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Issues Relating to the SECURE Act in view of the Proposed Regulations - Part 1

The SECURE Act. We discussed the SECURE Act, which became effective January 1, 2020, in our eight page newsletter dated January 15, 2020. The SECURE Act changed the "minimum distribution rules" relating to distributions from qualified employee benefit plans (such as 401(k) plans) and IRAs (jointly referred to as "retirement plans"). The minimum distribution rules are income tax rules that provide for the timing and taxation of distributions from retirement plans, both during the life of the plan participant/IRA owner (jointly referred to as the "participant") and after the participant's death, when the participant's retirement plan becomes distributable to the participant's beneficiaries.

Some SECURE Act Changes. The SECURE Act changed the age component of the "required beginning date" ("RBD") from 70½ to 72. The RBD is the date by which a living participant must begin taking "required minimum distributions" ("RMDs") from his/her retirement plan. (The age component of RBD may be changed to 75 pursuant to currently pending legislation dubbed "SECURE 2.0"). Other changes made by the SECURE Act (sometimes simply referred to as "SECURE") were more significant, however. Examples include the following:

1. SECURE divided "designated beneficiaries" ("DBs") into two categories: (i) "regular" DBs and (ii) "eligible designated beneficiaries" (a defined term—hereafter referred to as "EDBs"). Prior to SECURE, if the participant died having named one or more DBs as beneficiaries of his/her retirement plan, each DB could calculate RMDs after the participant's death using a life expectancy distribution method. The life expectancy distribution method allowed RMDs to be "stretched" over a long period of time, thus allowing significant tax-deferred growth inside the (pre-tax) inherited IRA and reducing the income taxes payable by the beneficiary each year. Thus, before SECURE, it was very important for the participant's retirement plan beneficiaries to qualify as DBs. As noted, SECURE created a distinction between EDBs and "other" DBs (not a defined term—hereafter referred to as "ODBs" when necessary to distinguish between the two types of DBs). The five types of EDBs are (i) the participant's spouse, (ii) the participant's minor child, (iii) a disabled individual, (iv) a chronically ill individual, and (v) an individual not more than ten years younger than the participant. Both ODBs and EDBs must be individuals, although the individual beneficiaries of certain trusts that qualify as "see-through trusts" can be treated as ODBs and/or EDBs (as applicable).

2. SECURE implemented a new "10 year rule" in the case of beneficiaries of the participant's retirement plan who are ODBs. Per SECURE, only EDBs may take distributions from retirement plans inherited from the participant using a life expectancy distribution method (not the same method for each type of EDB). Thus, the "stretch IRA" that existed prior to SECURE was eliminated for a large percentage of beneficiaries of retirement plans: ODBs. A typical ODB would be an adult child or grandchild of the participant who is not disabled or chronically ill. EDBs are not subject to the 10 year rule EXCEPT for the participant's minor child once that child reaches the age of majority (i.e., age 21).

3. SECURE authorized a new type of trust that could be used for disabled and chronically ill beneficiaries (two categories of EDBs) called an "Applicable Multi-Beneficiary Trust"

("AMBT"). Certain very favorable rules apply to AMBTs that are not available to other trusts named as beneficiaries of retirement plans.

Two Years Post-SECURE. For more than two years now, attorneys, accountants and financial advisors have been discussing with their clients how the provisions in the SECURE Act would likely be applied. This interpretation was based on (i) the wording used in the SECURE Act, (ii) longstanding prior regulations, and (iii) certain IRS publications, such as Publication 590-B. However, recent developments (discussed below) indicate that at least some of what has been assumed in regard to certain provisions in the SECURE Act is "inconsistent" with the interpretation of those provisions by the US Treasury Department.

Background: The 5 Year Rule. Dating back many years (since 1982 when TEFRA was passed--i.e., well before passage of SECURE), one of the distribution rules applicable to beneficiaries of deceased participants' retirement plans has been the "5 year rule." The 5 year rule applied (among other cases) when the participant died before RBD and the participant's beneficiary was not a DB. Examples of beneficiaries that are not DBs include (i) the participant's "estate" (this includes a beneficiary designation of "per my Will"), (ii) a non qualifying trust, (iii) charities and charitable trusts, and (iv) other entities. In cases where the participant died before RBD and the beneficiary of his/her retirement plan did not qualify as a DB, an inherited IRA was established for the benefit of that non DB beneficiary and, pursuant to the 5 year rule, that non DB beneficiary was required to withdraw the full amount in the inherited IRA by December 31 of the year containing the 5th anniversary of the participant's death. That non DB beneficiary was permitted to take discretionary distributions from the inherited IRA in years 1 through 4 after the participant's death (even the entire amount, if desired), but was not required to take any distributions from the inherited IRA during those years. The only required distribution per the 5 year rule was full distribution by the ultimate distribution date (i.e., by 12/31 of the year containing the 5th anniversary of the participant's death). SECURE did not change the 5 year rule applicable when the participant dies before RBD without having a beneficiary who qualifies as a DB (i.e., when the participant's beneficiary is a non DB).

