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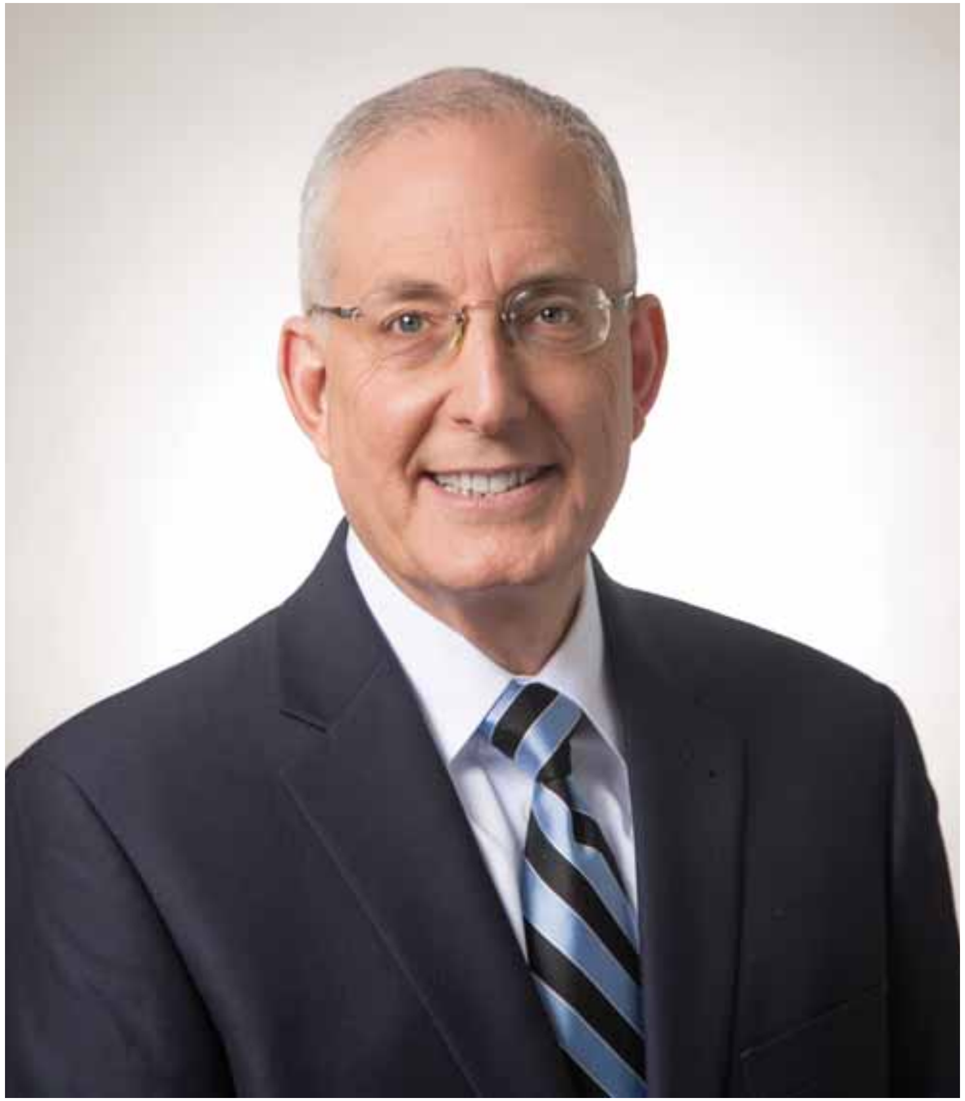
Planning for the End of the Stretch IRA

Webinar with Ed Slott | July 30, 2019

SECURE Act

Critical Issues that Must be Addressed for Large IRAs



SECURE Act

Setting Every Community Up for Retirement Enhancement Act of 2019

► **Current law:**

Stretch IRA for all designated beneficiaries – *individuals named on the IRA or plan beneficiary forms, and qualifying trusts*

