Beneficiary and wealth transfer planning after the SECURE Act

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CARES Act Affect on 2020 RMDs

Please note that this presentation was created in the spring of 2020 and the coronavirus pandemic has lead to legislative changes to the required minimum distribution (RMD) rules for 2020.

Specifically the Coronavirus, Aid, Relief, and Economic Security Act (the “CARES Act”) passed in March of 2020 waives RMDs in 2020 for both owners and beneficiaries of IRAs and retirement plans but not nonqualified annuities. In this presentation that waiver date will be noted, as necessary, in the examples.

The CARES Act RMD waiver expires at the end of 2020, at that point the presentation will be updated to reflect the current (2021 and beyond) RMD rules.

Agenda

- Overview of SECURE Act Changes
- Rules before the SECURE Act
- Rules after the SECURE Act
- Tax-efficient wealth transfer strategies

Overview of SECURE Act Changes

- SECURE: Setting Every Community Up For Retirement Enhancement
- Signed into law on December 20, 2019
- Allows participants to save more for retirement
- New distribution requirements for qualified plans and IRA's
- Nonqualified annuity planning remains unchanged
- Most changes effective January 1, 2020

IRA Beneficiary payout rules before the SECURE Act

- Commonly referred to as “stretch” or “extended” IRA
- Designated beneficiary’s may use their life expectancy to calculate minimum annual distribution
- Beneficiary can always take more
- First distribution must be taken by December 31 of the year following the year of the owner’s death
- Beneficiaries who inherited an IRA prior to 2020 can continue to stretch

Example One — Death of IRA owner in 2019

- An IRA deferred annuity owner died in 2019 and left the IRA annuity to their son
- The son may use his life expectancy to stretch out the inherited IRA
- The son has until December 31, 2021, to take out his first life expectancy-based payment
- Every year thereafter, the son must take out the minimum life expectancy-based amount, but he can always take more

What Hasn't Changed: Nonqualified Annuity Payout Rules

- Life expectancy (a.k.a. nonqualified stretch) and life annuitization
- Five-year rule
- Spousal continuation
- Annuitization beneficiaries can continue to use selected option

Example Two — Death of nonqualified deferred annuity owner in 2020

- A nonqualified deferred annuity owner dies in 2020 and his daughter is named beneficiary
- The daughter may use her own life expectancy to take out the RMDs
- The first minimum life expectancy-based payment must be taken within one year of the owner's death and every year thereafter
- Any gain in the annuity will be distributed first and will be taxable income to the beneficiary
- Distributions from the inherited annuity are not subject to the 10% tax on pre-59½ distributions because of the death of the owner

Scenario Three — Death of nonqualified immediate annuity owner in 2022

- A nonqualified immediate annuity is purchased in 2020. A life and 20-year term certain payout option is selected.
- The owner dies in 2022 and their son was named beneficiary
- The son may elect to continue receiving payments for the remaining 18 years of the term certain or take a commuted value of the remaining payments, if permitted by the contract
- The gains portion of the payments will be taxable income to the beneficiary, once all the remaining cost basis is recaptured

Rules Changes After the SECURE Act for IRAs and Retirement Plans

- RMD’s now must begin at age 72 for individuals that attain age 70½ after 12/31/2019
- Traditional IRA contributions after 70½ now permitted
- 10-year payout rule for designated beneficiaries where owner dies in 2020 or thereafter, with some exceptions

10-year Beneficiary Payout Rule Detail

- Account must be liquidated by 12/31 of the 10th year after the owner’s death, with certain exceptions
- Unlike stretch IRA provisions, the 10-year rule does not require annual or periodic distributions
- Applies to individual nonspouse beneficiaries and trusts that are considered designated beneficiaries

Example Four — Death of IRA owner in 2020

An IRA owner dies in 2020 leaving behind an IRA deferred annuity to their daughter

The daughter has until December 31, 2030, to liquidate the entire IRA

The daughter may wait until 2030 and liquidate the entire IRA at that time, she can liquidate the entire IRA in 2020, or she can take random amounts prior to the end of 2030

10-year Rule For Successor Beneficiaries — Owner and Beneficiary Death After 2019

If the owner dies after 2019

And the original beneficiary dies within 10 years of the owner's death

Then the successor beneficiary must liquidate the account within 10 years of the owner's death

