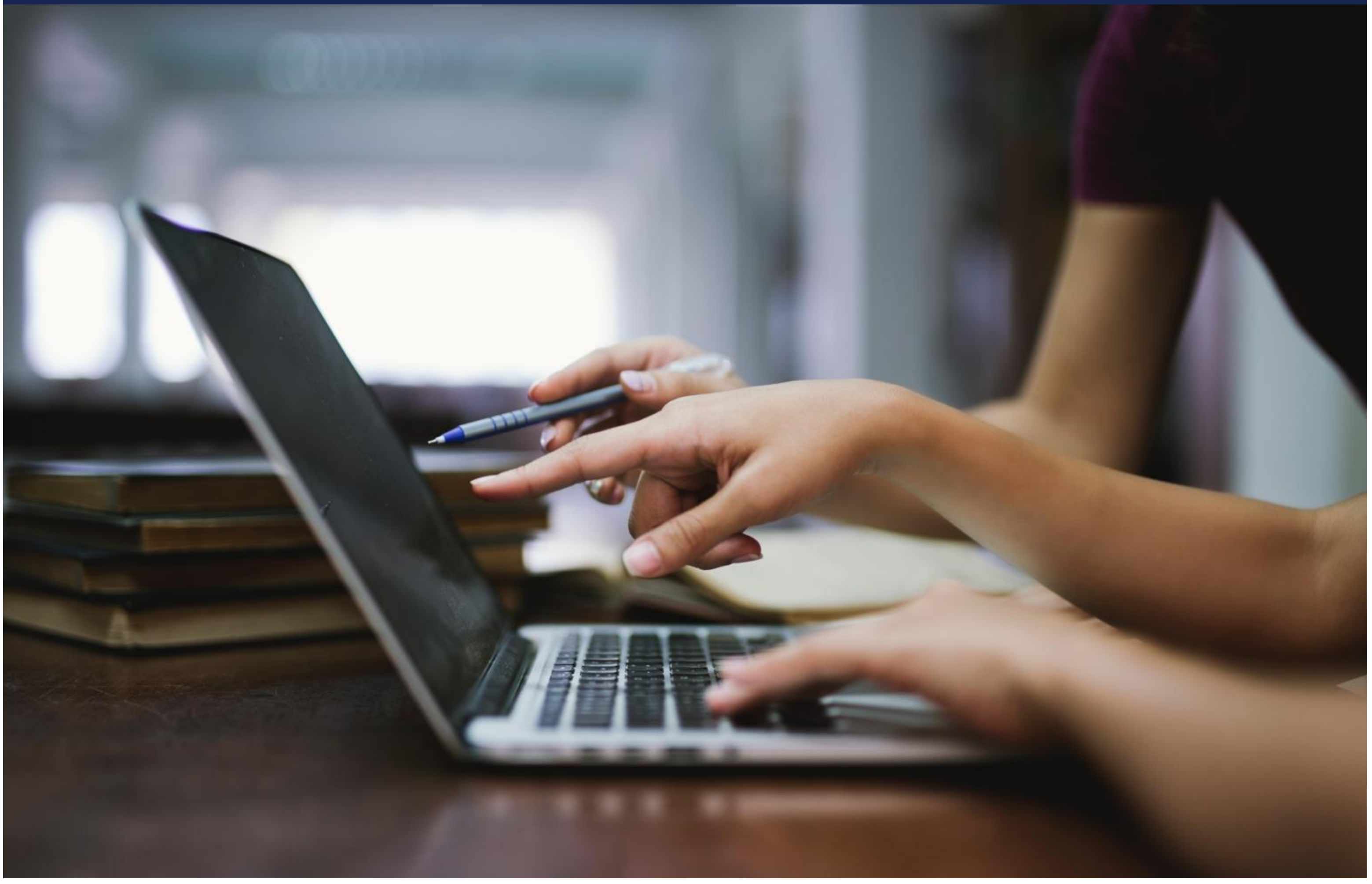
THE IRA TICKING TIME BOMB OF SECURE ACT -WHY YOU MAY NEED TO AMEND YOUR LIVING TRUST



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The IRA Ticking Time Bomb of SECURE Act – Why You May Need to Amend Your Living Trust

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A major change in the law affecting IRAs went into effect on January 1, 2020, known as the SECURE Act. The aspect of that law that has the most widespread impact on estate planning is the new requirement that inherited IRAs must be fully paid to heirs within 10 years of the death of the IRA owner. That is the new Minimum Required Distribution. This is a radical departure from prior law and fundamentally impacts how to plan for inheritance of IRAs, 401k plans, 403b plans, and other retirement plans.

There is no requirement that any distributions be made until the end of the tenth year. But if the full balance of the inherited IRA is not paid out by December 31 of the tenth year after the IRA owner's year of death, then there is a 50% penalty.