The New 10 Year Rule: What Congress Said – And Intended? In imposing the new 10 year rule on ODBs (i.e., DBs who are not EDBs), Congress wrote in the SECURE Act, "Except in the case of a beneficiary who is not a Designated Beneficiary, [the 5 year rule]--(I) shall be applied by substituting '10 years' for '5 years', and (II) [the 10 year rule] shall apply whether or not [the participant dies before or after RBD]." That wording made it seem as if (i) the 10 year rule would be applied like the 5 year rule and (ii) the 10 year rule would be THE RULE applicable to ODBs per the SECURE Act, whether the participant dies before or after his/her RBD.

The 10 Year Rule: Treasury's Interpretation. On February 23, 2022, the Treasury Department released proposed regulations providing its interpretation of the SECURE Act. The proposed regulations and the preamble to the proposed regulations are 275 pages (jointly referred to in this newsletter as the "proposed regulations"). Needless to say, everyone is still studying those 275 pages.

Perhaps the most shocking interpretation of the SECURE Act in the proposed regulations is how the 10 year rule applies in the case where the participant dies on or after RBD (hereafter, simply, "after RBD"). Per the proposed regulations, if the participant dies after RBD and the beneficiary of the participant's retirement plan is an ODB, that ODB must take RMDs during years 1 through 9 following the year of the participant's death based on pre-SECURE law PLUS that ODB must withdraw the entire amount in the inherited IRA that received the participant's retirement plan by December 31 of the year that contains the 10th anniversary of the participant's death. Thus, Treasury's interpretation of the 10 year rule per the SECURE Act is that there are two different 10 year rules based on when the participant dies. (There are other 10 year rules as well, which we will not discuss in this newsletter.)

To summarize:

1. If the participant dies before his/her RBD and the participant's beneficiary is an ODB, that ODB is subject to the 10 year rule that operates just like the 5 year rule (except that the ultimate distribution date is December 31 of the year that contains the 10th anniversary of the participant's death rather than December 31 of the year that contains the 5th anniversary of the participant's death). No distributions are required to be taken prior to the ultimate distribution date (although discretionary distributions may be taken prior to that date).
2. If the participant dies after RBD and the participant's beneficiary is an ODB, that ODB must take RMDs during years 1 through 9 after the participant's death based on pre-SECURE law PLUS that ODB must withdraw the entire amount in the ODB's inherited IRA by December 31 of the year that contains the 10th anniversary of the participant's death.

A Problem For Certain ODBs. As noted, the SECURE Act became effective January 1, **2020**. Per the proposed regulations released in February **2022**, if a participant died in 2020 after his/her RBD having named one or more ODBs as beneficiaries of his/her retirement plan, each of those ODBs should have taken an RMD during calendar year 2021. It is doubtful any ODB in that situation actually took an RMD in 2021. Failure to take an RMD of any type incurs a 50% penalty, although a taxpayer can ask for a waiver of the penalty using Form 5329. In this case, arguably, the taxpayer's reason for not taking the RMD in 2021 should constitute a "reasonable good faith interpretation of the law."

Why didn't those ODBs take an RMD in 2021? As noted above, during 2021, virtually no one advised ODBs in this situation that they were required to take an RMD by December 31, 2021. In fact, during 2021, virtually no one understood the 10 year rule per the SECURE Act to require an ODB to take *any* RMD prior to the ultimate distribution date (for the reasons explained above). So how can a penalty be imposed on ODBs who failed to take an RMD **by December 31, 2021** when the proposed regulations were not even published by Treasury until **February 2022**?

Also consider this: The IRS, the largest bureau within the Treasury Department and the agency responsible for administering the provisions in the Internal Revenue Code, released two drafts of Publication 590-B, *Distributions from IRAs*, during 2022 labeled, "For Use In Preparing 2021 Returns." One 590-B was released on January 5, 2022 and the other 590-B was released on February 25, 2022 (i.e., two days after Treasury released its proposed regulations). Here is what the IRS said in Publication 590-B in **2022** regarding the 10 year rule (emphasis added):

"10-year rule. The 10-year rule requires the IRA beneficiaries who are not taking life expectancy payments to withdraw the entire balance of the IRA by December 31 of the year containing the 10th anniversary of the owner's death. For example, if the owner died in 2021, the beneficiary would have to fully distribute the IRA by December 31, 2031. *The beneficiary is allowed, but not required, to take distributions prior to that date.*

"The 10-year rule applies if (1) [this one omitted—not applicable to DBs]; or (2) the beneficiary is a designated beneficiary who is not an eligible designated beneficiary, *regardless of whether the owner died before [or after] reaching his or her required beginning date.*"

Providing Comments to Treasury Regarding the Proposed Regulations. Numerous professional organizations (including ACTEC) are preparing comments to the proposed regulations that will be submitted to Treasury for its consideration. Hopefully, before the end of 2022, Treasury will provide explicit relief to ODBs in the situation described above, so that it will be clear what those ODBs must do to avoid the 50% penalty for failure to take the RMD during 2021.

NOTE ALSO: If Treasury's interpretation of the 10 year rule in the proposed regulations is adopted in the final regulations without change, then ODBs who inherited retirement plans from a participant who died in 2021 after his/her RBD will have to take their first RMD by December 31, 2022.

Stay Tuned for Part 2 in this Series.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone (713-520-5205), fax (713-520-5235) or email sent to:

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