SECURE ACT

Caldwell Law

April 2, 2020

603.643.7577

www.estateandeldlerlawgroup.com

1

SECURE ACT
TEN-YEAR RULE

H.R. 1994 – Sec. 401
Modification of
Required Minimum Distribution Rules
for Designated Beneficiaries

General Rule: Requires all IRAs and Qualified Plans to be distributed within 10-years of death of account owner

EFFECTIVE

DECEMBER 31, 2019

2

CARES ACT

''Coronavirus Aid, Relief, and Economic Security Act'' or "CARES Act" was enacted by Congress, and signed into law by President Trump, on Friday March 27, 2020.

Required Minimum Distributions (lifetime and post-death) are "**suspended**" for 2020.

Neither IRA owners, nor employees covered by company plans, nor beneficiaries of any type of covered plan or IRA is required to take a "required minimum distribution" in the year 2020.

3

SECURE ACT
TEN-YEAR RULE

- Exceptions for certain beneficiaries

("eligible designated beneficiary")

- Surviving Spouse
- The employee's Children under the age of majority *(not grandchildren or any other children)*
- Disabled
- Chronically ill
- Individual not more than ten years younger than account owner. IRC § 401(a)(9)(E)(ii)

4

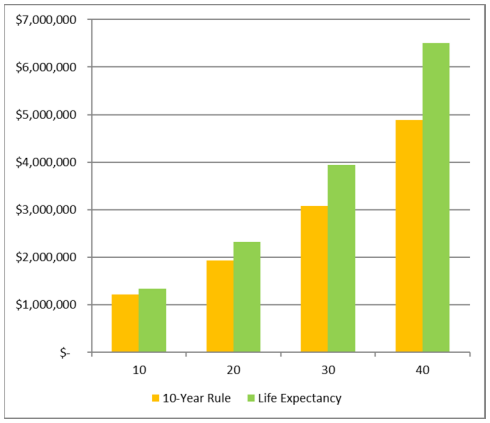
SECURE ACT
TEN-YEAR RULE

Ten-Year vs. Life Expectancy

Age of (Oldest Trust) Beneficiary	40
IRA Balance	$ 1,000,000
Pre-Tax Growth Rate	6.00%
After-Tax Growth Rate	4.75%
Average Income Tax Rate - Life Expectancy Rule	24.00%
Average Income Tax Rate - Ten Year Rule	28.00%
Distributions Occur at Beginning or End of Period?	End
Lump-Sum Distribution or Amortize Payments?	Amortize

5

SECURE ACT
TEN-YEAR RULE



6

"Inherited" IRAs

Common Goals

Prolong IRA payments over longest possible period of time: increase wealth to future generations and manage tax brackets

7

"Inherited" IRAs

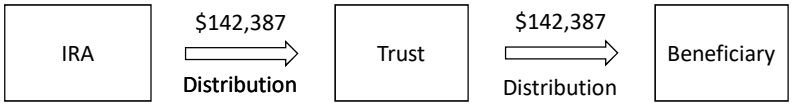
Pre-2020 Law

For deaths prior to the SECURE ACT, IRA assets can be distributed based upon the life expectancy of the beneficiary. IRC Sec. 401(a)(9)

8

The Conduit Trust, possible disaster

- A conduit ("safe–haven") trust requires all distributions from the IRA to the trust to be to distributed to the beneficiaries as received
- This worked well under the life expectancy rules
- However, it can be a disaster under the ten-year rule



9

Solutions – Common Goals

- Retain Income Tax Deferral
- Bracket Management within a Family (income taxes)
- Fulfill Charitable Goals with IRD
- "Convert" Ordinary Income to Capital Gain
- Manage State Income Taxes

