Act.
6. Roth accounts will grow tax exempt, instead of tax deferred.
7. While technically incorrect terminology, for clarity, this article will refer to the "employee" beneficiary as the "account owner."
8. §401 of the SECURE Act.
9. IRC §401(a)(9)(B)(iii).
10. At least as it relates to tax deferral.
11. IRC §401(a)(9)(B)(iv).
12. Section 401 of the SECURE Act.
13. Treas. Reg. §1.401(a)(9)-5,A-7(c); *See also* Choate, Natalie B., "Life and Death Planning for Retirement Benefits" for a detailed and comprehensive discussion on the conduit and accumulation trust rules, and the means to qualify for both.
14. IRC §401(a)(9)(B)(ii).
15. Treas. Reg. §1.401(a)(9)-5.
16. *Id* at A-7(3).
17. Roth accounts will grow tax exempt, instead of tax deferred.
18. Treas. Reg. §1.401(a)(9)-5.
19. A stand-alone retirement trust is a trust separate and apart from a revocable living trust of which the sole purpose is to accept qualified account assets for the benefit of its beneficiaries. While the stand-alone retirement trust can be drafted as a conduit trust, its real benefit is in its ability to qualify as an accumulation trust (to allow for both the stretch out as well as the assets protection), which most revocable living trusts cannot do.
20. Treas. Reg. §1.401(a)(9)-4, A-1.
21. §401(a)(1) of the SECURE Act.
22. Pursuant to IRC §408A(c)(4), the lifetime required minimum distribution rules do not apply for Roth accounts. Additionally, Roth contributions can only be made to the extent the account owner has earned income. IRC §408A(c)(2)(A).
23. IRC §401(a)(9)(A),(C).
24. IRC §408A(c)(4).
25. To the extent the client has earned income.
26. In fact, this may be the only available mechanism of increasing Roth funds if the account owner has no earned income.
27. In order to properly shift the income tax burden amongst the beneficiaries, however, the qualified account spray trust must be a separate trust (or sub-trust) from the other assets.
28. IRC §664(d)(1)(A).
29. IRC §664(b).
30. IRC §664(d)(1)(D).
31. There are numerous variations in which payments can be made to the beneficiary such as a standard annuity (CRAT), a unitrust (CRUT), a net income makeup trust (NIMCRUT).