ACTEC Law Journal

Volume 46 | Number 1 Article 14

9-1-2020

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Recommended Citation

Kaplan, Richard L. (2020) "Estate Planning for Retirement Benefits after the SECURE Act," *ACTEC Law Journal*: Vol. 46: No. 1, Article 14.
Available at: https://scholarlycommons.law.hofstra.edu/acteclj/vol46/iss1/14

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Estate Planning for Retirement Benefits after the SECURE Act

*Richard L. Kaplan**

In very general terms, the law of trusts and estates focuses on people's property after they are gone, while Elder Law focuses on the financial and legal implications of extended life.[1] This line of demarcation, however, is often not as precise as it might seem, and one of the most significant areas of overlap between these two fields pertains to retirement benefits, especially defined contribution plans. This article examines this intersection generally and with particular attention to the changes enacted by the SECURE Act on December 20, 2019.[2]

For most Americans, their retirement plans represent the largest store of economic value other than their residence and in many cases, even including their residence. These plans are typically much more liquid than residential property and can be converted into cash with relatively minimal hassle or delay. As such, they represent a major source of income during an employee's retirement and possibly to their spouse after the employee dies. Accordingly, the management of retirement plans has tremendous importance from both Elder Law and estate planning perspectives.

In earlier eras, retirement plans were typically of the defined benefit variety,[3] meaning that the plans promised employees specific benefit levels that depended on their employment tenure and earnings levels. These promises are backed by the assets of the employer and further backstopped by guarantees issued by a federal agency, the Pension Benefit Guaranty Corporation (PBGC), that operates similarly to the Federal Deposit Insurance Corporation for bank deposits.[4] The employee usually had no role in managing the investments of his or her defined

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1 *See* Richard L. Kaplan, *Elder Law as Proactive Planning and Informed Empowerment during Extended Life*, 40 STETSON L. REV. 15, 17 (2010).

2 Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019, Pub. L. No. 116-94, 133 Stat. 2534, 3137 (2019) [hereinafter SECURE Act] (enacted as Div. O of Further Consolidated Appropriations Act, 2020).

3 Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 453-54 (2004).

4 *Id.* at 465; CONG. RESEARCH SERV., PENSION BENEFIT GUARANTY CORPORATION (PBGC): A PRIMER 1 (2019).

benefit plan and had no serious risk beyond the solvency of that person's former employer.

But for most Baby Boomers and certainly for later generations, retirement plans are generally of the defined contribution variety.[5] Such plans stipulate how much an employer contributes to the pension plan, which is usually some percentage of an employee's earnings, but there is no guarantee what these contributions will produce in terms of annual income when the employee eventually retires. On the other hand, employees typically do have a role in choosing the investments that comprise their retirement plans and some ability to change those allocations within the parameters of the sponsoring employer's plan.

Retirees in defined contribution plans also have fairly unfettered control over how accumulated funds are withdrawn. Some retirees choose to annuitize these funds and thereby replicate a stream of monthly income comparable to what a defined benefit plan would produce. Other retirees simply withdraw amounts whenever they need to fund anticipated spending, either directly from the retirement plan or by rolling over the plan accumulation into an Individual Retirement Account (IRA) that they can then access at will.

In each such circumstance, the cost of removing funds from the retirement plan is payment of income tax,[6] both federal and in most cases state as well. These taxes, moreover, are calculated at the ordinary income rates that are otherwise applicable to the retiree when the funds are withdrawn, regardless of what the assets in the retirement plan consisted of or what tax rates applied when the retiree put the funds into the plan originally.[7] In any case, there is no protection comparable to that provided by the PBGC.

Withdrawing funds from one's retirement plan is not completely unrestricted, however. Retirement plans are intended to provide income *during retirement*, and withdrawals prior to retirement are therefore discouraged by imposition of an early-withdrawal penalty. Specifically, a distribution taken prior to a person reaching age 59½ is subject to a penalty of 10 percent of the distribution, in addition to the income tax otherwise imposed.[8] There are several possible exceptions to this pen-

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5 Zelinsky, *supra* note 3, at 454; *see Retirement Plan Access and Participation Across Generations*, THE PEW CHARITABLE TRS. 4 (Feb. 2017), https://www.pewtrusts.org/-/media/assets/2017/02/ret_retirement_plan_access_and_participation_across_generations.pdf.

6 I.R.C. § 402(a).

7 Zelinsky, *supra* note 3, at 516-17; *see* James M. Poterba, *Saving for Retirement: Taxes Matter*, B.C. CTR. FOR RETIREMENT RES. (May 2004), https://crr.bc.edu/wp-content/uploads/2004/05/ib_17-1.pdf.

