SECURE ACT PERSONAL PLANNING IMPACTS AND OVERVIEW

February 24, 2020

Key Highlights

- *The SECURE Act changes distribution, contribution, and inheritance laws including moving the required minimum distribution age to 72.*
- *Exceptions to the new ten-year rule on inherited IRAs or 401(k)s include those for spouses, minor children, and people with a disability or chronic illness.*
- *With the acceleration of the payout time frame under the SECURE Act, different strategies may become more useful for IRA owners and their families.*

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The Setting Every Community Up for Retirement Enhancement (SECURE) Act will have wide reaching effects on retirement and estate planning. These notable changes create opportunities for financial advisors to assist clients in effectively planning for retirement in 2020 and beyond.

Increased Required Minimum Distribution (RMD) ages
The SECURE Act changes the age for starting RMDs from 70½ to 72 for individuals who attain age 70½ after 2019. It is worth noting that the ability to utilize the qualified charitable contribution (QCD) planning technique from an IRA remains at age 70½.

Post age 70½ IRA contributions permitted
The SECURE Act repeals the prohibition on contributions to a traditional IRA by an individual who has attained age 70½.

Ten-year rule on inherited IRAs or 401(k)s
The time frame that most beneficiaries will have to take out IRA inheritances will change from life expectancy to ten years, meaning full liquidation no later than December 31 of the tenth year following the year of the owner's death. This new IRA inheritance rule eliminates the "stretch" IRA as we know it. However, there are exceptions to the new ten-year rule. The following types of beneficiaries will still be able to use life expectancy to take out beneficiary RMDs instead of following the ten-year rule:

<u>*Spouses*</u> — The spousal inheritance rules have not changed; spouses will still be able to re-register the IRA into their own name or leave the IRA in the name of the deceased spouse and take out RMDs using their life expectancy.

<u>*Minor children*</u> — A minor child may commence the payout using his/her life expectancy; however, once the age of majority is attained, as determined by state law, it reverts to December 31 of the tenth year following the date of majority to liquidate the IRA.

<u>*Disability*</u> — Any beneficiary, regardless of age, who is "disabled" within the definition provided in I.R.C. Sec. 72(m)(7) will be able to utilize their life expectancy to take RMDs. An individual will be considered "disabled" under Sec. 72(m)(7) "if he/ she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long continued and indefinite duration."

Chronic illness — Any beneficiary, regardless of age, who is "chronically ill" as defined by I.R.C. Sec. 7702B(c)(2) will be able to utilize their life expectancy to take RMDs. An individual will be considered "chronically ill" under Sec. 7702B(c)(2) if he/she is unable to perform at least two of six activities of daily living without assistance for ninety days or if he/she requires substantial supervision to ensure such individual's safety from threats to their health and safety due to severe cognitive impairment.

Beneficiary who is not more than ten years younger than deceased — A non-spouse individual beneficiary who is younger than the plan participant or IRA owner, but not more than ten years younger, will be able to use their life expectancy to take out RMDs, instead of using the ten-year rule. Presumably, this exception is in place to consider support relationships between similarly aged family members including siblings.

Successor beneficiaries

The beneficiary who succeeds the initial beneficiary must draw down the remaining balance from the inherited IRA within the remaining time not later than the end of the tenth year from the date of the IRA owner's death.

However, a beneficiary who receives an annuity that was annuitized prior to December 31, 2019 will not be required to use the ten-year payout rule, instead they will be able to continue to use their selected payout option.

Estates as beneficiaries

Beginning in 2020, when an estate is the beneficiary of an IRA that estate will have until December 31 of the fifth year following the year of the owner's death to liquidate the entire IRA.

Trusts as beneficiaries

Beginning in 2020, when a trust is the beneficiary of an IRA and if the trust can be considered a designated beneficiary then that trust will have ten years following the owner's death to liquidate the entire IRA.

If the trust is not considered a designated beneficiary, then the trust will have five years to liquidate the IRA.

WEALTH TRANSFER OPPORTUNITIES MADE POSSIBLE BY THE SECURE ACT

Effective long-term planning requires clients to think about both their lifetime income needs in retirement and what they will leave behind. As advisors, there may now be a path to discuss the SECURE Act's impact with your clients as it relates to wealth transfer opportunities. Of the SECURE Act's many provisions, the handful that focus on these wealth transfer opportunities are some that you should highlight when engaging with your clients.

One notable change going forward, described earlier, will be the reduction in the payout time frame from life expectancy to ten years for most IRA and defined contribution plan beneficiaries that will impact the efficiency of such inheritance (from an income tax perspective). Historically, the greatest utility for the family from a tax efficiency and wealth building perspective, was typically to limit distributions from the IRA both by the owner and beneficiary to have as much as possible in the IRA/inherited IRA for as long as possible to potentially grow tax deferred.

With the acceleration of the payout time frame under the SECURE Act, different strategies may become more useful for IRA owners and their families instead of maximizing tax deferral for the longest time frame possible, which was the basic premise of the "stretch" IRA planning concept. Instead, families may look to the following strategies:

1. Wealth replacement using life insurance

The premise of the planning here is that the IRA owner would utilize the after-tax amount of their annual RMD to purchase life insurance to replace the wealth lost due to the accelerated income tax under the ten-year payout rule.

2. Increasing the family income tax efficiency of IRA distributions with intra-family tax rate arbitrage

With this idea, the owner of the IRA increases their withdrawals from their IRAs if the owner is in a lower tax bracket than their children who are the beneficiaries of the IRA. This idea attempts to lower the tax rate the entire family (both owners and beneficiaries) pay on the IRA distributions by having a lower rate payor, the IRA owner, take more from the IRA than they otherwise would while they were alive. This extra cash flow could be a source of funding for life insurance, like in the wealth replacement example, or to start a gifting program for grandchildren, or the IRA owners could use the extra money for their own purposes.

