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# The Good Advisor

## Storm Chasers and SECURE 2.0: How Financial Professionals Can Help Guide and Reassure Clients

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For most people, the threat of a tornado, hurricane, or other severe weather brings a sense of trepidation. These weather events are uncommon, unpredictable, and potentially dangerous, requiring people to take action and seek shelter to ensure their own protection. For storm chasers, however, a severe forecast is cause for excitement as they head directly toward the storm. Beginning in 1956 with David Hoadley's *Storm Track* magazine (the first to focus on storm research and bringing storm chasers together) and boosted by the 1973 Tornado Intercept Project between the University of Oklahoma and the National Severe Storms Laboratory,[1] storm chasing has proven to be more than just a thrill (for the chasers and those who watch them from the comfort of their own homes), but an important way to gather useful data.

New legislation can feel like a storm to clients, who may approach the changes with trepidation, unsure how to best protect themselves and their finances. Financial professionals lead the way. Like storm chasers, they get close enough to learn key information, analyzing changes and anticipating the impact. Perhaps most importantly, they share that information, using it to reassure clients and guide them on how to keep their financial picture secure.

Passed in December 2022 as part of a $1.65 trillion Consolidated Appropriations Act of 2023, the SECURE 2.0 Act includes little for clients to fear. In this issue, we look at the key charitable giving provision of SECURE 2.0 and how clients can use it to make a gift and secure an income.

## Qualified Charitable Distributions—A New Option for Giving

Section 308 of the Consolidated Appropriations Act amended Section 408(d)(8) of the Internal Revenue Code (IRC) to provide for a new qualified charitable distribution (QCD) option for any IRA owner age 70½ or older who wants to make a charitable gift and secure a lifetime income stream.

### The Traditional QCD

Before SECURE 2.0, the IRC allowed IRA owners age 70½ or older to make a distribution directly to a qualified charity under the qualified charitable distribution provision (sometimes called a charitable rollover).[2] Donor-advised funds and supporting organizations are not considered qualified charities. The IRA distribution is treated as a QCD only if a deduction for the entire distribution would be allowable under IRC §170.

This QCD amount, up to the annual aggregate limit of $100,000, is not includible in gross income, meaning the donation has no impact on the donor's charitable limitation. There is no charitable income tax deduction for a QCD (which works well for the many donors who no longer itemize deductions after the Tax Cuts and Jobs Act of 2016), but no tax is due on the distribution and the distributed amount counts toward the donor's required minimum distribution (RMD) if one is due.

### The New QCD Option Under SECURE 2.0

The SECURE 2.0 Act added a new subparagraph to the Code at IRC §408(d)(8)(F), creating a new QCD option for IRA owners age 70½ or older in addition to the traditional option. This allows a one-time distribution up to $50,000 directly from an IRA to create a new charitable gift annuity (CGA) or charitable remainder trust (CRT), which can either be a charitable remainder unitrust (CRUT) or charitable remainder annuity trust (CRAT). Like the traditional QCD, no deduction is allowed, but the tax-free distribution counts toward the donor's RMD if one is due. However, this option allows the donor to not only make a gift but also secure a source of income.

The CGA or CRT must qualify for an income tax charitable deduction under the current IRC. That means the CGA or CRT must pass the 10% minimum income tax charitable deduction test. In addition, the CRT must have a minimum payout rate of 5%, and in the case of a CRAT, the trust must pass the 5% probability test. The CGA must have a minimum 5% payout rate.

Other specific requirements include the following:

- Spouses may contribute $50,000 each from their own IRAs to a single CRT or a joint-life CGA.
- CGA or CRT payments may only go to the donor and/or the donor's spouse—not to children or other beneficiaries.
- CGAs must be immediate, not deferred.
- CGA or CRT payments are treated entirely as ordinary income and are subject to the federal income tax. No portion of any payment will be considered tax free or taxed as capital gains.

### QCD Inflation Indexing

The $100,000 and $50,000 limits for the traditional and new QCD options, respectively, will be indexed for inflation beginning in 2024. This is also a change brought about under SECURE 2.0.