8 I.R.C. § 72(t)(1), (2)(A)(i).

alty including death or disability of the accountholder,[9] as well as withdrawals for certain designated purposes such as paying medical expenses.[10] More recently, a further exception was added for withdrawals by an accountholder (or that person's spouse or dependent) who is diagnosed with COVID-19.[11] But the point remains that retirement plans are intended to fund retirement.

In similar fashion, such plans are not intended to serve as vehicles for transferring wealth to one's progeny, and the tax code therefore penalizes the failure to withdraw funds from these accounts during an accountholder's lifetime. Specifically, if funds are not withdrawn once a retiree attains age 70½, a penalty of 50 percent is imposed on a calculated minimum amount that should have been withdrawn.[12] The policy rationale for this rather draconian penalty is that the tax code provides other mechanisms to facilitate wealth accumulation, such as preferential tax rates for capital gains[13] and a tax-free step-up in basis at death,[14] and that retirement accounts should not be used for what are basically testamentary purposes.

That said, the triggering age of 70½ was recently changed by the SECURE Act to 72 for persons born after June 30, 1949.[15] Although this change may seem relatively small, it nevertheless represents an opportunity for some holders of retirement accounts to defer taking withdrawals from their retirement accounts and incurring the associated tax cost. To be sure, most holders of retirement accounts need these funds to finance their retirement, but delaying so-called "Required Minimum Distributions" (RMD) can benefit those retirees who do not need those funds just yet. In any case, the triggering age of 70½ was enacted almost 40 years ago,[16] and subsequent increases in U.S. life expectancy would suggest that the age at which RMDs must commence should now be 75.[17] Thus, increasing the beginning age to 72 is only a partial remediation of this outdated parameter.

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9 *Id.* § 72(t)(2)(A)(ii), (iii).

10 *Id.* § 72(t)(2)(B); *see also id.* § 72(t)(2)(E) (higher education expenses), (F) (first-home purchases). *See generally* Richard L. Kaplan, *Retirement Funding and the Curious Evolution of Individual Retirement Accounts*, 7 ELDER L.J. 283, 292-303 (1999).

11 Coronavirus Aid, Relief, and Economic Security Act, Pub L. No. 116-136, § 2202(a), 134 Stat. 281, 340-42 (2020).

12 *See* I.R.C. §§ 401(a)(9)(A)(i), (C)(i)(I), 4974(a).

13 *Id.* § 1(h).

14 *Id.* § 1014(a)(1).

15 SECURE Act § 114(a), (d).

16 Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 242(a), 96 Stat. 324, 521.

17 Using life expectancy figures for 2020 and 1982, 78.93 ÷ 74.15 = 1.06446 *x* 70.5 = 75.04. *See U.S. Life Expectancy 1950-2020*, MACROTRENDS, https://www.macrotrends.net/countries/USA/united-states/life-expectancy [https://perma.cc/28CA-3VUD]; *see also*

If a retirement account is not completely liquidated before the accountholder passes away, the general rule is that funds remaining in the account must be withdrawn over the life expectancy of the new owner of this account.[18] For example, assume that Donald died at age 80 before withdrawing all the funds in his IRA and his son Erik inherited this account as its "designated beneficiary." In this situation, Erik would then withdraw the funds over his remaining life expectancy. Depending on Erik's age when Donald died, this withdrawal period could last 40 years or more. Indeed, Donald could leave his IRA to an even younger relative, say a grandchild, who would then have an even longer withdrawal period reflecting that person's longer life expectancy.

During this extended withdrawal period, the new owner would enjoy the benefit of continued tax deferral until specific funds were withdrawn. To be sure, many heirs of inherited retirement accounts are only too eager to drain these accounts as soon as possible, but they nevertheless have the option of transforming these accounts effectively into life annuities, sometimes referred to as Dynasty IRAs in financial blogs and similar media.[19]

It should be noted, however, that additional options are available if the designated beneficiary is the accountholder's surviving spouse. This spouse can transfer the balance in the account into his or her pre-existing IRA and then withdraw these funds over whatever schedule would otherwise apply to that account. Similarly, a surviving spouse can simply treat the inherited IRA as his or her own IRA without further ado. In any case, whoever inherits a retirement account is determined by that account's documentation indicating who is the account's designated beneficiary and *not by the original accountholder's will*. For this reason, it is essential that estate planners pay particular attention to retirement accounts' underlying documentation.

