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SECURE Act promises new life insurance opportunities

Strategies for clients with IRAs

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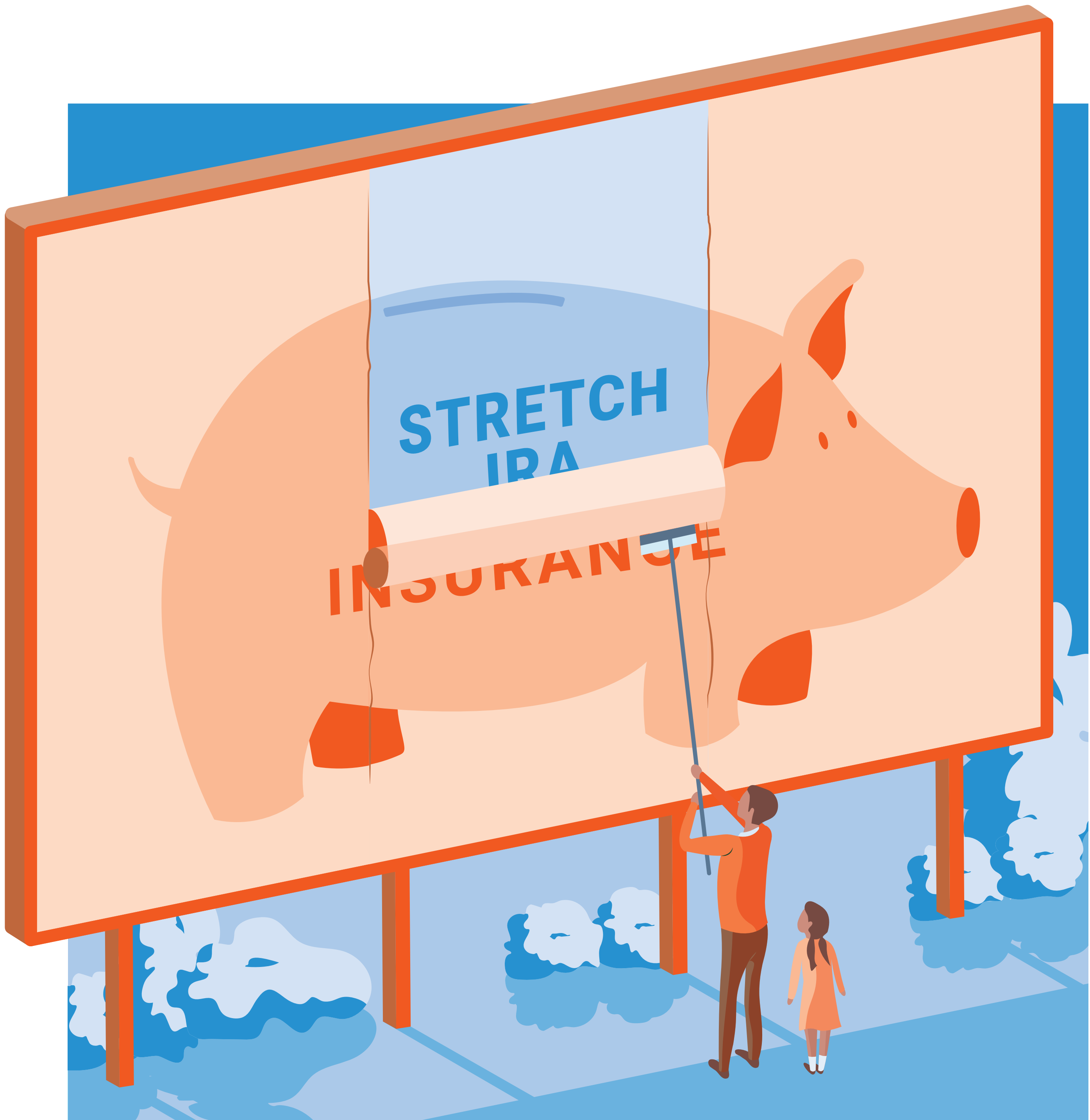

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The SECURE Act and Estate Planning

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Overview

The **Setting Every Community Up for Retirement Enhancement Act (SECURE Act)** was enacted on December 20, 2019, as part of the Consolidated Appropriations Act. The SECURE Act is the first real major retirement legislation since the Pension Protection Act in 2006.