◉ **Proposed changes:**

Stretch IRA would be eliminated – *replaced with a 10-year payout for all beneficiaries,* ***except for "Eligible Designated Beneficiaries"***

Proposed Changes

✘ **Stretch IRA would be eliminated:**

Replaced with a 10-year payout for all beneficiaries, except for these **"Eligible Designated Beneficiaries":**

- Surviving Spouse
- Minor children (but not grandchildren) up to majority
- Disabled individuals – ***subject to the strict IRS standard***
- Chronically ill
- Beneficiary not more than 10 years younger than the IRA owner (or plan employee)

Effective date: For deaths ***after 2019.*** For deaths ***in 2019 or prior years, the current rules would remain the same.***

How the New, Post-Death IRA Rules Work

"I realize that this may be carping, but I never did live long enough to enjoy my I.R.A. account."

✘ **No annual RMDs**

- The ***only*** RMD on an inherited IRA would be the balance at the end of the 10 years after death
- The ***entire*** amount would be the RMD

Planning Issues: *Which IRAs Will Be Affected?*

< $500,000

Largely unaffected

These **M** IRA balances will likely be consumed during a lifetime.

$500,000 – $1MM

Somewhat affected

A good portion of **L** IRA balances might be consumed during a lifetime, and the remaining funds to beneficiaries spread out over 10 years would not have a major tax impact.

$ Multi-MM IRAs

***BIG* impact!**

A good chunk of these **XXL** IRA balances will be left to beneficiaries and often in trusts.

Urgent! Planning options for these XXL IRAs will be critical.

Two Big Issues

1. **Post-death control**

2. **Taxes – *especially trust taxes***

▼ **IRA trust problems:**
Most XXL IRAs are left to trusts to protect and preserve those large inherited IRA balances for (and from) beneficiaries – *minors, disabled, spendthrifts, creditor / financial problems, lawsuits, divorces, 2nd marriages, or other vulnerable beneficiaries who may be easily preyed upon.*

▲ **IRA trust benefit – *long-term, post-death protection and control*:**
When an IRA is left to a trust, and the trust qualifies as a "see-through" trust, the inherited IRA funds can be stretched over the oldest trust beneficiary's lifetime, leaving the lion's share of the inherited IRA funds protected in the trust – *possibly for decades.*

Two Types of IRA Trusts

1. Conduit trusts:
Pay out only RMDs to trust beneficiaries over their lifetime. Taxes are paid by the individual beneficiaries at their own personal tax rates.

2. Discretionary trusts:
Trustee has the power (discretion) to pay out funds to the trust beneficiaries or hold and protect the funds (accumulate the funds) in the trust.

Funds held in the trust would be taxed at high trust tax rates

2019 Trust Tax Rates	
0%	\$0 – \$2,600
24%	\$2,601 – \$9,300
35%	\$9,301 – \$12,750
37%	Over \$12,750

Conduit Trusts

Conduit trusts will no longer work and essentially cease to exist.

► ***Why?***

There would no longer be RMDs.

10→ After the 10 years:

- The only RMD would be at the end of the 10 years – ***100% RMD at that point.***
- All inherited IRA funds would be released to the beneficiaries, nullifying any further trust protection – *exactly the opposite of what the client wanted!*

► **Conduit trusts would become discretionary trusts.**

Conduit trusts would have to be changed to discretionary type trusts to allow distributions within the 10 years to smooth out the tax bill, or be held within the trust for long-term protection.

Trusteed IRAs

- ► Trusteed IRAs are conduit trusts
- ► Conduit trusts and trusteed IRAs will no longer work
- ► They will *ALL* have to be scrapped and redone, probably as discretionary trusts
- ► Many major financial institutions have these in place for their largest IRAs

Discretionary Trusts (Accumulation Trusts)

These will still work but at a potentially heavy tax cost.

