Maximizing Clients' Total Wealth Post-SECURE Act

Enactment of new law substantially changes estate, tax and retirement planning strategies used for decades

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The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), which soared through the House of Representatives in a 417-3 vote, was approved by the Senate and signed into law by the end of 2019.[1] The SECURE Act established the most significant retirement planning reform since the Pension Protection Act of 2006.

Comprised of 29 separate sections, the SECURE Act impacts a broad range of tax, retirement, estate and financial matters. Title I of the bill focuses on expanding and preserving retirement savings. This includes adding some flexibility for multiple employer plans, increased credits for small employer-run retirement plans, a repeal of the age 70½ limitation on traditional individual retirement account contributions, increased portability of lifetime income distributions options among retirement plans, the addition of penalty-free withdrawals from retirement plans for individuals in the case of a birth or adoption of a child and an increase in the age for the required beginning date (RBD) for required mandatory distributions (RMDs) from 70½ to 72.

Key Changes

The change in Title I that will impact the most people is moving the age of the RBD for RMDs from 70½ out to 72. However, the change would only impact those that turn age 70½ on or after Jan. 1, 2020, moving the RBD by one or two years depending on when your client was born. But, anyone who has already reached age 70½ by the end of 2019 would fall under the previous RBD of 70½.

Title II makes some administrative improvements with some of the changes aimed at changing the annual reporting rules for group plans, adding a required annual disclosure of lifetime income and creating a fiduciary safe harbor that would allow plans to more easily add annuities.

However, what appears to be the largest and most impactful change in the bill is the modification of the RMD rules that apply to inherited IRAs, 401(k) and 403(b) plans, and defined contribution plans (referred to collectively as IRAs). Essentially, the change removes the so-called “stretch” provisions for IRAs for many beneficiaries of inherited IRAs. Removing the stretch IRA has been bouncing around Washington for years, and its time has finally come.[2]

Removing stretch IRAs significantly increases tax revenue for the government. Essentially, this provision allows the government to pay for the other tax breaks in the SECURE Act. While the SECURE Act does include a total of four revenue raising provisions, almost all of the projected revenue increases are from the removal of the stretch IRA. The four tax revenue generating provisions of the SECURE Act are projected to generate $16.4 billion in revenue from FY2019 through FY2029.[3] However, almost all of the revenue, or $15.7 billion, would come from the inherited IRA changes.

The tax revenue increase points to the importance of this change. Many beneficiaries of retirement accounts, IRAs and 401(k)s specifically will see higher taxes in the future and less tax-deferred gains inside of the accounts due to the changes. Because the SECURE Act, took effect Jan. 1, 2020, the planning horizon is short for many Americans. But, there are still strategic planning opportunities to maximize after-tax wealth and reduce the overall tax impact of the removal of the stretch IRA. Some of the new strategies really challenge the traditional notions of best practice estate and beneficiary planning around IRAs and 401(k)s prior to the SECURE Act.

Removing the Stretch IRA

Under current law, non-spouse individual beneficiaries of IRAs (typically children and grandchildren) could stretch RMDs from inherited IRAs over the span of their own lives in accordance

with Internal Revenue Service Life Expectancy Table I.[4] So, if a 47-year-old inherited her mother's IRA, she could take distributions of the IRA over a 37-year period—that is, her life expectancy in Table I.

For example, if your client inherited a $500,000 account, the first year RMD would be the account balance the previous Dec. 31, divided by the life factor of 37. The total distribution required that year would be roughly $13,513.52, less than 3% of the account balance. If the account grew by 4% that year, the inherited IRA would actually have grown by roughly $6,500, based on $20,000 of growth of 4% on $500,000 minus the RMD of $13,513.52. In fact, it could take years to actually start spending down the balance of the account if the investments performed well.

This stretch IRA tactic provided a number of benefits. First, it allowed a long period of tax-deferred or tax-free (Roth) accumulation. Next, it allowed the beneficiary of the IRA to spread out the taxable (non-Roth) income over a long period of time and keep distributions fairly low if the beneficiary was relatively young. Lastly, it allowed for significant postmortem tax planning because distributions weren't forced out rapidly, allowing the beneficiary to bunch higher distributions in lower tax years over the course of the beneficiary's life or spread out distributions over many years.

