Making Sense of RMDs

Required minimum distributions are changing drastically in 2020 after the passing of the SECURE Act, affecting tax planning and estate planning alike. Do you have a plan for what lies ahead?

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Introduction

The Upheaval of Required Minimum Distributions

The government recently made major changes that impact how retirement plans are taxed. Two of these changes include a significant upheaval of the current required minimum distribution rules on two fronts.

1. Congress pushed back when RMDs are required to begin, which could provide tax benefits to some and tax hurdles for others.
2. Congress overhauled the RMD rules as they pertain to your loved ones with a major change to the distribution timeframe.

Under previous rules, inherited IRAs and 401(k)s could often be stretched out to provide income over the life of the beneficiary. This was a very powerful tax benefit for loved ones. It also helped minimize the tax impact of inherited accounts. However, in part to raise substantial tax revenue, Congress is taking away these tax benefits. The SECURE Act is expected to raise roughly $16.4 billion in revenue from 2019 to 2029, with almost all of it – $15.7 billion – coming from the elimination of the stretch option. This revenue generation is essentially paying for the other benefits of the SECURE Act.

These changes require immediate planning from millions of Americans. You need to understand the new rules and how it might impact your situation.

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By examining RMD planning before and after the rule changes, you'll glean insights into new best practices now that stretch IRA strategies are going away.

If you're planning for your own RMDs or need to understand the estate planning ramifications of leaving a retirement account to your heirs, Congress' new rules could throw your plan on its head and increase taxes for you and your family without proper planning.

These new rules kick in Jan. 1, 2020, so there's no time to delay!

RMD Calculator

$100,000	50	3%
Value of All Inherited Accounts (as of Dec 31, 2019)	**Your Age** (as of Dec. 31 the year after the account owner died)	**Estimated Rate of Return of the Account**

CALCULATE

■ = RMD Amount ■ = Remaining Value

Yr.	Before Secure Act	After Secure Act	Yr.	Before Secure Act	After Secure Act
1	$3,968.25 $98,912.70	$10,000 $92,700	6	$4,600.29 $90,975.42	$11,592.74 $47,762.09
2	$4,087.30 $97,670.16	$10,300 $84,872	7	$4,738.30 $88,824.23	$11,940.52 $36,896.22
3	$4,209.92 $96,264.05	$10,609 $76,490.89	8	$4,880.45 $86,462.09	$12,298.74 $25,335.40
4	$4,336.22 $94,685.66	$10,927.27 $67,530.53	9	$5,026.87 $83,878.28	$12,667.70 $13,047.73
5	$4,466.30 $92,925.94	$11,255.09 $57,963.70	10	$5,177.67 $81,061.63	$13,047.73 $0

Total RMDs Before Secure Act	Total RMDs After Secure Act	Total RMDs Difference
$45,491.57	$114,638.79	$69,147.22

Values determined at year end.

Synopsis

What's Changing with RMDs

The bulk of the SECURE Act as it comes to RMD planning will kick in on Jan. 1, 2020 (Jan. 1, 2022 for government plans to comply with certain rules). The bill does two main things with RMDs.

First, it pushes the required start to age 72 from 70.5. This will have a minor impact on owners as it will only pushes RMDs one or two years depending on when you were born. This gives owners of IRAs and 401(k)s a little more time to figure out what to do and allows these accounts to grow for a few more years. But, pushing out RMDs without changing the life expectancy tables will cause retirees to have higher RMDs, which in turn could increase taxes and Medicare premiums for some.

For many beneficiaries, the SECURE Act requires that the entire account, in an IRA or defined contribution plan, is distributed within 10 years after the owner dies.

The second – and much more important change – is the elimination of the so-called "stretch" strategy for millions of future retirement account beneficiaries. In the "stretch" strategy, beneficiaries of inherited 401(k)s, IRAs, and other tax-advantaged retirement accounts could stretch the required distributions out over their own life expectancies. This way, they maintain the tax-preferential nature of the account for many years. For many beneficiaries, the SECURE Act instead requires that the entire account, in an IRA or defined contribution plan, is distributed within 10 years after the owner dies. The SECURE Act did change the beneficiary rules for defined benefit pension plans. Additionally, binding annuity contracts that were in effect at the time of the enactment of the SECURE Act are also exempt.

The legal change is expected to provide a huge tax revenue increase for the federal government by removing beneficiaries' ability to string out distributions. The government wanted these accounts to be retirement accounts – not tax shelters for multi-generational planning. The previous RMD rules apply to a beneficiary once the account owner dies and while complex, these rules offer significant tax benefits to heirs. The new rules will still remain complex, and perhaps increase planning complexity, but will significantly curtail the added tax benefits to certain types of inherited accounts.