The SECURE Act makes major positive changes in retirement planning. Several provisions of the SECURE Act will focus on encouraging the use of annuities as guaranteed income options in 401(k) plans. These provisions provide a fiduciary safe harbor that will make it easier for plan administrators and plan trustees to select annuities as 401(k) plan investments, as well as provisions that make lifetime income options in 401(k) plans "portable." Some other positive items enacted as a part of the SECURE Act include removing the IRA age funding limitation, delaying the start date for Required Minimum Distributions (RMDs), increasing use of multiemployer 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 RMDs" as we now know it. The SECURE Act changed the RMD rules for defined contribution plans and IRAs that apply upon the death of the account owner. Under the new rules, 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 are generally required to take distribution of the full value of the plan account or IRA by the end of the 10th calendar year following the year of the employee or IRA owner's death. In general, most beneficiaries are now subject to this "10-year payout" rule.

The value of an inherited IRA

Under prior law, a beneficiary who inherited an IRA from a deceased owner had several options for taking distributions from the IRA, including the ability to take distributions over his or her life expectancy determined at the death of the owner. If the beneficiary elected to take life expectancy distributions, RMDs would be distributed each year with the balance left to grow tax-deferred in the IRA until distribution.

To show the value of the life expectancy payout and continued tax-deferral, assume John is age 40, and he inherits an IRA worth $1 million. If the IRA earns 6% annually, John's required distributions for the first 10 years would be about $30,000 per year. However, because John's required distributions are less than the annual tax-deferred growth, the IRA will continue to increase substantially in value, even after the distributions are taken. Over 10 years, John's inherited IRA could have net growth exceeding 38%!

Under the new required distribution rules, however, the IRA must be fully distributed within 10 years. 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 then John 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. This example clearly illustrates that the new "10-year payout" rule is much less tax efficient than the life expectancy payout under the old rules.

Solving the distribution problem

The new RMD rules require a much more rapid distribution of income than under the old rules, but life insurance strategies, as discussed below, can ameliorate this income "bunching" problem. In fact, life insurance strategies can in some cases replicate the inherited IRA scenario. The starting point is a quick discussion of the "early distribution penalty." IRC § 72(t) provides for a 10% penalty on distributions from IRAs if the owner is under age 59½, in addition to the normal income tax paid on the distribution. However, the penalty does not apply if the IRA owner takes distributions from the IRA in the form of "substantially equal periodic payments," even if the owner is under age 59½. Revenue Ruling 2002-62 outlines three ways to calculate a "substantially equal periodic payment":

1

The RMD method

Under 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

Under 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

Under the fixed annuitization, 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.

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, but also wants to avoid the 10% penalty tax. Chris will celebrate his 50th birthday in January 2021. 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 72, 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:

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

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

Finally, it is important to note that between ages 59½ and 72, a participant can take any amount out without regard to penalties or RMDs.

Summary: Developing a distribution strategy

The first step 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 72, any amount can be taken out — and the sooner the better.
- If the participant is over 72, then the participant wants to take distributions in excess of RMDs.

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 each year's distribution, the net amount he receives is $100,000. Chris gifts that amount to the beneficiary of his IRA, Ben. Ben age 40, purchases *Lincoln Wealth Accumulate®* (2019) IUL 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, *Lincoln WealthAccumulate®* 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 $1,000,000 in his 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 her 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 could leverage the CRUT by taking $70,000 of the payout for 15 years and putting those funds into a *Lincoln WealthAccumulate* IUL 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**

By adding life insurance to the CRUT, one is able to generate an additional $7,660,000 of tax-free income. This is double what the CRUT alone could generate.

The hypothetical example assumes a female, age 40, preferred nontobacco, *Lincoln WealthAccumulate®* 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 10-year payout limitation. A variation is to create a testamentary CRUT, which can also be enhanced with life insurance.

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