3. Increasing income tax efficiency of IRA distributions with qualified charitable distributions

Qualified Charitable Distributions (QCDs) allow a traditional IRA or Roth IRA owner, but not a SIMPLE IRA, SEP IRA or qualified plan owner, who is currently over age 70½, to have their IRA custodian send up to $100,000 per year directly to a charity. This QCD distribution will not be taxable to the IRA owner and the distribution can also satisfy the owner's RMD requirement — essentially tax-free RMDs if done correctly. The owner does not get a charitable contribution income tax deduction for the gift to the charity but does not have to include the distribution sent directly to the charity as taxable income. This increases the income tax efficiency of their IRA withdrawals.

QCDs are available only for distributions to public charities, meaning that private foundations and donor advised funds are not eligible to receive QCDs. The IRA owner may direct more than their RMD to a charity under the QCD rules, but no more than $100,000 per year. The rule applies per IRA owner, so both a husband and a wife could utilize the strategy, and each would have their own $100,000 limit. And finally, the IRA owner can direct a certain amount go directly to a charity and have another amount be distributed to them. In this situation the distribution to the IRA owner would be taxable, but the amount sent directly to the charity would not be taxable as it is treated as a QCD.

4. Roth planning to create tax-free distributions for beneficiaries

Each of these strategies would be based on the basic premise that tax rates for the owners are likely to be higher in the future than today or that their current tax rate is lower than the rate of the beneficiaries. Beyond tax rate comparison an owner may still want to pay taxes now on Roth conversion amounts or make Roth/after-tax contributions even if they are in higher tax rates than the beneficiaries to "lock in" a known tax rate or to leave their heirs a potentially tax-free asset like an inherited Roth IRA.

A. Annual small Roth IRA conversions over time

With this idea the IRA owner undertakes Roth conversions each year up to the amount of the top of their current tax bracket essentially filling up their current income tax bracket via Roth IRA conversions. This is done to create a Roth IRA that will be left to their child(ren), so their child(ren) can enjoy the tax-free nature of Roth distributions. Under the SECURE Act, inherited Roth IRAs are subject to the ten-year payout rule just like pre-tax IRAs; however, the distributions of gain from the inherited Roth IRA can be tax free to the beneficiary if the Roth IRA is at least five years old. This is a potentially better tax treatment than distributions from pre-tax IRAs that are generally fully taxable to the beneficiary.

B. Back-door Roth IRA conversions

The back-door Roth conversion strategy is where an owner of a Traditional IRA makes after-tax non-deductible contributions to that IRA and then converts that Traditional IRA to a Roth IRA — essentially undertaking a tax-free Roth conversion. This is another strategy for IRA owners to use to create a Roth IRA that will be left to their children, so their children can enjoy the tax-free nature of Roth distributions.

However, there are some considerations to be aware of when implementing this strategy. The first consideration is the pro-rata rule that requires that the amount of any Roth conversion contain the same ratio of pre-tax and after-tax amounts that are in all the owner's pre-tax IRAs. This rule first assumes that for tax purposes an IRA owner only has one pre-tax IRA even if they have multiple accounts. The second assumption is that the ratio of pre-tax money and after-tax money in all those accounts is applied to the amount of the conversion without regard to what has been contributed to the particular account that is being converted. This rule is designed to prevent the cherry picking of accounts that are funded with mainly after-tax contributions and converting only those accounts to minimize taxation.

C. Mega back-door Roth conversions

The Mega-back door Roth conversion strategy goes a step beyond the back-door Roth IRA conversion strategy mentioned earlier by creating a mechanism to get larger amounts of after-tax contributions into a Roth IRA than the current Roth IRA contribution limits allow using after-tax qualified plan contributions and subsequent rollovers. This strategy is permitted by the IRS via Revenue Notice 2014-54.

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The mechanics of the strategy are that a plan participant makes after-tax contributions to a qualified plan (assuming a particular plan permits after-tax contributions) over a number of years and then undertakes a rollover (either at separation from service or in-service withdrawal where permitted) of the after-tax contribution amounts into a Roth IRA.

During the contribution phase the 401(k) participant can also contribute on a salary deferral basis either pre-tax or Roth or some combination of both, as well as receiving any employer pre-tax contributions. The sum of all these contributions types (pre-tax salary deferral, Roth salary deferral, employer contributions and after-tax contributions) cannot exceed the annual plan limits (2020 limits set at $57,000 if under 50 or $63,500 if over 50).

A further consideration with this strategy is that the entire qualified plan balance must be rolled over in the same year.

Using a simple example, assume a plan participant has $500,000 in their 401(k) account when they separate from service. That account is comprised of $400,000 of pre-tax employee contributions, employer contributions and pre-tax growth, and $100,000 of after-tax contributions. The participant can direct her employer to rollover the $100,000 of after-tax contributions to a Roth IRA and the $400,000 of pre-tax funds to a Traditional IRA. By doing so she has created a Roth IRA account that can then distribute tax-free income to herself if the owner is over age 59 ½ and the Roth IRA is over five years old, or her beneficiary if the Roth IRA is over five years old.

CONCLUSION

The SECURE Act will bring many changes to the American retirement system; it will increase individual's ability to save more for their retirement and create mechanisms for them to generate lifetime income. It will also accelerate the payout time frame for certain beneficiaries and thus presents an opportunity for IRA owners, their families, and advisors to undertake thoughtful retirement income and wealth transfer planning. We encourage our clients to engage with your RPg Advisor to ensure you're effectively addressing these new opportunities.

<u>Important Disclosures</u>:

Source: Nationwide Mutual Insurance Company

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