What Specifically Changed

Under the SECURE Act, the language in IRC Section 401(a)(9) would be amended to require beneficiaries to distribute the entire inherited IRA within 10 years "after the death"[5] of the owner. So in essence, it's really closer to 11 years because the year in which the IRA owner dies doesn't count as part of the 10-year period. Instead, the 10-year period starts the year after the death of the original IRA owner. Thus, if someone dies in 2020, the beneficiary's RMD rules would kick in during 2021, and the beneficiary's life expectancy wouldn't be set based on his age at the end of 2021. Instead, he would have until the end of 2030 to fully distribute the account under a 10-year distribution period. The rules don't require equal distributions among the 10 years, so the beneficiary could theoretically wait until Year 10, bunch contributions through other years or try to evenly spread out the distributions.

Looking back at our previous example, if the 37-year-old beneficiary decided to try to equally spread out distributions over 10 years, she would now be experiencing roughly $50,000-per-year distributions for 10 years, instead of the $13,513.52 distributions. This would represent a significant increase in taxable distributions and possibly increase exposure to higher marginal income tax rates.

> i While the SECURE Act does change RMD rules for beneficiaries significantly, it provides a number of exceptions for what's being categorized as "eligible designated beneficiaries."

What would be a potential impact of these larger taxable distributions? Let's say the beneficiary is earning roughly $140,000 per year and is single. Assuming these factors, a $13,513.52 increase in taxable income from an inherited stretch IRA would push the beneficiary up to $153,513.52 of income, keeping the current 24% tax bracket after the Tax Cuts and Jobs Act (TCJA).[6] However, a $50,000 taxable distribution would push the beneficiary up to roughly $190,000 of income, subjecting roughly $29,275 of the distribution to the higher 32% tax rate, which is triggered at $160,725 in earnings for

single individuals in 2019. As you can see, a shorter distribution period can cause significant increases in taxes pretty quickly.

While the SECURE Act does change RMD rules for beneficiaries significantly, it provides a number of exceptions for what's being categorized as "eligible designated beneficiaries."[7] To meet one of the exceptions as an eligible designated beneficiary, your client must qualify as of the date of the death of the account owner. Those meeting the designated status will be exempt from the 10-year RMD distribution rules for inherited IRAs.

These include surviving spouses, heirs who are less than 10 years younger than the decedent, chronically ill individuals, disabled individuals and minors. Minors will age out of the exclusion once they hit the age of majority in their state, typically 18 to 21. At that time, the 10-year RMD period becomes applicable.

Thus, spouses will still be able to engage in a number of strategies, including rolling over or retitling the IRA into their own name to stretch out RMDs over the course of their lifetime. However, while in the past clients often preferred to leave a surviving spouse the entire IRA due to the preferential treatment of surviving spouses under the RMD rules,[8] under the SECURE Act, splitting up IRAs among the surviving spouse and other beneficiaries could increase total wealth by reducing taxes.

Factors Impacting Planning

The good old days of stretching IRA distributions over the life of a beneficiary are nearly gone. Instead, beneficiaries need to prepare for faster distributions. For many engaging in retirement and estate planning, the goal might be to minimize the tax impact of leaving IRAs to their heirs and to maximize their total after-tax wealth. But, planning isn't quite that simple, as the IRA owners will need to think about what they want to accomplish through multigenerational planning, their own retirement income needs, the surviving spouse's income needs, the control over assets they want to maintain, liquidity needs, the timeframe they have for planning and taxes.

If, after a thorough analysis and goal-based planning process, it's determined that your client wants to engage in further planning to either attempt to mimic the stretch IRA or to reduce taxes overall, there are a number of techniques that will play a crucial role in achieving the best outcome from a tax and total wealth perspective for clients due to the removal of the stretch IRA.

Roth IRA Conversions

If the primary goal is to reduce taxes for the inheriting beneficiary, then Roth conversions will likely be the most powerful and popular planning strategy. In fact, Christopher R. Hoyt penned an article for Trusts & Estates outlining the benefits of strategic Roth conversions under TCJA rules.[9] However, one challenge with Roth conversions is that traditional IRAs can't be converted once inherited by non-spouse person beneficiaries. As such, the planning and conversions must generally occur before the death of the IRA owner.