0→10 Trustee can spread payouts to the trust (or trust beneficiaries) over the 10 years

10→ After 10 years, someone will pay the tax on the entire XXL IRA balance:

- Either the **trust,** at high trust tax rates (if the funds are held to be protected); *or*
- By the **individual beneficiaries** at their own rates – *but then the funds are no longer protected in the trust*

► **This is a better situation as far as trust protection, but still at a heavy tax cost. Roth IRAs will work better here; no trust tax when the funds go to the trust or to the trust beneficiaries.**

Individual Beneficiaries – *Not in Trusts*

The entire inherited IRA balance will have to be paid out to the beneficiaries after the 10 years, but they could take voluntary distributions over the 10 years to smooth out the income.

5 Solutions and Planning Opportunities

1. Re-evaluate beneficiaries

- Spousal rollovers can be more valuable for tax deferral

2. Tax bracket management

- Maximize low tax brackets
- Qualified charitable distributions (QCDs)

3. Roth conversions

4. Life insurance

5. Charitable remainder trusts (CRTs) and direct charitable beneficiaries

"... I'm just saying; grieving widows don't normally dance on the coffin singing, 'I'm in the money'."

1. Re-Evaluate Beneficiaries

► **Spousal rollovers become more valuable for tax deferral**
Surviving spouses are exempt from the 10-year payout.

► **Trusts become a poor IRA beneficiary –** ***significant downgrade as an estate planning vehicle***

Exception: Possibly a trust for a spouse's benefit (not a QTIP trust)

- IRS would have to provide guidance (Regulations) on how these IRA trusts would work under the new rules
- That would take time, maybe years, adding to the uncertainty of how IRA trusts would work when they are solely for the benefit of the spouse

1. Re-Evaluate Beneficiaries

- **Beneficiary planning will be inverted**

Example: A 75- year old spouse beneficiary can actually have a longer payout than a 25-year old child/grandchild (who would be stuck with the 10-year payout).

  - Surviving spouse will eventually die – *then the 10-year payout kicks in for children (or any beneficiary, other than the exception group)*
  - Credit shelter trust for a portion at the first death; single clients don't have this option

- **Coordinate with overall estate plan to maximize estate tax exemptions**

2. Tax Bracket Management

- **Lifetime strategies:**
  - ✓ Use traditional funds to pay heavy medical expenses (nursing homes, medical home improvements, etc.) partially offsetting the tax on the IRA withdrawals
  - ✓ Draw down IRA funds to soak up business losses
  - ✓ Use up lower tax brackets each year

2. Tax Bracket Management

Taxable Income Brackets for 2019 *Ordinary* Income Tax Rates

Marginal Tax Rates	Married Filing Jointly	Single
10%	$0 – $19,400	$0 – $9,700
12%	$19,401 – $78,950	$9,701 – $39,475
22%	$78,951 – $168,400	$39,476 – $84,200
24%	$168,401 – $321,450	$84,201 – $160,725
32%	$321,451 – $408,200	$160,726 – $204,100
35%	$408,201 – $612,350	$204,101 – $510,300
37%*	Over $612,350	Over $510,300

* *The top rate is effectively 40.8% for those subject to the 3.8% Medicare surtax on net investment income*

2. Tax Bracket Management | QCDs

For those who qualify (IRA owners or beneficiaries who are age 70½ or older)

► **If charitably inclined, IRAs are the best funds to give to charity**

► **The QCD allows the exclusion of income**

QCDs can offset RMD income

► **QCDs reduce the IRA balance without the tax, leaving less of a tax problem for beneficiaries under the 10-year payout**

2. Tax Bracket Management | Post-Death Strategies

► **Number of beneficiaries**

Look at the number of beneficiaries; each beneficiary should maximize their lower tax brackets each year within the 10 years

► **Use it or lose it!**

These low brackets are freebies each year; if they are not used, they are lost forever. *Don't waste them!*

► **"Beneficiary Tax Benefit Multiplier"**

The number of beneficiaries multiplies the benefit of the lower brackets

Example: Three beneficiaries means even a large IRA can be spread over 30 tax returns over the 10 years – *all maximizing the lower brackets*

Downside: Still no long-term stretch IRA beyond the 10 years; the inherited IRA funds will be paid out and not protected

3. Roth Conversions

Tax is paid upfront and eliminates the trust tax problem after death; better for discretionary trusts

► ***Is paying the tax worth it, if the Roth can only last for 10 years after death?***
Maybe, depending on **who the beneficiaries are (and how many)** and on the **eventual tax rate** that will be paid by the beneficiaries.

