Why It Still Makes Sense to Pay Inherited IRAs to a Trust Even After the Passage of the SECURE Act

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The largest investment asset for a majority of Americans is their retirement account either through an employer sponsored 401k plan or an investor funded individual retirement account ("IRA"). For convenience, this article refers to all qualified retirement accounts as IRAs. By some estimates, there is over $10 trillion held in IRA accounts in the United States. Generally, clients seek to pass on their IRAs to their beneficiaries, particularly their spouse or children, as a legacy, upon their deaths. Many people do not think, without good legal counseling, about leaving their IRAs to a trust for their children to protect inherited IRAs from creditors (e.g., lawsuits, divorce, bankruptcy and other creditor claims). However, with a properly drafted trust IRAs can be protected from a beneficiary's creditors. This article addresses why it still makes sense to utilize a trust even though the SECURE Act is law.

What is the Secure Act?

The Setting Every Community Up for Retirement Enhancement Act of 2019, better known as the "SECURE Act", was signed into law on Dec. 20, 2019. It is a far-reaching law that includes significant provisions aimed at, supposedly, increasing access to tax-advantaged accounts and preventing older Americans from outliving their assets. The SECURE Act has been the topic of past newsletter articles and the firm's "Elder Law Guys" column that appears in the Pittsburgh Post-Gazette. For more information on the SECURE Act, see the "Elder Law Guys: *Congress has come for your money*", Pittsburgh Post-Gazette January 27, 2020, edition.

How Has the Secure Act Changed the Payment Period of IRAs to Beneficiaries?

The biggest change caused by the passage of the SECURE Act is a mandatory ten (10) year distribution period for a majority of IRA beneficiaries instead of over a beneficiary's life expectancy (commonly referred to as "stretch distributions") which was permitted prior to the Secure Act becoming law. This change in the law has caused beneficiaries to incur greater tax liability in a shorter time period and thus has caused beneficiaries to lose the time value of tax deferred growth on their inherited IRA.

Here is an example: Under the SECURE Act, the 10 year distribution period starts on the first day of the year after the year of the owner's death. Thus, for example, if an account owner died on March 25, 2021, the first day of the 10-year distribution period will not start until January 1, 2022, and will not end until December 31, 2031. If the beneficiary has not completely withdrawn the inherited IRA account by

December 31, 2031, hefty penalties would be imposed. There is no requirement that a specific amount be distributed from the inherited retirement account at any time during the 10-year term. The only requirement is that the all taxes on the inherited IRA must have been paid and that the IRA has a $0 balance at the end of the 10-year term. (Note: the balance after payment of all taxes can be transferred to non-qualified IRA investment account or cash account which can also be held in trust for the beneficiary).

The SECURE Act created exceptions to the 10-year distribution period for a select group of special beneficiaries, who are called “Eligible Designated Beneficiaries” (“EDB”). A beneficiary who is an EDB can receive a distribution period based on the EDB’s life expectancy as opposed to the 10-year term (which usually means a longer distribution period and a more favorable income tax outcome).

The following individuals qualify as EDBs under the SECURE Act: (1) a surviving spouse; (2) a minor child of the decedent (until the child reaches the age of majority at which point the 10-year rule kicks in); (3) an individual with disabilities; (4) a disabled individual; and (5) an individual who is not more than 10 years younger than the decedent. Again, EDBs are entitled to distribution periods based on their life expectancies which in turn permits them to have longer tax deferred growth.

How can a Trust Protect Inherited IRAs from Unforeseen Circumstances?

At the time an account owner makes his or her IRA beneficiary designations it is impossible to know what circumstances his or her beneficiaries (e.g., children and grandchildren) may face in the future. For example, the divorce rate for first marriages in the United States is approximately 50%. Even a child who seems to have a good marriage now, may not have one later. Further, what if a child dies prematurely? Would you want your grandchildren to get it, or would you prefer that your child’s spouse gets it? What happens if your child’s spouse remarries? What if your child or grandchild becomes disabled? What happens to the inherited IRA then ?

Specifically, let’s discuss what would happen if a child inherited an IRA and is disabled. As stated above, your disabled child would get to stretch IRA distributions over his or her life expectancy, but that will not help to protect any means tested government benefits that you child may be entitled to receive such as a Supplemental Social Security Income and Medicaid. Often times, it is the ability to qualify for, and maintain, Medicaid benefits that permits the child to receive adequate medical coverage. Without proper planning, an inherited IRA would have to be exhausted before Medicaid benefits would kick in for the disabled child.

A well drafted trust can address all of the concerns discussed above and provide you with piece of mind that your child’s inherited IRA will protected against life’s unforeseen events. For more information or to schedule a consultation, please contact our office.