To engage in a Roth IRA conversion strategy, your client takes assets from a qualified retirement account or traditional IRA and moves them to a Roth IRA. This triggers taxable income on the taxable portion of the amount your client converted. However, your client can avoid the 10% penalty tax for early withdrawals if he's under age 59½. Typically, it's best to do trustee-to-trustee transfers to the Roth from the IRA to meet the 60-day deadline and to avoid any issues with multiple conversions triggering the once-per-year rollover rule.[10] If the conversion taxes are paid from within the IRA, that amount could be subject to income taxes and a penalty tax. As such, your client should try to pay taxes from outside the account when possible.

Generally, Roth conversions can help in a number of different ways. However, the dominant use of Roth IRA conversion planning has been around minimizing taxes by converting taxable amounts in years when taxes are lower than when your client otherwise would take a distribution. In short, your client should pay taxes today when they're lower as opposed to later when they're higher. Under the TCJA, many Americans are in a lower tax rate. This also tends to be the case when two spouses are still alive in retirement. However, when one spouse passes in retirement, income likely won't drop in half, but the tax rates might, subjecting the remaining income of the surviving spouse to higher tax rates. As such, without proper planning, many widows or widowers experience higher tax rates in retirement after the death of their spouse. Additionally, once the TCJA reverts back to the higher pre-2018 rates in 2026, many Americans will experience higher taxes again. For many clients, it's beneficial to convert today.

Now, moving forward under the SECURE Act, a new factor is added to the tax planning process when it comes to Roth conversion strategies: an examination of the beneficiary's tax rate under a 10-year distribution period. For instance, if the IRA owner can convert at the 24% rate while the heir would be in the 32% or higher rate, it can make sense to convert now to maximize total after-tax wealth.

For example, consider the following scenario: A single parent is 60 years old and owns an IRA with $200,000 in it, which he plans to leave to his daughter. He currently has $50,000 of taxable income in retirement. The retiree could do bracket bumping Roth conversions close to the $84,200 top end range in 2019, meaning he could add about $34,000 of taxable income before the next tax rate will apply. Over the next eight years, he could effectively move the entire IRA to a Roth IRA and stay in the 22% bracket. This would create a Roth IRA that isn't subject to RMDs when he reaches the RBD (age 72 under the SECURE Act).

Additionally, if the child was a professional with roughly $250,000 of joint income with her spouse, she would be squarely in the 32% tax bracket at the federal level. When the $200,000 IRA would be inherited, the roughly $20,000 per year distribution would be treated as taxed in the 32% bracket, essentially adding a 10% tax on the distributions over what the father could have paid.

Even if the father engaged in the Roth conversion strategy, the inherited Roth IRA would still be under the SECURE Act's 10-year distribution period, but the Roth income would come out tax free. Additionally, the inherited Roth IRA could be left for the entire 10-year period to grow tax free and be completely distributed at the end of the tenth year. Because of the tax-free nature of the Roth IRA in this situation, it essentially allows for a long period of no-distribution growth.

Multigenerational Spray Trusts

In the past, it was generally preferred to leave IRAs to beneficiaries who could stretch the income out over a long period of time. However, moving forward, because the IRAs will need to be liquidated more quickly, a multigenerational spray trust might make sense to manage taxable income for beneficiaries. If your client left an IRA outright to a grandchild, the annual taxable distributions could cause a significant tax increase as discussed earlier. So instead, a new strategy would be to leave the IRA to a multigenerational spray trust. Because the age of the beneficiaries no longer matters as much, your client will distribute the trust over 10 years. The spray trust will allow your client to spread out the taxable distributions from the IRA over a number of beneficiaries, limiting the impact of the larger annual distributions.