► ***Are you taking into account the client's lifetime tax rate while taking RMDs?***
The Roth conversion advantage is based on the **current tax rates compared to the tax rates that will be paid in retirement or by the beneficiaries**; Roth conversions are more advantageous if future tax rates are projected to be higher than current rates.

► **Low rate phase-out after 2025:**
Current lower rates put into place by the Tax Cuts and Jobs Act are scheduled to sunset in 2026

3. Roth Conversions | The Beneficiary Tax Benefit Multiplier

► **Pushing post-death distributions into 10 years can result in higher future tax rates, making a Roth conversion a better tax option now**

► **But this depends on The Beneficiary Tax Benefit Multiplier:**

- *Who are the beneficiaries?*
- *How many beneficiaries are there?*

3. Roth Conversions | Benefits

- **There are no lifetime RMDs**
- **Spousal rollovers can add to tax-free accumulation and continue to be exempt from lifetime RMDs (surviving spouses are exempt from the 10 year limit)**
- **Tax-free retirement income for the surviving spouse**
- **Eliminates trust tax problem**

Works for discretionary trusts under the 10-year rule; the inherited funds can remain protected in the trust even after the 10 years, even though the inherited Roth funds still must all be paid out to the trust after 10 years

- **Eliminates accelerated income tax to beneficiaries after 10 years**
- **For larger estates (those that might be subject to federal or state estate tax), the tax paid on conversion reduces the estate and the eventual income tax paid by the beneficiary**

4. Life Insurance

" And the beauty part is you can be your own beneficiary for the first eight times. "

▲ **Upgrade: Life insurance moves to the top of the list as an estate and tax planning vehicle for the largest IRAs.**

▼ **Downgrade: IRA trusts will move to the bottom of the list (or possibly become extinct) under the proposed tax rules.**

► **Life insurance can replace all of the benefits of the stretch IRA and IRA trusts.**

4. Life Insurance | Benefits for the XXL IRAs Under the Proposals

▲ More tax efficient

- Life insurance will be income tax-free to beneficiaries (except for annual investment income)
- Life insurance can also be estate tax free – *set up outside the estate*

▲ More flexibility

Life insurance is a better, more flexible and customizable asset to leave to a trust

4. Life Insurance | Simplicity

▲ **No RMDs**

▲ **No complex tax rules**

- No rigid stretch IRA trust provisions
- No IRA custodian issues

▲ **No trust tax on the life insurance proceeds paid to the trust (earnings on the proceeds though will be taxable)**

4. Life Insurance | Other Policy Benefits

▲ **Life insurance trusts can be *customized* to simulate the stretch IRA over *any payout period desired***

- Trustee can have the power to keep the funds protected in the trust without having to incur a trust tax (other than on annual earnings); *or*
- The trustee can invade the trust for beneficiaries

▲ **Second-to-die policies can work well – *since the surviving spouse can do a spousal rollover and continue the tax deferral for life***

▲ **Long term care (LTC):**

Certain life insurance policies can include long-term Care riders to protect other assets

4. Life Insurance | Leverage

▲ **Life insurance provides leveraged wealth transfer**

More funds will go to the eventual beneficiaries and with less tax than if the IRA was left directly to the beneficiaries or to an IRA trust

- **Life Insurance / IRA Strategy:**
  - ✓ Pay down IRA during lifetime – *pay tax at current low rates, over a number of years*
  - ✓ Invest the after-tax funds in life insurance
  - ✓ If a trust is needed, the life insurance can be paid to an insurance trust (ILIT)
  - ✓ Reduces current income tax by eliminating RMDs on IRA funds withdrawn