The SECURE Act did provide a number of what is being categorized as "eligible designated beneficiaries." In order to meet this status, you must qualify as of the date of the death of the account owner. Those meeting the eligible designated beneficiary status will be exempt from the 10-year RMD distribution rule. These include surviving spouses, heirs that are less than 10 years younger than the decedent, chronically ill individuals, disabled individuals, and minors. Minors will age out of the exclusion once they hit the age of majority in their state, typically 18 to 21. At that time, the 10-year required minimum distribution period would become applicable.

Those meeting the eligible designated beneficiary status will be exempt from the 10-year RMD distribution rule. These include surviving spouses, heirs that are less than 10 years younger than the decedent, chronically ill individuals, disabled individuals, and minors.

Section I

The Basics of Required Minimum Distributions

Retirement accounts like 401(k)s and IRAs allow individuals to save for their future in a tax advantaged manner. IRA and 401(k) contributions are often tax deductible and gains are tax deferred – you only pay taxes when you withdraw money from your account. Unlike with a Roth account where you pay taxes today but the gains can come out tax free.

So let's say you contribute tax-deferred money to a 401(k) plan in your 20s. You won't pay taxes on it until you start withdrawing money – likely when you're in your 60s. This gives you ample time to grow your savings and investments for retirement.

However, the government will eventually come to collect its taxes. IRAs and 401(k)s are designed to help fund retirement – not act as tax-free accounts for passing wealth to future generations. As part of that, Congress established rules that require annual distributions from tax-advantaged plans once you reach age a certain age, which had previously been 70.5. For anyone who did not reach age 70.5 by January 1, 2020, the new rules allow your required beginning date to be age 72.

Required minimum distribution (RMD) rules can be complex. In fact, even the age of 70.5, and now 72, isn't a hard and fast start in all situations as many factors determine when the RMD rules actually affect you. However, there are some basics about RMDs you should understand.

When Do RMDs Start?

RMD rules can be divided into two distinct categories: during an individual's life and after an individual's death. While an individual is alive, RMD rules generally kick in after age 70.5. If you keep working after age 70.5, in some cases you can defer certain account RMDs until retirement. However, the SECURE Act has pushed that age to 72. This makes sense as individuals are working longer, and it allows the money to remain in the account longer.

For individuals who are or turn age 70.5 by the end of 2019, you will still be subject to the previous RMD age of 70.5.

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Planning Tip

Starting in 2020, the required minimum distribution beginning dates will be pushed from age 70.5 to 72. Additionally, it gives people a little longer to let their money sit. This makes sense as individuals are living and working longer. However, if you are 70.5 or turn age 70.5 by the end of 2019, you will still be subject to the 70.5 RMD rules.

Starting in 2020, If you continue working for an employer past age 72 (or age 70.5 previously) and aren't a "5-percent owner" of the company, you can delay your required beginning date for RMDs of that employer's plan until you retire. For example, if your employer has a 401(k), you can push off RMDs until April 1 in the year after you retire. However, if you had an IRA on the side, it would be subject to RMD rules at age 72 according to the SECURE Act and continued employment wouldn't have an impact.

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Planning Tip

If the 401(k) plan offered the ability to accept rollovers, you could rollover the IRA to the 401(k). RMD rules apply to the account the money is currently in – not where it used to be. So, rolling an IRA to a 401(k) to continue working past the required distribution age would exempt your money from RMD rules until you retire.

After an individual dies, RMD rules for the new owner generally kick in the following year. These RMD rules that apply to inherited IRA and 401(k) accounts are more complicated than the RMD rules applied during the account owner's life.

For starters, you have to factor in if the owner died prior to beginning their RMDs and who the beneficiary of the account is. Beneficiaries also have a few options when it comes to withdrawing from the inherited retirement account. A spouse or non-spouse beneficiary can stretch distributions over their own life expectancy; a spouse or non-spouse beneficiary can withdraw more money than required at any time; in some cases all assets must be withdrawn by the fifth year after the original account holder's death; a spouse beneficiary can take distributions based upon the account owner's remaining life expectancy; and a spouse that inherits an account can even push off RMDs until they reach age 72 (or 70.5 if it's before 2020).

If spouses don't want to keep the IRA in the name of the decedent, they can roll it over into their own IRA or retitle the inherited account. This gives spouses the most flexibility with regards to inherited accounts. For those with the least amount of flexibility, you would look at non-person beneficiaries. For non-person beneficiaries (e.g., trusts, estates, companies, non-profits) distributions must happen over five years.