### Charitable Remainder Trust—Review Plus New

A charitable remainder trust is an irrevocable trust that provides annual distributions to the donor and/or one or more noncharitable beneficiaries designated by the donor for life or a specified period up to 20 years. At the end of the trust term, the remainder interest in the trust is paid to a qualified charity. This is a powerful way to make a significant gift while also supplementing retirement income or providing for loved ones.

CRTs come in two forms. A CRAT pays out a steady income—a specified percentage of the initial trust assets—not less than annually.[3] A CRUT pays out a variable income—a specified percentage of the annually revalued trust assets.[4] A CRUT can accept additional funding while a CRAT cannot.

CRT income payments are tax-advantaged, as income is taxed in four tiers—ordinary income, capital gain income (with net short-term capital gains distributed before net long-term capital gains), "other income" (which generally means tax-exempt income), and tax-free return of principal.

The CRT is a gift of a remainder interest (to the charitable remainderman) with a retained income interest (for the amounts paid to the income beneficiary). To qualify as a split-interest trust that generates an income tax deduction for the donor, the CRT must meet criteria described under IRC §664(d).[5] The future charitable interest qualifies for a charitable deduction equal to the present value of the remainder interest in the year the trust is created.[6]

**NOTE:** A CRT funded with the new QCD option does not qualify for a charitable income tax deduction, and whether it is a CRAT or a CRUT, it cannot accept any additional funding. In addition, the noncharitable beneficiaries are limited to the IRA owner and/or the owner's spouse, and all income payments are taxed only as ordinary income.

**EXAMPLE:** Abby is 74 and retired from a career as a software engineer. She owns an IRA with a significant balance. As a result of their other investments, Abby and her husband Rick (also 74) do not need the RMD she must take from her IRA. Abby and Rick have embraced a lifetime commitment to charitable giving to a handful of charities but give consistently to one favorite charity. They decide to take advantage of the new QCD option to fund a charitable remainder trust from Abby's IRA.

Working with her attorney, Abby creates a new CRAT. She directs her IRA custodian to make a tax-free transfer of $50,000 directly into the CRAT. This transfer fulfills her RMD requirement for the year. According to the terms of the CRAT, Abby and Rick will receive annual payments of $2,500 for 20 years (taxed as ordinary income), at which point the remainder will go to their favorite charity.

### Charitable Gift Annuity—Review Plus New

A charitable gift annuity is a contractual agreement between the donor and the charity. The donor agrees to make an irrevocable charitable gift (often cash or long-term appreciated stock), and in return, the charity agrees to pay a fixed amount periodically for the lifetime of one or two annuitants. Income payments can begin immediately or be deferred to some future date.

However, the transaction is not merely a "quid pro quo" between the donor and charity. Since the present value of the donor's annuity is less than the value of the property transferred, the transfer is considered part charitable gift, part annuity purchase. The donor qualifies for a tax deduction for the gift portion of the transaction.

Annuity payment amounts depend on the amount of the gift and the age of the annuitant(s). In addition, deferred gift annuities result in higher payment amounts. Payments are tax-advantaged, as they may be taxable as a tax-free return of principal, long-term capital gain, and ordinary income.

#### New Higher ACGA Rates

The American Council on Gift Annuities (ACGA) publishes suggested gift annuity payout rates that are revised periodically. The ACGA announced new, higher rates effective January 2023, presenting donors with the opportunity to lock in higher rates when establishing a fixed lifetime income stream for one or two people.

**Sample one-life gift annuity rates, effective January 1, 2023**

| Age | 70 | 75 | 80 | 85 | 90 |
|---|---|---|---|---|---|
| Rate | 5.9% | 6.6% | 7.6% | 8.7% | 9.7% |

**NOTE:** A CGA funded with the new QCD option must begin immediately, does not qualify for an income tax deduction, and must be non-assignable. The annuitants are limited to the IRA owner and/or the owner's spouse. In addition, annuity payments are taxed entirely as ordinary income.