For instance, if your client had a $1 million IRA and left that all to one grandchild, the roughly $100,000 a year RMD, if spread out over 10 years, would certainly cause some of the distribution

to be taxed at a higher-than-normal rate for the grandchild. Instead, your client could put the IRA into a spray trust and split the income among a few grandchildren and a few children. Even if your client had four beneficiaries, he could drop the annual taxable distributions down to $25,000 each, perhaps saving thousands in total wealth by reducing taxes for the beneficiaries.

Life Insurance

A big aspect of beneficiary planning is picking the right beneficiary. But, picking the desired beneficiary isn't always just a tax play. In most cases, the beneficiary designation is being picked for practicality, to benefit a surviving spouse or to leave wealth to a specific group or individual beneficiary. So, while spray trusts might make sense from a tax perspective, they might not accomplish the IRA owner's stated goals. If the goal is really to transfer wealth, keep in mind that life insurance can also play an important role.

There are a number of ways that life insurance could fit into planning after the SECURE Act. First, life insurance could be used to help provide the liquidity to pay the additional taxes on the IRA due to a shorter distribution period. Life insurance could also be used to fill in the gap of lost value that will occur due to the shorter distribution period. Life insurance can also create a tax-free death benefit to supplement income in a more tax-efficient manner than an inherited IRA. As such, it could make sense in some cases for the owner to take taxable distributions while alive and purchase a life insurance policy instead of trying to transfer over the IRA.

New Spousal Planning

In the past, the general rule of thumb was to leave all IRAs to the surviving spouse. Because of portability of the estate tax credit and because spouses can stretch out the IRA over their own life and then leave the remainder to children once they pass away, this appeared to be the best strategy. However, moving forward under the SECURE Act, there will be many situations in which partial transfers to children and partial transfers to the surviving spouse, or even cases in which the surviving spouse is skipped altogether, could be used to maximize wealth and reduce taxes.

There are a number of ways that life insurance could fit into planning after the SECURE Act.

Let's look at a new strategy that splits the IRA between the surviving spouse and other heirs to minimize the tax impact of a 10-year distribution period under the SECURE Act. Because surviving spouses can be exempt from the 10-year distribution rules for inherited IRAs, they still have a lot of options to stretch out distributions over their own lives instead of the remainder of the deceased owner's life expectancy. However, at the surviving spouse's death, the 10-year rule will then start for any other heirs. As such, it might make sense, at the death of the first spouse, to send the IRA to the children. This allows the children to have a 10-year period of distributions on this IRA. However, it's important to note that if the primary goal is to leave an IRA for the support of the surviving spouse, that will likely override any tax benefits of splitting up the IRA between generations prior to the death of the second spouse. If no planning is done ahead of time, it's possible a qualified disclaimer could work if the children are left as contingent beneficiaries.

Then, when the second spouse dies and leaves a new IRA, the children get another 10-year period of

distributions on this newly inherited IRA. This can help spread out distributions over a longer period of time. However, if the surviving spouse inherits the entire IRA and subsequently leaves all assets to the children, there would be just one 10-year period to distribute the assets. This could result in larger annual taxable distributions, causing more of the money to be subject to taxes.

In some cases, it's not advisable to bequeath the entire retirement savings of the first-to-die spouse over to the children. Instead, your client might split up the original IRA to send some money to the surviving spouse and some money to the children. This can allow the surviving spouse to have access to the first-to-die spouse's IRA and take RMDs from the account while alive.

To illustrate the value of splitting up IRAs among the surviving spouse and children, let's look at a quick example. Let's say that you have two spouses—Jane and Jack. Jack dies at 85, leaving a $1 million IRA. Jane, also 85, owns her own $1 million IRA. At age 85, Jane has a distribution period of 14.8 years.[11] This means that presently, her RMD would be $67,567. You could essentially double that amount to $135,135 if she took over her deceased spouse's IRA. If these RMDs were her only income, the tax rate hike wouldn't be terribly detrimental to Jane. In this scenario, she would see more of her money subject to higher rates because she would move from the 22% tax rate to the 24% tax rate for her highest bracket. However, if she had, for instance, another $80,000 of taxable income sources, the new $67,567 of income would push most of the inherited IRA money from her spouse into the 32% tax range.