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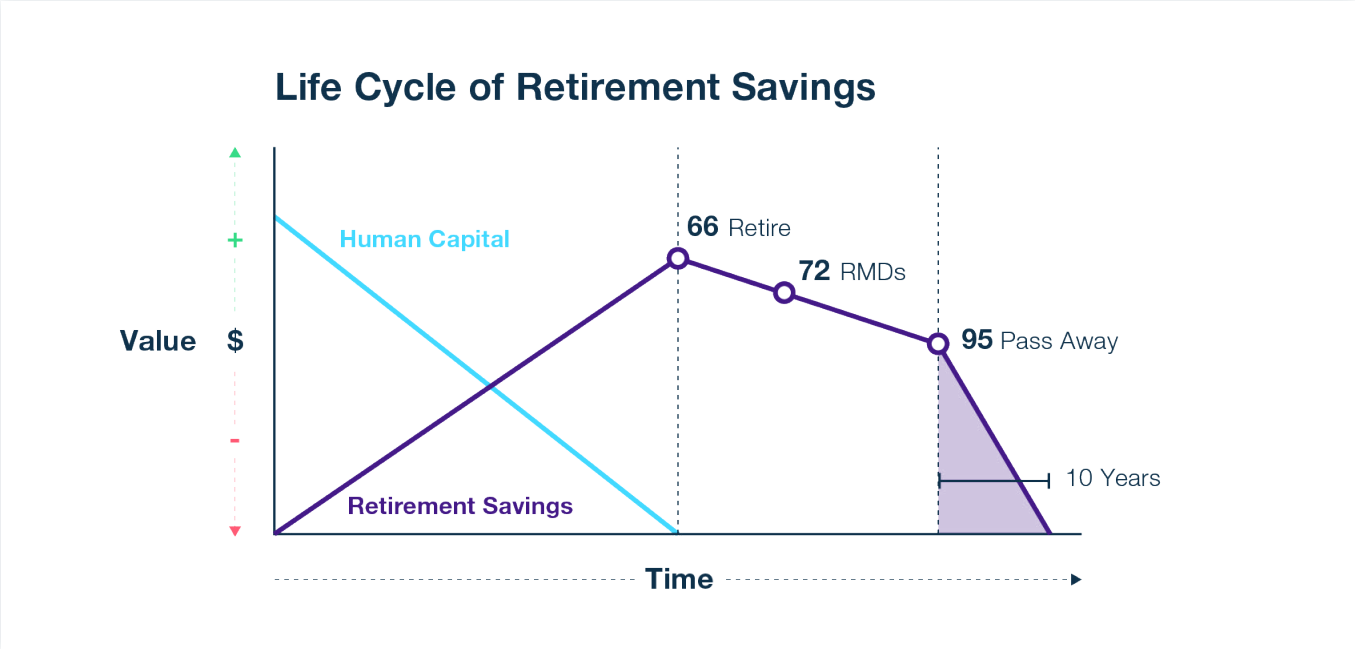
Once the SECURE Act kicks in, when an individual reaches age 72, they must start taking RMDs by April 1 of the following year. So let's say you hit 70.5 just after the turn of 2020, in March 15, 2020. As such you will turn age 71 in September of 2020 and 72 in September of 2021. If you turned 72 on Sept. 15, 2021, you'd then have until April 1, 2022, to take your first RMD. However, this wouldn't count as your RMD in 2022, which would still need to occur by the end of the year.

The general rule regarding RMDs is they have to be taken by Dec. 31 of each year. Taking two RMDs in a year could increase your tax burden as you now have two taxable distributions happening. While you have until April of the following year to take your first RMD, it might make more sense to take it in the same year you turn 72.



Calculating RMDs

RMDs are calculated in a simple manner. Divide the account balance from the previous year by a life expectancy factor provided by the IRS.

Let's say your 401(k) had a balance of $200,000 on Dec. 31, 2018. If you turned 73 in 2019, find age 73 on the table and the corresponding applicable distribution period divisor of 23.8. Divide $200,000 by 23.8. The answer – $8,403.36 – is the RMD amount you'd have to take from your 401(k) by Dec. 31, 2019.

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If you don't take the RMD by the end of the year, you could owe a 50% penalty tax on it in addition to the ordinary income taxes you'd already owe. However, you can take out more money each year – there's no maximum cap on yearly withdrawals.