Example Five — Owner and Beneficiary Death After 2019

- An IRA owner dies in 2020 leaving the IRA to their daughter
- The daughter has until December 31, 2030, to liquidate the entire IRA
- The daughter dies in 2022 and her son is named successor beneficiary
- The son has until December 31, 2030, to liquidate the entire IRA

10-year Rule For Successor Beneficiaries — Owner Died Before 2020 and Beneficiary Died in 2020 or thereafter

- For owner deaths prior to 2020
- Where the original beneficiary dies in 2020 or thereafter
- The successor beneficiary has 10 years from the original beneficiary's death to liquidate the account

Example Six — Owner Died Before 2020 and Beneficiary Died in 2020 or Thereafter

- IRA owner died in 2019 and left the IRA annuity to their son
- The son may use his life expectancy to stretch out the inherited IRA and has until December 31, 2021, to take out his first life expectancy-based payment
- The son dies in 2022 and names his nephew successor beneficiary
- The nephew has until December 31, 2032, to liquidate the entire amount remaining in the inherited IRA

10-Year Rule Distribution Exceptions — Spouses

- Rules have not changed
- May re-register into their own name, or
- May leave in deceased owner's name
- 10-year rule applies to nonspouse designated beneficiary who inherits after surviving spouse dies

10-Year Rule Distribution Exceptions — Minors

- May use life expectancy until they reach age of majority
- Then ten year distribution period starts at age of majority
- Only for children of the participant
- Life expectancy-based payments must begin by December 31 of the year following the year of the IRA owner's death

Example Seven — Minor as Beneficiary

- An IRA owner dies in 2020 leaving the account to their 12 year old daughter
- The state of residence age of majority is 18
- As a minor the daughter can use her life expectancy to take out RMDs from the inherited IRA until she reaches 18 years of age
- When the daughter becomes 18 in 2026, she has 10 years to liquidate the entire remaining value of the inherited IRA - December 31, 2036

10-Year Rule Distribution Exceptions – 10 Years or Less Younger

- Not more than ten years younger than IRA owner
- Could be unmarried individuals or siblings
- Beneficiary may use life expectancy to take out required distributions
- After initial beneficiary's death the successor beneficiary has 10 years liquidate the inherited IRA

Example Eight — 10 Years or Less Younger Beneficiary

- An IRA owner dies in 2020, at age 58, leaving the account to their unmarried partner, age 55
- The beneficiary can use their life expectancy to take annual RMDs from the inherited IRA because they are less than 10 years younger than the deceased owner
- The life expectancy-based payments must begin by December 31, 2021

10-Year Rule Distribution Exception – Disability

Disabled individual as defined by I.R.C. Sec. 72(m)(7)

"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"

Beneficiary's status is determined as of the date of the participant's death

Ten Year Rule Distribution Exception – Chronic Illness

- Chronic illness as defined in I.R.C. Sec. 7702B
- Unable to perform 2 of 6 activities of daily living (ADL's) or cognitive impairment
- Beneficiary's status is determined as of the date of the participant's death

Beneficiary of an IRA Annuitized After 2019

10-year rule applies to beneficiaries who inherit IRAs that were annuitized after 12/31/2019

Example Nine — Death of an Annuitized IRA Owner — Annuitized After 2019

An individual annuitized an IRA in 2020 with a life and 20-year term certain payout option

The owner died in 2022 and the owner's cousin is named as beneficiary

The cousin must take all remaining payments by December 31, 2032

Beneficiary of an IRA Annuitized Prior to 2020

Beneficiaries who inherit an IRA that was annuitized prior to 2020 may continue with the selected option

Example 10 — Death of an Annuitized IRA Owner — Annuitized Prior to 2020

An individual annuitized an IRA annuity in 2018 with a life and 20-year term certain payout option

The owner dies in 2022, and the owner's niece is named as beneficiary

The niece may either continue to receive payments for the remaining 16 years of the term certain or take a lump sum commutation value of the remaining payments (if the contract allows)

Estates and Non-designated Beneficiary Trusts as Beneficiary of an IRA

- Payout rules depend on age of participant at death
- If owner dies prior to Required Beginning Date (RBD), full distribution by December 31 of the fifth year after death
- If owner dies after RBD, the owner’s remaining life expectancy may be used to take annual RMDs
- Non-designated beneficiary trusts include charitable remainder trusts (CRT)