4. Life Insurance | Downside

▼ Only for funds specifically earmarked for beneficiaries

This is a long-term strategy that must be committed to – ***clients need to understand this***

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▼ Limited life

This strategy assumes the IRA funds will not be needed during lifetime (which is likely the case for the XXL IRAs); other (non-IRA) funds will need to be available for lifetime use

5. Charitable Remainder Trusts (CRTs) and Direct Charitable Beneficiaries

▲ Upside:

- Best for the XXL IRAs
- If your client is charitably inclined, CRTs can simulate the stretch IRA, with yearly payouts to beneficiaries for a term of years or life
- Tax-free to CRT – *no income tax on the transfer to the CRT*
- *Estate tax deduction based on time period*

5. Charitable Remainder Trusts (CRTs) and Direct Charitable Beneficiaries

▼ **Downside:**

- Funds go to charity after the beneficiary dies, but if the beneficiary is in poor health, **funds may go to the charity earlier than planned**
- There is no payout to a successor beneficiary ***(however, those funds can be replaced tax-free with life insurance on the beneficiary)***
- The longer the beneficiary lives and receives payments from the CRT, the greater the CRT benefit
- Won't work for very young beneficiaries; they won't satisfy charitable requirements when a charity has to wait too long for their money

5. Charitable Remainder Trusts (CRTs) and Direct Charitable Beneficiaries

▼ **Downside:**

- No lifetime access for lump-sum payments. *Beneficiaries won't have access to lump-sums, even for emergencies (only annual distributions), but clients may want that kind of protection*
- CRTs have ongoing trust administration costs – ***only worth it for XXL IRAs***
- CRT distributions will be taxable to the beneficiaries – ***beginning as ordinary income***
- CRT payouts are subject to Tier ordering rules under IRC Section 664(b) "Character of Distributions": **1)** ordinary income; **2)** capital gains; **3)** tax-exempt; **4)** tax-free-return of principal

5. Charitable Remainder Trusts (CRTs) and Direct Charitable Beneficiaries | Additional Charitable Option: Leave IRAs Directly to Charity

► **Leave IRAs directly to charity –** ***without a CRT (much simpler).***
Leaving more step-up in basis assets (non-IRAs) to beneficiaries

► **No income or estate tax**

► **This leaves more non-IRA assets to beneficiaries**

► **Income in respect of a decedent (IRD) tax-trap caution:**
IRAs are IRD; name the charity directly as the IRA or plan beneficiary

► **DO NOT FUND A CHARITABLE BEQUEST UNDER A WILL WITH AN IRA!**
<u>This will trigger taxation without an offsetting deduction.</u>

Action Steps for Advisors

- ✓ **Contact clients to advise them on the proposed tax rule changes eliminating the stretch IRA – *they should hear this from you!***

- ✓ **Review all IRA and Plan beneficiary forms *(especially the XXL IRAs where substantial sums will be left to beneficiaries):***
  - ✓ Evaluate the post-death tax impact
  - ✓ Evaluate post-death protection and control desired
  - ✓ Check **contingent beneficiaries** to provide post-death flexibility if situations or tax rules change

Evaluate These Solutions

- **Lifetime planning options, QCDs, other IRA distributions to use up lower tax brackets and offset IRA income**

- **Identify clients who have named a trust as their IRA beneficiary.**
Will IRA trusts still be a viable beneficiary option? **Probably not. Changes will be necessary.**

- **Roth conversions**

- **Life insurance replacement plan**

- **Leaving IRAs to charity –** ***CRTs or direct beneficiary***

Contact your clients *NOW!*

Show your clients that you have their back and you are a pro-active advisor. Alert them to how the SECURE ACT may potentially affect their retirement and their beneficiaries. ***This is a great opportunity to connect with families.***

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