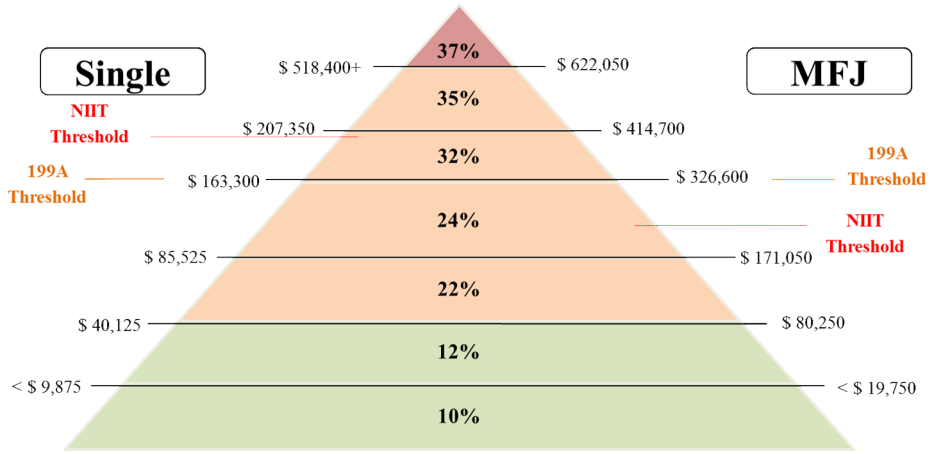
10

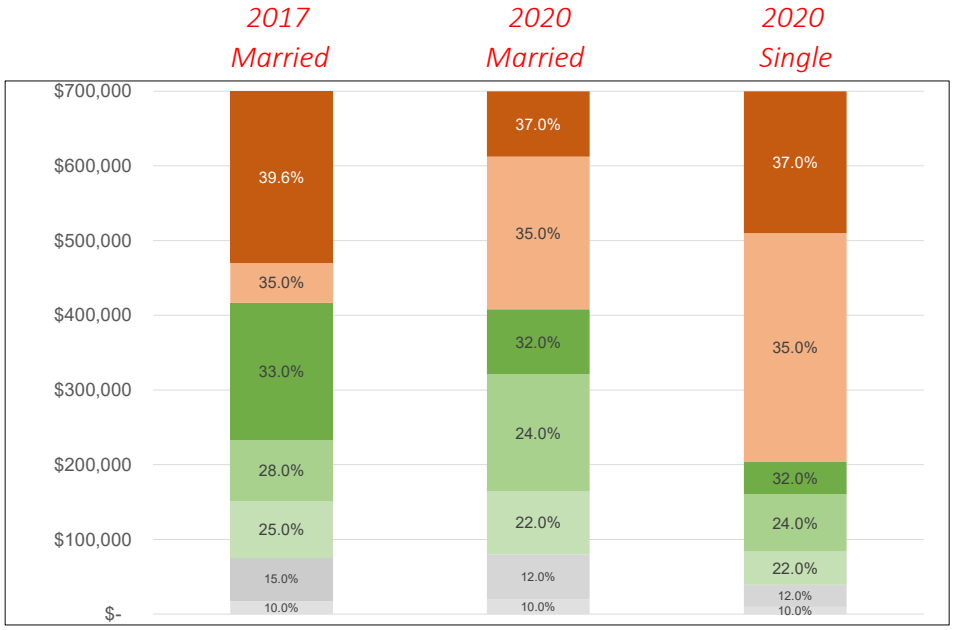
Solutions to Analyze

Overview

- Multi-generational Spray Trusts
- Roth Conversions
- Spousal Rollovers and the New Spousal Rollover Trap
- IRAs Payable to CRTs
- IRA Trusts for State Income Tax Savings
- Life Insurance Solutions