**EXAMPLE:** Juan and Reina, both age 75, met in Marine Corps basic training and eventually married while serving their country. After retiring from the military, Juan opened and ran a popular lunch counter, and Reina started up her own private security firm. After the successful sale of both businesses, Juan and Reina are now retired and financially secure. They each have an IRA with a significant balance, but due to their sound financial decisions, they do not need the income from their RMDs.

This year, they decide to use the new QCD option to fund an immediate charitable gift annuity with their favorite charity. They each ask their IRA custodian to transfer $50,000 into a new joint-life CGA, for a total of $100,000. Juan and Reina will receive $5,800 per year for life—an amount that will be fully taxed as ordinary income.

## Providing for Someone with Special Needs *and* for Charity

### Special Needs Trusts

A special needs trust (SNT), sometimes referred to as a "supplemental needs trust," is designed to provide financial support for the sole benefit of an individual with physical or mental disabilities (money for collateral needs that enhance quality of life) in such a way that the beneficiary remains eligible for government benefits. The SNT does this by removing the trust assets from the individual's pool of "countable" assets that are used to determine eligibility for means-tested government programs. While an SNT is generally considered the strongest planning tool for providing assets to a beneficiary with special needs, it also requires a certain level of expense to set up and maintain the trust—expense that may be more than some families can realistically afford.

### ABLE Accounts

To address this problem, in 2014, Congress created the Achieving a Better Life Experience (ABLE) account under IRC §529A as a way to support individuals with special needs without the expense of creating a trust. ABLE accounts are modeled on IRC §529 college savings plans but are administered by the states and are intended to supplement benefits provided through private insurance or public programs. Individuals may choose the state program that best fits their needs when it comes to investment options, fees, limitations, etc.

An ABLE account allows for tax-free savings for individuals with a disability that began prior to age 26 and is expected to last at least 12 months or result in death. Upon account initiation, beneficiaries must certify, under penalty of perjury, that they meet the qualification standards and have a signed physician's diagnosis ready to supply to the IRS upon request.

Distributions from ABLE accounts are tax free for qualified expenses, including education, housing, transportation, employment training, personal support services, health and wellness costs, legal fees, financial management, funeral and burial costs, and more. Distributions for non-qualified expenses are considered distributions of principal and gains and are taxed accordingly, along with a 10% early withdrawal penalty. In the event funds in an ABLE account transfer at death, final Treasury Regulations address the gift, estate, generation-skipping, and transfer tax consequences.

ABLE beneficiaries will need to categorize distributions for tax purposes—states are not responsible for establishing safeguards to verify qualified distributions. Nondeductible contributions are capped at $17,000 per year (in 2023). Any balance up to $100,000 is not counted as a resource for the purposes of SSI, and resources above $2,000 disqualify the beneficiary from SSI. So, once the account assets reach $102,000, the individual will be disqualified from SSI benefits. Medicaid benefits are not affected. If the state has a system in place to reject contributions that exceed these annual limits, contributors do not need to provide taxpayer identification numbers.

At death, the state may claim funds left in these accounts. Disabled workers can make contributions above the existing annual contribution cap up to the poverty level of the state where the account is maintained.

### Changes Under SECURE 2.0

SECURE 2.0 has brought about two welcome changes in this arena:

1. Those with **special needs trusts** can now name a charity as the remainder beneficiary of an SNT holding an inherited defined contribution pension plan or IRA without causing issues with the timeframe under which the inherited retirement assets must be paid out. We will discuss this in more detail below.
2. Starting in 2026, the age at which disability or blindness must occur to qualify for an **ABLE account** will increase from 26 to 46. This will be particularly beneficial for wounded military veterans injured after age 26.

### SNTs and Applicable Multi-Beneficiary Trusts

Before the SECURE Act of 2019, inherited IRAs followed RMD rules, and a "designated non-spouse beneficiary" (such as a child or grandchild) had the option to take the RMDs spread out over the beneficiary's life expectancy. That was beneficial as it kept more money in the account to continue growing tax-deferred over a longer time (thus, the common name "stretch IRA"). The beneficiary heir had to retitle the inherited IRA in both the beneficiary heir's name and the deceased owner's name to take advantage of the extended RMD period. Then, beginning the year following the original owner's death, the designated non-spouse beneficiary heir had to begin taking RMDs.

