The SECURE Act and the RMD: Now's the Time to Review Your Retirement Account Trust Beneficiary Designations

Christopher Rogers
crogers@mwlaw.com
(479) 464.5651

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The Setting Every Community Up for Retirement Enhancement Act of 2019 (the "SECURE Act") was signed into law on December 20, 2019, with a January 1, 2020 effective date. Although mostly designed to provide additional flexibility in creating and administering retirement accounts, the SECURE Act's most significant change is arguably limiting the ability to stretch an inherited retirement account's required minimum distributions over the beneficiary's lifetime.

I. Required Minimum Distributions Under the SECURE Act:

The new required minimum distribution ("RMD") rules, contained at IRC §401(a)(9)(E) and §401(a)(9)(H), provide for three groups of beneficiaries:

1. Eligible Designated Beneficiaries: Designated Beneficiaries can continue to stretch RMDs over the beneficiary's life expectancy. Eligible Designated Beneficiaries are limited to:

- Spouse of the participant.
- Minor Children of the participant (with the 10 year rule kicking in upon reaching majority).
- Disabled and Chronically Ill individuals.
- Individuals that are not more than 10 years younger than the owner.

2. Designated Beneficiaries: Beneficiaries must fully distribute an inherited retirement account within 10 years of the participant's death. Designated Beneficiaries include individuals (that are not Eligible Designated Beneficiaries) and certain types of trusts.

3. Other Beneficiaries: For all other beneficiaries, the RMD rules are the same as before the SECURE Act:

- If the participant dies before his/her required beginning date – the retirement account must be fully distributed within 5 years of participants death.
- If the participant dies on or after his/her required beginning date – the retirement account must be fully distributed within what would have been the participant's life expectancy had the participant not died.

II. Pre-SECURE Act -- RMDs and Trusts as Beneficiaries:

Prior to the SECURE Act a Designated Beneficiary could elect to stretch the RMD over that beneficiary's lifetime. (Old IRC §401(a)(9)(B(iii)).

For a variety of reasons, it was often desirable to name a trust, rather than an individual, as beneficiary of a retirement account. Because a trust does not have a life expectancy, a trust initially would not qualify as a Designated Beneficiary. The Treasury Regulations created the concept of a "see-through" trust, in effect, giving the trust a measurable life expectancy and qualifying the trust as a Designated Beneficiary. See Treasury Regulation 1.401(a)(9)-4, Q&A-5.

To qualify a trust as a see-through trust the trust could be structured as a "conduit trust" or an "accumulation trust." The conduit trust required the trustee to distribute the RMD through the trust to the beneficiary. The accumulation trust gave the trustee the discretion to distribute the RMD to the beneficiary, or hold/accumulate the RMD within the trust.

Conduit Trust – The conduit trust requires distribution of RMD to the current trust beneficiary. Common conduit trust language read as follows:

"Furthermore, if the trust is a beneficiary of any assets that are part of a retirement plan or account which is subject to the minimum distribution provisions of § 401(a)(9) of the Code, then notwithstanding any other provision of this trust which may appear to the contrary, *the trustee of the trust shall cause distributions from such account or plan in each calendar year to be at least equal to the minimum distribution required to be made from such plan or account under § 401(a)(9) of the Code, and such distribution shall be paid to the income beneficiary of such trust who is considered the "look-through" beneficiary of such trust for § 401(a)(9) purposes."*

The conduit trust worked fine as long as the RMD could be stretched over the trust beneficiary's life expectancy. For example, if Parent named the Child A Trust as beneficiary of Parent's IRA, and if the Child A Trust was structured as a conduit trust that qualified as a Designated Beneficiary -- following Parent's death, the Child A Trust would then hold an inherited IRA, the RMD would be calculated based on Child A's life expectancy, the RMD would be distributed from the inherited IRA to the Child A Trust, and the trustee would distribute that RMD to Child A.

Accumulation Trust – An accumulation trust allows for discretionary distributions of RMD to the trust beneficiary. If RMD not distributed to the trust beneficiary, the RMD is accumulated within the trust and that RMD is taxed to the trust. Under current trust income tax laws, a trust is taxed at the maximum federal income tax rate of 37% at only $12,750 of income; while an individual doesn't reach the maximum tax bracket of 37% until he/she has $612,350 of income (married filing joint) or $510,300 (single). So in most instances, the accumulation trust will pay more income tax if the RMD is accumulated, than would be paid by the beneficiary if the RMD is distributed.

Notwithstanding the higher income tax rates associated with a trust, the accumulation trust also worked fine where the beneficiary had a longer life expectancy so that the RMD could be stretched over a long period of time. The higher tax rates could be managed without defeating the purpose of the accumulation trust. In the above example, as the RMD is distributed from the inherited IRA to the Child A Trust, the trustee could exercise its discretion in distributing the RMD to Child A in a sufficient amount to minimize income taxes.

III. Post-SECURE Act -- RMDs and Trusts as Beneficiaries:

Prior to the SECURE Act, the disadvantages associated with the conduit trust (required distribution) and accumulation trust (potentially higher income tax) were manageable because the RMDs were generally distributed over a longer period of time.

Under the SECURE Act, assuming the trust qualifies as a Designated Beneficiary, an inherited retirement account must be fully distributed within 10 years of the participant's death, the result being the disadvantages of the conduit and accumulation trusts are compounded. If it continues to be appropriate to name a trust as beneficiary of a retirement account, there are two options:

- Structure the trust as a conduit trust with the knowledge that the retirement account will be fully distributed to the individual beneficiary within 10 years of the participant's death, potentially defeating the purpose of naming the trust as beneficiary in the first place.
- Structure the trust as an accumulation trusts, presumably providing more flexibility in that the trustee of the accumulation trust can decide between a larger than preferred distribution of the RMD to the trust beneficiary, or an accumulation of the RMD with a higher income tax. Keep in mind, however, that with many/most accumulation trusts, the trust distributions are based on an ascertainable standard – the beneficiary's health, education, support and maintenance needs. Where the RMD could be distributed over a longer period (the beneficiary's life expectancy), the RMD would often come within the ascertainable standard. With the retirement account now having to be fully distributed within 10 years of the owners death – the distributions may not be within the ascertainable standard, forcing the accumulation and higher income taxes.

Note that if the trust beneficiary is an Eligible Designated Beneficiary (for example, a spouse or minor child of the participant) -- to be able to stretch the RMDs over the beneficiary's life expectancy, the trust must be set up as a conduit trust and not an accumulation trust because the Eligible Designated Beneficiary has to be the sole beneficiary. So a trust for the benefit of a spouse or a minor child must be set up as a conduit trust. There is an exception to the sole beneficiary rule, that allows a trust is for the benefit of a disable or chronically ill individual to be structured as an accumulation trust. See IRC §401(a)(9)(H)(v).

The bottom line is, where naming a trust as beneficiary continues to be appropriate (and except in the case of a trust for the benefit of an Eligible Designated Beneficiary), you will need to decide what is more important – the long-term protection the trust may provide to the beneficiary, or minimizing income taxes by distributing the RMD.