Chapman and Cutler LLP

Chapman Client Alert

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How the SECURE Act Will Impact Your IRA and 529 Plan

Late in 2019, Congress passed the Setting Every Community Up for Retirement Enhancement or the SECURE Act ("Act"), as part of an appropriations bill. With few exceptions, the provisions in the Act are effective for retirement plans, IRAs, contributions and distributions on or after January 1, 2020. While the SECURE Act has a number of provisions impacting employer retirement plans, this Alert focuses only on the changes that impact traditional and Roth IRAs and reviews some of the planning options under the new Act. This Alert also covers the new rules added for 529 Plans.

Individuals Under Age 59 with IRAs

For individuals who have traditional or Roth IRAs, the Act adds a new exception to the early withdrawal rules. Individuals may withdraw up to $5,000 for the birth or adoption of a child, without paying the early withdrawal penalty.

For graduate and doctoral students, many non-tuition and stipend payments will now qualify as earned income, permitting these students to make contributions to an IRA based on that income.

Individuals Approaching Age 70-1/2

Individuals with traditional IRAs are required to take minimum distributions (RMDs) from their IRA. Previously, these distributions began at age 70-1/2. These distributions will now begin at age 72. Individuals born after June 30, 1949 will begin taking RMDs at age 72. Individuals born on or before June 30, 1949 are still required to begin taking RMDs at age 70-1/2.

Individuals Over Age 70-1/2

The age limitation for contributions to traditional IRAs has been eliminated. Previously, individuals could not make contributions to traditional IRAs after age 70-1/2. Starting in 2020, individuals who are still working (i.e., have earned income) can contribute to a traditional IRA regardless of age.

Inherited IRAs After 12/31/19

The largest change made by the Act applies to the required miminum distribution rules (RMDs) for beneficiaries who inherit traditional or Roth IRAs after December 31, 2019. For beneficiaries who inherited their IRAs before then (i.e., the IRA owner died on or before December 31, 2019), the prior RMD rules continue to apply. Previously, an individual who inherited a traditional or Roth IRA could stretch out the distributions over his or her life expectancy, with special rules for spouses. A qualified trust that was the beneficiary of an IRA could also qualify for the stretch out.

For many beneficiaries, the Act eliminates the stretch out, replacing it with a simple 10-year rule. Spouses and a few other beneficiaries (referred to as "eligible designated beneficiaries"), can still use the stretch out. The following summary reviews the new rules for the various types of beneficiary.

Spouse is Beneficiary

The distribution rules for an IRA where the IRA owner's surviving spouse is the beneficiary are only minimally changed. As before, the surviving spouse may rollover the IRA into his or her own IRA. Alternatively, the spouse may elect to take distributions, as a beneficiary of an inherited IRA, over his or her life expectancy. In the latter case, at the surviving spouse's subsequent death, any funds remaining in that IRA must be distributed within 10 years.

Individual Other Than Spouse is Beneficiary

Subject to a few exceptions, the distribution rules for non-spouse individuals are completely different. For these individuals, an inherited traditional or Roth IRA must be fully distributed by the end of the 10th year after the IRA owner's death. These beneficiaries can wait until the 10th year and withdraw the whole IRA or they can pick and choose the withdrawal amounts and years, so long as the IRA is fully distributed by the end of the 10th year.

In addition to a spouse, a few other individual beneficiaries are not subject to the 10-year rule. If the beneficiary is (1) disabled or chronically ill, or (2) not more than 10 years younger than the IRA owner, then the inherited IRA may be paid out over the life expectancy of that individual beneficiary. In addition, if a child of the IRA owner is the beneficiary and the child has not reached the age of majority, distribution must be made within 10 years after the child reaches majority.

Qualified Trust is Beneficiary

Under regulations in effect prior to 2020, if a qualified trust is the beneficiary of an inherited IRA, the trust could qualify for the strech out based on the life expectancy of the oldest trust beneficiary. Careful planning and, at times, complex provisions were needed for a trust to be a qualified trust.

The qualified trust rules are provided by Treasury regulations; they are not part of the tax code. Nothing in the Act appears to change the idea that a qualified trust could benefit from the stretch out rule if the beneficiary of the trust is an eligible designated beneficiary, or from the 10-year rule. However, it is possible that the IRS could simply drop the qualified trust rules when they issue new regulations for the new tax code provisions. If the IRS keeps the qualified trust rules, it is very likely that the IRS will have such specific rules that, at best, most trusts will simply fall into the 10-year rule.

Non-Individual is Beneficiary

If an estate, non-qualified trust (or all trusts, if the IRS completely drops the qualified trust rule), charity or other entity is the beneficiary of an IRA, that inherited IRA must be distributed within 5 years of the IRA account owner's death, if the IRA owner dies before age 72. If the IRA owner dies after age 72, the inherited IRA may be distributed over the IRA *owner's* remaining life expectancy.

529 Plans

The Act expands the use of 529 education savings accounts to cover costs associated with registered apprenticeships, up to $10,000 of qualified student loan repayments, and certain costs associated with elementary and secondary education, including some homeschooling expenses. Check your individual state's 529 Plan to confirm that these new rules will apply.

Planning for IRA Owners

If you have significant assets in traditional or Roth IRAs, you should revisit the question of who should be the beneficiary of your IRA with your estate planning attorney and financial adviser. These strategies will require some number crunching. Below are items to examine.

If you are married and both of you have significant traditional IRAs that name each other as the initial beneficiary, consider whether it would be better to name children or qualified trusts as the initial IRA beneficiary(ies), for at least part of the IRA. The purpose of this strategy would be to have two different 10 year periods for distributions, instead of having children or qualified trusts inheriting all these IRAs at the survivor's death, with one 10 year period.

If you have a living trust, consider whether your traditional or Roth IRAs should be paid to your living trust or directly to individual beneficiaries or charities. Although this question was often asked and analyzed under the prior rules, the Act changes the pros and cons of this choice and makes this question worth re-visiting.

If your living trust is the beneficiary of an IRA, any provisions in your living trust agreement regarding IRAs should be examined. These provisions may need updating to address the changes made by the Act and/or give the trustee more flexibility.

Does a Roth conversion make sense? Those who could benefit from a Roth conversion before will likely still benefit. However, since the stretch out is largely gone for both traditional and Roth IRAs, the math supporting a Roth conversion (paying tax early at the IRA owner's income tax rate vs. tax-free growth) will be over a shorter period. On the one hand, converting a traditional IRA to a Roth IRA is beneficial when the Roth IRA has time to grow, and that time will now be shorter. On the other hand, the short distribution period for inherited IRAs means the income tax deferral in keeping a traditional IRA is much less.

Planning for Inherited IRAs

If you inherit a traditional IRA in 2020 or future years, you will want to be strategic in your withdrawals. For individuals, if you expect your income levels to be fairly steady, it may be best to spread the withdrawals over the 10 years or at least over the last few years (depending on your tax bracket). If you expect your income levels to fluctuate, you should consider larger distributions in years when other income is smaller.

For trusts that inherit an IRA, the distribution requirements may not be as clear until the IRS issues further regulations. The best practice will be to consult with a knowledable adviser to provide guidance on the required distributions and any income tax strategies for distributions from inherited traditional IRAs.

If you inherit a Roth IRA in 2020 or future years, the planning is simple: wait as long as you can (such as the end of the 10 year period), so long as you think the investments will be appreciating.

For More Information

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