SECURE Act promises new life insurance opportunities

Strategies for clients with IRAs

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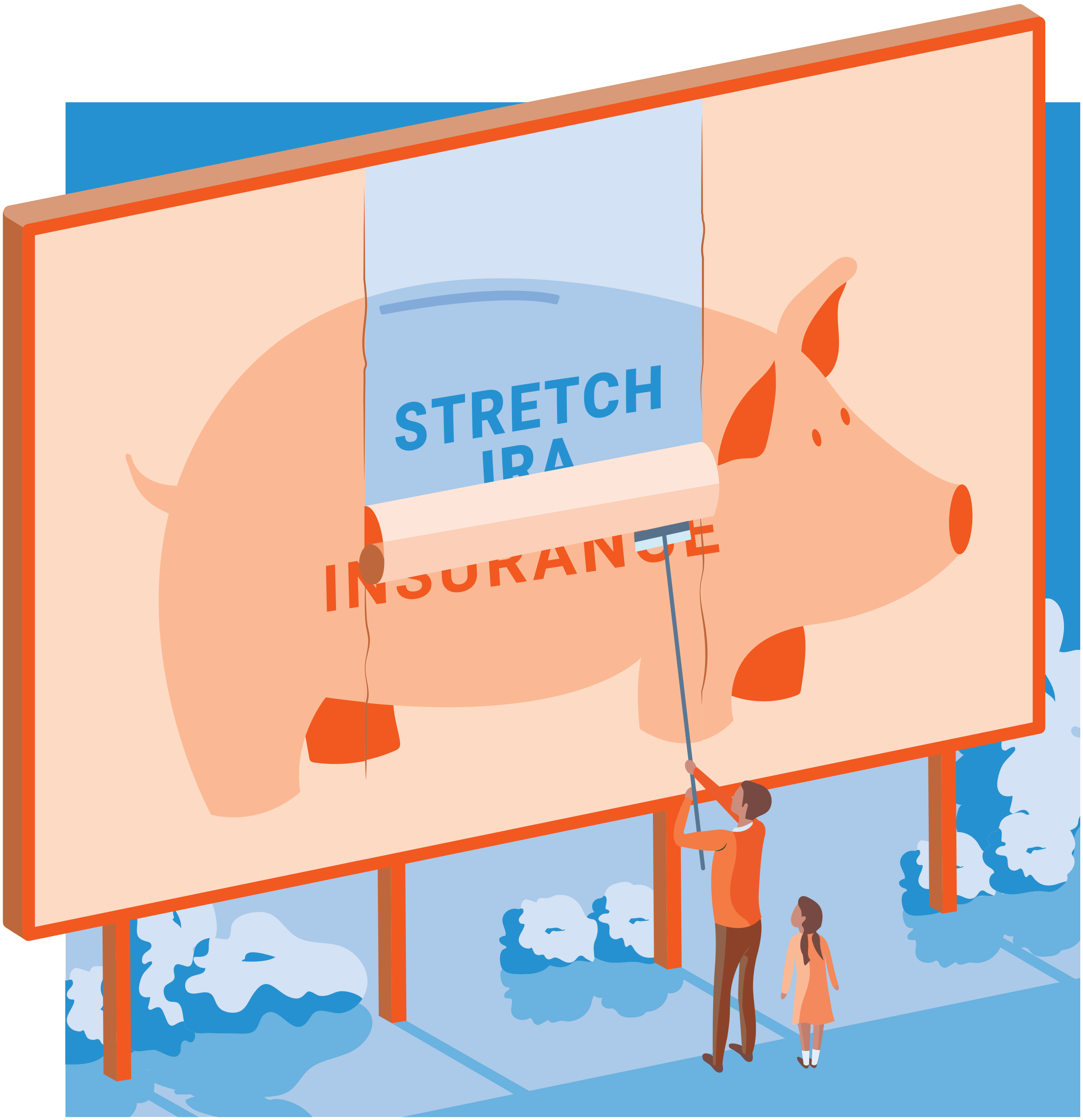

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The SECURE Act and Estate Planning

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Overview

The **Setting Every Community Up for Retirement Enhancement Act (SECURE Act)** has passed Congress as part of the Consolidated Appropriations Act. The SECURE Act will be the first real major retirement legislation since the Pension Protection Act in 2006. This comes after the Tax Cuts and Jobs Act (TCJA) back in 2017 eliminated major retirement proposals because of a lack of time in completing the TCJA.