If you have multiple 401(k) plans, you would need to perform the same calculation with each plan and take the distribution required from each individual plan. You can't combine your RMDs from one 401(k), though. So, if you had four plans, you would need to take four separate RMDs – one from each.

IRAs are different. You can aggregate the account balances and take one distribution to meet the RMDs from multiple IRAs. If you have inherited accounts, you generally cannot aggregate them together unless it is IRAs from the same deceased owner.

What Accounts Are Subject to RMDs?

For the most part, your retirement accounts – ERISA covered qualified retirement plans and IRAs – are subject to the rules for RMDs. Qualified retirement plans include 401(k)s, defined benefit plans, target-benefit plans, ESOPs, stock bonus plans, cash balance plans, profit-sharing plans and money purchase pension plans. The rules also apply to traditional, SEP, and SIMPLE IRAs. Government plans and the Federal Thrift Savings Plan are also subject to RMDs. The new SECURE Act rules would only apply generally to IRAs and Defined Contribution plans, but not to defined benefit plans and cash balance plans.

Planning Tip

Roll the Roth accounts like Roth 401(k)s over to a Roth IRA before age 70.5 to avoid RMDs in the future. But remember, even Roth IRAs can be subject to RMD rules once inherited.

Roth IRAs present a unique counter option. When an individual is alive, they're not required to take an RMD from their account. Roth IRAs are only subject to the RMD rules once an individual has passed away. However, Roth accounts in 401(k)s, 403(b)s and the Federal Thrift Savings Plan are subject to RMDs after age 70.5. But under the SECURE Act, all of these plans being employer sponsored defined contribution retirement plans, would then be subject to the new RMD age of 72 starting in 2020.

NEXT SECTION: HOW DO INHERITED ACCOUNTS WORK?

Section II

How do Inherited Accounts Work?

Today, and prior to the SECURE Act, there are two different sets of rules govern how required minimum distributions affect retirement account beneficiaries. The determining factor is if the account owner died before or after their required beginning date – generally age 70.5 (or when retired, if later) before Jan. 1, 2020, and 72 (or when retired, if later) after that. Other factors affecting RMDs are the beneficiary's relationship to the account owner, the age of the beneficiary, and the type of tax-advantaged account.

Depending on these factors, the beneficiary's RMDs can change. Even more challenging, different situations call for the use of three different IRS Tables in order to determine RMDs. It's important to understand what rules and IRS tables should apply based on the situation.

Generally, for non-spouse persons, the SECURE Act will require that the account be distributed within 10 years, regardless if the owner died before their required beginning date or after. As such, moving forward many of these rules will no longer apply to newly inherited accounts. However, for accounts where the owner died before 2020, these rules will still continue to apply. Additionally, the rules pertaining to spouses will generally still apply as they were exempted out of the SECURE Act changes to inherited accounts.

Account Owner Dies On or After Required Beginning Date for RMDs

Let's start by looking at how the RMD rules can apply to three sets of potential beneficiaries – spouses, non-spouse persons, and non-persons – when an owner of an IRA or 401(k) passes away after reaching (or on) his or her required beginning date for RMDs (age 70.5 before the SECURE Act begins and age 72 after that).

Spouse Beneficiary

Spouses have the most options of anyone as beneficiary of their spouse's retirement account and are the most common beneficiary of the first spouse to pass away. This allows the assets to continue to support the livelihood and retirement needs of the surviving spouse. Once the second spouse passes away, the assets will likely transfer to another type of beneficiary like children or a charity. A spouse that inherits a retirement account at the passing of their spouse typically has three options for RMD purposes.

1. A spouse can treat the account as his or her own account – meaning they can roll over or retitle the account. In this case, you would just follow the RMD rules that apply to the surviving spouse.
2. They can distribute the account using their own life expectancy. This would essentially be a "stretch" strategy.
3. They can distribute it over the expected remaining life expectancy of their deceased spouse if it's longer than their own. The math involved in this: Take the deceased owner's age as of their birthday in the year of death and look up the corresponding life expectancy on the IRS Table I. Reduce by one each subsequent year after death to determine the RMD divisor factor. However, the RMD for the year of death would still be based on the more favorable Table III.

So let's look an example, because if you use your deceased spouse's life expectancy, it can get complicated. Let's say Joe dies in 2019 at age 75. Joe had not taken his RMD for 2019. His spouse could still take the RMD for 2019 based on his life expectancy from IRS Table III, which is 22.9. However, under Table I, his life expectancy is 13.4. In 2020, you would use 12.4 (13.4 minus one year) for the new divisor.

