SHERMAN WELLS
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TAX AND TRUSTS & ESTATES UPDATE

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The New SECURE Act's Effect on Estate Planning for Retirement Plans

On January 1, 2020, the new federal law known as the Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act") went into effect and applies to plan participants and retirement account holders who die after December 31, 2019. Among other changes, the SECURE Act significantly altered the laws governing the payout of retirement accounts inherited by certain designated beneficiaries. Below, we discuss the most salient portions of the SECURE Act in the estate planning context.

Prior Law Permitted Lifetime "Stretch" Distributions

The most significant change is the elimination of the ability to "stretch" annual required mandatory distributions ("RMDs") over the lifetime of most types of designated beneficiaries.

Under prior law, the designated beneficiary of an inherited retirement account was entitled to take annual RMDs from the account "stretched" over the beneficiary's life expectancy, as calculated according to the IRS actuarial tables. This lifetime "stretch" withdrawal allowed beneficiaries to minimize the effect the distributions would have on their income tax liability, and, in the case of traditional retirement accounts, allowed the accounts to grow with their deferred tax treatment. [1]

The SECURE Act's New 10-Year Rule

The SECURE Act eliminates stretch distributions unless the beneficiary qualifies as one of the five categories of beneficiaries "eligible" for stretch RMDs discussed below. Instead, designated beneficiaries are now required to withdraw the full amount of the retirement account over a ten year period (the "10-year rule"). However, there are no longer annual RMDs, which means the benefits could continue to grow on a tax-deferred basis during the ten year period and be taken in a lump sum at the end of the ten year period.

"Eligible Designated Beneficiaries" Still Entitled to "Stretch" Distributions, with Limitations

The SECURE Act sets forth five categories of beneficiaries still eligible to stretch withdrawals across life expectancy: (1) the surviving spouse of the deceased account holder; (2) minor children of the deceased account holder (with limitations discussed below); (3) disabled beneficiaries; (4) chronically ill beneficiaries; and (5) beneficiaries who are not more than ten years younger than the deceased account holder. All other designated beneficiaries must fully withdraw the retirement accounts within the ten year period.

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Surviving Spouses as Beneficiaries

Under the SECURE Act, a surviving spouse who is designated as an outright beneficiary is entitled to stretch distributions over his or her lifetime and may also roll inherited retirement accounts into his or her IRA and may also elect to treat an inherited IRA as his or her own. (The rules governing rollover and election were not affected by the SECURE Act.)

If a trust for the surviving spouse's benefit is the designated beneficiary of the retirement account, so long as the trustee is required to distribute out the greater of the income and the required distributions, the trust may still stretch RMDs across the surviving spouse's lifetime. If, however, the trust is required to pay out only income to the surviving spouse, as in an "income only" marital trust, the trust must comply with the 10-year rule.

Minor Children as Beneficiaries

Until the minor child of a deceased retirement account holder reaches majority, the minor child, and any conduit trust held on account of the minor child, is entitled to stretch the annual distributions over the child's life expectancy. However, when the minor child reaches majority, the 10-year rule applies.

An important note is that the SECURE Act specifies that *only* the minor children of a deceased retirement account holder qualify as "eligible designated beneficiaries." So, the account holder's minor grandchildren or any other minors would not qualify for this exception.

Finally, if the minor child becomes disabled when the child reaches the age of majority, the child may be treated as if he or she is still a minor and will remain an eligible designated beneficiary so long as the child continues to be disabled.

Disabled and Chronically Ill Beneficiaries

A designated beneficiary who is disabled (within the meaning of section 72(m)(7)) or who is chronically ill (within the meaning of section 7702(B)(c)(2)) qualifies as an "eligible designated beneficiary."

A beneficiary's status as disabled or chronically ill is determined as of the date of the plan participant's death.

The SECURE Act provides for two special rules in connection with multi-beneficiary trusts for the benefit of a disabled or chronically ill beneficiary. First, a disabled or chronically ill beneficiary does not have to be the sole beneficiary of the trust, but he or she does have to be the sole current beneficiary. Second, if the trust's terms require that the trust create separate trusts for each beneficiary, the withdrawal rules will be applied separately for the trust held for the benefit of the disabled or chronically ill beneficiary.

What Happens When the Eligible Designated Beneficiary Dies?

The SECURE Act makes clear that, upon the death of the "eligible" designated beneficiary, the 10-year rule applies to subsequent beneficiaries. However, we do not know whether a subsequent beneficiary who separately qualifies as an "eligible" designated beneficiary will be entitled to stretch RMDs or will be required to comply with the 10-year rule. We await subsequent regulations to clarify this point.

The SECURE Act's Changes to Lifetime Rules

Starting Date for RMDs Increases from Age 70 ½ to Age 72

For plan participants who reach age 70 ½ in 2020 and afterwards, the starting date for RMDs has increased to age 72. As a result, RMDs will begin on April 1 of the year following the year in which the plan participant reached age 72.

Conclusion

In light of the SECURE Act's significant changes to longstanding retirement distributions rules, it may be time to reconsider beneficiary designations and related estate planning, especially if trusts have been named as the beneficiary of your retirement plan, 401k, or IRA.

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[1] The SECURE Act leaves unchanged the prior law that if a retirement plan participant dies without having designated a beneficiary, the length of time that the heirs of the deceased plan participant have to withdraw the account depends on whether the plan participant was "in pay" (i.e., had reached the minimum age for RMDs) at the time of his or her death.

