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insights

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The 2020 repeal of stretch IRAs: How will it affect estate planning?

On December 19, Congress approved a $1.4 trillion appropriations bill that included significant changes to the way IRAs and qualified plans will be administered, effective January 1, 2020. Two of the changes are to eliminate the maximum age at which an individual can make contributions to a traditional IRA and to delay the starting date for required minimum distributions from age 70½ to 72. The most significant changes, however, relate to required minimum distributions from inherited retirement plans and IRAs. This article will refer to only IRAs, because most qualified plans distribute to an IRA. Those changes shorten the period over which most non-spousal beneficiaries may be able to take distributions.

Background

Under pre-2020 law, a designated beneficiary could receive distributions over his or her lifetime through an estate planning strategy known as "stretch IRAs." Other beneficiaries must receive all of the inherited benefits over a five-year period after the participant's death unless the participant had reached his or her required beginning date before death. In that case, the payments could be made at least as rapidly as they were being made to the deceased participant. A "designated beneficiary" was any individual designated by the participant, and included trusts that met certain conditions. Thus, for example, if a child or grandchild was designated as the beneficiary of an IRA and the participant died, the payments to the beneficiary could be spread out over several decades.

About the new law

For account owners dying after 2019, the new law creates a new category of designated beneficiaries known as "eligible designated beneficiaries." An eligible designated beneficiary is any one of the following: (i) the surviving spouse, (ii) a minor child of the employee (until the child has reached "majority"), (iii) disabled (as defined in Code section 72(m)(7)), (iv) a chronically ill individual (as defined in Code section 7702B(c)(2)), or (v) an individual who is not more than 10 years younger than the participant. For eligible designated beneficiaries and non-designated beneficiaries, the law has not changed, except that the payout for minors is 10 years from attaining majority. For any other designated beneficiary, the payment period from an inherited IRA or plan may not exceed 10 years from the death of the participant (or the prior eligible designated beneficiary, as the case may be). This is true even if the participant had reached his or her required beginning date and had begun to take payments during lifetime. As a result, in some cases, the best result will be to avoid designated beneficiary status.

These changes will significantly impact estate planning for retirement benefits. Where the participant does not want to leave benefits outright to a beneficiary, a trust is made as the beneficiary. For a trust to qualify as a designated beneficiary, it needs to be a “see through trust” that is either a “conduit trust” or an “accumulation trust.”

Conduit trusts

A conduit trust requires the trustee to distribute immediately to the beneficiary any IRA distributions the trust receives. Under pre-2020 law, a long stretch meant that the conduit payout was relatively small, and generally an IRA would not be required to distribute principal until the beneficiary reached retirement age. With the change in the law, conduit trusts for designated beneficiaries will force the entire IRA to be paid to the beneficiary in as few as 10 years. As a result, they will rarely be a good option if protecting a spendthrift beneficiary or protecting the beneficiary from his or her creditors is the goal. However, given that trusts are in the top tax bracket at around $13,000 in taxable income, distributing the IRA may save significant income taxes, and a conduit trust will provide some spendthrift protection for a limited amount of time, if long-term spendthrift protection is not a more important goal.

Accumulation trusts

An accumulation trust will still be able to provide a beneficiary with substantial protection (as well as protecting a GST exempt trust from “leakage”) at the possible cost of higher income taxes being owed on amounts distributed from the IRA. Regardless of whether the trust qualifies as a designated beneficiary, the funds can remain in the trust indefinitely after they have been distributed from the IRA. Moreover, if the trust does not qualify as a designated beneficiary and the owner dies after his or her required beginning date, the payments to the trust can be spread out over the participant’s remaining life expectancy.

Other items to consider

If a minor child is named as a beneficiary, the child is considered an eligible designated beneficiary until he or she reaches the age of majority, and any remaining IRA must be distributed within 10 years after that. For purposes of this rule, “majority” is postponed for a certain amount of time while the beneficiary is a qualifying student (including college). Note that this rule only applies to a child of the participant and not any other minor, including a grandchild.

These rules do not apply to a participant who died prior to January 1, 2020. In that case, the old rules apply and anyone receiving benefits is grandfathered into the current system.

Planners may want to consider giving a trust protector or independent trustee the power to change a conduit trust to an accumulation trust or vice-versa, or to change the status of a trust from designated beneficiary to non-designated beneficiary or vice versa. To be recognized under the rules determining who is a beneficiary, any such amendment needs to be made no later than September 30 of the calendar year following the calendar year of the owner’s death. That will provide maximum flexibility to adjust to future changes in the law and the beneficiaries’ circumstance so that the trust protector or independent trustee can determine the optimum structure to protect beneficiaries or save income tax.

This article is not intended to provide legal or tax advice. Please consult an appropriate professional to advise you whether these ideas might help your particular situation.

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