This highlights an important point about determining RMDs: The IRS provides three tables. Table I is typically used for beneficiary planning purposes and is a less favorable table for RMDs than Table II or Table III. Table II is used for spousal situations where the sole beneficiary on an account is a spouse who is 10 or more years younger than the owner. Table III is the table used for the account owner's RMDs.

Non-Spouse Beneficiary (Before SECURE Act)

Any account that has already been inherited, or if the owner dies by the end of 2019, the following rules would still apply. The SECURE Act is not being applied retroactively to already inherited accounts.

Two different options are available for inherited accounts with non-spouse person beneficiaries (typically a child or grandchild) where the owner had reached their required beginning date prior to death. The account would be required to be distributed based on the younger of either the beneficiary's age or the owner's age on their birthday in their year of the owner's death. In either case, you would use IRS Table I to determine the life factor to use. However, for the year of death, you would still use Table III to

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determine the owner's RMD. If there were multiple beneficiaries, you use the oldest beneficiary's age for calculation purposes.

So let's look at a quick example. Susan inherits her father's $100,000 retirement account (balance on Dec. 31, 2018.). Susan is 50 at the end of 2019 and her father would have been 75 by end of year. In the year in which her father passed away, 2019, she could take the RMD based on her farther being 75 under IRS Table III, which would provide a life factor of 22.9. This would allow a RMD of $4,367 ($100,000/22.9).

Now in 2020, the RMD would switch and be based off of Susan. At the end of 2020, Susan would be 51. Under Table I, her life expectancy factor is 33.3. Assuming the account ended 2019 at $98,000, her RMD for 2020 as the beneficiary would be $2,943 ($98,000/33.3).

Now, it gets even trickier. In 2021, Susan would not use Table I to determine her life expectancy factor for a 52-year-old. Instead, she would just use the one that was set in the year after the owner's date of death, which in her case was for a 51-year-old at 33.3. For 2021, two years after death of the owner, she would just take 33.3 minus 1, to determine the correct life factor of 32.3. In 2022, she would do this again but now take 33.3 minus 2 to get a divisor for 2022 of 31.3. Essentially, you fix the life expectancy the year after death for this type of beneficiary. So, upon each following year, you would reduce the beginning life expectancy factor by one until the account was depleted.

Non-Spouse Beneficiary (After SECURE Act)

For non-spouse beneficiaries that do not fall into the SECURE Act's category of "eligible designated beneficiaries," all inherited accounts subject to these rules must be distributed within 10 years after the death of the owner. What this means is you could spread out distributions over a 10-year period, somewhat equally, take them all out in any year, or mix and match the distributions. But, the bottom line is all the money needs to come out in 10 years.

In order to meet the SECURE Act "eligible designated beneficiary" status, you must qualify as of the date of the death of the account owner. Those meeting the eligible designated beneficiary status will be exempt from the 10-year RMD distribution rule. These include surviving spouses, heirs that are less than 10 years younger than the decedent, chronically ill individuals, disabled individuals, and minors. Minors will age out of the exclusion once they hit the age of majority in their state, typically 18 to 21. At that time, the 10-year required minimum distribution period would become applicable to any remaining balance in the inherited defined contribution plan or IRA. As such, minors will still be able to stretch out distributions a bit further than other individuals.

Those meeting the eligible designated beneficiary status will be exempt from the 10-year RMD distribution rule. These include surviving spouses, heirs that are less than 10 years younger than the decedent, chronically ill individuals, disabled individuals, and minors.

Minors should likely still be left IRAs via trusts as the beneficiary in many situations. However, the previous best practice of setting up a conduit trust to pass through the income and still meet the stretch RMD strategy won't work well moving forward. Now, the IRA, even if held within the trust, will need to payout in a conduit trust once subject to the 10-

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year period. This severely limits the ability to hold this money in a trust for a long period of time. As such, many people with existing conduit trusts for minors and children might want to consider revising the trust to remove the conduit language and instead make the trust an accumulation trust. The downside here is that accumulation trusts have some negative tax consequences for income purposes, but they could still hold onto the assets for longer. So, if you are worried about giving the child or another young heir too much control, this could be a better strategy.

Many people with existing conduit trusts for minors and children might want to consider revising the trust to remove the conduit language and instead make the trust an accumulation trust.

Non-Person Beneficiary (Before SECURE Act)

Sometimes beneficiary designations are left blank or the account is left to a non-person (e.g., an estate, charity, business, trust, etc.). If a beneficiary designation is left blank it could be paid out to an estate. In these cases, if the owner had already started RMDs, you would use IRS Table I and the deceased owner's age as of their birthday in their year of death. Reduce the beginning life expectancy by one year for each subsequent year until the account was depleted.