2020 Ordinary Income Tax Rates





13

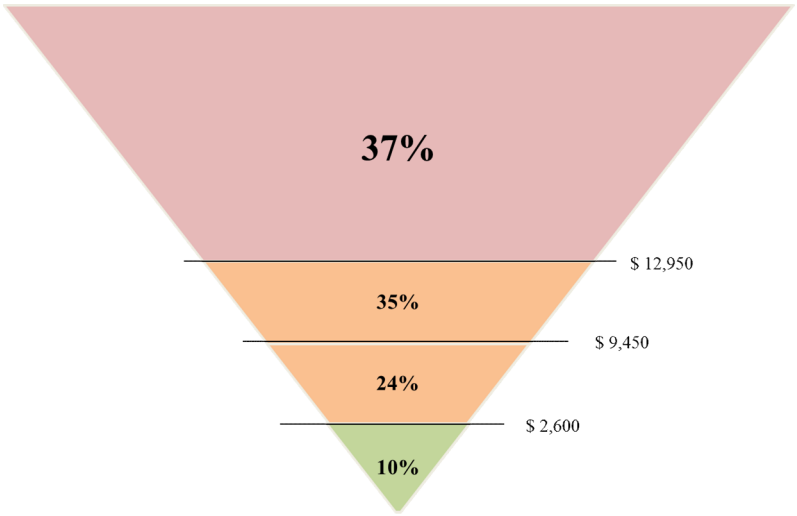
Foundational Concepts
General Tax Rules

- Income taxed to either the trust or the beneficiaries
  - If income is accumulated, then the income is taxed to the trust/estate
  - If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income

14

Foundational Concepts

2020 Ordinary Income Tax Rates for Estates & Trusts



15

MULTI-GENERATION SPRAY TRUST

- The purpose of using a spray trust is to spread income across more taxpayers and lower the effective tax rate and to retain the ability to accumulate income as prudent

Kiddie Tax Issues

IRC § 1(g)

16

MULTI-GENERATION SPRAY TRUST

- The "Kiddie Tax" is assessed on a child's unearned income over $2,200 for 2019 and 2020.
- The tax applies to dependents if they are under 19 or full-time students between 19 and 23.
- Under the SECURE Act tax rates are equal to the parents' marginal tax rate, not estate and trust rates.

17

ROTH CONVERSIONS

- The purpose of Roth Conversions is to spread distributions over many years and use lower brackets.

18

General Roth IRA Concepts

- 100% of growth is tax-exempt
- No required minimum distributions at age 70½ (72 under the SECURE Act)
  - NOTE: Distributions from Roth IRAs cannot be used to fulfill the RMD from a traditional IRA
- RMDs on Inherited Roth IRAs (10 year rule)

19

General Concepts

- Convertible accounts
  - Traditional IRAs
  - 401(k) plans
  - Profit sharing plans
  - 403(b) annuity plans
  - 457 plans
  - “Inherited” 401(k) plans (see Notice 2008-30)
- Non-convertible accounts
  - “Inherited” IRAs
  - Education IRAs

20

General Concepts

Who Should Consider a Roth Conversion?

- Taxpayers who have favorable tax attributes including charitable deduction carry-forwards, investment tax credits, net operating losses (NOLs), high basis non-deductible traditional IRAs, etc.
- Taxpayers who can pay the income tax on the IRA from non-IRA funds
- Those who expect their tax rate to increase in the future

21

General Concepts

Who Should Consider a Roth Conversion?

- Those who expect to owe estate tax
- Those who expect large RMDs which may:
  - Cause exposure to higher ordinary income rates,
  - Increase your capital gains rate,
  - Increase the percentage of your Social Security subject to taxation, and
  - Increase your Medicare premiums

22

General Concepts

Who Should Consider a Roth Conversion?

- Those who expect a surviving spouse to require large distributions for living expenses because the single tax brackets are "compressed."
- Those who expect their beneficiaries to have a higher tax rate at distribution than the account owner's current-year tax rate.
- Those whose accounts have lost value, but expect recovery in the long term.