In any case, the previously referenced SECURE Act made a very significant change to the distribution requirements for non-spouse beneficiaries. Effective for decedents who die after December 31, 2019, inherited retirement accounts must be completely withdrawn no later than

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Richard L. Kaplan, *Reforming the Taxation of Retirement Accounts*, 32 VA. TAX REV. 327, 357 (2012).

18 I.R.C. § 401(a)(9)(A)(ii).

19 Gerald Nowotny, *The Dynasty Annuity – Multi-Generational Tax Deferral for High-Net-Worth Families*, TAX MGMT. ESTS., GIFTS, & TRS. J., Nov. 5, 2012, at 1, 3; Gerald Nowotny, *The Dynasty Annuity – Achieving Tax Deferral For High Net Worth Families In Family Trusts Using Variable Annuities*, MONDAQ (Oct. 15, 2014), https://www.mondaq.com/unitedstates/capital-gains-tax/347084/the-dynasty-annuity-achieving-tax-deferral-for-high-net-worth-families-in-family-trusts-using-variable-annuities [https://perma.cc/X83W-7PAV] (providing a strategic example of how a beneficiary would be taxed).

10 years after the death of the original accountholder.[20] Spousal beneficiaries are not affected by this change,[21] so the options described in the immediately preceding paragraph remain, but the withdrawal period for Erik in the earlier example can no longer exceed 10 years.

From an estate planning perspective, therefore, choosing the designated beneficiary now demands especially careful attention. If the likely beneficiary is currently in as high or higher a tax bracket as the accountholder, the tax benefit of minimizing withdrawals during the lifetime of the accountholder will be partially offset by the higher taxes now owed by the succeeding owner.[22] The time value of money still provides a financial benefit, but tax rate differentials might mitigate or even negate this benefit entirely. Political factors, as unfathomable as they may be, might further militate in favor of withdrawing funds presently, rather than waiting until after the accountholder's death if a change in government and likely higher tax rates is anticipated.

Slightly different considerations apply if the retirement account in question is of a Roth variant. So-called Roth retirement accounts do not require any minimum distributions during the lifetime of the original accountholder,[23] but do impose RMDs on subsequent owners of these accounts.[24] These accounts formerly had to be distributed over the life expectancy of the new owner, even though the distributions remained free of income tax.[25] The principal impact of this requirement is to limit the extent of tax deferral that Roth accounts have in the hands of heirs. But the new statutory change imposing a 10-year required maximum withdrawal period applies to inherited Roth accounts as well.[26] Accordingly, the optimum tax strategy would now be to avoid withdrawals by the inheritor of a Roth account until the end of the 10-year period from the death of the original accountholder. In this manner, the tax deferral potential of the Roth account is maximized. A similar strategy for non-Roth accounts would *not* be optimal, however. Withdrawals from these accounts are subject to income tax, and a large distribution at the end of

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20 I.R.C. § 401(a)(9)(H)(i)(I) (added by SECURE Act § 401(a)(1)).

21 *See* I.R.C. § 401(a)(9)(E)(ii)(I). These rules also do not apply to an accountholder's minor child or anyone who is disabled or "chronically ill." *Id.* § 401(a)(9)(E)(ii)(II)-(IV).

22 *See* Richard L. Kaplan, *What Now? A Boomer's Baedeker to the Distribution Phase of Defined Contribution Retirement Plans*, N.Y.U. Rev. Emp. Benefits & Exec. Comp. 4-1, 4-29 (2015).

23 I.R.C. § 408A(c)(4)(A).

24 Treas. Reg. § 1.408A-6, Q&A (A-14)(a) (1999).

25 *Id.* § 1.408A-6, Q&A (A-14)(b); I.R.C. § 408A(d)(1), (2)(A)(ii).

26 SECURE Act §§ 101, 404; *Publication 590-B (2019), Distributions from Individual Retirement Arrangements (IRAs)*, Internal Revenue Serv., https://www.irs.gov/publications/p590b#en_US_2019_publink1000231059 [https://perma.cc/F6ZS-7VT5] (last updated Feb. 24, 2020).

the 10-year period would likely subject the new owner to an unusually high tax burden due to the effect of graduated income tax rates.[27]

Conclusion

Retirement accounts have numerous planning considerations regarding when withdrawals should begin and which non-spousal beneficiaries should take over these accounts when the original accountholder passes away. Recently enacted changes alter the time when RMDs must begin and radically affect optimal tax strategies for non-spousal beneficiaries who inherit these accounts.

27 *See* I.R.C. § 1(a)-(d).