Just like with spouses and non-spouse persons, the non-person beneficiary can also take the owner's RMD for the year of death and start the new RMDs the following year. Many non-person beneficiaries will just withdraw the full amount immediately as the tax-deferral aspect of the inherited account is not as beneficial to places like charities that already do not pay income taxes.

Non-Person Beneficiary (After SECURE Act)

The SECURE Act was clear that the only real exceptions to the 10-year payout period are those defined as an "eligible designated beneficiary." As such, when you have no designated beneficiary – and only people can be designated beneficiaries – any charity, estate, or non-qualifying trust is treated as if there is no beneficiary at all. While in the past this group could stretch out RMDs in some cases, many situations required RMDs over five years. With the new rules in place, some will actually be able to distribute over 10 years instead of the previous five-year period. However, non-person beneficiaries will no longer be able to stretch RMDs over the owner's remaining life expectancy.

Account Owner Dies Before Beginning Date for RMDs

Now in some cases the owner of a retirement account might pass away before they reach their required beginning date for RMDs. Again, in these situations the RMDs will be partially determined by the relationship of the beneficiary to the owner and the ages of the beneficiaries and owner at death.

However, after the SECURE Act the distinction between if the owner died before or after the beginning date for inherited RMDs is less important. This is because the non-person and non-spouse beneficiaries are pretty much set to a 10 year distribution period. It no longer matters how old the owner was in those cases after the year in which they pass away in many instances.

Spouse Beneficiary

Spouse beneficiaries have three options. First, the spouse may treat the inherited account as his or her own account. In that situation, you just follow any RMD rules that would apply to them as the owner.

Next, if the spouse beneficiary didn't elect to be treated as the account owner, they don't have to take RMDs until the year in which the deceased spouse would have reached age 70.5. However, these RMDs would be based on Table I and the beneficiary spouse's current age each year to find the applicable divisor.

Lastly, the spouse could just take the entire balance out by the end of the fifth year following the year of the owner's death. In all three situations, there is no RMD for the year of death since the owner died before RMDs started.

Remember, spouses were exempted out as designated beneficiaries under the SECURE Act from the requirement to distribute the entire account within 10 years of the year of death of the owner.

Non-Spouse Beneficiary (Before SECURE Act)

Non-spouse beneficiaries, typically children and grandchildren, have two options.

Option one: They can withdraw the entire amount by the end of the fifth year following the account owner's year of death.

Option two: They can stretch out the account based on their year-end age following the year of death by the owner. For instance, if the owner died in 2018, you would determine the age of the beneficiary on Dec. 31, 2019, and look at the IRS Table 1 to determine the applicable life expectancy factor. Then you would reduce that factor by one for each subsequent year until the account was depleted. So, if a 25-year-old inherited the account, they could take RMDs of the inherited IRA over 59 years. This would allow the majority of the account and investments the opportunity to grow tax deferred for many years.

Non-Person Beneficiary (Before SECURE Act)

If the owner died before starting RMDs, the charity, trust or estate would be required to take out the entire balance of the inherited account by the fifth year following the owner's year of death. This can cause a big tax burden for trusts and estates as the entire account would need to be treated as taxable in a short period of time.

Non-Person and Non-Spouse Beneficiary (After SECURE Act)

Again, it will no longer matter in many instances if the owner started his or her RMDs before death in determining the RMDs for inherited accounts. Instead, any beneficiary of an IRA or defined contribution plan will have to distribute the entire account within 10 years after the year in which the owner died. So if an IRA owner dies in 2020 and leaves the entire IRA to a 35-year-old daughter, by the end of 2030 the entire account would have to be distributed by the daughter.

NEXT SECTION: PLANNING POINTS MOVING FORWARD

Section III

Planning Points Moving Forward

Today, and prior to the SECURE Act, there are two different sets of rules govern how required minimum distributions affect retirement account beneficiaries. The determining factor is if the account owner died before or after their required beginning date – generally age 70.5 (or when retired, if later) before Jan. 1, 2020, and 72 (or when retired, if later) after that. Other factors affecting RMDs are the beneficiary's relationship to the account owner, the age of the beneficiary, and the type of tax-advantaged account.

Depending on these factors, the beneficiary's RMDs can change. Even more challenging, different situations call for the use of three different IRS Tables in order to determine RMDs. It's important to understand what rules and IRS tables should apply based on the situation.