The bill makes major positive changes in retirement planning. The most important provision will now allow annuities to be sold in 401(k) plans This is done by eliminating lawsuits against plan trustees and administrators who recommend annuities as 401(k) plan investments. The other many positive items in the Act include removing the IRA age funding limitation, expanding the start date for RMDs, increasing use of multi-employer plans, and increasing the likelihood of small employers starting retirement plans. However, as a revenue raiser, the SECURE Act would essentially do away with the stretch IRA as we now know it. The legislation would change the rules for defined contribution plans and IRAs upon the death of the account owner. Under the proposed legislation, distributions to beneficiaries other than the surviving spouse, disabled or chronically ill individuals, individuals who are not more than 10 years younger than the account owner, or child of the account owner who has not reached the age of majority would generally be required to be distributed by the end of the tenth calendar year following the year of the employee or IRA owner's death. The end result is that most beneficiaries would end up with a "10-year payout rule".

The Act's primary goal

For a number of years, some congressional staffers have complained that IRAs have become wealth transfer vehicles, rather than retirement vehicles. Various plans, such as limiting the size of IRAs, have been discussed as a way of preventing this perceived abuse. By limiting the payout period of an "inherited IRA," the Act intends to do away with the abuse.

The value of an inherited IRA

IRS Publication 590-B establishes the basic rule for a beneficiary who inherits an IRA from a deceased owner who has started to receive distributions. It states: "If the owner died on or after his or her required beginning date (defined earlier), and you are the designated beneficiary, you must base required minimum distributions for years after the year of the owner's death on the longer of:

- Your single-life expectancy shown on Table I in Appendix B as determined under beneficiary of an individual, later; or
- The owner's life expectancy as determined under Table 1.

In most instances, the beneficiary is younger than the owner, so the required minimum distribution is based on the beneficiary's life expectancy.

Example: To see the value of this provision, assume John is age 40 when he inherits an IRA worth $1 million. The IRA earns 6% per annum. This table shows the results over the next 10 years:

Year	Age	Balance	Life expect	Distribution	Net	Plus 6%
1	40	$1,000,000.00	43.6	$22,935.78	$977,064.22	$1,035,688.07
2	41	$1,035,688.07	42.7	$24,254.99	$1,011,433.08	$1,072,119.07
3	42	$1,072,119.07	41.7	$25,710.29	$1,046,408.78	$1,109,193.31
4	43	$1,109,193.31	40.7	$27,252.91	$1,081,940.40	$1,146,856.82
5	44	$1,146,856.82	39.8	$28,815.50	$1,118,041.32	$1,185,123,80
6	45	$1,185,123,80	38.8	$30,544.43	$1,154,579.38	$1,223,854.14
7	46	$1,223,854.14	37.9	$32,291.67	$1,191,562.47	$1,263,056.22
8	47	$1,263,056.22	37	$34,136.65	$1,228,919.57	$1,302,654.74
9	48	$1,302,654.74	36	$36,184.85	$1,266,469.89	$1,342,458.08
10	49	$1,342,458.08	35.1	$38,246.67	$1,304,211.41	$1,382,464.10
TOTAL: $300,373.74						

There are a couple of important items to note. The amount of income averages about $30,000 per year with a total of $300,373.74. Also, the IRA increases substantially in value, even with the distributions. The net growth exceeds 38%.

Under the proposed new rules, the IRA can be distributed ratably over the 10 years, or it can be distributed all in year 1, all in year 10 or any other pattern during the 10-year period.

- If distributed in year 1, day 1, the beneficiary would have $1 million of includible income with $0 left in the IRA.
- If the distribution occurs in the last day of year 10, at 6% growth with no prior distributions, the IRA would be worth $1,790,848. This would be fully taxable in year 10, and the remaining value would be $0.