23

Taxation of Roth IRA Distributions

	Distribution within 5 years	Distribution beyond 5 years
Age < 59½	Income Tax: Yes (earnings only) 10% Penalty: Yes (earnings & taxable portion of prior conversion amounts)	Income Tax: Yes (earnings only) 10% Penalty: Yes (earnings only)
Age ≥ 59½	Income Tax: Yes (earnings only) 10% Penalty: No	Income Tax: No 10% Penalty: No

24

Mathematics of Roth IRA Conversions

	Traditional IRA	Roth IRA
Current Account Balance	$ 1,000,000	$ 1,000,000
Less: Income Taxes @ 40%	-	(400,000)
Net Balance	**$ 1,000,000**	**$ 600,000**
Growth Until Death	200.00%	200.00%
Account Balance @ Death	$ 3,000,000	$ 1,800,000
Less: Income Taxes @ 40%	(1,200,000)	-
Net Account Balance to Family	**$ 1,800,000**	**$ 1,800,000**

25

Mathematics of Roth IRA Conversions

- Critical decisions:
  - Tax rate differential (year of conversion vs. withdrawal years)
  - Use of “outside funds” to pay the income tax liability
  - Need for IRA funds to meet annual living expenses
  - Time horizon

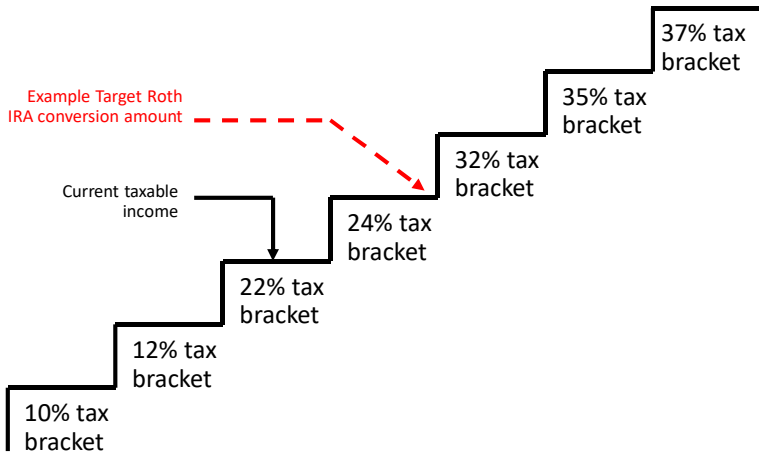
26

Mathematics of Roth IRA Conversions

Generally, the key to successful Roth IRA conversions is to avoid exposure to higher marginal rates.

27

Mathematics of Roth IRA Conversions



28

Mathematics of Roth IRA Conversions

2019 Income Tax Brackets

	Single	Married Filing Jointly	Married Filing Separately	Head of Household
10% Tax Rate	$9,700	$19,400	$9,700	$13,850
12% Tax Rate	$39,475	$78,950	$39,475	$52,850
22% Tax Rate	$84,200	$168,400	$84,200	$84,200
24% Tax Rate	$160,725	$321,450	$160,725	$160,700
32% Tax Rate	$204,100	$408,200	$204,100	$204,100
35% Tax Rate	$510,300	$612,350	$306,175	$510,300
37% Tax Rate	> $510,300	> $612,350	> $306,175	$510,300

29

State Income Tax Planning

- Review State Law of the IRA Owner
  - Will the home state tax the IRA Trust?
- Design a beneficiary form to be payable to non-grantor trust in states with no income tax
- The payments trapped in the trust will avoid state income taxes

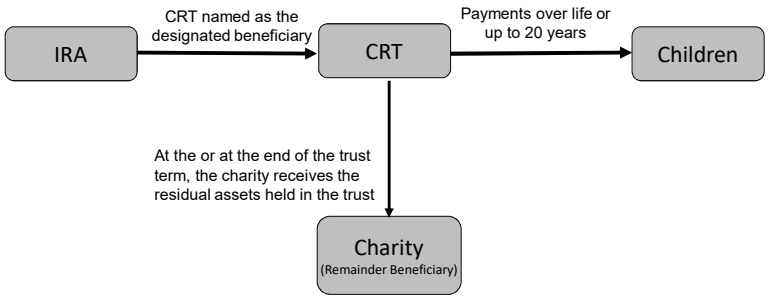
30

Charitable Remainder Trusts

Warning: <u>must be charitably inclined</u>

31

Charitable Remainder Trusts



IRC §§ 401(a)(9), 664.