Other SECURE Act Changes – Kiddie Tax Updates

- The Tax Cuts and Jobs Act of 2017 mandated using trust tax rates for taxing unearned (investment) income of children
- SECURE Act repeals this provision and income is again taxed at parents' highest marginal tax rate
- This reversion to previous law will generally result in a lower tax bill, as trust rates are highly compressed

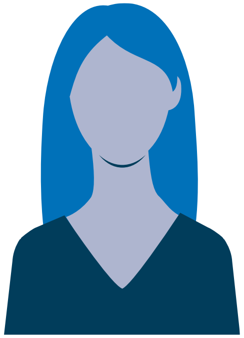
Tax Efficient Planning Opportunities After the SECURE Act

Wealth replacement with life insurance	• Death benefit for heirs • Long term care protection for owners • Intra-family tax arbitrage
Roth planning	• Annual Roth conversions strategy • “Back door” Roth conversion • Mega “back door” Roth conversion
Charitable opportunities	• Qualified Charitable Distributions • Charitable Remainder Trusts As IRA Beneficiary
Nonqualified annuity for life expectancy payouts	

Wealth Replacement with Life Insurance

- The after-tax amount of IRA distributions can be used to purchase life insurance to close the benefits gap caused by the loss of stretch opportunities versus the 10-year rule
- May insure either the IRA owner or beneficiary, depending on which generation is to be benefitted
- Living benefits, such as LTC or cash accumulation can be addressed by the life insurance policy

What is the wealth replacement “Gap”?



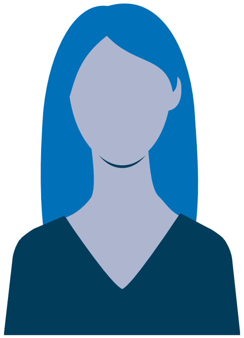
IRA Beneficiary
Age 55
Beneficial IRA Balance
$500,000

Stretch IRA Rules	Vs.	Secure Act-10 Year Rule
Total Benefit to Beneficiary Life expectancy 29.6 years		Total Benefit to Beneficiary^
$1,435,193*		**$1,047,537****

Decreasе of benefit over life of beneficiary – **$387,655**

*Annual tax rate - 25%, **Secure Act year 10 lump sum tax rate - 37%, Net rate of return 5%
^After tax amount of lump sum distribution at the end of the first 10 years then accumulated tax deferred through beneficiary’s life expectancy of 29.6 years then distributed and gains taxed

Who is doing the planning?



IRA Beneficiary
Married
2 Children

IRA Owner
Married
1 Child
2 Grandchildren

- **Understand the potential gap**
- **Decide the need(s):**
  - ➢ **Replace the gap**
  - ➢ **Accumulate cash for potential use**
  - ➢ **Protect against LTC event**
- **Determine funding as it relates to RMDs**
- **Tax arbitrage**
- **Insurability**

Intra-family tax arbitrage and insurability

IRA Owner
- **1 Child**
- **2 Grandchildren**

Does not anticipate needing this asset now or in the future

Let the asset continue as is:
- **Minimize current tax to RMDs**
- **Maintain full access/control**
- **Subject to investment risk**

Insurance on self and/or spouse:
- **Tax Arbitrage**
- **Less access/ control**
- **Lock in a death benefit**
- **Potential LTC access**

Gifting: insurance on beneficiary:
- **Tax arbitrage**
- **No access/control**
- **Greater premium value**
- **Potential living benefits for Child/ Grandchildren**

Roth Planning – Generally

Roth accounts create the potential for tax free distributions to owners and beneficiaries

Roth conversion can be attractive when the tax rates for the owner are likely to be higher in the future

Three strategies to consider:

- Annual Roth Conversions Strategy
- “Back Door” Roth Conversion
- Mega “Back Door” Roth Conversion

Annual Roth Conversions Strategy

- Annual Roth conversions over time up to the top of the current tax bracket may be advantageous
- This is done to create a Roth IRA that will likely be left behind to a nonspouse beneficiary
- Beneficiaries can receive gain in Roth IRAs tax-free if the Roth account is at least 5 years old
- Inherited Roth IRAs are still subject to the 10-year payout rule of the SECURE Act

“Back Door” Roth Conversion

- “Back Door” Roth strategy starts by making a non-deductible contribution to a traditional IRA
- The traditional IRA is then converted into a Roth with no additional tax
- Conversion may not be tax free if owner has other IRA’s – pro-rata rule
- Pro-rata rule requires all IRA’s to be considered when calculating taxes due