Now, instead, the $1 million could have been either split up among her and her children or left to her two children. If the first-to-die spouse's $1 million IRA was split three ways, the new distributions for Jane and the kids would likely minimize the tax impact of the new RMDs. Jane could even possibly stay at the same tax rate. The one-third that Jane inherited could be subject to her roughly 15-year distribution period, with the other two-thirds being split between her two children over a 10-year period. Essentially, the taxable distributions have now been split over three families to minimize the tax impact.

Additionally, if Jane lives for another 10 years, the children will have depleted the taxable IRAs and can inherit what's left of Jane's and spread it over a new 10-year period starting the year after she passes away. However, if they inherited both IRAs, say $1.5 million or so all at once (assuming Jane spent down some while alive), the distributions would be

extremely large, almost certainly subjecting them to higher tax rates. By splitting up the IRAs earlier, they were able to extend out the RMDs over two separate 10-year periods, thereby minimizing the tax burden of the distributions.

IRA to Trusts

In the past, another popular trust strategy was to name a conduit trust as the beneficiary of an IRA. This strategy allowed for the pass-through stretch capabilities, while still maintaining the trust for spendthrift protections and control the owner sought. With a stretch provision conduit trust, the RMDs were paid out of the IRA to the trust and then out to a beneficiary. The beneficiary paid taxes, and the trust received a deduction. Accumulation trusts weren't used as IRA beneficiaries in the past as frequently as conduit trusts because accumulation trusts needed to include considerations for both the income and remainder beneficiaries, while the stretch was only done based on the oldest beneficiary.

RMDs that remained in the trust were generally taxed at the trust level. Because it didn't qualify for the stretch, the accumulation trust typically needed to be distributed within five years. However, under the new rules, both trusts will essentially be treated equally in the sense of the stretch provisions, and both will receive a 10-year distribution period from the IRA.

Depending on how previous conduit trusts were drafted, under the new rules, an inherited IRA with a conduit trust as a beneficiary might not make any payments for 10 years. At that point, the entire IRA would be distributed out of the trust, creating a huge potential tax liability. Instead, an accumulation trust could be more beneficial. It could, depending on the trust and other factors, take multiple distributions every year, and what was passed out to the beneficiary would be taxed at the beneficiary tax level, and the trust could still take a distributions deduction for what was distributed, avoiding the negative tax consequences of being taxed at the trust level. If the beneficiary is already in a high tax bracket, your client might be willing to pay the higher taxes in the accumulation trust to achieve additional creditor protections and control over the assets at the end of the 10-year RMD period.

Charitable Planning Techniques

Leaving an IRA to a charity can be a beneficial and effective planning technique if the owner has charitable intent. Assuming there's sufficient charitable intent, there are a number of charitable planning techniques that can tie to IRAs.

An outright transfer of the IRA to a charity by naming a charity as a beneficiary or contingent beneficiary is the simplest strategy.[12] Generally, it isn't advisable from a tax standpoint to leave a Roth account to charity because charities don't pay income taxes, meaning the tax benefit of the Roth would be lost. If the goal is instead to spread out the charitable benefit of the IRA to the charity over multiple years, a donor-advised fund might be a preferred beneficiary over a direct transfer to a charity. But, remember, your client can't gift his IRA to a charity while he's still alive. He can name a beneficiary or withdraw the money and then gift it, but he can't outright gift IRAs. You can use a qualified charitable distribution (QCD) from an IRA after age 70½ to pay out up to $100,000 directly from an IRA to a qualified charity. QCDs can satisfy all or part of an RMD from the IRA for that year, and the distribution can be excluded from taxable income. A QCD can be done with an inherited IRA also but the individual needs to be over age 70½.

When it comes to charitable giving of IRA assets after the SECURE Act, there will be a significant opportunity to strategically use charitable remainder trusts (CRTs) to stretch out benefits to a beneficiary, defer taxes, give money to a charity and generate a sizable charitable deduction.[13]

The two main types of CRTs are charitable remainder annuity trusts (CRATs) and charitable remainder unitrusts (CRUTs). Under the SECURE Act, you can see instances in which using a CRUT or CRAT could generate a net positive amount of total wealth transferred. Granted, your client still needs to have a desire to transfer assets to a charity, but by using a CRT, he can draw out distributions from the trust to his heirs for life, and then the remainder goes to the charity. This is likely the best way to mimic the stretch IRA in the sense of lifetime deferred income for a non-spouse person beneficiary.