32

Charitable Remainder Trusts

Types of CRTs

- Charitable Remainder Unitrust (CRUT)
  - Income beneficiaries receive a stated percentage of the trust's assets revalued each year.
    - The distribution will vary from year to year depending on the investment performance of the trust assets and the amount withdrawn.
  - The annual payment must be 5-50% of the fair market value of the assets at the time of contribution.
- Charitable Remainder Annuity Trust (CRAT)
  - The annual payment must be 5-50% of the fair market value of the assets at the time of contribution.
  - The term of the annuity can be:
    - For a term up to 20 years,
    - Over the life of the annuitant(s),
    - Over the shorter of the two, or
    - Over the longer of the two.

33

Charitable Remainder Trusts

Taxation of Distributions

- The character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b):
  - First, distributions are taxed as ordinary income
  - Second, distributions are taxed as capital gains
  - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
  - Finally, distributions are assumed to be the non-taxable return of principal

34

Charitable Remainder Trusts

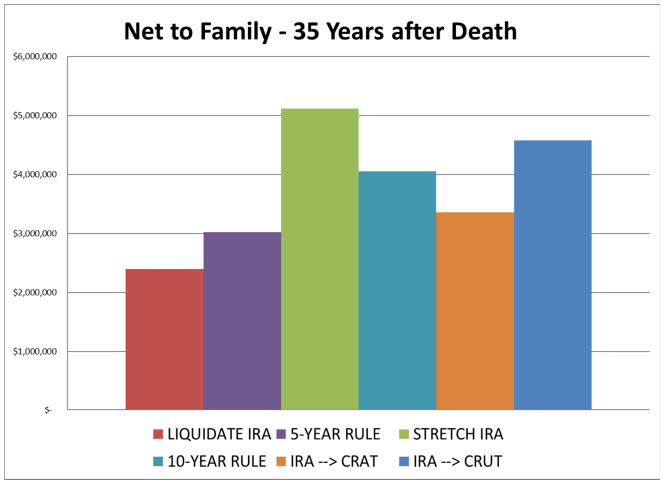
Example

- Basic Assumptions
  - $1,000,000 in a Traditional IRA at death
  - 50 year old beneficiary
  - Pre-tax growth rate of 6%
  - Tax rate *assumptions*
    - 37% income tax rate applies if the IRA is liquidated
    - 32% income tax rate applies if the IRA is distributed over 5-years
    - 24% income tax rate applies if the IRA is distributed over 10-years
    - 22% income tax rate applies if the IRA is distributed over the life-time of the beneficiary or passed to the beneficiary via a CRT