Under prior law, an heir other than the deceased owner's spouse could take Minimum Required Distributions over the life expectancy of the heir, which would be longer than 10 years except for the most elderly heirs. For example, an heir who was 40 years old in the year of death of her father would have 42.7 years over which the balance of her father's inherited IRA must be withdrawn. In the first year, the MRD would be calculated by dividing the balance as of December 31 of the prior year by a factor 42.7, found at the IRS Uniform Life Table. The next year, the December 31 balance would be divided by 41.7 for the MRD, which was the prior year factor reduced by one. And so on every year for 41.7 years at which time any remaining balance must be taken. Any withdrawal from an inherited IRA would be taxed to the heir as ordinary income.

IRAS PAYABLE TO LIVING TRUSTS

IRAs are often paid to heirs through a revocable living trust when the owner dies. There are many reasons for doing that which are not related to taxes. Under pre-SECURE Act law, where it was desirable for an IRA to pay to heirs through a trust, the best practice was to include provisions in trusts that might receive an IRA when the owner dies that are technically known as a Conduit Trust. Common examples would be where a minor child or grandchild could inherit, or where a family member with Special Needs who is receiving government entitlement benefits such as Medicaid or SSI may inherit an IRA. In the former situation, paying the IRA to a Trustee for benefit of young heirs would allow the IRA to be managed by responsible adults serving as Trustee, for intended purposes. In the latter situation, paying the IRA to a Trustee would prevent the inherited IRA from being a countable resource for the Special Needs heir, which would cause the SSI or Medicaid benefits to stop. Another common example would be paying an inherited IRA for benefit of an irresponsible or spendthrift type beneficiary to a Trustee to protect it for good uses or lawsuits.

In ZIMMER LAW FIRM trusts, we refer to those provisions as a Family Retirement Preservation Trust (FRPT). The effect was to require all Minimum Required Distributions payable from the IRA to the Trustee to be paid to the trust beneficiary. The advantage of this requirement was that each beneficiary of a trust who inherits a share of an IRA would be entitled to use his/her own life expectancy for calculating RMDs every year. The longer that period would be (younger beneficiaries have a longer period for RMDs than older beneficiaries), the more the tax savings. Otherwise, the age of the oldest possible beneficiary would have to be used to calculate RMDs for all younger beneficiaries, which would put younger heirs at a tax disadvantage.

ALONG COMES THE SECURE ACT….

Now, under the SECURE Act, most heirs will have only 10 years to draw out inherited IRAs. That makes the FRPT provisions inappropriate because they could lead to unintended results. Therefore those provisions should be deleted from existing trusts.

An example will illustrate. Suppose Bill and Mary Jones created a revocable living trust that paid half to each of their children when the second spouse died. They set up their IRAs to pay half to their oldest child, Susan, outright. They were not concerned about how she handled the inherited IRA because she was very responsible and prudent with her money.

On the other hand, her brother, John, was just the opposite. He could not effectively manage money. Bill and Mary wanted to make sure that whatever he inherited was protected for him for his lifetime so he would always have some financial security. They named their bank as Trustee for his trust share. Their IRA was $1.0 million in value. To be sure the inherited IRA was protected they made his 50% share payable to the Trustee for John's benefit.

The provisions under their trust included a Family Retirement Preservation Trust for his inherited IRA. (That is what we call a Conduit Trust.) The effect would be to allow his inherited IRA to be paid out over his individual life expectancy, which would save taxes. The RMDs would be payable by the Trustee to him directly, but all other withdrawals from the account were solely in the discretion of the bank as Trustee. The bank would not be required to take more than the annual minimum from the IRA and could make sure that the money was used wisely for John. The annual RMDs would pay out to John, but that was acceptable. The IRA would last his entire lifetime, and if he were ever sued the inherited IRA would be protected under the trust.

But after the SECURE Act, the entire IRA balance must be withdrawn by 10 years from the death of the owner. Under the Family Retirement Preservation Trust provisions (the FRPT), the bank would be required to pay the full balance of the IRA to John when it was received in 10 years, free of the trust. That would not be what Bill and Mary would want, and John would surely spend the money foolishly. Also, if he were in legal trouble, the lawsuit protection for the inherited IRA would be lost because the IRA would no longer be payable to the Trustee.

In this story, having the FRPT provisions in the trust that were appropriate under pre-SECURE Act law would have backfired on Bill and Mary and ruin their estate planning goals. What is more unfortunate is that having the FRPT clauses in the trust served no purpose any longer under the new law. Prior to the Secure Act the FRPT provisions saved taxes by assuring John was considered as the direct IRA beneficiary even though his trust share was the true beneficiary. That made it possible for the IRA to last John's entire lifetime, as what is known as a "Stretch IRA". But the Secure Act limits John to 10 years for withdrawing the IRA, regardless of whether it is payable to John directly or to a trust for his benefit. There is no longer any benefit like that from including FRPT clauses in a trust. It is 10 years and out for John. Also significant is that having FRPT clauses meant the protections of the trust would end at the 10-year distribution point, and the money would be exposed to lawsuits and poor lifestyle or investment decisions by John as the direct heir to the IRA.