The SECURE Act eliminated the option for "stretch" IRAs for many beneficiaries. Instead, under SECURE, a non-spousal beneficiary heir must withdraw all assets from the IRA by December 31 of the year that contains the 10th anniversary of the original owner's date of death. The result is that the non-spouse designated beneficiary may have to pay higher taxes on the withdrawal (depending on their annual income). For the non-spouse designated beneficiary, no RMDs are required during the 10-year period.

For purposes of the stretch provision, a "designated beneficiary" includes a spouse, disabled and chronically ill individuals, individuals not more than 10 years younger than the decedent, and minor children of the retirement account owner (but only while they remain minors). This was particularly important for special needs trusts that are referred to as applicable multi-beneficiary trusts (AMBTs).[7] An AMBT may only have an individual or a trust as a beneficiary. This created a problem for an account owner with a beneficiary who was disabled or chronically ill if the account owner also had an interest in naming a charity to receive any remaining funds following the death of the disabled or ill beneficiary. If the owner named a charity as a beneficiary for any amount of the AMBT, the entire trust was disqualified from using the stretch provision for the funds in the account.

### The Impact of SECURE 2.0 on AMBTs

As noted, beginning in 2023, SECURE 2.0 brought a significant change to inherited defined contribution pension plans or IRAs within an SNT. Now, a special needs trust holding an inherited IRA or defined contribution plan account can name a charity as the remainder beneficiary without causing issues with the timeframe under which the inherited retirement assets must be paid out.[8] This provides account owners with the ability to provide for the needs of an individual beneficiary while also benefitting a meaningful, eligible charity with the remaining funds from the trust. However, it is important to note that only qualified charities under IRC §408(d)(8)(B)(i) can be named as remainder beneficiaries under this new section. A donor-advised fund or private foundation may not be named as a beneficiary.

## Other Important Retirement-Related Changes

### RMDs

To prevent retirement accounts from merely being estate planning tools to pass assets to the next generation, Congress requires that retirement account owners withdraw a minimum amount each year once the owner reaches a certain age. In 2020, the SECURE Act raised the age to begin taking required minimum distributions (RMDs) from 70½ to 72. Starting in 2023, SECURE 2.0 revised IRC §401(a)(9)(C)(i)(I) again, raising the age to 73. The RMD starting age is scheduled to increase again on January 1, 2033, to age 75. These RMD requirements apply to traditional IRAs and qualified defined contribution plans, including profit sharing, money purchase, 401(k), and 403(b) plans.

In addition, SECURE 2.0 reduced the excise tax penalty for failure to take required minimum distributions in full from 50% of the amount that should have been taken but was not down to 25%. That amount drops to 10% if the distribution error is corrected quickly.

### IRA Contributions

Starting in 2024, §108 of the CAA revises IRC §219(b)(5) to automatically index IRA contribution limits.

In addition, starting in 2025, §109 of the CAA raises the limit on catch-up contributions under retirement plans for individuals ages 60 to 63. The new limit will be the greater of $10,000 or 50% of the regular catch-up limit for 2025.

## QLAC Limits

A qualified longevity annuity contract (QLAC) is intended to protect individuals from exhausting their retirement savings as they age by paying a stream of income late in life, starting at a future date selected by the contract owner. Final Treasury Regulations issued in July 2014 provide that an individual may purchase a QLAC using assets in traditional IRAs, defined contribution plans (e.g., 401(k), profit sharing plans, money purchase plans), Section 403(b) plans, and Section 457(b) governmental plans (but not defined benefit plans). So, for example, a 55-year-old could buy a QLAC within a traditional IRA and choose to begin benefits at age 80.

An individual can purchase multiple QLAC contracts, provided the cumulative premium for all contracts does not exceed the stated limit. Prior to SECURE 2.0, only 25% of a participant's account balance could be used to purchase a QLAC, with an overall dollar limit of $155,000 (for 2022). Starting in 2023, there is no percentage limitation, just an inflation-indexed $200,000 cap on using account balances from retirement plans to buy QLACs.