35

Charitable Remainder Trusts

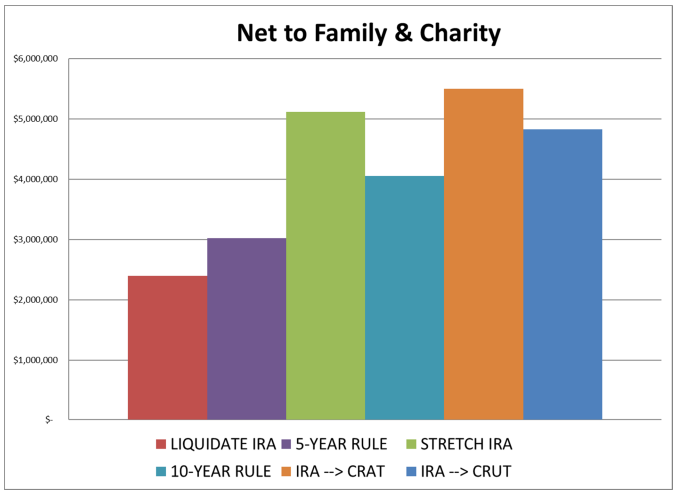
Example



36

Charitable Remainder Trusts

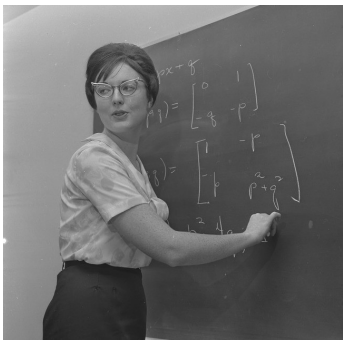
Example



37

Life Insurance

- Two Strategies
  - IRA Roth Conversion Insurance Hedge
  - IRA Relocation: Replacing an IRA with insurance



38

Life Insurance – Roth Hedge

It's a Balancing Act …
Bet to Live? Bet to Die?

39

Life Insurance – Roth Hedge

- The 10-year rule, creates new actuarial risk of early death:
  - Under the previous law, qualified accounts could be drawn-down over decades after death, capturing deferral and virtually assuring bracket arbitrage
  - However, a 10-year distribution requirement will unfairly tax those who die when their savings peak around retirement age or shortly thereafter
  - Life insurance could offset this risk that family wealth will be lost to tax

40

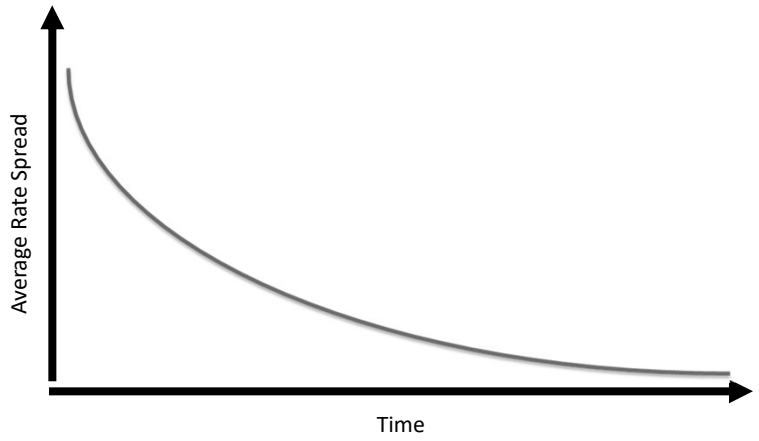
Life Insurance – Roth Hedge

- Roth conversions will be the primary way in which those with large IRAs avoid exposure to higher rates after death
  - However, the effectiveness of this strategy increases with time
  - A life insurance policy equal to the difference between the theoretical terminal tax and the terminal tax in the event of early death would offset this risk

41

Life Insurance – Roth Hedge

- The tax-cost of early death will decrease with age for many people



42

Life Insurance – Roth Hedge

- Therefore, a policy structure with a declining death benefit would best offset the risk
- A whole or universal life product with a term rider may be the best fit

43

Life Insurance – Relocation

- The basic theory is that Roth Conversions will generally produce the same tax deferral result as a permanent life insurance policy
- Therefore, using IRA distributions to fund premium payments can make sense
  - Often works for those with excessive RMDs and high tax rates (basic minimal funding until RMDs begin possible)
  - Often works for those who may be subject to an estate tax
- Wealth Replacement (outright or in trust)
  - Deferral
  - Asset protection
  - Multigenerational

44

Thank you

This outline is for discussion purposes only. It is intended to provide general information about some of the law applicable to estate planning and estate settlement. The author, Caldwell Law or anyone forwarding or reproducing this work shall have neither liability nor responsibility to any person or entity with respect to any loss or damaged caused, or alleged to be caused, directly or indirectly by the information contained in this work. This work does not represent tax, accounting or legal advice. Individuals are advised to and should rely on their own advisors.

45