COPING WITH WHAT THE SECURE ACT HATH WROUGHT

What can Bill and Mary do after the Secure Act to protect the inherited IRA from John's issues and from lawsuits? They could amend the Trust to eliminate the FRPT clauses. That would make the trust share for John what is technically known as an Accumulation Trust. This change would not eliminate the 10-year distribution requirement; that is not possible. But it would mean that the Trustee would not have to pay all that money out to John in 10 years. Instead, the Trustee could hold that money under the trust and release it for John's bona fide needs as Bill and Mary would want.

Another benefit is that eliminating the FRPT wording from the trust would restore the loss of the lawsuit protection that would be afforded by the Trust which is caused by the SECURE Act. There are 2 facets to this point. One, after the 10-year payout the IRA proceeds could be protected from lawsuits against John if the trust includes certain language, which we make standard under trusts prepared by Zimmer Law Firm. Two, during the period (up to 10 years) that the IRA is intact and payable to the Trustee, Ohio law protects the IRA from lawsuits against John. If there were pending lawsuits when the IRA terminated and paid out to the Trustee, then the lawsuit protection of the trust would kick in. Thus eliminating the FRPT wording and thereby converting John's trust to an Accumulation Trust would protect the inherited IRA and John from a multitude of issues and risks by keeping the IRA under protection of the Trustee,

SOME IRA HEIRS GET TO STILL USE THE OLD RULES

There are 5 exceptions to the 10-year rule under the SECURE Act. Those exceptions allow certain persons to still use the old laws. They are called Eligible Designated Beneficiaries. They are the spouse of the owner, children of the owner under age 21 years, an heir less than 10 years younger than the owner, a chronically ill person, and a special needs person, e.g. someone who is disabled and eligible for government entitlements such as Medicaid or SSI. For IRAs payable to these 5 categories of heirs, the 10-year rule under the SECURE Act does not apply. This affords a significant tax advantage to them.

Of particular import is the exception for a **Special Needs Beneficiary**. The 10-year rule applies to an IRA payable directly to a Special Needs Beneficiary, or to a trust *for sole benefit* of a Special Needs Beneficiary. We include provisions in ZIMMER LAW FIRM trusts that would apply to anyone who may in the future qualify as a special needs beneficiary, that would allow termination of the trust share and distribution of the holdings to someone other than the disabled beneficiary. This is called a Poison Pill and is intended to protect the trust from being disregarded by a state Medicaid agency or the Social Security Administration. We also include those provisions in any trust share for a beneficiary who is presently known to qualify as a Special Needs Beneficiary.

Poison pill provisions are standard practice in planning for protection of a Special Needs Beneficiary's SSI or Medicaid benefits. However, the SECURE Act is anew factor to contend with. Under that law, an IRA payable to a trust for benefit of a Special Needs Beneficiary is eligible for the pre-SECURE Act rules *only if the trust could never pay to anyone other than the Special Needs Beneficiary during her lifetime*. The poison pill provisions *could* result in a Trustee terminating the trust share intended for a Special Needs Beneficiary and paying out to someone else. That would violate the "for sole benefit of" requirement for the trust share to be an Eligible Designated Beneficiary and the 10-year rule would apply. In other words, the poison pill clauses would make the trust *not* for the sole benefit of the disabled heir.

Another example illustrates this point. Let us return to Bill and Mary. Instead of John being irresponsible and a spendthrift child, let us change the facts and assume that he is disabled and receives SSI and Medicaid. When Bill and Mary die, his $500,000 interest in the IRA is payable to his trust share which includes the typical poison pill clause that would give the bank as Trustee the power to terminate his trust share in case the Medicaid agency were to consider the assets of the trust as John's personal assets. Because Medicaid and SSI are resource based benefits, that characterization would spell the end of John's government benefits.

When the IRA owner dies, the IRS is notified who are the heirs and so is the Custodian. The Trustee in ignorant bliss takes RMDs every year for the next ten years based on John's age, in the belief that the trust for John's benefit is an Eligible Designated Beneficiary trust. The IRS eventually issues some regulations about how the SECURE Act is to be applied and under those rules the Custodian reports to the IRS after 10 years that the entire $500,000 IRA balance is to be paid to John's Trustee and the IRA is to terminate. But the date passes by and the IRA continues. The IRS then assesses a 50% penalty in the sum of $250,000 plus income tax on the IRA because it was not fully paid out in 10 years, citing the effect of the poison pill clause. The IRS reasons that the trust share was not an Eligible Designated Beneficiary because the Trustee had the *power* to terminate the trust and pay it to another family member. That trust share as a consequence was not for the sole benefit of John.