It is very clear that an inherited IRA is much more tax efficient than a 10-year force-out limitation.

Solving the distribution problem

Life insurance strategies, as discussed below, can remedy this income bunching problem and replicate the inherited IRA scenario. The starting point is a quick review of the early distribution penalty. IRC 72(t) provides for a 10% penalty on distributions from IRAs before age 59½, in addition to the normal income tax paid on the distribution. However, the penalty does not apply after the death of the participant. Obviously, the penalty cannot apply to an "inherited IRA" since the participant is deceased and did not inherit their individual retirement account. As Justice Sotomayor stated in the case of *Clark v. Rameker*, "Inherited IRAs do not operate like ordinary IRAs.[1] Unlike with a traditional or Roth IRA, an individual may withdraw funds from an inherited IRA at any time, without paying a tax penalty. Indeed, the owner of an inherited IRA not only may but must withdraw its funds...."

While the IRA owner is still alive he or she can receive "substantially equal periodic payments" from an IRA and avoid the penalty tax even if they are younger than age 59½. Revenue Ruling 2002-62 outlines three ways to calculate a substantially equal periodic payment.

1

The RMD method

The annual payment for each year is determined by dividing:

- The account balance for that year, by
- The number from the chosen life expectancy table for that year

Under the RMD method, the account balance, the number from the chosen life expectancy table, and the resulting annual payments, are redetermined for each year.

2

The fixed amortization method

The annual payment for each year is determined by amortizing in level amounts the account balance over a specified number of years, determined using:

- The chosen life expectancy table
- The chosen interest rate

Under the fixed amortization method, the number from the chosen life expectancy table and the resulting annual payment are determined once for the first distribution year, and the annual payment is the same amount in each succeeding year.

3

The fixed annuitization method

The annual payment for each year is determined by dividing:

- The account balance, by
- An annuity factor that is the present value of an annuity of $1 per year, beginning at the taxpayer's age and continuing for the life of the taxpayer (or for the joint lives of the individual and beneficiary). The annuity factor is derived using the mortality table in Rev. Rul. 2002-62, Appendix B, and the chosen interest rate.

Under the fixed annuitization method, the account balance, the annuity factor, the chosen interest rate, and the resulting annual payment are determined once for the distribution year, and the annual payment is the same amount in each succeeding year.

[1] -U.S.-; 134 S.Ct 2242 (2014).

Example

Assume that Chris is a participant in an individual account plan that operates on a calendar year. Chris would like to start receiving distributions starting in 2022. Chris will celebrate his 50th birthday in January 2021. Chris would like to begin receiving distributions but avoid the 10% excise tax. Assume the following:

- The account balance as of December 31, 2021 (the relevant date), is $400,000.
- 120% of the federal mid-term rate for the appropriate month is 4.5% and, when applicable, this is the interest rate that will be used for calculations.
- Distributions will be over Chris' life only and, when applicable, single-life expectancy will be used for calculations.

It is important to note that between ages 59½ and 70½, a participant can take any amount out without regard to penalties or RMDs.

The annual distribution using the RMD method

For 2022, the annual distribution amount ($11,695.91) is calculated by dividing the account balance as of December 31, 2021 ($400,000), by the single-life expectancy (34.2) obtained from Q&A-1 of Treasury Regulation § 1.401(a)(9)-9 when age 50 is used.

For subsequent years, the annual distribution amount is determined by dividing the account balance as of December 31 of the prior year by the single-life expectancy obtained from the same single-life expectancy table using the age attained.

	$400,000	**Account balance**
÷	34.2	**Single-life expectancy**
	$11,695.91	**Annual distribution**

The annual distribution using the fixed amortization method

For 2021, annual distribution amount is calculated by amortizing the account balance ($400,000) over a number of years equal to Chris' single-life expectancy (34.2) at a rate of interest equal to 4.5%. If an end-of-year payment is calculated, then the annual distribution amount in 2021 is $23,134.27. Once the annual distribution amount is calculated, the same amount will be distributed in subsequent years.