Generally, for non-spouse persons, the SECURE Act will require that the account be distributed within 10 years, regardless if the owner died before their required beginning date or after. As such, moving forward many of these rules will no longer apply to newly inherited accounts. However, for accounts where the owner died before 2020, these rules will still continue to apply. Additionally, the rules pertaining to spouses will generally still apply as they were exempted out of the SECURE Act changes to inherited accounts.

Strategies for New Inherited RMD Rules

The stretch strategy provided two big benefits to beneficiaries:

1. It allowed the tax-advantaged nature of retirement accounts to be continued for years, and sometimes even decades. Investments continued to grow tax deferred inside of the IRA or 401(k).
2. The beneficiary could spread out the distributions to help reduce the tax burden.

But with the likely end to the stretch strategy under the SECURE Act, these benefits vanish. Is there a strategy or solution that'd serve as a viable replacement option?

Insurance

It'd be near impossible to fully replicate the tax-deferred nature of the IRA or 401(k) on the inherited accounts. However, charitable remainder trusts and insurance products could provide some similar benefits. Life insurance policies and annuities can also provide tax-deferred build up inside of the policies. This allows some aspects of the tax-deferred nature to be accomplished. So in some cases, an owner of an IRA or 401(k) might consider taking a distribution from the IRA or 401(k) in order to buy a life insurance policy or annuity in order to pass wealth in a tax advantaged manner to the next generation.

CRTs

Charitable remainder trusts (CRTs) also provide a potential benefit under the new rules. CRTs can be named as the beneficiary of the IRA. The tax-deferred nature of the IRA would be maintained and the ability to stretch out distributions to a non-charity beneficiary could also be maintained. For instance, you could have payments made from the CRT to a child as the beneficiary for 20 years. At the death of the child or the end of the term, the remaining trust assets would pass to the charity. In general, the owner would still need to be charitably inclined, but with the 10 year mandatory distribution of an IRA, a CRT could actually provide an overall better tax, charitable, and wealth accumulation outcome.

Tax Planning

A shorter time period to fully distribute a taxable account (10 years in the SECURE Act) could push some of the beneficiary's distributions into a higher tax bracket. To counter, individuals would need to focus on more tax efficient planning as part of the retirement and estate planning process. This also means paying attention to which beneficiary is receiving the IRA. Leaving all of an IRA to a high-income child can be a bad way to maximize the account's tax benefits.

Additionally, leaving all of an account to the surviving spouse at the death of the first spouse might no longer make sense. It might be better in some cases to now leave some of the IRA money to children for tax planning purposes at the death of the first spouse.

For example, let's say a husband passes away today and leaves a $1 million dollar IRA. In the past, best practice was to just pass that over to the surviving spouse, who might combine it with her own $1 million dollar IRA. Then, when she passed it to her daughter, they could spread the $2,000,000 over many years. However, under the SECURE Act, the daughter would now need to distribute that over 10 years. This would be a $200,000 taxable distribution each year, which would likely increase their taxes.

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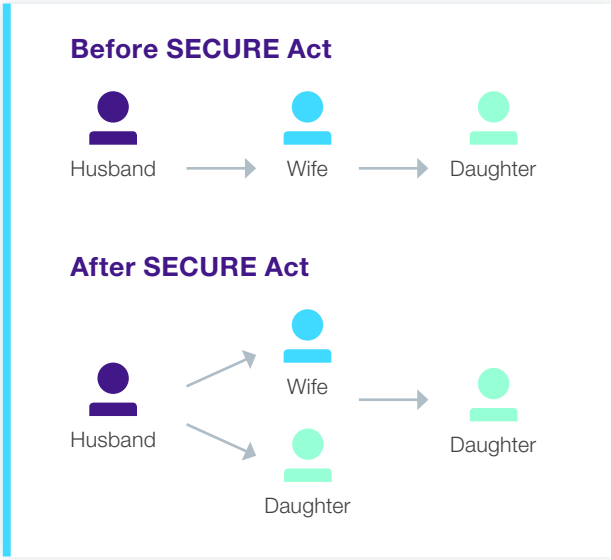
Instead, it might have been better to split up the dad's IRA, sending maybe half to the surviving spouse and half to the daughter. This would have allowed the daughter to start a 10-year RMD on the father's $500,000 IRA, at $50,000 a year while leaving the other half to mom. Once mom passed away and left the remaining $1.5 million, if 10 years had passed, the daughter would now have another 10 years to distribute the $1.5 million, at roughly $150,000 a year. It is possible this helps reduce the total tax burden as $50,000 of income over those 10 years might have been taxed at a lower rate.