## Other Changes of Note

- **Military Spouse Tax Credit.** The availability of this tax credit has expanded for employers to include small businesses. The certified military spouse must be made eligible for plan participation within two months of being hired, and upon eligibility, must be eligible as if they had worked there for two years. The military spouse is 100% vested in all employer contributions. This tax credit does not apply to highly compensated employees.
- **Employee 401(k) Incentive.** Employers are allowed to offer an immediately applicable financial incentive or small reward (such as a gift card) for plan contributions as a long-term incentive for employees contributing to a 401(k) or 403(b) plan.
- **Emergency Savings for Non-Highly Compensated Employees (NHCE).** For NHCE, SECURE 2.0 gives employers the option to use a pension-linked emergency savings account. Contributions are limited to no more than 3% of employee salary, with the portion accountable to the employee capped at $250. Contributions are made as if to a Roth IRA and treated as elective deferrals. The employee's first four withdrawals will not be subject to any fees or penalties.
- **Exceptions to the 10% Early Distribution Penalty.** There are new exceptions to the 10% penalty for early distributions from tax-preferred retirement accounts for:
  - <u>Terminally ill individuals.</u>
  - <u>Public safety officers</u> with at least 25 years of service with the employer sponsoring the plan or who reach age 50 (whichever is earlier). Private-sector firefighters and corrections officers employed by state and local governments are now part of the "public safety officer" group for the purposes of this exception.
  - <u>Distributions triggered by an excess IRA contribution.</u> This applies to payments and distributions made on or after the date of enactment, regardless of when the excess contribution was made.
  - <u>Federally declared disaster.</u> Individuals may continue to use retirement funds exempt from the 10% early distribution penalty, but these distributions are now limited to $22,000, treated as gross income over three years, and may be repaid into the retirement account. Amounts distributed to purchase a home before the disaster can also be recontributed, and employers may authorize a larger amount. This affects disasters occurring on or after January 26, 2021.
  - <u>Emergency expenses.</u> Beginning in 2024, there will be an exception for distributions used for emergency expenses, defined as unforeseeable or immediate financial needs relating to personal

or family. Only one distribution per year will be allowed, up to $1,000, and the taxpayer has the option of repaying the distribution. Unless the distribution is repaid, no further emergency withdrawals will be allowed.

- **Student Loan Match.** Starting in 2024, employers can match payments to qualified student loans as contributions to a 401(k), 403(b), or SIMPLE IRA.
- **Age 50 Catch-Up.** Starting in 2024, the annual deferral limit and catch-up contribution will increase by 10% at age 50 for an employer with 25 or fewer employees. An employer with 26 to 100 employees may provide higher limits, but only when providing a 4% matching contribution or a flat 3% employer contribution.
- **529 to Roth Rollovers.** Beginning in 2024, SECURE 2.0 will allow for penalty-free, tax-free rollovers up to $35,000 from a 529 account (tax-advantaged educational savings account) to a Roth IRA, subject to the Roth IRA annual limits. The 529 account must have been open for at least 15 years.

## Weathering the Storm

Predicting the arrival of severe weather almost always includes some type of estimation, with forecasters often using percentages to provide those in the potential path of the storm with a sense of the possible outcomes. At times, legislation being considered in Congress can be as uncertain as the threat of severe weather. SECURE 2.0 had a few iterations, then appeared to be dead before being resurrected and included in the final version of the Consolidated Appropriations Act of 2023. As a financial professional, you certainly can't forecast the actions of Congress, but when Congress does take action, you have the experience and education to provide your clients insight on how any new items may impact their estate and financial planning.

## ENDNOTES

1 "A History of Storm Chasing," *MetMatters*, June 26, 2018.
2 IRC §408(d)(8).
3 Treas. Reg. Sec. 1.664-2.
4 Treas. Reg. Sec. 1.664-3.
5 26 U.S.C. 664(d).
6 26 U.S.C. 2522(c)(2).
7 26 U.S.C. 401(a)(9)(H)(iv) and (v).
8 26 U.S.C. 401(a)(9)(H)(v).

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