$400,000	**Amortize account balance**
34.2	**Single-life expectancy**
4.5%	**Rate of interest**
$23,134.27	**Annual distribution**

The annual distribution using the fixed annuitization method

For 2021, annual distribution is equal to the account balance ($400,000) divided by the cost of an annuity factor that would provide one dollar per year over Chris' life beginning at age 50 (that is, the actuarial present value of an annuity of one dollar per year payable for the life of a 50-year-old). The age 50 annuity factor (17.462) is calculated based on the mortality table in Appendix B of Revenue Ruling 2002-62 and an interest rate of 4.5%. The annual distribution amount is calculated as:

Once an annual distribution amount is calculated under this method, the same amount will be distributed in subsequent years.

	$400,000	**Account balance**
÷	17.462	**Age 50 annuity factor**
	$22,906.88	**Annual distribution**

Summary: Distribution strategy

The basic idea in developing a strategy to replicate the "inherited IRA" is to start taking distributions as soon as possible from the IRA.

- If the participant is separated from service and is under age 59½, then this is accomplished by "substantially equal periodic payments."
- If the participant is age 59½ to 70½, any amount can be taken out — and the sooner the better.
- If the participant is over 70½, then the participant wants to take distributions in excess of RMDs.
- If it is an inherited IRA subject to the 10-year rule, the idea is to take distributions earlier in the 10-year period, rather than waiting.

Strategy 1: Fund a life policy

Case study

This strategy is very simple. Take distributions from the IRA and fund a life policy on the beneficiary. The beneficiary can then use the policy's cash value to provide a tax-free income source.

Chris, the owner of an IRA, takes distributions of $158,730 per year for 10 years, using a strategy discussed above. After paying a 37% federal income tax on that amount, the net amount is $100,000. Chris gifts that amount to the beneficiary of his IRA, Ben. Ben age 40, purchases an indexed universal life insurance policy.

The outcome

Age 40, Ben uses the gift to pay annual premiums	His initial death benefit
$100,000 for 10 years	**$2,739,943**
Age 65, Ben takes annual policy loans to supplement his retirement income	His total retirement income supplement
$369,077 income tax-free for 20 years	**$7,381,540**

The hypothetical example assumes a male, age 40, preferred nontobacco, indexed UL, death benefit option is increasing by cash value for 10 years then switch to a level death benefit option, solve for maximum annualized participating loans from ages 65 through 85. 100% premium allocation to Perform Plus Indexed Account, 5.75% assumed index crediting. At 0% guaranteed interest crediting and no policy loans, policy lapses at age 64.

Strategy 2: Create a charitable remainder unitrust (CRUT)

Case study

Chris has a $1,000,000 IRA. Chris names his testamentary charitable remainder unitrust as the beneficiary of the IRA. Under its terms, the unitrust interest is payable to his child Leslie, for Leslie's life. Leslie is age 40 at Chris' death. The payout of the trust is 7%. The CRUT has 3% growth and produces 5% income.

The outcome

Leslie receives an income supplement during her life expectancy	Chris' estate gains a tax advantage
$3 million income tax-free	**10% charitable deduction**

Case study variation

Leslie does not need income until she reaches age 55. She is going to leverage the CRUT by taking $70,000 of the payout for 15 years and put it into an indexed universal life insurance policy. She will take 20 years of loans commencing at age 66.

The outcome

Leslie receives an income supplement for 20 years	Leslie's total income supplement
$244,754 per year income tax-free	**$4,895,080 income tax-free**

The total income tax-free distributions from life insurance is significantly more than what the CRUT can generate.

The hypothetical example assumes a female, age 40, preferred nontobacco, indexed UL, level death benefit, solve for maximum annualized participating loans from ages 66 through 86. 100% premium allocation to Perform Plus Indexed Account, 5.75% assumed index crediting. At 0% guaranteed interest crediting and no policy loans, policy lapses at age 60.

Conclusion

By using an advantageous distribution system, coupled with life insurance, the "inherited IRA" can actually be improved. With this planning, one can overcome the proposed 10-year payout limitation. A variation is to create a testamentary CRUT, which can also be enhanced with life insurance.

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