This really flips traditional IRA and beneficiary planning on its head, where you generally left everything to the surviving spouse.

Roth Conversions

The strategy most primed to provide big benefits to beneficiaries post-stretch strategy era is bracket-bumping Roth conversions. Roth conversions require advanced planning by the account owners. But if done correctly, they can cancel out the result of shortened distribution periods: increased taxes.

In general, Roth conversions are a tax strategy where you pay taxes now on tax-deferred money instead of in the future. Once the money is in a Roth IRA, it gets tax free gains instead of tax-deferred. A Roth conversion takes place when you withdraw money in a tax-deferred account like a traditional IRA, turn that money into income, pay ordinary income taxes on it, and convert it to a Roth IRA. This is a very valuable tax planning strategy when done right. The goal is to convert IRAs and other accounts like 401(k)s during years when you are paying lower taxes.

Doing Roth conversions also gives you control. For instance, if you know your taxes will be higher in the future, it is better to convert and pay them today. With higher RMDs for inherited beneficiaries, it might make sense to convert today while in control and pay lower taxes than if the beneficiaries are forced to take a hefty RMD, pushing them into a higher tax bracket.

Additionally, since most people have more tax-deferred retirement savings in 401(k)s and IRAs, converting money to a Roth IRA helps with tax-diversification for retirement. So, the strategy might not only be beneficial for estate and inherited IRA planning, but for retirement. Because the Tax Cuts and Jobs Act reduced tax rates and increased the standard deduction, many people are in a lower tax bracket than they were previously, making now a great time to do Roth conversion.

However, another strategy called recharacterization went away in 2018 for Roth conversions. Recharacterization used to allow us more flexibility to undo an overly aggressive Roth conversion. Now, instead, we need to be more precise on how much we would want to convert in a tax year. This is important because to have a conversion show up for the 2019 tax year, you need to engage in the conversion by Dec. 31, 2019.

This brings up one challenge with Roth conversions: You need to do actual planning. It is not an after-the-fact or on-a-whim strategy. It needs to be done strategically and incorporated with estate, tax, and retirement income plans.

Now, how could a Roth conversion impact IRA beneficiary RMD planning after the new law changes?

Let's look at a quick example. You leave $1,000,000 in an IRA to your child – a 40-year-old, single professional who earns $120,000 a year. Under previous rules, they could stretch out distributions over 44 years, according to IRS Life Expectancy Table I. The first-year distribution would be about $22,727.27. This wouldn't push them into a higher tax bracket as all of that income would stay at the current 24% tax bracket in 2019 or 2020.

However, under the new rules of the SECURE Act, the child would now have to distribute the account over 10 years. They decide to spread it out evenly and take $100,000 out in the first year. This pushes them up to $220,000 of income with roughly $40,000 of the distribution into the 32% tax bracket and roughly $16,000 of the distribution into the 35% tax bracket. This significantly increases the taxes they'd pay on the IRA.

Instead of leaving the money in an IRA, the parent can start doing strategic Roth Conversions while alive to alleviate the tax burden. Let's say one parent was in the 24% tax bracket with $100,000 of income. They could start doing Roth conversions early in retirement to take advantage of their full tax bracket, up to roughly $160,000, without going to the next tax rate.

This strategy of using Roth conversions when you plan to leave tax-deferred accounts to children has a lot of value today. It will be even more valuable as distributions get bunched into 10 years under the SECURE Act.

While Roth IRAs will still be subject to the 10-year distribution period under the SECURE Act, the distributions from the Roth won't impact the beneficiary's taxable income. Roth conversions allow both parties to take control of their taxes instead of being forced into taxes as a beneficiary.

Next Steps

RMD rules, estate planning, and retirement income planning is complex and only getting more and more complicated after these new rule changes. Congress shifted the burden of planning for IRA RMDs in part onto the owner and away from the beneficiaries.

This means everyone with a retirement account should rethink their beneficiary designations, estate plan, and retirement income strategies in light of the new rules. If you feel uncomfortable with where your estate, legacy, tax, retirement, or general financial planning is today get a second opinion and look.

If anything, find out that you are on the right track and that you are doing all you can to secure the future you want for your loved ones.

Know Your RMDs

Whether you're inheriting or leaving behind a retirement account, the SECURE Act will impact you. Carson Wealth is here to help. Get your financial plan in place to help ensure your handing required minimum distributions properly.

Contact an Advisor Today

Source: H.R.1994 — 116th Congress (2019-2020): Sec. 401, 26 USC Code Section 401(a)(9)(b)

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