This is but one way in which this matter could be brought to the attention of the IRS. No one knows for sure at this point how the issue may arise or what regulations the IRS will issue. The result as seen can be dramatic if the IRS views the effect of the poison pill clauses as disqualifying the trust share as an Eligible Designated Beneficiary.

What could Bill and Mary do to avoid such a result? They could amend their trust to provide that the poison pill provisions will not apply to inherited IRAs. Since those provisions are in addition to other protective provisions, making them not applicable to inherited IRAs should not have a negative effect on eligibility for Medicaid or SSI.

RESCUE YOUR TRUST FROM THE NEGATIVE IMPACT OF THE SECURE ACT

Any living trust agreement with conduit trust provisions, or a resulting trust share for an heir that does not pay out immediately when an IRA owner should be reviewed for these tax-related and asset protection issues.

Also, any trust that is presently written for a Special Needs Beneficiary, or that could conceivably be payable to a Special Needs Beneficiary in the future, should be reviewed as well so the Eligible Designated Beneficiary rules are not violated.

Adjustments to an existing trust for these types of matters are made in the form of a Trust Amendment. An Amendment revokes the unwanted trust provisions and if applicable replaces them with substitute wording or adds new provisions. The name and date of the trust are not affected. The Trust amendment must be in writing and signed by the Trustor(s) and the Trustee(s).

Beneficiary designations of record with IRA custodians or employer sponsored retirement plans such as 401k and 403b plans should be checked and adjusted to be sure the trust is properly named as a primary or backup beneficiary. Other trust funding is not affected.

If you are a Zimmer Law Firm client, contact us for a simplified process to review your trust and to make adjustments. If you have a child or heir who is a Special Needs Beneficiary, or if your children have a Special Needs child, and you have an IRA, these changes could be critical and should be taken care of as soon as convenient.

ABOUT THE ZIMMER LAW FIRM

Zimmer Law Firm, LLC is a charter member of the American Academy of Estate Planning Attorneys. It is the only member firm in Southwestern Ohio. The Firm has been providing quality estate planning services since it was founded in 1993. The fastest growing demand for its services has been asset protection from the cost of long term nursing care. Whether you need an Elder Law attorney, an attorney for general estate planning with trusts or wills, or an attorney to help settle an estate, our team of qualified staff are here to help you and your loved ones.

In these turbulent times, access to an experienced lawyer to protect your estate and accomplish your goals is more important than ever. If you or your family would like a complimentary consultation to discuss your estate plan or how to protect your estate from depletion to pay for long term nursing care, call us today at **513-721-1513** or visit our website at **www.zimmerlawfirm.com**. Check our website for upcoming seminars, or learn more about the firm at www.avvo.com where you will also find testimonials from our clients. See why *Cincinnati Magazine* recognizes us as a Five Star Wealth Manager. If you would like to receive email announcements for upcoming seminars, call to be added to our seminar mailing list.

A MESSAGE FROM THE FIRM FOUNDER

The goals of Zimmer Law Firm are to make asset protection and estate planning pleasant, easy, and understandable processes for clients. We believe that planning is much more than just creating legal documents. Rather it is about establishing relationships with clients and their family by providing a continuum of services through the passages of their lives. What we do makes an important difference and we take great professional pride and satisfaction in that.

If you or your loved ones would like a complimentary consultation to review your estate plan or to implement a plan, visit our website at www.zimmerlawfirm.com or call us today at 513-721-1513 (Toll-Free 1-866-799-4050) to schedule an appointment. See for yourself why *Cincinnati Magazine* has recognized the Firm as a Five Star Wealth Manager. For the latest news about estate planning or upcoming law firm events, subscribe to our blog and “like” us on Facebook. Check our website for upcoming educational events. We continue to expand our capabilities and services to meet the demands of a complex and changing estate planning world. Our experience has shown us what was a solution yesterday may no longer be adequate to fully protect our clients today.

This report reflects the opinion of the Zimmer Law Firm. It is based on our understanding of state and federal laws and is intended only as a simple overview of the planning issues.

We recommend you do not base your own planning on the contents of this report alone. Review your estate planning goals with a qualified estate planning attorney.

ABOUT THE ACADEMY

The Academy is a national organization dedicated to promoting excellence in estate planning by providing its exclusive membership of attorneys with up-to-date research on estate and tax planning, educational materials, and other important resources to empower them to provide superior estate planning services. The Academy expects members to have at least 36 hours of legal education each year specifically in estate, tax, probate and/or elder law subjects.. The Academy has also been recognized as a consumer legal source by *Money Magazine and Consumer Reports Money Adviser,* and its Education Department has been quoted by other consumer press.

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