Pro-rata Rule Example

Traditional IRA	After-tax Contributions	Pre-tax (Deductible) Contributions	Pre-tax Earnings	IRA Values
# 1	$0	$35,000	$40,000	**$75,000**
# 2	$20,000	$0	$5,000	**$25,000**
# 3	$30,000	$40,000	$30,000	**$100,000**
Totals	**$50,000**	**$75,000**	**$75,000**	**$200,000**

- Client wants to convert IRA #2 to a Roth IRA thinking it will result in lowest amount of taxation
- Pro-rata rule prevents this from happening

Example continues on next slide

Pro-rata Rule Example, …continued

Traditional IRA	After-tax Contributions	Pre-tax (Deductible) Contributions	Pre-tax Earnings	IRA Values
# 1	$0	$35,000	$40,000	**$75,000**
# 2	$20,000	$0	$5,000	**$25,000**
# 3	$30,000	$40,000	$30,000	**$100,000**
Totals	**$50,000**	**$75,000**	**$75,000**	**$200,000**

- After-tax/pre-tax ratio of all IRAs is 25%/75%
- Taxable amount of the Roth conversion - $18,750

Mega “Back Door” Roth Conversion

- Make after-tax contributions to a qualified plan in addition to your salary deferrals
- Transfer after-tax contributions to a Roth IRA when eligible
- The strategy is predicated on using the annual maximum qualified plan contribution limit
- Eventually creates a Roth IRA with larger balance that is allowed through “normal” Roth contributions to IRA and qualified plan

Mega "Back Door" Roth Conversion Example

- A plan participant has $500,000 in her 401(k) account when she separates from service
- She has been making after-tax contributions to her plan for many years as well as making pre-tax salary deferrals and receiving an employer matching contribution
- Her account is comprised of $400,000 of pre-tax employee contributions, employer contributions and pre-tax growth, and $100,000 of after-tax contributions

Example continues on next slide

Mega "Back Door" Roth Conversion Example, …continued

- She 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
- She has created a Roth IRA account with no taxable income that can then distribute tax-free income to herself or her beneficiary
- She also has a $400,000 Traditional IRA to provide retirement income – distributions will be taxable from this account

Qualified Charitable Distributions (QCD)

- Allows traditional IRA and Roth IRA owners to direct the custodian to make a distribution directly to a charity
- This distribution is not taxable to the owner, and can be used to satisfy RMD requirements.
- This strategy could be considered to increase the overall income tax efficiency of IRA distributions.
- Applies to IRA owners that are over 70 ½ and is limited to $100,000 per year

Explanation continues on next slide

Qualified Charitable Distributions

- Only available for distributions to public charities, not to donor advised funds or private foundations
- Both spouses can utilize this provision
- Can also split the distribution between themselves and a charity
- Total tax-free amount is reduced if IRA owner makes deductible contribution in the same year – SECURE Act change

Charitable Remainder Trust as IRA Beneficiary

- Naming a CRT as beneficiary of the IRA avoids taxation on the entire lump sum all at once when the trust liquidates the IRA
- The income beneficiary of the trust can receive income from the CRT over their life or a term (no more than 20 years) directed by the trust
- The receipt of payments from the trust by the income beneficiary will be taxable income

Explanation continues on next slide

Charitable Remainder Trust as IRA Beneficiary, …continued

- May provide for deferral opportunity greater than 10 years because of the trust’s payout language
- At the end of the term or the beneficiary’s life the balance of the trust assets are paid to the charity named in the trust

Nonqualified Annuity as Inheritance Payout Vehicle

If an IRA owner desires a life expectancy or life annuitization payout for a nonspouse designated beneficiary then consider taking distributions from IRA accounts and depositing the after-tax proceeds into a nonqualified annuity

Nonqualified annuities are not subject to the SECURE Act's ten-year payout rule – so beneficiaries can stretch or annuitize over their life expectancy

Explanation continues on next slide

Nonqualified Annuity as Inheritance Payout Vehicle, …continued

- Depending on tax bracket and time horizon, overall tax efficient payouts could result
- Life expectancy payout for designated nonspouse beneficiaries may be enforced with a beneficiary restriction form

Conclusion

Families should review their beneficiary designations and wealth transfer plans to make those plans as efficient and effective and possible

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