If the deceased plan participant was not "in pay," then his or her heirs are required to withdraw the full amount of the retirement account within a five year period. Conversely, if a plan participant or retirement plan participant was "in pay" at the time of his or her death, his or her heirs are permitted to stretch distributions over the deceased plan participant's life expectancy, as determined by IRS actuarial tables.

The proposed IRS actuarial tables for 2021 for persons aged 73-80 is slightly longer than ten years. This has the (likely unintended) consequence of putting designated beneficiaries of plan participants who die between ages 73 and 80 (and who would be subject to the 10-year rule if they do not qualify as "eligible designated beneficiaries") in a worse position than non-designated beneficiaries, who would be able to stretch the required distributions over the longer period of time.

Relief from Federal Limitation on Deduction for State and Local Income Taxes for Some New Jersey Business Owners

On January 13, 2020, New Jersey enacted the "Pass-Through Business Alternative Income Tax Act" ("PBAITA") to mitigate the impact of the $10,000 cap on an individual's annual federal deduction for state and local taxes (the "SALT Cap") enacted pursuant to the 2017 Tax Cuts and Jobs Act. Because the SALT Cap applies only to taxes paid by individuals, New Jersey income tax paid with respect to a pass-through entity's income is not deductible if paid by an individual owner of such entity but may be deductible if paid by the entity itself. The PBAITA allows multiple member pass-through entities, such as S corporations, limited liability companies, and partnerships, which have at least one shareholder, member or partner who is subject to New Jersey income tax, to elect to pay a new entity level income tax. Single member limited liability companies and sole proprietorships are not eligible to make such election. To avoid double taxation, the PBAITA provides corresponding New Jersey tax credits to taxpayers who receive income from electing entities. The following discussion provides a general overview of the PBAITA.

As noted above, certain pass-through entities will have the option to elect into the PBAITA regime. The election may be made annually on or before the due date of the entity's return and must be consented to by each shareholder, member or partner at the time the election is filed or by any properly authorized officer, manager or member of the electing entity. Absent such an election, a pass-through entity and its owners would continue to be subject to the existing New Jersey owner-level tax regime.

Electing pass-through entities would pay the new pass-through business alternative income tax ("PBAIT") with respect to the entity's "distributive proceeds". For this purpose, "distributive proceeds" means net income, dividends, royalties, interest, rents, guaranteed payments and gains derived from or connected with New Jersey sources and upon which owners of the pass-through entity would be subject to New Jersey income tax.

For tax years beginning on or after January 1, 2020, the PBAIT sets forth four rate brackets, as follows: 5.675% on the first $250,000 of distributive proceeds; 6.52% on distributive proceeds between $250,000 and $1 million; 9.12% on distributive proceeds between $1 million and $5 million; and 10.9% on distributive proceeds over $5 million.

Taxpayers who are shareholders, partners or members of an electing pass-through entity would receive a refundable credit against their New Jersey income taxes in the amount of their pro rata share of the PBAIT paid by such entity. Corporate owners may receive a corporation business tax credit, which, if unused may be carried forward for up to 20 years.

This is not New Jersey's first attempt to soften the impact of the SALT Cap. Previously, New Jersey enacted legislation that would have allowed donations to local government organizations to offset federal taxable income, however, the federal government subsequently issued rules which effectively negated the benefit of that workaround. While not certain, there are historical and current indications that the PBAITA will not be challenged. Prior to 1993, New Jersey had a similar regime in place, whereby pass-through entities were taxed at the entity level, which was not challenged by the IRS. Likewise, the IRS has not yet challenged similar entity level workarounds already enacted by several other states.

The PBAITA applies to taxable years of pass-through entities beginning on or after January 1, 2020. Its impact is expected to be significant, potentially saving New Jersey business owners and professionals approximately $450 million a year on federal taxes. Owners of eligible pass-through entities should assess the potential benefit of an election under the PBAITA and consider whether their shareholder, partnership or operating agreements should be amended to accommodate such an election.

Private Foundation Excise Tax Rate Simplification – Law Change Effective 2020

On December 20, 2019, the year-end spending bill simplified the private foundation excise tax to provide for a one-tier, flat rate of 1.39%. The tax on private foundation investment income had previously been taxed at two tiers (2% and 1%), with the lower rate being available for foundations that made proportionately more charitable distributions. While the new “flat” tax is lower than the previous 2%, the lower 1% rate is no longer available. This new excise tax rate went into effect on January 1, 2020, for calendar-year foundations.

Misleading Notices from Third Parties of Annual Report Delinquencies for New Jersey Entities

New Jersey (as well as many other states) requires any entity formed in New Jersey to file an annual report with the state. Failure to file annual reports can result in the involuntary forfeiture of the entity’s charter.

We are aware that registered agents of record of various New Jersey entities (including entities that are completely current with their annual report filings) have been contacted by private firms to advise them that their annual reports are delinquent, and soliciting the payment to the private firm of the annual report fee (which will purportedly be forwarded to the state).

If you receive such a notice, we encourage you to check with your legal or tax advisors, since this “notice” may be completely without foundation. And if your annual report fees are delinquent, it is best to seek professional advice in order to properly address that deficiency.

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