With a CRAT, the IRA could be left to the trust, with a beneficiary locked in to a lifetime or up to a 20-year term of payments. At least 10% of the IRA assets would be expected to go to the charity. The payment with a CRAT is fixed. If a lifetime strategy is used, the remainder would go to the IRC Section 501(c)(3) charity whenever the beneficiary dies. With a CRUT, the general layout is the same, except the payment to the non-charitable beneficiary is based on a fixed percentage, and the actual payment would fluctuate based on the annual value of the trust. This gives the beneficiary the possibility of receiving a higher payment if trust assets grow.

Most other strategies will still require taxable distributions faster than over the life of the beneficiary. However, with a CRT, your client can essentially control these distributions to go over a lifetime. If your client has concerns about giving the beneficiary too much control or the higher taxes due to the new SECURE Act 10-year stretch provision of the IRA, using a CRT when your client has charitable intent may make the most sense after the SECURE Act.

Generally speaking, for smaller IRAs, the cost and time associated, along with the risk of the beneficiary's death earlier than expected, make CRT less effective. In most cases, you'll be looking for clients with larger IRAs and a strong desire to leave money to charity. As a pure wealth transfer vehicle, this will be less effective in some cases than leaving assets to heirs, Roth conversion strategies and life insurance.

Revisit Existing Plans

The SECURE Act is the largest retirement reform in over a decade. It substantially changed estate, tax and retirement planning strategies used for decades. What used to be best practice of leaving the entire IRA to a surviving spouse or using conduit trusts to protect the stretch IRA has essentially been flipped on its head.

Instead, tax planning will support splitting up IRAs more often, increased Roth conversions and using more CRTs. It substantially curtails the beneficial use of conduit trusts as the lifetime stretch option will go away for many beneficiaries and could shift the focus to accumulation-based trusts.

Not only will the SECURE Act require more advanced planning, but also it will require many to revisit the existing plan and fast! Many people today might need to unwind some current conduit trusts or reform them, change beneficiaries or retitle assets. While this reform will necessitate change for your clients, it also holds great potential for you to deepen your relationship with them by having proactive conversations about the changes they need to implement.

Endnotes

1. Title I of The Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), www.congress.gov/bill/116th-congress/house-bill/1994/text.
2. Section 310, Highway Investment, Job Creation and Economic Growth Act of 2012.

3 Congressional Research Service (May 24, 2019), The SECURE Act and the Retirement Enhancement and Savings Act Tax Proposals (H.R. 1994 and S. 972), https://fas.org/sgp/crs/misc/IF11174.pdf.

4 Internal Revenue Service Publication 590 (2018), www.irs.gov/pub/irs-pdf/p590b.pdf.

5 26 U.S.C. Section 401(a)(9)(B)(ii).

6 IRS, 2019 Tax Rates, www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2019.

7 Section 401 of the SECURE Act, www.congress.gov/bill/116th-congress/house-bill/1994/text.

8 James Lange, "Optimizing IRAs and Retirement Plan Distributions," Trusts & Estates (December 2014).

9 Christopher R. Hoyt, "Roth IRA Conversion Sweet Spot," Trusts & Estates (June 2019).

10 Treasury Regulations Section 1.408A-4, Q&A-1(b)(l) and Treas. Regs. Section 1.408A-6, Q&A-13.

11 IRS Uniform Lifetime Table III, www.irs.gov/pub/irs-pdf/p590b.pdf.

12 Jonathan G. Tidd, "Giving or Leaving IRA Assets to Charity," Trusts & Estates (October 2018).

13 For a more robust look at charitable remainder trusts for stretch individual retirement account planning, see James Lange, "Preparing for the Death of the Stretch IRA," Trusts & Estates (February 2016), which really focuses only on in-depth charitable remainder unitrust planning techniques. According to Lange, under current law "naming a [CRT] as the beneficiary of an IRA is less favorable than naming children as beneficiaries."

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